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Unlocking Public and Private
Finance for the Poor

FINANCING SUSTAINABLE URBAN DEVELOPMENT IN THE LEAST DEVELOPED COUNTRIES



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IN THE LEAST DEVELOPED COUNTRIES

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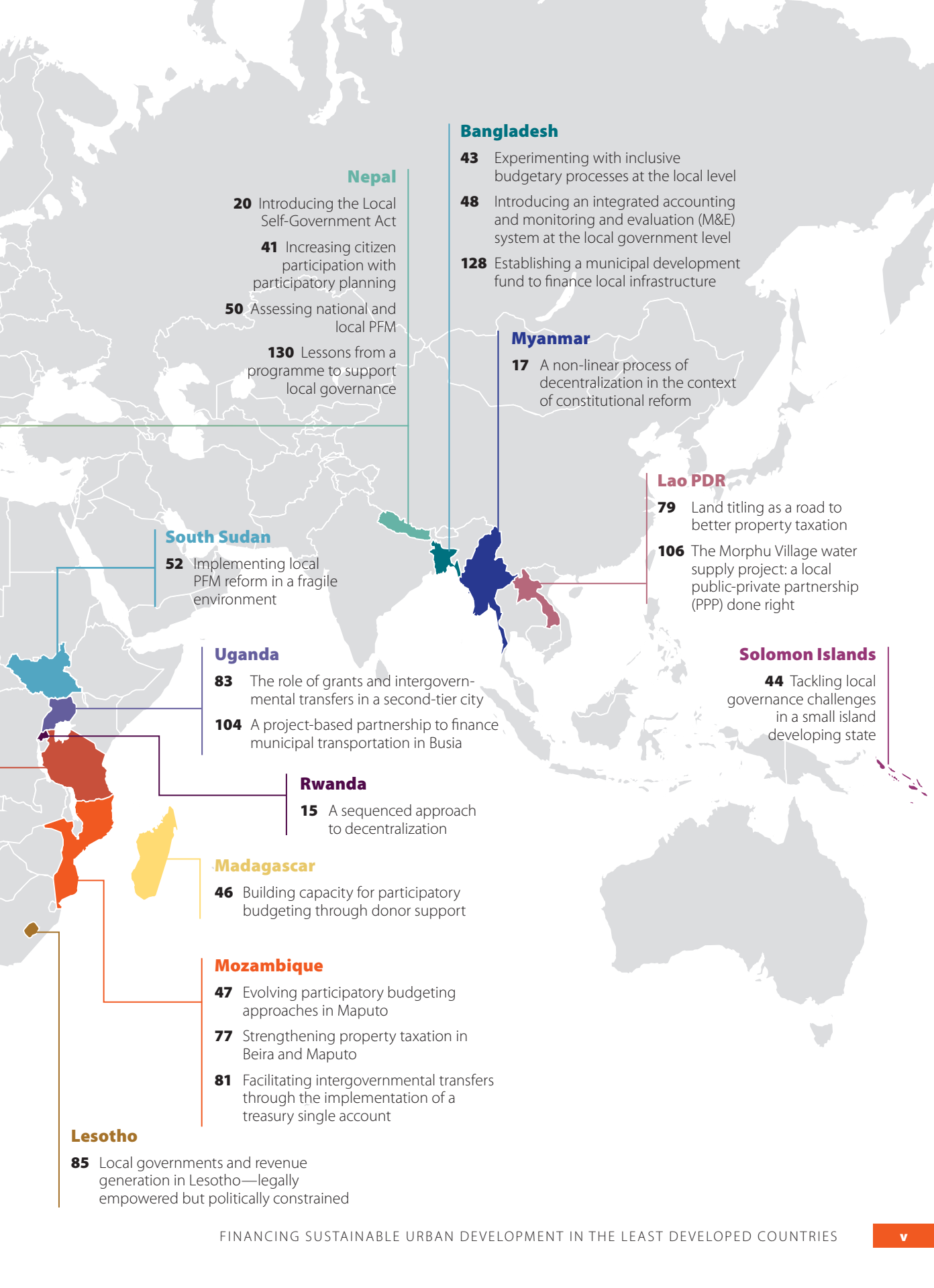
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ABOUT THE FINANCING FOR DEVELOPMENT OFFICE, UN-DESA

The Financing for Development Office provides support for sustained follow-up to the commitments contained in the Addis Ababa Action Agenda, building upon the 2008 Doha Declaration and the 2002 Monterrey Consensus, in seven main areas: (i) domestic public resources; (ii) domestic and international private business and finance; (iii) international development cooperation; (iv) international trade as an engine for development; (v) debt sustainability; (vi) addressing systemic issues; and (vii) science, technology, innovation and capacity-building. The Addis Agenda also deals with data, monitoring and follow-up in its conclusion and establishes a dedicated and strengthened follow-up and review process for the financing for development (FfD) outcomes, and all the means of implementation of the 2030 Agenda for Sustainable Development. The Financing for Development Office supports the FfD follow-up and review process, working with Member States, major institutional stakeholders, other relevant organizations, civil society, the business sector, academia and local authorities.

ABOUT UNCDF

UNCDF is the UN's capital investment agency for the world's 48 least developed countries. With its capital mandate and instruments, UNCDF offers “last mile” finance models that unlock public and private resources, especially at the domestic level, to reduce poverty and support local economic development. UNCDF's financing models work through two channels: financial inclusion that expands the opportunities for individuals, households, and small businesses to participate in the local economy, providing them with the tools they need to climb out of poverty and manage their financial lives; and by showing how localized investments — through fiscal decentralization, innovative municipal finance, and structured project finance — can drive public and private funding that underpins local economic expansion and sustainable development. By strengthening how finance works for poor people at the household, small enterprise, and local infrastructure levels, UNCDF contributes to SDG 1 on eradicating poverty and SDG 17 on the means of implementation. By identifying those market segments where innovative financing models can have transformational impact in helping to reach the last mile and address exclusion and inequalities of access, UNCDF contributes to a number of different SDGs.

FOREWORD

In 2015, world leaders adopted three landmark agreements that seek to set the world on an unprecedented path to a prosperous and sustainable future. The 2030 Agenda for Sustainable Development, the Addis Ababa Action Agenda on Financing for Development and the Paris Agreement on climate change are historic achievements which, if fully implemented, will usher in a new era of sustainable development. But realizing sustainable development on the ground will not be possible without strong buy-in and local leadership from states, cities and towns across the globe. It is local authorities that are ultimately in charge of providing basic and essential public goods and services, investing into critical infrastructure and expanding economic opportunities to an ever-growing number of people. Their expanding range of responsibilities in realizing sustainable development for all will require the full and sustained support of the international community.

The new global framework for financing sustainable development, provided by the Addis Ababa Action Agenda, acknowledges the challenges local authorities face in light of a lack of adequate resources, capacity constraints and, at times, insufficient national and international support. To address these challenges, world leaders committed to scaling up international cooperation to strengthen the capacities of municipalities and other local authorities. Such scaled up international cooperation must support the development of local infrastructure, revenue mobilization, local debt management, and direct lending from financial institutions, while also ensuring the engagement and representation of citizens. The New Urban Agenda, adopted at the Habitat III Conference in Quito in October 2016, further translates the Addis Agenda and the 2030 Agenda for Sustainable Development—including SDG 11—to local level needs and should guide local authorities and central governments in their quest for financing sustainable development.

In support of these historical commitments, the Financing for Development Office of the United Nations Department of Economic and Social Affairs and the United Nations Capital Development Fund have joined forces to facilitate a constructive dialogue on how to finance sustainable urban development, especially in the Least Developed Countries (LDCs). The present publication is an important outcome of this collaborative effort. It follows a series of in-depth consultations, various rounds of dialogues and expert group meetings across the world with a broad set of stakeholders engaged in local government finance in LDCs. The publication provides an overview of the multi-dimensional challenges LDCs face in financing sustainable development at the local level from the political, institutional and economic perspectives. It explores the critical

interlinkages between the different dimensions of urban finance, including revenue generation, financial management and long-term capital formation. Most importantly, it illustrates concrete country experiences in meeting related challenges through a wide range of case studies from local governments in LDCs. A clear assessment of country-specific challenges in LDCs and the sharing of experiences of how they have been overcome should ultimately help local government officials in LDCs, as well as UN Member States and development organizations, with the implementation of relevant commitments made in the Addis Agenda, the 2030 Agenda and the New Urban Agenda.

Our conclusion is that sustainable development at the local level requires recognition of the critical role of local authorities and sustained collaboration and dialogue between all levels of government, as well as the meaningful inclusion of local communities in decision-making processes. In this regard, we invite all stakeholders to utilize this publication as a basis to strengthen local, national and international cooperation on urban finance, to further deepen engagement with local authorities and to continue the discussion on urban finance as part of the Financing for Development follow-up process and the means of implementation of the 2030 Agenda.

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ABBREVIATIONS

Addis Agenda	Addis Ababa Action Agenda
ADB	Asian Development Bank
ADL	Local Development Agency / L'Agence de Développement Local
AFD	French Development Agency / Agence Française de Développement
BGT	Biwater and Gauff Tanzania
BOT	Build-Operate-Transfer
BPT	Business Profit Tax
CADF	China-Africa Development Fund
CDB	China Development Bank
CDP	Committee for Development Policy
CFAA	Country Financial Accountability Assessment
CIT	Community Income Tax
CWS	City Water Services Limited
DAC	Development Assistance Committee
DAWASA	Dar es Salaam Water & Sewerage Authority
DDCs	District Development Committees
DFID	Department for International Development
ECOSOC	Economic and Social Council
EU	European Union
EVI	Economic Vulnerability Index
FMDV	Fonds Mondial pour le Développement des Villes (Global Fund for Cities Development)
GCF	Green Climate Fund
GCR	Global Credit Ratings Company
GDP	Gross domestic product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH
HAI	Human Assets Index
ICR	Implementation Completion and Results Report
ICT	Information and Communications Technology
IDA	International Development Association

IFMIS	Integrated Financial Management Information Systems
IMF	International Monetary Fund
IPFC	Integrated Planning Formulation Committee
ISISA	Imposto Autárquico de Sisa
IT	Information Technology
LAFIAS	Local Authorities Financial and Institutional Management System
LDCs	Least Developed Countries
LGs	Local Governments
LGAs	Local Government Authorities
LGSP	Local Government Support Programme
LSGA	Local Self-Government Act
M&E	Monitoring and Evaluation
MDGs	Millennium Development Goals
MoFALD	Ministry of Federal Affairs and Local Development
MIIU	Municipal Infrastructure Investment Unit
NGOs	Non-Governmental Organizations
NUA	The New Urban Agenda
ODA	Official Development Assistance
PB	Participatory Budgeting
PBGS	Performance-based grant system
PCC	Phonekham Construction Company
PEFA	Public Expenditure and Financial Accountability Programme
PER	Public Expenditure Review
PFM	Public Financial Management
PFMRP	Public Financial Management Reforms
PIT	Personal Income Tax
PP	Participatory Planning
PPP	Public-Private Partnership
RAGEM	Régie Autonome de Gestion des Équipements Marchands
RALGA	Rwanda Association of Local Government Authorities

RGB	Rwanda Governance Board
SDGs	Sustainable Development Goals
SIDs	Small Island Developing States
SUC	Serviços de Urbanizacao e Cadastro
TDF	Town Development Fund
UCLG	United Cities and Local Governments
ULB	Urban Local Government Body
UNCDF	United Nations Capital Development Fund
UN-DESA	United Nations – Department of Economic and Social Affairs
UNDP	United Nations Development Programme
UNICEF	United Nations Children’s Fund
UP	Union Parishads
UPGP	Union Parishad Governance Project
UZGP	Upazila Governance Project
USAID	United States Agency for International Development
VAT	Value-Added Tax
VDCs	Village Development Committees

EXECUTIVE SUMMARY

The present publication of the Financing for Development Office at the United Nations Department of Economic and Social Affairs (UN-DESA) and the United Nations Capital Development Fund (UNCDF) is designed to promote knowledge sharing among stakeholders in urban finance and local sustainable development. Its prime objective is to support government officials in the Least Developed Countries (LDCs) at the local and national levels to strengthen their urban finance frameworks and to create an enabling environment in their constituencies. At the same time, it should provide relevant insights for donor organizations and other stakeholders that want to strengthen their engagement with local governments in LDCs.

The publication also aims to enrich the policy dialogue at the United Nations in the context of the 2030 Agenda for Sustainable Development. It serves as an input to the Financing for Development follow-up process to enhance stakeholder accountability and to ensure the continuous engagement of local governments. It should support the means of implementation of the New Urban Agenda, especially in LDCs, as well as the implementation of SDG 11. Finally, it provides a contribution to the follow-up process of the Istanbul Programme of Action for the Least Developed Countries for the Decade 2011-2020.

Many of the conceptual elaborations presented in this publications build on the technical consultations held during two expert group meetings (29 February–1 March 2016, Dar es Salaam, Tanzania; 5-6 September 2016, Bangkok, Thailand) and several side events (during the Habitat III thematic meeting on “Financing Urban Development: the Millennium Challenge”, 8 March 2016, Mexico City; the inaugural ECOSOC Forum on Financing for Development follow-up, 18 April 2016, New York; and Habitat III, 18 October 2016, Quito, Ecuador). In particular, the case studies are based on the expert presentations made at these meetings. For some of them, complementary sources have been used to provide additional background information.

The authors firmly believe in the value of learning from both successful and less successful policy experiences to strengthen urban finance. However, the overall picture is invariably more complex than what can be captured within the scope of the case studies, especially in light of the very challenging environments faced by central and local governments in LDCs. As a result, conclusions and lessons drawn should be seen as starting points for further discussions on how to tackle urban finance challenges in LDCs rather than policy prescriptions. The authors also aim to provide a broader context for the case studies by providing regional and global data and

information wherever possible. However, gathering data at the local level remains a significant challenge, especially in LDCs, and any mistakes are the sole responsibility of the authors.

The overall approach of the publication builds on the authors' understanding of urban finance (sometimes also referred to as local or municipal finance) as a holistic concept that covers three essential activities: revenue mobilization (including resource transfers), public financial management, and long-term borrowing and investment, as these are heavily interlinked and mutually reinforcing.

Chapter 1 provides the broader context for the challenges faced by the LDCs in implementing the ambitious and transformative 2030 Agenda for Sustainable Development and the Addis Ababa Agenda (Addis Agenda) at the urban level. It explains the common characteristics of LDCs, trends and challenges of urbanization in LDCs, and the resulting issues these countries and their cities face in the current global economic environment. It concludes with the following key messages.

- Improving urban finance is a global development imperative. Local governments will be critical in ensuring that the 2030 Agenda for Sustainable Development delivers for the poorest and most vulnerable people on the planet.
- The state of urban finance in LDCs is particularly challenging and deserves special attention. Megatrends such as rapid urbanization, changes to the global economic environment, climate change, large movements of refugees and migrants and increased vulnerability to natural disasters and public health emergencies can strongly affect the local level in LDCs. In addition, LDCs often face challenging national circumstances that may result in small local revenue bases; limited public financial management capacities; unpredictable and insufficient intergovernmental transfers; and little to no access to private capital for long-term investments.
- Strengthening local public financial management, own source revenue generation and intergovernmental transfers, as well as new and innovative borrowing mechanisms, will be critical to improve urban finance. More importantly, efforts must go beyond technical issues to recognize country-specific implementation challenges and tackle political economy constraints in LDCs.
- There is a need for continued dialogue and sharing of local experiences in LDCs among all actors to ensure that urban governments are better equipped to respond to the challenges of financing sustainable development and to meet the ever-growing needs of their populations.
- More emphasis should be placed on capacity-building. A well-resourced and highly-skilled professional municipal workforce can help transform cities into liveable places that will withstand the social and economic pressures of rapid urbanization.

Chapter 2 describes on-going decentralization reforms in LDCs. It explores the steps LDCs have taken towards political, fiscal and administrative decentralization. The chapter places particular emphasis on political economy constraints and illustrates how those can be overcome through well-coordinated decentralization strategies that take such constraints into consideration in their design and implementation phases. The chapter draws the following conclusions.

- Although many LDCs have taken steps towards political, fiscal and administrative decentralization, the actual implementation of decentralization reforms remains uneven. Administrative and political decentralization have progressed in a number of countries but fiscal decentralization has had less progress.
- Challenges in implementing a well-sequenced and well-resourced decentralization effort can be better understood through an analysis of the prevailing political economy. A deeper understanding of the actual motives for implementing decentralization at the central government level will go a long way toward predicting and preventing potential pitfalls in the implementation phase.
- It is crucial to understand and recognize the dynamics and interactions between different levels of governments and, in the case of LDCs, donors and multilateral agencies, as these will almost certainly shape the success or failure of decentralization reforms.

Chapter 3 focuses on the role of public financial management (PFM) reform in LDCs as a core prerequisite for the mobilization and effective use of local resources for sustainable development. The chapter highlights common trends and challenges in the implementation of PFM reforms at the urban level in LDCs. Good practices in design and implementation of PFM reforms are explored. At the same time, much emphasis is put on the need to take country-specific contexts into account in the design and roll-out of these reforms. The chapter includes the following key messages.

- Sound PFM is a core prerequisite for successful service delivery at the local government level. It is inextricably tied to the success of decentralization, in particular fiscal decentralization. If properly implemented, PFM reforms can result in more effective and efficient allocations of public resources and better service delivery, thus helping governments at all levels to overcome existing disparities that hinder the implementation of sustainable development.
- A strong case can be made in favour of participatory budgeting as an important element of PFM: participatory budgeting may produce better and more equitable service delivery as local residents know their own priorities better than central or urban government representatives. Participatory budgeting can reduce the scope for catering to a limited clientele, elite capture, and corruption through greater public oversight. Participatory budgeting can help mobilize local resources for development, since the willingness to pay taxes is likely to increase

where public money is spent on visible improvements on service delivery and local infrastructure.

- PFM reforms must be tailored to the country-specific context to maximize the chances for a successful achievement of its objectives. One cannot mechanically seek to transfer approaches and practices that work well in one setting to other very different institutional contexts. Improvements in PFM performance have often failed to materialize where cutting-edge practices from mature economies are rushed through very different and challenging developing country settings.
- Major PFM reforms are difficult and complex undertakings that require years (or even decades) to fully come to fruition. Laws and regulations must be drafted; longstanding practices restructured; political and administrative cultures changed; institutions built; and capacities strengthened. To attempt this in a short space of time, is a recipe for eventual failure.
- In general terms, PFM reforms tend to deliver results when three conditions coincide: (i) a strong political commitment to their implementation; (ii) well-tailored reform designs and implementation models according to the institutional and capacity context; and (iii) strong coordination arrangements—led by government officials—to monitor and guide reforms.

Chapter 4 deals with urban revenue mobilization both in terms of own source revenues and central government transfers. The chapter explores common revenue sources for urban governments and highlights principles for effective own source revenue mechanisms in the context of LDCs. It explores different types and designs of intergovernmental transfers and explores their suitability in various circumstances. The following conclusions are drawn.

- Local revenues in LDCs are insufficient to meet urban development needs. In terms of own source revenue mobilization, important progress has been made where revenue mechanisms embrace a set of key principles, including revenue adequacy, buoyancy, stability, correspondence between payments and benefits, reduced distortionary impact, autonomy and accountability, as well as administrative and political feasibility and equity.
- Improved registration processes, the building of fiscal cadastres, automation and utilization of information technology systems, including online payment options, are helpful mechanisms to increase compliance with tax laws and to promote greater willingness to pay local taxes.
- Intergovernmental transfers are essential for local governments. They are a part of the division of responsibilities between the central and local government based on their core advantages and competencies. Central governments have inherent advantages in generating revenues and local and regional governments have

inherent advantages in providing certain key services, invariably necessitating intergovernmental transfers.

- If properly designed, intergovernmental transfers can provide incentives for own source revenue mobilization and increase flexibility in intergovernmental relations. There are certain overarching principles that should be met when designing intergovernmental transfer systems related to the timeliness, adequacy, predictability, underlying incentive structure and modalities of transfers.

Chapter 5 describes existing modalities and explores the potential of new and innovative mechanisms that may help facilitate access to long-term finance for local authorities in LDCs. Given the enormous infrastructure financing needs in the face of increasing urbanization and ambitious new local development agendas, the chapter explores the potential and suitability of new market-based mechanisms to leverage and scale up local revenues. It suggests a range of concrete policy interventions to strengthen the capacity of local authorities in LDCs to leverage budgetary resources with domestic capital and concludes with the following key messages.

- Weak institutions and legal frameworks, a lack of substantive and administrative capacity, and underdeveloped capital markets are among the main reasons why access to long-term finance is a frequent problem for urban governments in LDCs.
- Financial intermediaries, including national, regional and international development banks, can play an important role in promoting urban finance in developed countries. Their experiences in emerging markets and developed countries offer rich lessons on how municipalities can access long-term finance in LDCs. However, lending instruments need to be carefully designed in order to avoid creating disincentives for market intermediaries.
- There are a wide range of policy interventions that can help pave the way for local governments to access long-term finance for local infrastructure investments, including (i) actions geared towards building local capacity for project development; (ii) efforts to improve local creditworthiness, including through sustained and well-sequenced PFM reforms; (iii) the promotion of local rating industries; (iv) the use of certain credit enhancement and risk mitigation tools; and (v) the creation of a conducive legal and regulatory framework for local finance that balances financial stability concerns with greater access to credit for local governments.
- Local governments in LDCs are beginning to explore a range of more advanced market-based finance tools that have generated both excitement and apprehension among donors and local stakeholders alike. Such mechanisms include equity finance, pooled finance arrangements, municipal bonds and public-private partnerships. Depending on the local context these mechanisms may hold significant potential. However, they are complex instruments that should be

approached, designed and implemented at a deliberate and careful pace to avoid potential pitfalls with adverse effects on the local population.

- A realistic assessment of the institutional, political and financial local context must determine if and where such instruments deserve further consideration. Sustained political buy-in of all layers of governments, politically sensitive capacity-building efforts, technical assistance and a willingness of stakeholders to adjust to changing circumstances are critical when pioneering new and innovative financing mechanisms.

Chapter 6, the final chapter, assesses trends, challenges and prospects for international cooperation on urban finance. It explores the scope, level and focus of multilateral and bilateral support to urban finance and development in LDCs. It further analyses new forms of South-South cooperation between local governments as an emerging complement to traditional development assistance. The chapter draws some conclusions on how to strengthen international cooperation on urban finance taking policy lessons from previous chapters of the publication into consideration. In this connection, it highlights the following key messages.

- Total official development assistance (ODA) for projects at the urban level has more than doubled in the last decade. However, the benefits of this trend have largely bypassed LDCs. The major share of ODA for urban projects goes to middle income countries, while LDCs receive only about 23 per cent. Less than 10 per cent of multinational climate funds were spent on cities in LDCs.
- South-South cooperation, for example, city-to-city cooperation or aid by Southern donors, is becoming increasingly relevant for local governments in LDCs.
- There is a greater need for partnership development, better coordination and a more focused division of labour in all areas of urban finance. This type of partnership requires continuous engagement by all relevant stakeholders.
- More long-term, programmatic and sequenced approaches to donor engagement in urban finance and development are crucial. Donor engagement must be structured in a way that allows for a systematic hand-off of projects to the local partner and/or other international partners to assure sustainability and scaling up of successful interventions.
- A lack of capacity remains a key challenge for urban service delivery, revenue generation, financial management and project implementation in cities in LDCs. International cooperation can play a critical role through the provision of targeted measures, especially through projects that are specifically geared towards increasing financial capacity, like PFM. Capacity-building efforts should also aim for improved communication, collaboration and coordination between urban finance stakeholders, including different layers of government.

- There is a vast repository of experiences with different approaches, tools and mechanisms to strengthen urban finance in LDCs. International cooperation should further intensify efforts to learn from past successes and failures. With their focus on the role of local governments for sustainable development, the 2030 Agenda for Sustainable Development, the Financing for Development process and the Habitat III follow-up can provide platforms at the global level for all stakeholders to engage.

Chapter 1

LOCALIZING THE NEW GLOBAL DEVELOPMENT AGENDA IN THE LEAST DEVELOPED COUNTRIES



With the adoption of the 2030 Agenda for Sustainable Development, the Addis Ababa Action Agenda (Addis Agenda), and the Paris Agreement in 2015, the international community has laid out a clear vision and roadmap for achieving sustainable development in its three dimensions—economic, social and environmental. Yet, while the 2030 Agenda is global, it will ultimately be implemented at the local level with the participation of local governments and local stakeholders. Local governments are closer to the people, and have specific mandates and responsibilities through which many of these global goals will be delivered. Therefore, they are uniquely positioned to identify development needs and contribute to the formulation and implementation of adequate policy measures to address these needs.

World leaders have recognized the importance of the local dimension in sustainable development. All landmark agreements during 2015—the year of “global action”—recognized the imperative to work with local authorities. Sustainable Development Goal (SDG) 11 is a local objective in itself and calls for cities and human settlements to be “inclusive, safe, resilient and sustainable”.

The local dimension is a key component of other SDGs, targets, and means of implementation, including those on basic public service provision in health, energy, education and water and sanitation. Furthermore, the local dimension is also relevant to many other crucial areas, including climate change-related planning, ecosystem and biodiversity, sustainable tourism, and the capacity of local communities to pursue sustainable livelihood opportunities.

In 2015, the Secretary-General of the United Nations emphasized that “our struggle for global sustainability will be won or lost in cities.”¹ How to win that struggle and “localize” the 2030 Agenda and other recent landmark United Nations agreements were at the heart of the deliberations leading up to the Third United Nations Conference on Housing and Sustainable Urban Development (Habitat III, 17-20 October 2016). The Conference presented a timely opportunity to chart new pathways in response to the challenges of urbanization and the implementation of the 2015 landmark agreements. The outcome document of Habitat III, “The New Urban Agenda,” promotes a new model of urban development that integrates all dimensions of sustainable development and helps align national and urban priorities to support inclusive and equitable economic and social development. Implementing the New Urban Agenda will rest on three pillars: sound urban rules and regulations, long-term urban planning and design, and strengthened financial arrangements for local governments, particularly for growing towns and cities.

The financing required to implement the 2030 Agenda is estimated to be of the order of several trillion dollars per year (ICESDF, 2014), and a significant portion of it will have to be mobilized and spent at the local level (German Development Institute, 2016; UNSDSN, 2016). Mobilizing adequate revenues to meet recurrent expenditures and make long-term investments in support of inclusive and sustainable local development are among the most significant challenges cities are facing across the globe, especially those in Least Developed Countries (LDCs).

1 United Nations Secretary-General Statement at High-level Delegation of Mayors and Regional Authorities, New York, 23 April 2012, <http://www.un.org/press/en/2012/sgsm14249.doc.htm>.

This is the urban finance challenge addressed by this publication.

The Addis Agenda provides a natural starting point to discuss local finance in the context of sustainable development. It presents a coherent framework for financing the 2030 Agenda, including the SDGs, by putting forward a comprehensive set of corresponding policy actions. It further commits Member States to fully engage local authorities in their implementation efforts.

To meet the urban finance challenge, the Addis Agenda highlights the need to draw upon all sources of finance (public, private, national and international) and puts forward

a policy framework that realigns financial flows with public goals. It calls for an enabling environment comprised of appropriate public policies and regulatory frameworks that help unlock the transformative potential of people and incentivize changes in consumption, production and investment patterns in support of sustainable development.

The comprehensive approach of the Addis Agenda translates well for local governments. For local authorities, drawing upon all sources of finance implies the need to more effectively mobilize internal (e.g., local taxes, user fees and land value capture) and external revenue streams (e.g., intergovernmental transfers and donor support), in order to provide

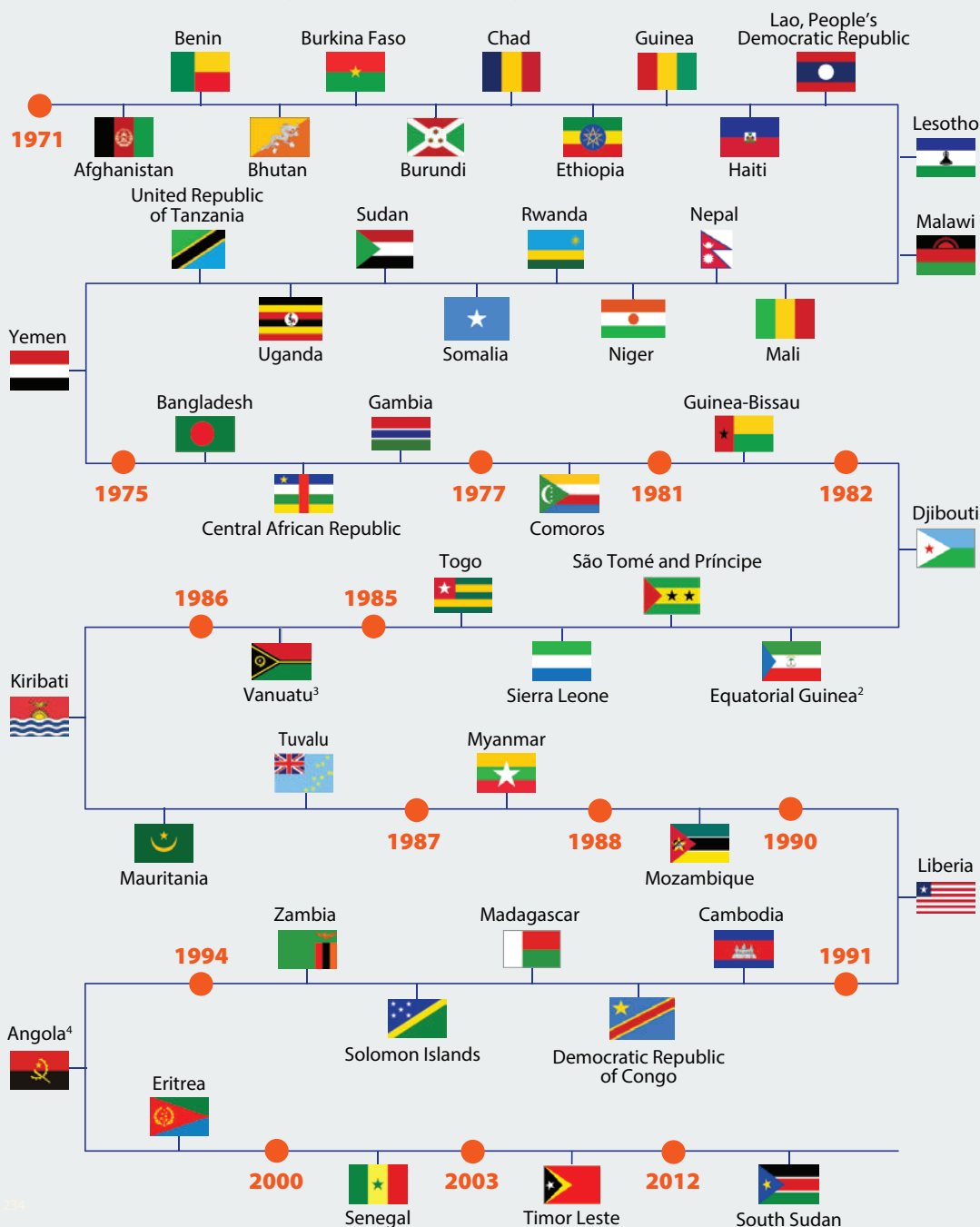
Box 1: What are Least Developed Countries?

Least Developed Countries (LDCs) are the poorest and most vulnerable countries. They comprise more than 945 million people, or around 13 per cent of the world's population, but account for less than 2 per cent of the world's gross domestic product. The low level of socio-economic development in LDCs is linked to weak human and institutional capacities, low income in conjunction with high inequality, and a lack of domestic financial resources. Governance crises, political instability, and, in some cases, internal or external conflicts often exacerbate the situation. LDCs often suffer from low productivity and low investment with high shares of employment in subsistence agriculture and the informal sector. Furthermore, they are exposed to external shocks due to various reasons, such as their dependency on only a few commodity exports as their primary source of revenue or their high vulnerability to climate change. Also, their access to external finance is typically limited.

The United Nations defines LDCs as those countries suffering from structural impediments to sustainable development. Every three years, the list of LDCs is reviewed by the Committee for Development Policy (CDP), which gives recommendations for inclusion and graduation of countries. Recommendations are then endorsed by the Economic and Social Council and decided on by the General Assembly. The criteria used by the CDP to determine graduation are (1) gross national income per capita; (2) the Human Assets Index (HAI); and (3) the Economic Vulnerability Index (EVI). To leave the LDC category and graduate, a country must cease to meet any two criteria in two consecutive reviews or the GNI per capita of the country must be at least twice the graduation threshold in two consecutive triennial reviews (income-only criterion). The thresholds for graduation are also higher than for inclusion to limit the possibility that graduated countries fall back into the LDC category.

Source: CDP and UN-DESA (2015).

Figure 1.1: LDCs as of May 2016 according to year of inclusion



Source: CDP and UN-DESA (2016).

- 2 General Assembly resolution A/RES/68/18 adopted on 4 December 2013, decided that Equatorial Guinea will graduate 3.5 years after the adoption of the resolution, i.e. on 4 June 2017.
- 3 General Assembly resolution A/RES/68/18 adopted on 4 December 2013, decided that Vanuatu will graduate 4 years after the adopted of the resolution on 4 December 2017. General Assembly resolution A/RES/70/78 adopted on 9 December 2015, decided to extend the preparatory period before graduation for Vanuatu by 3 years, until 4 December 2020, due to the unique disruption caused to the economic and social progress of Vanuatu by Cyclone Pam.
- 4 General Assembly resolution A/RES/70/253 adopted on 12 February 2016, decided that Angola will graduate 5 years after the adoption of the resolution, i.e. on 12 February 2021.

public goods and services and to leverage financing for large-scale capital investments. A policy framework that realigns local financial flows with local public goals implies a well-coordinated fiscal, political and administrative decentralization effort, where local expenditure responsibilities are backed by reliable intergovernmental transfers and fiscal empowerment (e.g., the legal and technical capacity to levy taxes). The Addis Agenda pays special attention to LDCs as the most vulnerable group of countries in the world (see box 1 and figure 1.1). It calls for global support to overcome the structural challenges they face and encourages donor countries to increase the allocation of official development assistance (ODA) to the world's poorest nations to 0.2 per cent of national income.

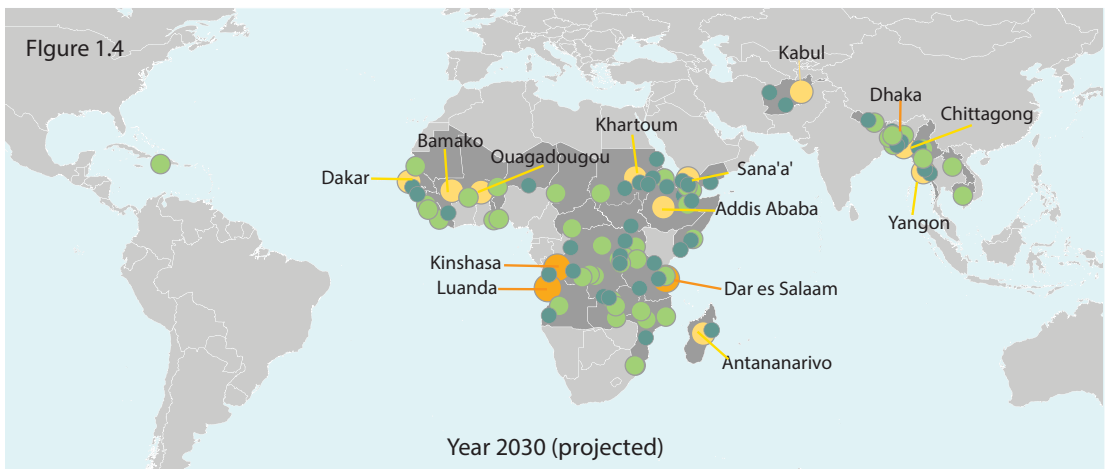
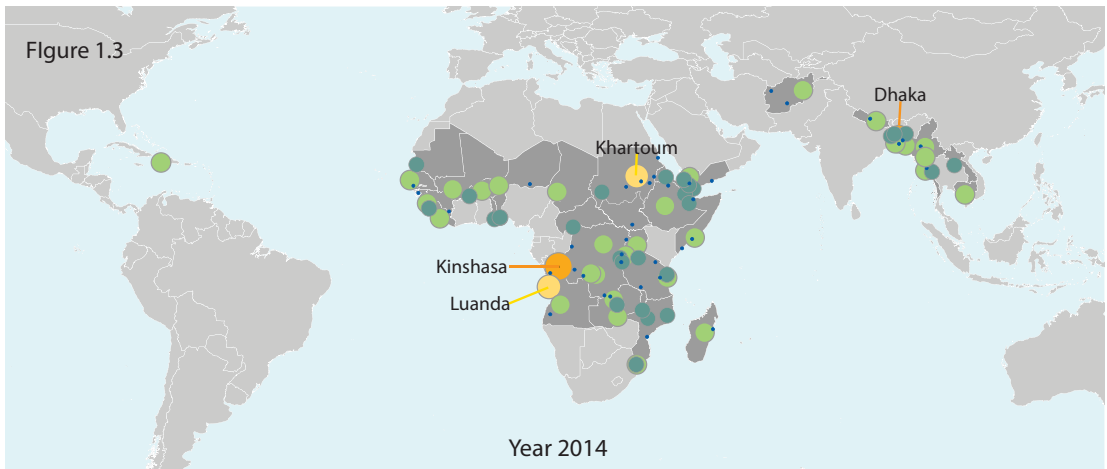
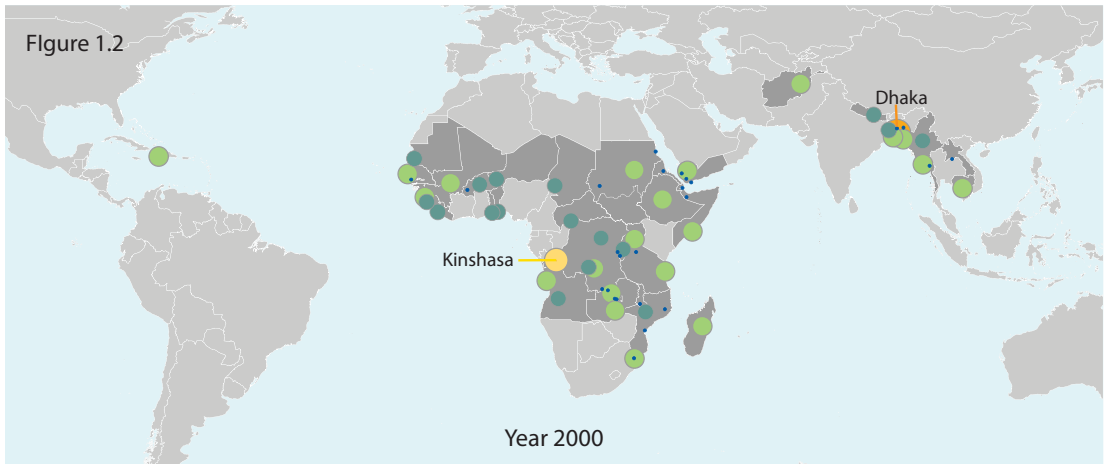
This publication argues that these resources will be most effective if delivered through, or in coordination with, local governments. The next paragraphs will introduce the global, national, and local dimensions of the urban finance challenge, focusing in particular on urbanization and economic trends.

The urban finance challenge in LDCs: global, national, and local dimensions

The state of urban finance in LDCs is affected by conditions and developments at the global, national and local levels. Certain global megatrends such as rapid urbanization, changes to the global economic context, climate change, large movements of refugees and migrants and increased vulnerability to natural disasters and public health emergencies can strongly affect the local level in LDCs. Limited urban financial capacities reduce the ability of the local

authorities in LDCs to effectively manage the impact of such exogenous factors, especially in light of the long-term objective to improve local service delivery and finance local infrastructure development. In addition to global megatrends, LDCs are confronted with challenges at the national and local levels. At the national level, institutional capacity challenges, low per capita income, widespread poverty, hunger and malnutrition, low productivity and shallow financial sectors are frequently combined with protracted political instability, and in some cases violent conflict, and a high vulnerability to terms-of-trade shocks due to their reliance on a limited number of commodities for export. At the local government level, these characteristics may translate into small local revenue bases; limited public financial management capacities; unpredictable and insufficient intergovernmental transfers; and little to no access to private capital for long-term investments, as described in chapters 4 and 5. In addition, political economy constraints (e.g., unclear assignments of revenues and expenditure responsibilities), pose complex challenges to urban finance in LDCs, as discussed in chapters 2 and 3. Without structural transformation that tackles institutional and capacity constraints, both at the national and local levels, LDCs will remain vulnerable to economic, social and environmental shocks and underequipped to meet the urban finance challenge. Consequently, there is a need for continued dialogue and sharing of local experiences in LDCs among all actors to ensure that urban governments are better equipped to respond to the challenges of financing sustainable development and to meet the ever-growing needs of their populations.

Figures 1.2 – 1.4: Projected urban agglomerations in LDCs



Source: Based on data on projections from UN-DESA Populations Division (2015).

Urbanization in LDCs

Cities around the world are expanding as a result of overall population growth and continuous migration from rural to urban areas. Since 2007, the majority of the world's population has been living in urban areas. Africa (where most LDCs are located) and Asia are urbanizing faster than any other region. By 2050, an additional 2.5 billion people are expected to live in cities, with almost 90 per cent of the growth located in these two regions (see Figures 1.2, 1.3 and 1.4).

The proportion of the urban population in LDCs is expected to increase from 31 per cent in 2014 to 49 per cent in 2050. Some

LDCs, such as the Democratic Republic of the Congo, the United Republic of Tanzania, and Bangladesh are predicted to increase their urban population by 50 million people each, over that timeframe. Figure 1.5 illustrates the current and projected rapid growth of a wide range of different types of cities in LDCs. While Kinshasa is currently the only megacity (with more than 10 million inhabitants) in African LDCs, Dar es Salaam and Luanda are both expected to surpass the 10 million mark by 2030. As the map illustrates, rapid urbanization affects not only the largest cities, but also many smaller cities, in particular those with less than 500,000 inhabitants. As urbanization speeds ahead, improving rural-urban linkages will remain critical as

Figure 1.5: Urbanization: Number of cities in LDCs in 2000, 2015 and 2030



Source: Authors' calculation based on data from UN-DESA Populations Division (2015).

44 per cent of the African population and 33 per cent of the Asian population will still live in rural areas in 2050.

The global economic context

Since local governments in LDCs depend heavily on transfer or tax-sharing arrangements with the central government, most global economic developments that affect the national governments of LDCs will also have a significant impact at the local level. Even though LDCs are generally less integrated in the global financial system than emerging economies, they can be severely affected by global economic trends through other channels, in particular commodity price fluctuations, trade and tourism. For example,

economic growth in LDCs has been weak in 2015 due to reduced demand for exports from emerging economies, lower commodity prices, net capital outflows and low investment growth. The adverse effects of such trends were exacerbated by protracted conflict situations in some LDCs and the impact of extreme weather events on agricultural output. Gross domestic product growth forecasts for LDCs (4.5 per cent for 2016, 5.2 per cent for 2017 and 5.8 per cent for 2018) remain well below potential and the target of 7 per cent set in the 2030 Agenda (SDG 8.1). LDCs that depend on commodity exports are particularly unlikely to reach the necessary level of public spending, increasing the financial constraints imposed on local governments.

KEY MESSAGES

- Improving urban finance is a global development imperative. Local governments will be critical in ensuring that the 2030 Agenda for Sustainable Development delivers for the poorest and most vulnerable people on the planet.
- The state of urban finance in LDCs is particularly challenging and deserves special attention. Megatrends such as rapid urbanization, changes to the global economic environment, climate change, large movements of refugees and migrants and increased vulnerability to natural disasters and public health emergencies can strongly affect the local level in LDCs. In addition, LDCs often face challenging national circumstances that may result in small local revenue bases; limited public financial management capacities; unpredictable and insufficient intergovernmental transfers; and little to no access to private capital for long-term investments.
- Strengthening local public financial management, own source revenue generation and intergovernmental transfers, as well as new and innovative borrowing mechanisms, will be critical to improve urban finance. More importantly, efforts must go beyond technical issues to recognize country-specific implementation challenges and tackle political economy constraints in LDCs.
- There is a need for continued dialogue and sharing of local experiences in LDCs among all actors to ensure that urban governments are better equipped to respond to the challenges of financing sustainable development and to meet the ever-growing needs of their populations.
- More emphasis should be placed on capacity-building. A well-resourced and highly-skilled professional municipal workforce can help transform cities into liveable places that will withstand the social and economic pressures of rapid urbanization.

Chapter 2 **DECENTRALIZATION**

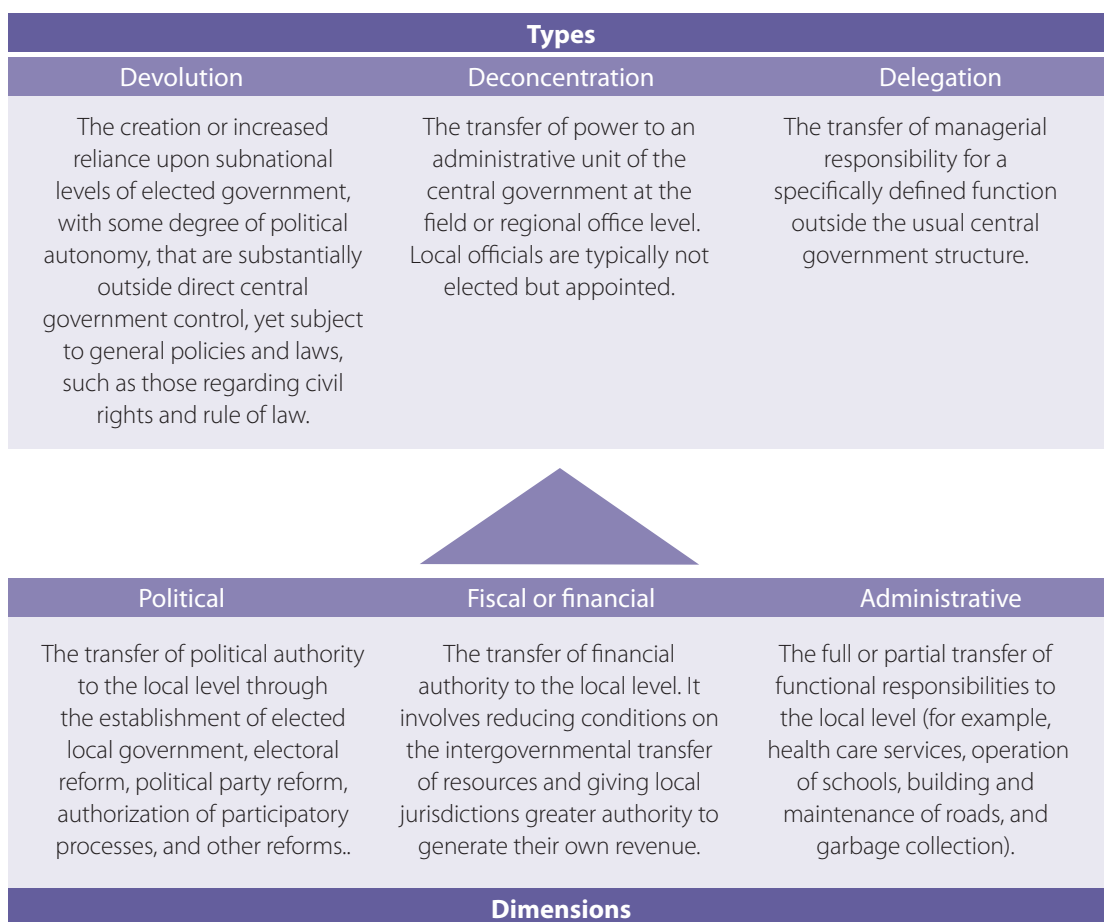


Decentralization has been widely advocated as a way to promote a pluralistic social order, bring the government closer to the people, and promote greater local autonomy. Furthermore, decentralization has also come about because of significant economic divides between rich and poor areas or inter-ethnic tensions. Many developing countries, including LDCs, embarked on decentralization efforts in the 1990s to enhance economic and social development at the local levels. More recently, many LDCs have initiated decentralization reforms to respond to

urbanization challenges. If properly designed and implemented such reforms have the potential to improve the efficiency of public service delivery. They may also promote more equitable distribution of services and resources through greater political participation in local governance, as well as result in more accountable and responsive local authorities.

There are different types of decentralization (devolution, deconcentration and delegation) and different dimensions (political, fiscal and administrative), as explained in figure

Figure 2.1: Types and dimensions of decentralization



Source: Based on Siegle and O'Mahony (2006).

2.1. Reforms are rarely implemented in their purest form, and consequently, there is a wide range of centralized and decentralized governing arrangements in the world, including in LDCs.

Although many LDCs have taken steps towards such decentralization, the actual implementation of decentralization reforms across the different dimensions (political, fiscal and administrative) has been uneven. This may cause challenges, in that those dimensions are mutually reinforcing and dependent on each other, as illustrated by the case studies at the end of this chapter. For example, successful political decentralization depends on the institutional viability, capacity and accountability of the decentralized units. Therefore, political decentralization is inextricably linked to administrative decentralization, which strengthens local administrative capacities and further clarifies the roles and responsibilities of institutions at each administrative level, especially those of local executives like mayors, vice mayors and treasurers (see the case study on Myanmar). Comprehensive administrative decentralization reforms are long-term efforts that require sustained political commitment at the central and local levels of government. In practice, there are cases where administrative reforms remain far from complete, both in terms of design and implementation. Sometimes, an urban government is merely made responsible to account for funds that have been planned, budgeted and executed by a deconcentrated line ministry administration. In those cases, the level of true administrative decentralization is minimal in practice.

Yet, even where they are clearly assigned, enhanced administrative roles and

responsibilities can only be met if sufficient resources are allocated to or generated by local governments, that is, either transfers from the central government increase or the capacity to enhance own-source revenue improves or both. A local government entity or administrative unit does not have effective administrative responsibility or control over service delivery unless it has the resources needed to perform that function.

Consequently, fiscal decentralization is a prerequisite for successful decentralization. Without adequate resources, local authorities cannot meet new political and administrative mandates. Indeed, there is a wide range of examples where slow fiscal decentralization has stood in the way of broader decentralization reforms. In some LDCs, one of the main features of fiscal decentralization has been the reassigning of sector-related functions to local governments. However, administrative decentralization has not been accompanied by adequate fiscal decentralization. In other words, the reassignment has yet to be met by a corresponding increase in unconditional transfers to lower tiers of government and access to local revenue sources. As a result, many functions, which in principle are the responsibility of the local government, continue to be controlled and funded through central government programmes and grants (see the first case study on Nepal).

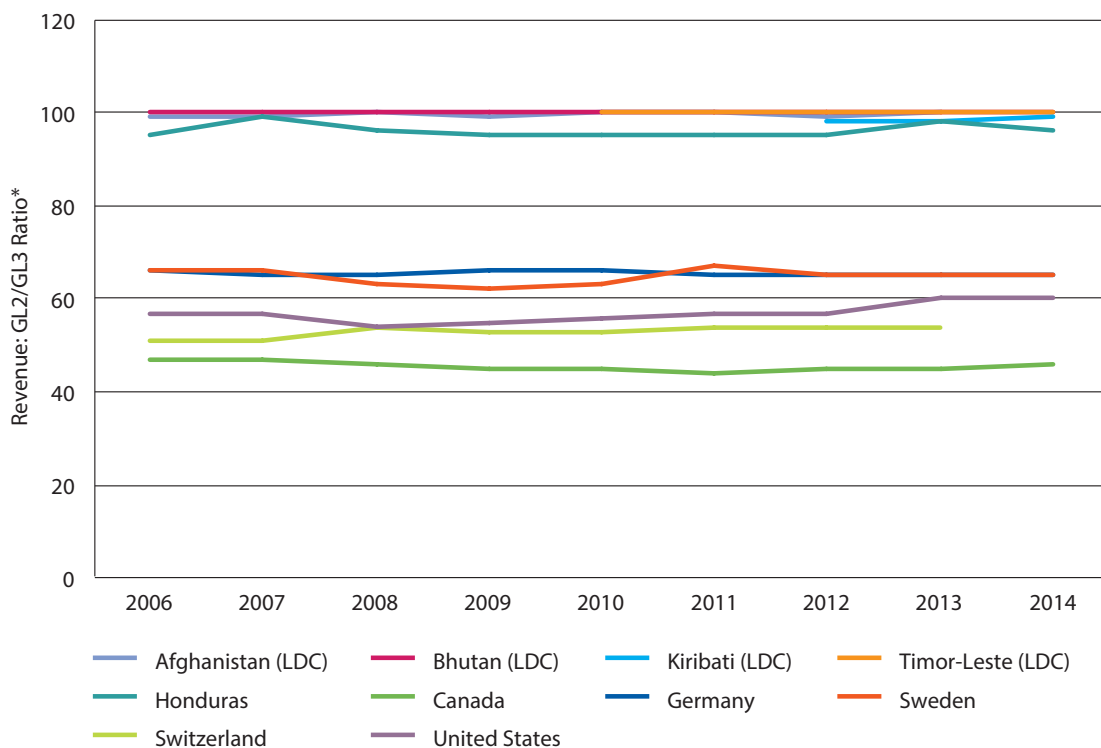
While administrative and even political decentralization efforts have continued to progress in a number of countries (as illustrated by several case studies in this and subsequent chapters), very little progress has been observed in fiscal decentralization in recent years, particularly in the areas of local

revenue and spending. As illustrated by a sample of countries in figure 2.2, between 2006 and 2014, the central government's share of total government revenue and expenditure has remained stable in a range of LDCs, lower-middle-income economies, and high-income economies. In other words, LDCs and lower-middle-income economies appear to have high levels of fiscal centralization, with central governments in some developing countries accounting for over 90 per cent of revenues and expenses of all levels of governments, while high-income economies show more

advanced fiscal decentralization with ratios below 70 per cent.⁵

The general lack of progress on fiscal decentralization, that is, the absence of fiscal empowerment at the local level, may seem surprising to some extent, given the broad consensus among experts and policy makers that greater own source revenue generation is the foundation of successful decentralization. Thus, it is unclear why legal provisions for fiscal decentralization, even in cases where there is strong political commitment at the central

Figure 2.2: Central government share of revenues and expenses



Source: IMF Government Finance Statistics Yearbook database.

* GL2 = Central government, GL3 = General government

5 These findings build off of those from Dziobek, Mangas, and Kufa (2011), who found that with the exception of countries transitioning from command to market economies, between 1995 and 2008, the degree of fiscal decentralization has seen little change regardless of countries' level of development or population. Other estimates also show little movement on fiscal decentralization in Africa and South-East Asia, where most LDCs are located (United Cities and Local Governments, 2010). However, in general, subnational expenditure information in LDCs (in particular time series data) remains extremely limited.

government level, have not been successfully implemented. To fully understand and evaluate the purpose and ultimate performance of fiscal decentralization efforts, it is important to look beyond legal and regulatory reforms or numerical indicators and to understand the political economy of decentralization. Indeed, political economy factors leave their imprint on all areas of municipal finance, whether it is own source revenue generation, public financial management or capital investment.

A fruitful place to start is to examine the initial motives for a certain policy reform, as they will be directly linked to implementation challenges. The case for decentralization is typically based on the argument that it will likely promote democratization and efficiency. Localizing political decisions can give a greater say to those people that are ultimately affected by government policies, allowing citizens to shape political decisions that have a direct effect on their lives and well-being (such as local taxation and the provision of local essential services). Linked to this is also the benefit of stability in cases of conflict, or the threat of conflict. Transferring more power to local governments can create new avenues for political participation and may prevent or reduce possible conflict.⁶ With regard to efficiency, granting responsibilities to local authorities may allow for better policy adjustments to local needs. This also refers to the provision of critical public goods and services in times of crises or natural disaster (see the case study on Haiti).

However, understanding the implementation challenges of decentralization must go

beyond a discussion of whether these arguments are valid or not. They very well may be especially where decentralization efforts are carefully designed, implemented and take the local context into consideration. What is more important for the local authorities is to thoroughly assess whether these arguments correspond to the actual motive of decentralization, as those will shape the level of genuine sustained commitment to follow through with decentralization reforms.

In some cases the push to decentralize may not be the result of a clear central government commitment to empower local governments for the common good. The sometimes observed initial reluctance of central governments to pursue decentralization reforms stems from an obvious logical paradox: why should the central government promote a reform that may strip it of significant authority and revenue sources? Consequently, motives for decentralization may be quite political. For example, the promise to decentralize functions and thereby reduce “big government” may be a popular platform for a re-election campaign. Furthermore, giving local authorities more autonomy may be seen as a solution to reduce secessionist calls and help stabilize the country as a whole, especially in times of economic or political crisis.⁷ Access to development assistance may be another reason for central governments to consider the potential benefits of decentralization reform, as many donor programmes favour decentralized over centralized systems. A deep understanding of the actual

6 Studies show that decentralization has highly differentiated effects on ethnic conflict. In the long term, decentralization may actually accentuate ethnic, political and geographical divisions and increase fragmentation and instability (Siegle and O'Mahoney, 2006).

7 Ibid.

underlying motives for decentralization will go a long way in gauging the level of genuine political commitment at both the central and local government levels, while a greater understanding of the “politics” of decentralization could help stakeholders foresee and prevent potential pitfalls in the implementation of decentralization reform.

In addition, it is crucial to understand the political dynamics between different levels of stakeholders as these will almost certainly shape the success or failure of decentralization reforms. Dynamics at the national level involve interactions among the diverse set of ministries and central agencies that shape,

implement and supervise decentralization. Local level dynamics include citizens and local authorities (see the case study on Rwanda). Interactions among different donor agencies are also involved. In addition to the horizontal dynamics that occur within layers of government, there are vertical dynamics that occur between different layers of government, as well as with outside stakeholders such as bilateral donors and multilateral institutions. These diverse dynamics may jeopardize successful implementation in the absence of a robust and empowered decentralization coordination mechanism or strong incentives for individual agencies to work together (Smoke, 2015b).

KEY MESSAGES

- Although many LDCs have taken steps towards political, fiscal and administrative decentralization, the actual implementation of decentralization reforms remains uneven. Administrative and political decentralization have progressed in a number of countries but fiscal decentralization has had less progress.
- Challenges in implementing a well-sequenced and well-resourced decentralization effort can be better understood through an analysis of the prevailing political economy. A deeper understanding of the actual motives for implementing decentralization at the central government level will go a long way toward predicting and preventing potential pitfalls in the implementation phase.
- It is crucial to understand and recognize the dynamics and interactions between different levels of governments and, in the case of LDCs, donors and multilateral agencies, as these will almost certainly shape the success or failure of decentralization reforms.

CASE STUDIES

RWANDA: A SEQUENCED APPROACH TO DECENTRALIZATION

The Government of Rwanda adopted its National Decentralization Policy in 2001 with the objective to increase the quality and accessibility of essential services at the local level. The policy is being implemented in successive phases. Every five years, the Government has adjusted its strategic priorities, based on a critical assessment of the previous phase. In phase I (2001-2005), the Government set out to improve local governance by promoting

POLICY LESSON:

Decentralization is more likely to succeed when it follows a sequenced and flexible approach that is based on regular progress assessments and is open to corrective actions.

democratic structures at the urban level and institutionalizing the decentralization effort. During phase II (2005-2010), the Government undertook concrete efforts to devolve more resources to local governments and to promote territorial restructuring, result-

ing in the clear delineation of four provinces and Kigali City, 30 districts, 416 sectors, 2,150 cells and 14,953 villages. Phase III (2010-2015) focused on consolidating past achievements and scaling up local economic development. During the current decentralization phase (2015-present) the Government has honed in on what it sees as the key challenges for a successful decentralization. These include challenges in quality of service delivery and economic and corporate governance.

Other lessons drawn from the decentralization process in Rwanda, in particular its second



phase, are that sectoral ministries and agencies can be slow to adjust their role from directing and controlling local authorities to supporting them and facilitating their efforts in meeting new responsibilities. Some sectoral agencies, notably education, health, agriculture and infrastructure, have established a direct presence at the local level, while other sectoral service functions are still in the process of being integrated into local government bodies. In order to increase the political buy-in of line ministries into sectoral decentralization, efforts were made to fully engage them in the process. The creation of a technical working group ensured that line ministries were kept up-to-date on implementation efforts.

While sectoral decentralization in Rwanda has moved ahead, it is still hampered by capacity constraints at the local level. As a result, the new responsibilities granted to



the local authorities have yet to be fully matched by a corresponding increase in human, technical and financial resources. Important initiatives have been launched to streamline capacity development, including the recently formulated local government capacity development strategy. One of the major objectives of the strategy is to empower decentralized entities, to attract, grow, productively deploy and retain the level of competence and talent desired in order to function effectively in all decentralized domains. In addition, capacity development in local governments shall, in addition to human aspects, address institutional and organizational aspects of capacity development.

Much of the focus of fiscal decentralization has been put on increasing central government transfers. Thus, financial resources transferred from the central Government to the districts have grown more than threefold from 2006 to 2011/12. Although local government budgets have increased significantly over the past few years, challenges remain as they still do not meet all local government needs.

According to the National Human Development Report for Rwanda, political decentralization has advanced, as evidenced by increased participation of citizens in local decision-making processes. As stated by the Report, “participation in local government elections attracts as much interest as the national elections. In the national elections of 2010, 93 per cent of registered voters turned up in local government elections compared to 97 per cent turnout for the presidential elections, where the stakes and publicity were much higher.” To increase the effective participation of citizens in matters affecting their daily lives, mechanisms are being designed to promote bottom up accountability, such as the use of social media platforms and the strengthening of community radios. Rwanda also remains committed to female participation in local governance. As of 2015, 46 per cent of all decision-making positions at the district level are held by women and there are continuous efforts to raise awareness on gender equality and women’s empowerment.

Complementary sources: United Nations Development Programme and Government of Rwanda (2014).

MYANMAR: A NON-LINEAR PROCESS OF DECENTRALIZATION IN THE CONTEXT OF CONSTITUTIONAL REFORM

The constitution of Myanmar established a federal government structure with 14 states and regions providing each with individual budgeting processes and revenue generating mechanisms. Since the adoption of the constitution in 2008, Myanmar has taken steps to advance decentralization, and these have been further expanded in the long-term national development plan (2014). In terms of political decentralization, assembly

members are now elected at the state and regional levels. Fiscal decentralization is advancing; key administrative planning and budget formulation responsibilities have been devolved to the state and regional levels as a component of the national planning

POLICY LESSON:

Fiscal decentralization works best if it is based on clearly delineated expenditure and revenue responsibilities and the alignment of policy, budget and capacity.

process. For example, the capital investment budget is improving the balance of central government funds to state/regional funds and the share of national expenditures included in state and regional budgets had more than tripled by 2013. However, in some areas the national planning process still requires central government approval of larger capital investments by local governments. For example, larger scale projects with significant foreign direct investment are being implemented through line ministries.



Once the government fully adopts the international standards of public accounting, inter-departmental fiscal relationships among government bodies at the central and local levels will become clearer, making it easier to distinguish their respective funds within the published budgets. Distinguishing these relationships and adding transparency through improved data disaggregation and reporting will help avoid overlapping responsibilities and target resources more effectively and advance decentralization efforts.

Complementary sources: Nixon and Joeline (2014); Dickenson-Jones et al. (2015); UNDP (2013a); UNDP (2013b).

HAITI: THE ROLE OF LOCAL GOVERNMENTS IN THE AFTERMATH OF A NATURAL DISASTER

Haiti, the only LDC in the Americas, was marked by disaster on 12 January 2010 when it was hit by a devastating earthquake. The epicentre was only about 15 kilometres away from Port-au-Prince, home to more than 2.5 million people. Some 220,000 people died, 300,000 were injured and about 1.3 million lost their homes and were displaced. In the days and weeks following the earthquake, central and municipal governments were overwhelmed by the management of emergency relief efforts. Haiti is still suffering from

continuing humanitarian challenges. Over 60,000 individuals remain internally displaced in 33 sites and camp-like settlements since the 2010 earthquake. Relocation efforts have proved particularly challenging in light of the current political crisis. In 2016, the relocation process of

displaced people had still not concluded and about 10 per cent of the victims continued to live in emergency camps.

The 1987 Haitian constitution includes a decentralization mandate, but implementation has hardly advanced since then. A 2006 Decentralization Decree assigns responsibilities to different levels of government but does not fully specify how their activities should be implemented and coordinated. Several



reasons have been identified for the lack of progress, including political and economic instabilities as well as a shortage of resources and limited political support. Port-au-Prince thus remains the dominant centre of economic, financial and political activities in Haiti. Essential public services are frequently not accessible in municipalities outside the capital city. For example, applications for passports, identification cards and birth certificates can often only be submitted in Port-au-Prince.

The financial situation of the 140 municipalities in Haiti is challenging. Aggregate spending by municipalities is extremely low even for LDCs. Spending barely covers essential services and activities such as police, cemeteries, markets, basic hygiene and health services, and cultural infrastructure. The local authorities provide trash collection and public

POLICY LESSON:

Empowering secondary cities through effective decentralization may relieve urban hot-spots from bearing unsustainable administrative and financial burdens, especially when natural disaster strikes.



lighting only in the two largest municipalities. Urban expenditures are financed from a mix of national and local taxes. Intergovernmental transfers and earmarked taxes account for about 1 per cent of GDP and are transferred to local governments by the Ministry of the Interior. Real estate taxes are the main source of income for local governments; however, municipalities have close to no influence on land management, infrastructure investments, local skill development, and other critical issues of local development. In addition, municipalities collect fees for certain public services. Municipalities virtually do not hold any debt with domestic banks. The Court of Accounts checks compliance with the rules for public spending for municipalities, in particular the procurement framework, on an annual basis (IMF, 2015a).

This challenging financial situation complicated the post-earthquake reconstruction phase because administrative control over human and financial resources remained in the capital. Local authorities had little involvement

in the decision-making process regarding resource allocation. The lack of communication led to the duplication of projects and difficulties with the coordination of recovery efforts, including from international cooperation. Support measures focused on the Port-au-Prince metropolitan area, which resulted in a large number of people returning to the city after they had initially fled the area. As a result, the ability of the capital to provide relief measures as well as other services was stretched further and slum development in Port-au-Prince accelerated. The case of Haiti shows that the lack of fiscally empowered municipalities and secondary cities will increase pressure on the capital city and the central government during the provision of essential public services, especially during times of crises. Decentralization can thus be an important option to enable secondary cities to help respond to emergency situations, which would ease the pressure on the capital region.

Complementary sources: IMF (2015a); United Nations Security Council (2016).

NEPAL (1): INTRODUCING THE LOCAL SELF-GOVERNMENT ACT

The enactment of the Local Self-Governance Act (LSGA) in 1999 has been an important milestone for local governance in Nepal because it devolved greater fiscal, political and administrative powers to the local authorities. The LSGA divided the country into districts, each governed by an executive body known as a District Development Committee (DDC) that acts as a deconcentrated entity of central government ministries. These

POLICY LESSON:

Deconcentration can help enhance capital expenditure at the local level but should also strive to properly take into account local priorities (and balance those with central government priorities).

districts were then broken down into village areas, governed by a Village Development Committee (VDC) and municipalities (for more urban areas) and further into wards, the lowest administrative level.

The LSGA was crucial in strengthening the administrative

dimension of decentralization by outlining and expanding the functions of local bodies such as the DDC and VDC to make decisions on the matters affecting the day-to-date needs and lives of citizens. For instance, the LSGA highlighted the functions of local bodies at various levels: VDCs commanded the agricultural, rural water supply and works and transport sectors among others, while DDCs oversaw the hydropower, land reform and management and labour and wage sectors, among others. Notably, sectors such as agriculture and rural water supply



overlap, creating slight ambiguity over the demarcation of responsibilities between VDCs and DDCs (two different tiers of government).

The LSGA further accelerated the fiscal aspect of decentralization by mandating that local authorities plan annual budgets and raise revenue locally through a combination of internal instruments such as taxes, service charges, fees, sales, income-generating activities and user contributions. The LSGA outlines how DDCs and VDCs can source external revenue through intergovernmental fiscal transfers. For instance, the central Government provides a minimum annual grant to local bodies and additional grants in areas such as population, level of development, possibility and capability of mobilizing revenues, necessity of financial resources, regular record keeping of incomes and expenditures, and the situation of auditing and financial discipline. Additionally, greater commitments from the central



Government to fund capital expenditures at the local government level have positively influenced district economic growth through investment in socio-economic sectors and improved basic service delivery. These guarantees notwithstanding, capital expenditures are still determined by DDCs. At the same time, DDCs and municipalities, and to a lesser degree VDCs, have yet to fully utilize their authority to generate own-source revenues. Consequently, spending may sometimes be driven not by local priorities but by central government priorities. For example, a greater portion of capital expenditure has focused on items with clear country-wide benefits, such as roads, while a smaller portion of expenditures has been directed to sectors like education, health and agriculture.

Greater local discretion over the allocation of grants could help identify expenditures among sectors and better ensure that outlays are based on local demand. Building on the LSGA, the Government of Nepal sought to put in place a new constitution, which came into effect on 20 September 2015. The new constitution was considered an historic achievement as it was the first one since the end of the conflict in 2006. It shifted the country from the previously unitary and decentralized system framed by the LSGA to a federalist framework for governance at the federal, state and local levels.

Complementary sources: Nepal Ministry of Law and Justice (1999); Nepal (2016).

Chapter 3 LOCAL PUBLIC FINANCIAL MANAGEMENT



Local public financial management (PFM)

refers to the set of laws, rules, systems and processes used by local authorities to mobilize revenue, allocate public funds, undertake public spending, account for funds and audit results. PFM reforms have great potential to help local authorities pursue a proactive, clear-cut transition strategy to enable them to assume responsibilities and deliver enhanced governance and improved service delivery in an accountable and efficient manner. If properly implemented, PFM reforms should result in more effective and efficient allocations of public resources and better service delivery, thus helping governments at all levels to overcome existing disparities that hinder the achievement of the SDGs. Local PFM arrangements are comparable to central government arrangements albeit with a more limited scope, especially within the planning and budgeting process, debt management and tax administration. More specifically, the nature and scope of these processes directly depends on the degree of decentralization, that is, the degree to which local political, administrative and fiscal decision-making powers have been delegated from the central government to the local authority. Since decentralization reforms will change these decision-making powers, PFM reforms often follow at the local government level. The political, administrative and fiscal components of such reforms need to be carefully designed and integrated to ensure the sustainability of PFM. In particular, strengthening the PFM of local governments in the context of decentralization requires political accountability mechanisms, administrative and institutional capacities, and clearly-defined fiscal responsibilities and resources (Boex and Yilmaz, 2010).

The experience of many LDCs highlights the difficulty of coupling PFM reform to admin-

istrative, political and fiscal decentralization processes. On the one hand, slow administrative decentralization may become a disincentive to local capacity-building: where the central government continues to manage the overall administrative affairs for the day-to-day operation of local governments, there is little reason for local authorities to strengthen their PFM processes and capabilities. On the other hand, decentralization can move too fast: as more funds and more powers are devolved to a new, untrained local leadership and a local administration with limited capacity, fiduciary risks as well as the threat of misuse of funds or corruption may increase.

Building capacity has been the major focus of PFM reform. In this connection, PFM experts have put much emphasis on the need for a comprehensive approach that aims to strengthen the general financial management capacity of local government administrations, including all of its components, as outlined in table 1. In line with such a comprehensive approach, PFM reform in LDCs usually aims for timelier budget authorization and execution, improved accounting and reporting systems in local governments, increased own-source revenue generation and more robust internal and external audits.

Table 1 lists the many elements involved in PFM and the main related activities. As described above, strengthening these elements in practice can be a complex undertaking, also because of the large number of stakeholders that engage in a “PFM cycle” to ensure it operates effectively and transparently, while preserving its accountability. Box 2 provides an example of such PFM challenges by illustrating the complexities involved for LDCs in the planning and budgeting component of PFM.

Table 1: Overview of the main components and corresponding activities of local PFM

Component	Main Activities
Planning and budgeting	<ul style="list-style-type: none">■ Prepare planning documents■ Prepare budget guidelines that determine timetables, actors and budget methods■ Publish multi-year and annual budget(s)
Debt management	<ul style="list-style-type: none">■ Forecast long-term and short-term borrowing needs■ Manage local debt in capital markets■ Issue and sell bonds (not yet an activity in LDCs at the local government level)
Revenue administration	<ul style="list-style-type: none">■ Project income related to taxes and other revenue items, such as user fees■ Maintain tax registers and administer tax bills and receipts■ Follow up on tax arrears
Accounting and reporting	<ul style="list-style-type: none">■ Determine accounting regulations, methods, systems, structures and codes■ Control accuracy and compliance with regulations■ Monitor budget■ Register financial transactions■ Forecast annual outcomes■ Present annual final accounts
Payments	<ul style="list-style-type: none">■ Manage information related to payments and accounts
Audit	<ul style="list-style-type: none">■ Provide assessment of compliance with financial regulations and of the accuracy and quality of financial information and internal control systems■ Assess the efficiency of local government service provision
Procurement	<ul style="list-style-type: none">■ Make technical specifications of required goods or services■ Prepare invitations to tender■ Evaluate and select suppliers■ Award tenders and place orders■ Ensure quality and delivery control and evaluation

Source: Based on Sjölander, et al. (2007).

Box 2: Local budgeting and planning in LDCs

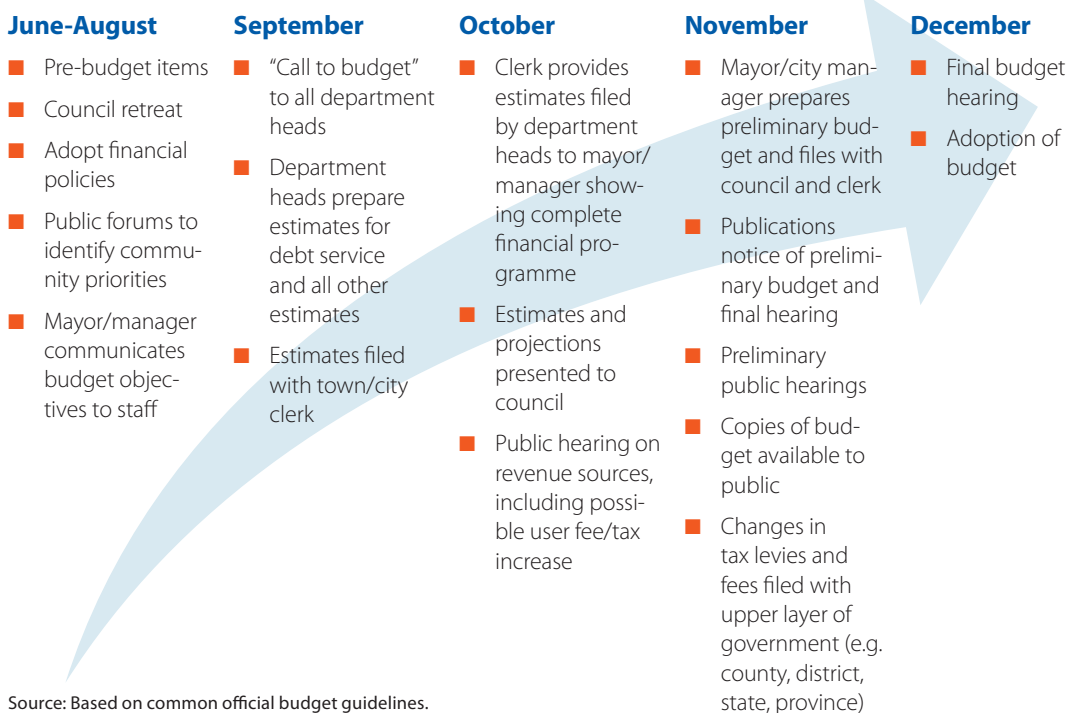
Proper municipal budgets should clearly delineate and quantify the different types of planned local expenditures. They should explain what the money will be spent on and clarify how it will be funded. Traditionally, municipal budgets in LDCs have been prepared with a one-year horizon. However, some LDCs have moved to three- to five-year horizons in order to better link their local budgets to longer-term development objectives. For example, municipalities in Tanzania are required by law to prepare medium-term budget frameworks that are in line with national development strategies. To implement the new requirement, local government officials have received training in medium-term budgeting processes, as well as in the use of relevant software that allows for better planning of longer-term infrastructure investments. However, many local authorities in LDCs and developing countries still lack a medium-term outlook in their local budgets. The focus remains predominantly on current and operating expenditures, which are captured in the current account. Infrastructure investments and other investments whose benefits extend well beyond one year are often not accounted for, since in many LDCs, there is no legislative basis for local governments to receive or manage capital or development budgets.

Creating a comprehensive budget is a complex task and requires enormous amounts of information and data from different local units as well as consultations with the community on spending priorities and possible changes in user fees and taxes. Planning ahead and setting up a calendar is crucial so that each specific unit knows when to produce certain types of data. Figure 3.1 shows a typical urban budget process in a developed country.

There are a range of challenges that LDCs face in the timely preparation of such a comprehensive local budget. More than in developed countries and most other developing countries, budgets by local authorities in LDCs are affected by central government budget constraints: central governments in LDCs are often highly dependent on official development assistance and revenues from commodity exports and both sources are of a volatile nature. As a result, intergovernmental transfers to local authorities may be reduced and result in decreased local government programmes and initiatives. The volatile nature of intergovernmental transfers also limits the information available to local authorities to plan ahead. Moreover, the central government often allocates budgets to line ministries instead of routing it through local governments resulting in fragmented planning and tensions between local governments and the line departments. Another challenge lies in the fact that budgets are not synchronized. For example, it is typical for the central governments to approve development grants very early in the fiscal year, rather than the year before, making it hard to include them in the local government planning process and leading to unspent funds in many cases. A common result of these complications is a high "budget-actual variance" in many cities in LDCs, where actual expenses and those that were budgeted for differ to a large degree (often more than 10 per cent in many local authorities in LDCs).

Source: Farvacque-Vitkovic and Kopanyi (2014).

Figure 3.1: An example of a well-defined budgeting process for local governments



General implementation challenges for PFM reform in LDCs

There are several basic tenets for the successful implementation of PFM reform that are well recognized among experts and practitioners. On the political side, local authorities should have mechanisms for being responsive and accountable to their residents, such as through a system of elected local representatives. To be able to deliver services, local authorities must also have the capacity to plan, budget, deliver and account for them (whether services are fully devolved or just deconcentrated), with opportunities for active citizen participation in planning, budgeting, monitoring and social auditing.

On the fiscal or financial side, local authorities must have clear expenditure and revenue responsibilities, including appropriate own

source revenues, access to intergovernmental transfers (or tax revenue sharing arrangements) and clarity on local borrowing options. Moreover, PFM reforms must be tailored to the country-specific context to maximize the chances for a successful achievement of its objectives (Bahl and Martinez, 2006).

If these tenets are met, PFM reforms have great potential to help local authorities assume responsibilities and deliver enhanced governance and improved services in an accountable and efficient manner.

Even if properly designed, challenges often arise in the actual implementation process of PFM reforms. One such fundamental challenge lies in finding the right balance between central control and local autonomy. Local PFM reform that is too lax creates

the risk of enabling irresponsible local government fiscal behaviour, whereas PFM reform that is excessively controlling can unduly constrain the local autonomy essential for effective decentralized systems.

An important technical challenge with regard to PFM reform implementation in LDCs is how to upgrade the local public finance system to achieve better financial management and a more judicious use of limited resources. Efforts are usually geared towards strengthening expenditure controls (including public procurement), ensuring better information flow throughout the system, enhancing audit capacities, and making sure sufficient support is given to accounting aspects. To achieve these objectives, PFM reform often involves the implementation of a computerised accounting system. However, as explained later, experience has shown that those systems need to be implemented pragmatically and with due consideration to the country-specific context, especially in LDCs. Consequently, proper sequencing is crucial. In designing and implementing PFM reforms all stakeholders must pay heed to whether sufficient capacity is in place to implement the proposed reform measures. In some cases, local capacity requires further development before a higher level of reform can be initiated.

Speaking in more general terms, it is not always clear whether an overarching strategic PFM framework, or integrated plan, is more or less effective in instituting change than a flexible and improvised approach. In certain contexts, local authorities in LDCs have greatly benefited from adopting a more comprehensive approach to PFM reform. In particular, a full PFM reform strategy can be valuable as a statement of intent, to communicate priorities and secure donor

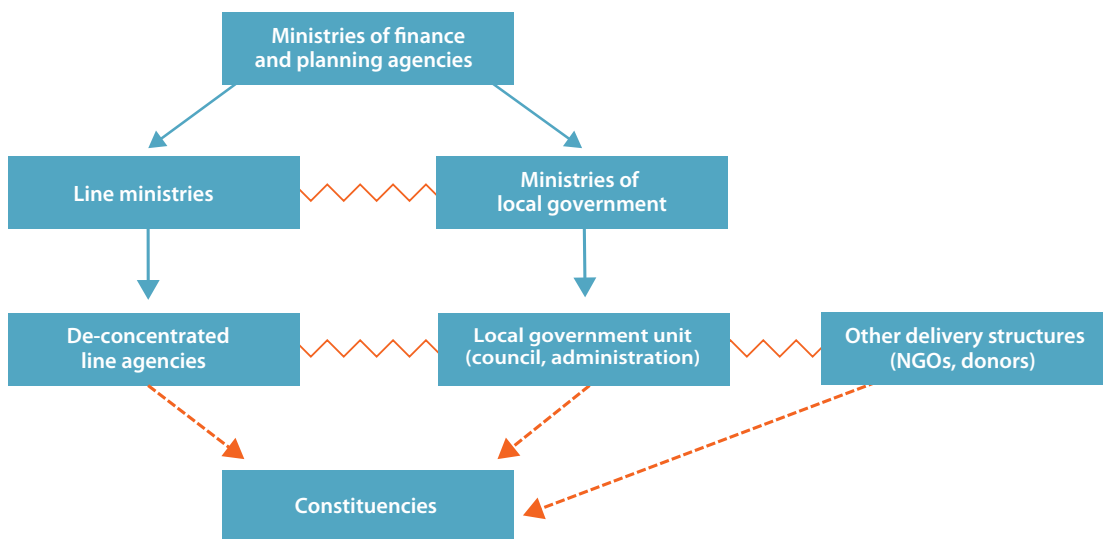
support for LDCs. However, there are also examples of successful PFM reforms in LDCs that did not follow a fully articulated PFM reform strategy. In those cases PFM reform evolved over time with significant changes to initial objectives and strategic frameworks.

Accountability challenges for local PFM

If properly implemented, PFM reforms should result in more effective and efficient allocations of public resources and better service delivery, thus helping governments at all levels to overcome existing disparities that hinder the achievement of the SDGs. The Addis Ababa Action Agenda recognizes the role of local governments in promoting investments into sustainable development. In order to implement the ambitious commitments on urban finance from Addis, PFM reform efforts should take into consideration the range of accountability challenges that may emerge in the process, especially in the context of on-going decentralization reforms.

Indeed, local PFM reforms are often more complex and diverse in countries with an ongoing decentralization reform process as both central government and donors demand significantly improved budgeting, planning, procurement, accounting and internal auditing systems to make sure that government transfers and donor resources are well spent and accounted for. In countries with little or no decentralization reform, local PFM is often a function of a deconcentrated central government ministry carrying out a centrally planned and executed service delivery system with the local government as a junior partner.

Figure 3.2: Accountability challenges in a decentralized system of governance



Source: Authors' elaborations based on Olsen, Hans Bjørn, et al. (2010).

Figure 3.2 lists a large number of accountability challenges that typically emerge during decentralization reforms where institutional adjustments in governance structures are slow or non-existent. Instances of friction (illustrated by jagged lines) occur at almost every level in the resource delivery chain, and these are mostly the result of overlapping mandates of line and local government ministries and their respective entities, as well as parallel delivery structures put in place through external stakeholders such as non-governmental organizations (NGOs) or donors. Consequently, upward and downward accountability for service delivery often remains hard to understand. In the worst case scenario, low accountability may lead to disruptions in service delivery with potentially adverse consequences for citizens.

There are both supply side and demand side measures that can help address these accountability imbalances. The following

supply side measures are aimed at improving central and local governance to improve financial accountability.

1. Strong local capacity for budgeting and public financial management
2. Standards for control on intergovernmental transfer revenues (i.e., clean audit reports, submission of financial statements)
3. Publication of central government transfer figures
4. Transparent local public audit systems (with publicly available audit findings)
5. Clear rules for responsible local borrowing (including rules regarding defaults)
6. Public access to borrowing information
7. Clearly defined rules regarding hard budget constraints for local governments

and proper information on how public funds are allocated and spent through procurement processes

The following demand side measures are aimed at engaging civil society for fiscal accountability.

1. Publicly accessible local government financial information (including budgets and end-of-year financial statements)
2. Strong public involvement in the budgetary process through participatory budgeting practices
3. Gender-sensitive planning, budgeting and resource allocation, reinforced by gender audits
4. Independent budget analysis
5. Participatory public expenditure tracking programmes that monitor budget execution and leakage of funds

The sustained success of a PFM system in helping to deliver the SDGs will depend on how these accountability measures are put into place and how they are being used.

PFM reform in practice—common trends at the local government level in LDCs

In Africa and Asia, PFM reforms have gained prominence over the past decades, in particular at the national levels. At the local level, PFM reforms have been implemented

as an integrated, or stand-alone, part of these national reforms.⁸

Somewhat surprisingly, the relationship between decentralization and PFM reforms, however apparent in principle, is not well established in practice. The two reforms are often formulated through independent initiatives and managed by different national ministries and agencies with different perspectives and objectives—decentralization often falls under a ministry of local government and PFM reforms fall under the finance ministry. In LDCs, the two reforms are sometimes supported by different international donor organizations with different priorities. Different approaches and objectives between those responsible for PFM reform and those responsible for decentralization policy is not uncommon, and the two efforts may also start at different times. The resulting reforms can create mixed signals for actors and generate inconsistencies in government systems and operations.

These types of complexities occur in virtually all countries undertaking PFM and decentralization reforms, but especially where policy and management coordination challenges are more prevalent and institutional capacity is spread very thinly in coordinating sometimes incompatible reform priorities across different layers of government.

More specifically, PFM reform challenges arise because of uneven and unbalanced decentralization. Public services are often provided and

8 The local PFM reforms are often more complex in countries with an on-going decentralisation reform process as both central government and donors demand better budgeting, planning, procurement, accounting and internal auditing systems to make sure that government transfers are well spent and accounted for. In countries with little or no decentralisation reform, local PFM is often a function of a deconcentrated central government ministry carrying out a centrally planned and executed service delivery system with the local government as a junior partner. Such arrangements frequently suffer from low accountability of the service, neither towards the local population nor the national government.

funded through a combination of different funding streams. For example, the provision of health services at the hospital/clinic level may be brought about by a combination of deconcentration (a deconcentrated district health office may be authorized to manage and oversee local health facilities, including the facilities' staff); devolution (the support for the rehabilitation of a health facility may be provided by elected local governments that operate in parallel to the deconcentrated structure); delegation (an NGO supported by the health ministry may engage in health promotion in local jurisdictions); and the direct provision of service delivery inputs by the central line ministries (for example, the in-kind provision of medical supplies).

Further challenges related to the implementation of PFM reforms in the context of decentralization reform can be summarised along a number of broad themes.

- There is a challenge in balancing non-sector local government planning/budgeting and sector plans and budgets, which is often done through a central government planning/budgeting system. This has an impact on local government budgeting and fiscal autonomy.
- In several LDCs, a wide range of local services are delivered by NGOs working on behalf of certain user groups. There can be tensions between the work of such user groups and locally elected councils in terms of accountability and transparency.

- Local finance keeps on changing, particularly in terms of the balance between intergovernmental fiscal transfers and own source revenues. No fiscal arrangement between the central and urban governments is forever: arrangements evolve and change reflecting the new realities, challenges and, ideally, increased capacities for service delivery at the urban level.
- The balance between unconditional and conditional grants determining the level of local autonomy in expenditure prioritization is sometimes characterized by retreats and diversions. Several countries have seen what is known as re-centralization or the strengthening of the role of the central government in local PFM and service delivery after failed decentralization efforts. Recentralization does not necessarily come in the form of legal changes that takes devolved functions back from local authorities. From a formal point of view, there may be no change in their devolved responsibilities but de facto the local government competences may be significantly curtailed.⁹
- Sustained capacity-building at local levels may be limited by the rotation of staff from one district to another. At the same time, local authorities do not retain staffing authority, as employees can be recruited centrally and are part of a national civil service system.

⁹ For example, local revenues in Uganda have been declining in recent years. This is mainly because of the abolition of a graduated tax in 2004 that constituted over 80 per cent of district own source revenues and 30 per cent of own source revenues in city governments. Furthermore, the proliferation of districts (creation of new districts) has had a marked negative effect on their ability to raise own source revenues. The decline of local revenues has also been associated with an increase in conditional grant transfers. As a result, many local authorities have found their ability to exercise their service delivery mandates substantially curtailed.

- There are sometimes multiple systems of planning, budgeting, accounting and reporting that overburden the local government and are not well coordinated. It is thus important to avoid duplication in monitoring, inspection and reporting systems generated by the cross-cutting ministry in charge of local governments, and the more sector-specific ministries.

Trends in automation of PFM in LDCs

Over the past few decades, governments and development agencies alike have invested enormous financial and human resources into automating PFM systems in LDCs (both nationally and locally), including through the Integrated Financial Management Information System (IFMIS). IFMIS refers to the use of information and communications technology in financial operations to support management and budget decisions, fiduciary responsibilities, and the preparation of financial reports and statements. In the local (and central) government realm, IFMIS refers more specifically to the computerization of PFM processes, from budget preparation and execution to accounting and reporting, with the help of an integrated system for financial management. It often starts as a national programme and is then extended to the local government level.

However, often the results have been less than hoped for, especially at the local level. Many local governments have had difficulty implementing these systems and have not always achieved the desired functionality. At the same time, development partners have sometimes invested large sums of money, only to find systems delayed in implementation, having limited impact, and facing challenges regarding their sustainability.

Despite this there have also been success stories where IFMIS was delivered on budget, ahead of schedule, and beyond specification. For example, the experience of Ethiopia has challenged conventional wisdom on how to implement IFMIS. Ethiopia followed a prudent and pragmatic system by ensuring that basic forms of IFMIS were promptly delivered at a relatively low cost and then gradually updated into technically more robust, sophisticated systems meeting international standards. In the end, the introduction of IFMIS in Ethiopia succeeded because it built a stable and sustainable 'plateau' that is appropriate to the local context, instead of aiming for a risky and irrelevant 'summit' of international best practice (Peterson, 2011).

In many LDCs, when introducing IFMIS, challenges remain due to the historical separation between state functions and municipal functions, which can make it difficult for IFMIS to be used at the local level and to capture municipal level finances. Ideally, IFMIS should be able to provide an instant, detailed picture of municipal revenues and expenditures for each local jurisdiction in the country. Some countries, such as Mozambique have made great strides in this field and have made such municipal level data on public finances widely available.

Several inter-related lessons on automating PFM can be drawn from country experiences: (i) automation supports, but does not drive, public financial reform and it cannot compensate for systemic PFM issues; (ii) procedural reform, not information technology, is the driver of change in processes; (iii) a lack of high-level political will does not necessarily hamper success at the local level; (iv) an incremental strategy of frequent operational upgrades is fruitful; (v) off-the-shelf solutions

are not necessarily the most appropriate and cost-effective; and (vi) the best possible technically advanced financial management information system is useful in the context of decentralization only to the extent that it is utilized and applied both at the central and local government levels.

The political economy of PFM reforms at the local level

Both PFM and decentralization reforms share a common political challenge in terms of their technical complexity and associated implementation challenges. As a result, they frequently attract considerable political opposition (Eaton et al., 2011). The expected redistribution of power linked to decentralization may be perceived as a zero-sum game by higher layers of governments. Consequently, decentralization efforts in LDCs often fail to make constitutional provisions that ensure the institutionalization of local governments. The lack of political commitment at the central level may result in a delay to the implementation of relevant legal provisions for PFM reform, thus perpetuating the gap between the national, often very far-reaching, legal framework for decentralization and inadequate regulatory arrangements for local governments. Moreover, explicit and implicit provisions in regional constitutions and statutes can render local governments as a mere subsidiary structure whose function is limited to implementing centrally adopted policies.

Political economy challenges are not limited to the central government level. From the local perspective, decentralization reform can potentially undermine existing informal social relations based on kinship, regional and ethnic loyalties and patron-client relations. These informal aspects of politics and

governance can be particularly important in the poorest countries.

As a result, national and local political and bureaucratic dynamics can support or undermine effective PFM reform. National agencies may neglect decentralization-related obligations to retain power. Divergent incentives and goals can result in inconsistent actions and policy incoherence. A local government ministry, for example, may act to empower local governments, while a finance or sector ministry may adopt policies with the opposite effect.

When it comes to international support for PFM reform, most efforts are focused on capacity-building that targets technical and managerial staff and teaches the mechanics of new systems. While such capacity-building remains important, it must be broadened to pay more attention to the interactions of staff among various layers of government and promote collaboration between local and central government actors who are involved in PFM reform. Decentralization and PFM reforms are characterized by a rather complex set of bureaucratic stakeholders and often require the active engagement of a much broader range of ministries and other stakeholders than sectoral efforts, like education or health sector reform.

Consequently, purely focusing on technocratic solutions for local government PFM misses many important country-specific context and political economy issues. A political economy lens broadens operational considerations beyond technical solutions to include an emphasis on stakeholders, institutions and processes. Issues of a technical nature and the lack of capacity are considerable concerns for urban finance but fall short when not considered alongside the political dimension. It is thus important for all stakeholders, including

the donor community, to focus analytical resources on understanding some of these processes and trying to get the right balance between central and local government accountability for the political, administrative and financial dimensions of decentralization.

Donor engagement in local PFM reform

Donor funding for PFM reform has often facilitated its implementation. External funding is usually directly focused on the government's reform programme. However, central governments in LDCs also fund PFM reforms directly and their ability to do so has been significantly facilitated by the General Budget Support inflows they were receiving. Yet, recent years have seen a steady decline in general budget support as a component of ODA, which may affect the capacity of LDCs to fund PFM reforms directly in the future.¹⁰

When it comes to local PFM reform and decentralization reforms, donors may have their own specific institutional incentives. However, sometimes inconsistencies arise. The same donor may support decentralization reforms, for example through devolving more sectoral responsibilities (e.g., education or health services) to local governments, while, at the same time, supporting line ministries in providing such services at the local level. In other cases, donors may have institutional mandates (and incentives) to promote alternative arrangements for decentralization, such as through social action funds or community-driven development. Such incoherent approaches may further fragment PFM systems.

External technical assistance and advisory support can help advance PFM reform processes where they are focused on clear objectives and outputs, and directly linked to government reform programmes. However, many technical assistance activities do not meet these conditions. Donor promises to enhance the utilization of country-wide implementation systems are sometimes contradicted by small stand-alone projects focusing on a narrow aspect of local government PFM reform. Consequently, there is a need for technical assistance activities to better coordinate PFM reform. Some experts have suggested that donors be more explicit about their overall objectives and anticipated outcomes and to be subjected to independent evaluation on a more systematic basis.

Monitoring and evaluating PFM reforms

In the past, many donors and multilateral agencies developed their own tools to assess fiduciary risks and systems of public expenditure management. As a result, some recipient countries have on occasion been subject to overlapping missions and a large number of externally driven, sometimes inconsistent recommendations. Multiple reform plans were also designed to provide financial support to implement recommended changes. In a number of cases, such overlap resulted in heavy transaction costs for governments in developing countries. The Public Expenditure and Financial Accountability (PEFA) programme¹¹ emerged as one part of a multi-donor initiative to come up with a strengthened, common approach to sup-

10 See <http://www.oecd.org/dac/financing-sustainable-development/development-finance-data>.

11 PEFA: Public Expenditure and Financial Accountability is an internationally recognized and widely accepted methodology used to measure the performance of a public finance management (PFM) system—at the country, regional (state) or local government levels—by comparing its operation and functioning to international best practices. Related tools include PER: Public Expenditure Review (World Bank) and CFAA: Country Financial Accountability Assessment (IMF).

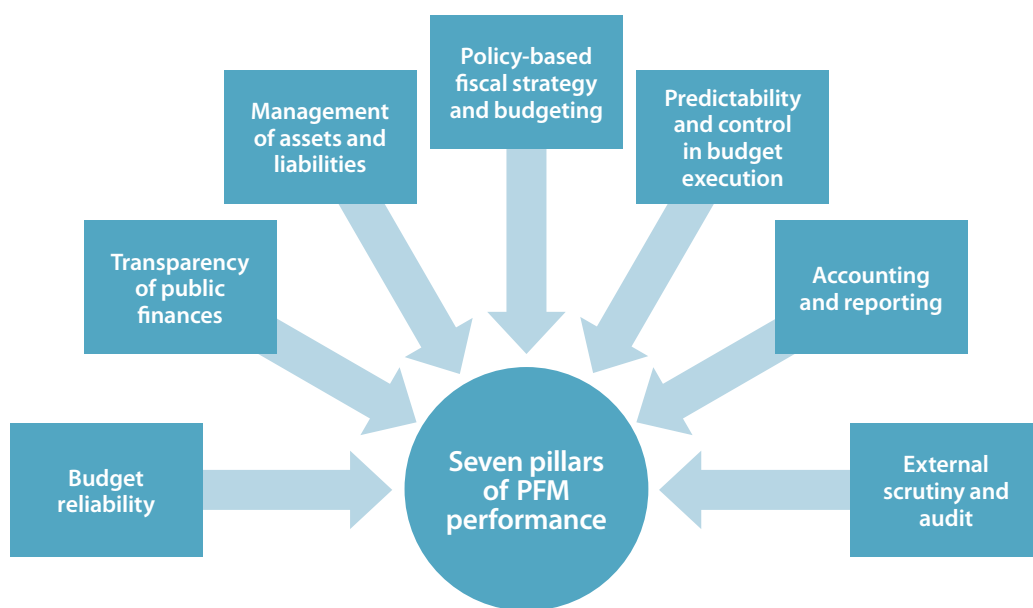
porting PFM reform. PEFA has been successful in harmonizing approaches to PFM systems in developing countries at the national level. PEFA was designed with two goals in mind: (i) to strengthen the ability of donors and recipients to assess systems of public expenditure and fiduciary management; and (ii) to support the development and monitoring of reform programmes. The PEFA framework remains the most comprehensive indicator of PFM to date (Hadley and Miller, 2016).

In February 2016, the general PEFA Framework was upgraded following almost four years of review, refinement and testing (PEFA, 2016). The upgraded general framework provides a thorough, consistent and evidence-based analysis of PFM performance at a specific point in time that can be reapplied in successive assessments to track progress. According to the PEFA Secretariat, PEFA

identifies seven pillars of performance as key elements in an open and orderly PFM system. The pillars also reflect what is desirable and feasible to measure. Within the seven broad areas marked by these pillars, PEFA defines 31 specific indicators disaggregated into 94 dimensions that focus on key measurable aspects of the PFM system (figure 3.3). It measures, to some extent, how PFM systems, processes and institutions contribute to the achievement of desirable budget outcomes: aggregate fiscal discipline, strategic allocation of resources, and efficient service delivery.

The 2016 update also included a revised version of the supplementary guidance for subnational PEFA assessments, which had been issued for the first time in January 2013. It offers advice on how each of the PEFA dimensions and indicators can be applied or adjusted to better suit the specific context

Figure 3.3: The seven pillars of PFM performance



and features of subnational governments. In particular, the subnational guidance includes an indicator to be applied in the case of transfers or earmarked grants from higher-level to subnational governments.

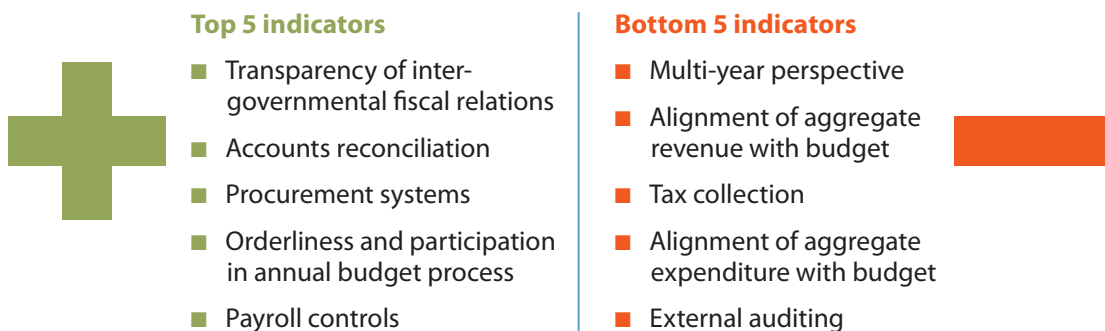
Many donors and LDCs now use the PEFA framework as a basis for their diagnostics of PFM systems and assessing the associated fiduciary risks. However, not all elements of the framework are universally relevant and while it has been applied to the local government level (see box 3), some indicators may not be fully relevant in an LDC context.

Nonetheless, local PEFA results can be used to complement other forms of analysis and existing local knowledge in LDCs. Figure 3.4 highlights some of the main PFM challenges for LDCs based on publicly available PEFA assessments. The figure shows that progress has been made in promoting transparency of intergovernmental fiscal relations, accounts reconciliation and

procurement systems; while challenges remain in capturing and formulating multi-year budget perspectives, tax collection and aligning budget with revenue.

A more LDC specific diagnostic tool for PFM is the Local Authorities Financial and Institutional Management System (LAFIAS). LAFIAS was designed by the United Nations Capital Development Fund (UNCDF) and builds on earlier efforts to map and analyse the challenges of local development and local development finance in a specific country context in LDCs. LAFIAS is a concerted approach that aims, through analytical tools, to grasp the problems linked to local management and governance. It emphasizes the organizational operations of the authorities, their financing and the economic dimension of their development. LAFIAS relies on diagnostic tools (organizational, financial and economic), public consultations and action plans created with input from all concerned stakeholders.

Figure 3.4: Public financial management subnational performance indicators in selected African LDCs based on PEFA assessments



Source: Author's calculations based on PEFA assessments.

Notes: Countries include Burkina Faso, Ethiopia, Madagascar, Senegal, Sierra Leone, South Sudan and Tanzania. The data were averaged first among all rated subnational governments within a country, then between the included countries. Data for non-African LDCs is not publicly available.

Box 3: Assessing local financial management through standardized tools—lessons learned from applying PEFA at the urban level

The PEFA framework was originally designed to be applied at the central level, but countries and donor organizations are increasingly considering using the framework at the urban level. An Agence Française de Développement review concludes that while PEFA would be generally adaptable for assessing local governments, several differences and special characteristics should be taken into account. It is critical that the local situation is adequately reflected in the final report in order to draw the right conclusions from a local PEFA assessment. The level of de facto decentralization will form the critical context for the interpretation of the assessment results.

In addition, it is suggested that only governments with sufficient autonomy, especially discretion over budget and finances, and corresponding capacity should undertake a PEFA assessment. The review further cautions against the comparison of results across different local governments without a thorough verification of the similarity of the political and economic context, which is in line with the position of the PEFA secretariat. Readers and policy makers of urban PEFA results should be aware that the PEFA assessment is not intended to rank local governments, but to assess their financial management performance, which is to a large extent impacted by the actions of and relationship with the central government.

Source: Audras and Almanza (2013).

To date, LAFIAS has not been used outside the West African region where it was pioneered, and the dominant PFM tool at both the central and local government levels remains the PEFA exercise. This might be because LAFIAS is a holistic and comprehensive tool that is very resource intensive and more time-consuming than the PEFA exercise. Despite its limited application, LAFIAS has brought to the fore some key issues that are relevant for LDCs beyond West Africa: (i) many LDC governments lack capacity and commitment to update and prepare expenditure frameworks, further burdened by bureaucratic gridlock as historic “top-down” budgeting processes meet decentralized “bottom-up” processes; (ii) capacity in public expenditure management requires cross-sectoral capacity-building and systems development, which often gets lost between various reform silos that operate independently of each other; (iii)

there is the prevalence of poor budgeting and expenditure control in local governments for service delivery systems, expressed in terms of the weak link between plans and budgets and the absence of expenditure discipline; and (iv) the majority of local governments in LDCs have limited capacity to collect their own revenue. Different PFM assessment tools are compared in table 2.

A promising new trend: improving fiscal accountability in PFM reforms through participatory budgeting

As discussed before, in many instances, fiscal accountability at the local government level has remained low for a range of complex factors. Financial plans, budgets, expenditure accounts, project implementation records and audit reports are rarely shared with citizens, and there is often a lack of citizen involvement

Table 2: Comparison of various PFM assessment tools

	Performance-based grant system	LAFIAS	PEFA	Credit-rating
Created by/ Lead organization	Central governments	UNCDF	Multiple donors, secretariat hosted by World Bank	Various credit-rating agencies
Objective	Incentivize local governments to reform	Develop a reform strategy	Provide a diagnostic tool	Monitor risk level of lending
Main Focus	<ul style="list-style-type: none"> ■ Governance ■ Management ■ PFM ■ Own source revenue generation ■ Cross-cutting issues (for example, climate change) 	<ul style="list-style-type: none"> ■ Governance ■ Management ■ PFM ■ Finance and fiscal balance, debt ratios, etc. (substantial) ■ Local economic development and potential 	<ul style="list-style-type: none"> ■ PFM in broad sense from budgeting to auditing 	<ul style="list-style-type: none"> ■ Overall fiscal framework ■ Management ■ PFM ■ Finance ■ Intergovernmental relations and autonomy
Typical number of indicators and scoring	40-60	50+ (20 for PFM)	94 overall, 31 main indicators. Score per indicator	20+ Total score (e.g. AA+)
Collection methods	Various methods, contracting out etc. with committee review and quantitative analysts	External study team and local governments	PEFA teams with quantitative analysts sent from Headquarters	Analysts and panel decision
Under local government control and attribution	Yes: Always (main principle)	Most, but not all	Most, but not all	External, but local governments can request confidential ratings (i.e. only local government will see results)

in fiscal decision-making and monitoring and control.

To improve fiscal accountability, some LDCs have started integrating participatory planning and budgeting processes into their PFM reforms. Participatory planning (PP) and participatory budgeting (PB) are closely linked yet distinct concepts that allow non-elected citizens to participate in local planning processes and the allocation of public finances.

Full-fledged PB was first reported in the Brazilian city of Porto Alegre in 1989. Since then, up to 50,000 people have participated each year to decide on as much as 20 per cent of the Porto Alegre budget. By some counts, PB has spread to over 1,500 cities in Latin America, North America, Asia, Africa and Europe since 1989. PB has also become a mainstay policy tool that has been heavily promoted by the United Nations Development Programme, including UNCDF, the World Bank Group (see

the Maputo case study), and regional development banks around the world.

Consequently, PB in LDCs has spread as a “result of a set of forces deployed by individuals and institutions, a constant work of legitimating participatory governance, connecting players through international events, training teams and producing technical material” (Dias, 2014). Many instances are still under development and are more consultative in nature as opposed to actual decision-making at the local level. Some of the more advanced PB experiments are present in African LDCs, namely, Madagascar, Mozambique and Senegal. However, important steps toward greater participation in local government budgetary matters have also been taken in Asia and the Pacific region (see case studies on PB).

Most experts and practitioners agree on five basic criteria that characterize local PB: (i) budgetary decisions are made; (ii) local authorities are involved; (iii) the process is not a one-off exercise, thus, it must be repeated; (iv) there must be public deliberation on spending priorities; and (v) accountability is required (Sintomer et al., 2010). The shape, depth and breadth of PB can vary widely. For example, in some local governments, entire municipal budgets are allocated through PB while many other local authorities limit PB to a certain share of the budget or directly allocate a small amount to neighbourhoods that can decide on their own spending priorities (see Maputo case study).

PB implementation varies significantly, but some common threads can be identified. Decisions are usually made in regular local assemblies where residents meet to discuss the most pressing local needs and identify spending ideas. A smaller number of selected

representatives (preferably those with some financial or budgeting expertise) then develop concrete projects that address these priorities and present them to the residents (the Nepal case study presents a variation of this framework). Once residents vote on which proposed projects to fund, the local government then allocates the funds to implement the chosen projects. Since accountability for implementation lies with the local authority, the government should report back regularly to local assemblies on the status of implementation. In short, the process can thus be described as one of diagnosis, discussion, decision making, implementation and monitoring.

There are various welfare, ethical, political and economic arguments in favour of PB, sometimes also referred to as “participatory promises.” On the welfare side, it is argued that PB produces better and more equitable service delivery as local residents know their own priorities better than central or urban government representatives. Consequently, PB helps direct local government expenditures towards communities with the greatest needs. If carried out effectively and in line with the principles described earlier, PB will result in greater access to basic services and improved living conditions. From an inclusion angle, PB is an end in itself, as by its very nature PB stands for empowerment and inclusion if properly implemented. Citizen empowerment can reduce the scope for catering to a limited clientele, elite capture and corruption through greater public oversight. PB can also represent an important political tool both for governments and citizens. New structures and opportunities for participation promote community building and the understanding of complex political issues. They can be important opportunities for experiencing

democratic decision-making from the ground up (see the Bangladesh (1) case study). Citizens may also feel more connected to their city, leading to a “political stability” argument. Through PB, politicians can build closer relationships with their constituents and vice versa which may help thwart civil unrest and violence in unstable settings. Such arguments may explain why PB has become popular even

in less mature democracies in LDCs. On the economic side, PB may help mobilize domestic resources for development, especially at the urban level. The willingness to pay taxes is likely to increase where public money is spent on visible improvements in line with the clearly defined priorities of citizens. Such arguments may explain why PB has become popular in many LDCs.

KEY MESSAGES

- Sound PFM is a core prerequisite for successful service delivery at the local government level. It is inextricably tied to the success of decentralization, in particular fiscal decentralization. If properly implemented, PFM reforms can result in more effective and efficient allocations of public resources and better service delivery, thus helping governments at all levels to overcome existing disparities that hinder the implementation of sustainable development.
- A strong case can be made in favour of participatory budgeting as an important element of PFM: participatory budgeting may produce better and more equitable service delivery as local residents know their own priorities better than central or urban government representatives. Participatory budgeting can reduce the scope for catering to a limited clientele, elite capture, and corruption through greater public oversight. Participatory budgeting can help mobilize local resources for development, since the willingness to pay taxes is likely to increase where public money is spent on visible improvements on service delivery and local infrastructure.
- PFM reforms must be tailored to the country-specific context to maximize the chances for a successful achievement of its objectives. One cannot mechanically seek to transfer approaches and practices that work well in one setting to other very different institutional contexts. Improvements in PFM performance have often failed to materialize where cutting-edge practices from mature economies are rushed through very different and challenging developing country settings.
- Major PFM reforms are difficult and complex undertakings that require years (or even decades) to fully come to fruition. Laws and regulations must be drafted; longstanding practices restructured; political and administrative cultures changed; institutions built; and capacities strengthened. To attempt this in a short space of time, is a recipe for eventual failure.
- In general terms PFM reforms tend to deliver results when three conditions coincide: (i) a strong political commitment to their implementation; (ii) well-tailored reform designs and implementation models according to the institutional and capacity context; and (iii) strong coordination arrangements—led by government officials—to monitor and guide reforms.

CASE STUDIES

NEPAL (2): INCREASING CITIZEN PARTICIPATION WITH PARTICIPATORY PLANNING

Some LDCs have taken important steps toward citizen empowerment that have great potential to evolve, over time, into more advanced engagements like participatory budgeting (PB). In Nepal, participatory planning (PP) involves the local community in the strategic and management processes of urban planning, that is, community-level planning processes. The modern form of PP was ushered in through the “Local Self

POLICY LESSON:

Where structures for participatory budgeting are not in place, participatory planning is an important first step. Similarly, participatory budgeting initiatives can be piloted in certain sectors before they are scaled up.

Governance Act,” introduced in April 1999. The act laid the foundation for increased citizen participation and called for “the enjoyment of the fruits of democracy through the utmost participation of the sovereign people in the process of governance by way of decentralization.”

Since the introduction of the Local Self Governance Act, development agencies, the United Nations system, as well as international and local NGOs have been actively working with the Government of Nepal to provide training for local citizens as well as strengthening the administrative capacity of local bodies in support of greater participation in local decision-making processes, including planning and budgeting.



PP in Nepal varies across different Village Development Committees (VDC), municipalities, and districts. In most cases, community-based organizations are invited to deliberate policy and budget guidelines presented through a Ward Committee, which comprises government-appointed officials. Deliberations are open and take place in public spaces. The resultant recommendations are forwarded to the Ward Citizen Forums, which then organize a comprehensive workshop (Ward-Bhela) with selected representatives of community-based organizations to further discuss the decisions at the community level. The Ward-Bhela makes its own recommendations, which are forwarded to the municipal/VDC secretariat. The municipality reviews all the proposals with regard to their technicality and financial viability. The refined proposals are sent to an “Integrated Planning Formu-



lation Committee”, which comprises all the representatives of communities, NGOs and sectoral organizations. The outcome of its deliberation on the refined proposals is then endorsed by the centrally appointed Ward officials. In Nepal, the ultimate decisions on the implementation of PP proposals are still in the hands of central government appointed bureaucrats. To make PP even more inclusive, an important step could be to allow for local elections of Ward officials. However, local elections have not taken place for a

decade. Given the political and institutional challenges Nepal has faced over the past decades the country has come a long way in empowering citizens at the local level. In certain areas, especially the water sector, PP and PB are even further advanced. Indeed, many water supply projects are initiated, financed and implemented by water user communities through a combination of central government grants, own source revenues and loans.

Complementary source: Farvacque-Vitkovic and Kopanyi (2014).

BANGLADESH (1): EXPERIMENTING WITH INCLUSIVE BUDGETARY PROCESSES AT THE LOCAL LEVEL

Bangladesh has made important strides in involving citizens in local decision-making through a range of donor projects undertaken in collaboration with the Government. While falling short of institutionalizing participatory budgeting (PB) as a municipal management practice, these projects sparked great interest and even enthusiasm for the idea of PB, which could pave the way for sustained citizen engagement in local budgeting processes

POLICY LESSON:

International and local donors and NGOs can “whet” citizens’ appetite for participatory budgeting by encouraging local authorities to experiment with different forms of inclusive budgetary processes at the local level.

in the future. For example, as part of the Sirajganj Project in the early 2000s, co-sponsored by UNDP and UNCDF, participatory planning and budgeting meetings were organized at a number of Union Parishads (UP), which are the smallest rural administrative and local government

units in Bangladesh. Also, The Hunger Project, a global NGO to combat hunger and malnutrition, helped organize open budget sessions at UPs all over Bangladesh, giving citizens the chance to submit concrete project proposals that would meet their practical needs. A local NGO called Agrogati Sangstha carried out a similar type of exercise by organizing a meeting in which the chairman of a UP declared the budget of the UP before some 500 local citizens, many of whom posed concrete questions about revenue



and development expenditures. Building on these experiences and similar exercises, the Government in 2007 launched a national decentralization programme, known as the Local Government Support Programme, with the aim of improving local governance and local service delivery. As the programme ended in December 2011, UNCDF and UNDP developed the Union Parishad Governance Project and the Upazila Governance Project, which scale up promising innovations tested in previous pilots.

SOLOMON ISLANDS: TACKLING LOCAL GOVERNANCE CHALLENGES IN A SMALL ISLAND DEVELOPING STATE

The case of the Solomon Islands highlights the particular challenges of SIDS in promoting local participation in economic decision-making. It also shows the potential for performance-based grants to promote good governance and lay the groundwork for PB approaches. The Solomon Islands' population is culturally diverse with some 80 different languages reflecting geographical dispersal across some 300-400 inhabited

POLICY LESSON:

Participatory budgeting can face particular challenges in Small Island Developing States (SIDS) due to geographical constraints. As a result, capacity-building efforts must take into consideration how such constraints affect local governance as well as the interaction between local and central governments.

islands. Experts have identified some major challenges for participatory approaches to local governance. First, transportation and communication links across the country are limited, restricting opportunities for engagement in the formal economy. Second, there is very little devolution of funds from the central Government to provincial governments. Third,

central government interventions and support at the urban level can vary significantly depending on the geographical location of the local authority, which complicates local planning processes. Fourth, there are instances of institutional and capacity challenges at the local government level.



The central Government has taken concrete steps to tackle these challenges. For example, in April 2013, the Ministry of Provincial and Institutional Strengthening formally launched a process to develop ward profiles for each of the 170 wards and strategic plans for each province. To promote good governance at the local government level, the Provincial Governance Strengthening Programme provides access to the Provincial Capacity Development Fund (\$33.5 million) for provinces that meet minimum conditions for principles of transparency and accountability, providing additional incentives for participatory budgeting. Provinces that meet the requirements (seven out of nine in 2015) can tap the fund for investments for small-scale infrastructure projects.

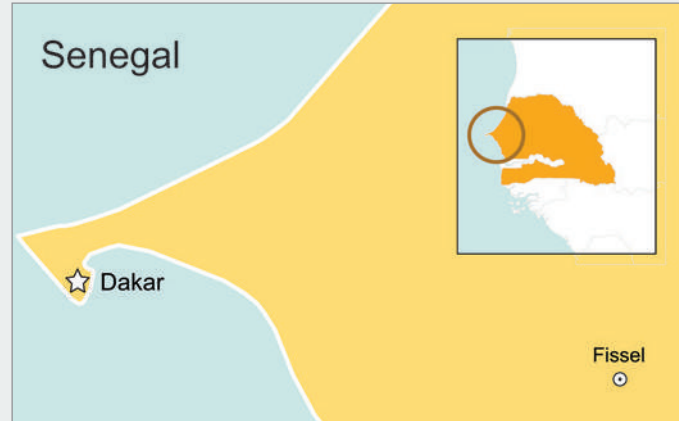
Complementary source: Bennet et al. (2014).

SENEGAL (1): THE EXPERIENCE OF PARTICIPATORY BUDGETING EXPERIMENTS IN THE TOWN OF FISSEL

Senegal has a long tradition of decentralization dating back to 1972. In 2003, the country launched new participatory budgeting (PB) experiments in the town of Fissel. Participatory budgeting in Fissel followed a programme for strengthening citizen participation that began in 2001. Fissel also benefitted from a long tradition of social mobilization through, for example, the launch of community radio by grassroots organizations in the mid-1990s. The

Fissel experiment was successful in improving local revenue management because its citizens were consistently active and its politicians receptive, and it demonstrated that PB can be successful in a rural context. Since then, the major challenge

has been to establish PB as a permanent and accepted tool of governance. It is thus import-



POLICY LESSON:

Embedding participatory budgeting in a sound institutional and legal framework at the national level could help it survive political change at the local government level.

ant to institutionalize the principles of PB.

One option to ensure that PB survives beyond election cycles would be to make citizen participation a legal requirement for municipalities in the constitution rather than just encouraging it. Some 12 years after the Fissel pilot began, Senegal is embracing PB in earnest with legislative changes and new pilot projects with the ultimate aim of ensuring that there is PB in all 45 of its departments.

Complementary sources: Dias (2014); Sintomer, Allegretti and Herzberg (2010).



MADAGASCAR: BUILDING CAPACITY FOR PARTICIPATORY BUDGETING THROUGH DONOR SUPPORT

Participatory budgeting (PB) in Madagascar started in 2008 with nine municipalities, six of which were in mining areas. Following the introduction of PB, revenue collection increased dramatically in some areas. For example, the Ambalavao rural municipality raised its revenues from land and property taxes more than six-fold to 52 per cent, an impressive jump that has been attributed to citizens' greater willingness to pay taxes in

PB scenarios. PB in mining areas also facilitated more transparency and fairer management of mining royalties paid by mining companies to the State. Following the positive initial experience, the Government of Madagascar decentralized

POLICY LESSON:

Participatory budgeting can increase the willingness of citizens to pay local taxes. It can also promote the contributions from extractive industries to local development.



the Local Development Fund, rolled out PB for 50 selected municipalities, and financed the training of 206 community facilitators.



MOZAMBIQUE (1): EVOLVING PARTICIPATORY BUDGETING APPROACHES IN MAPUTO

Urbanization rates are increasing steadily in Mozambique, from 32.2 per cent of the population living in urban areas in 2015 to a predicted 49.1 per cent by 2050. Mozambique has received increasing levels of official development assistance, with up to 40 per cent of its budget financed by its donor community. Many development funds encouraged the government to implement a series of 'good governance' reforms, including

participatory budgeting (PB). The current form of PB in Maputo, which has evolved over the past decade, rotates through 16 neighbourhoods each year on a three-year cycle, with each neighbourhood able to spend up to 1.5 million Meticaís (roughly \$50,000)

on its priority project(s). A few years ago, the World Bank shortened the cycle from three to two years. The Maputo model highlights that beyond the benefits a well-framed PB brings to the population, it can also be good politics as it helps reconnect the central government to the population in a face-to-face manner.

Complementary source: Nylen (2014); United Nations Department of Economic and Social Affairs, Population Division (2015).



BANGLADESH (2): INTRODUCING AN INTEGRATED ACCOUNTING AND MONITORING AND EVALUATION (M&E) SYSTEM AT THE LOCAL GOVERNMENT LEVEL

In Bangladesh, the PFM capacity at the local government level is sometimes constrained by a lack of skilled planners, accountants and information technology operators. In some local authorities, there is only one permanent staff member, the Union Parishads (UP) secretary, performing most of these tasks. Despite the shortage of staff, there have been several improvements in local capacity and in the performance of UPs.

POLICY LESSON:

Strengthening local monitoring and evaluation systems is important for localizing the SDGs.

For example, under the Union Parishad Governance Project (UPGP) supported by UNDP and UNCDF, Bangladesh has piloted an integrated accounting and

M&E system at the local government level. The system was introduced and piloted in 564 UPs. During the project, training was provided to 2,469 auditors recruited by the Government, who carried out performance assessments and audits of the 4,556 UPs across the country. These audits have led to 3,976 service improvement interventions. Looking ahead, a major challenge is to align national and local PFM reforms, including through more effective M&E, with the new 2030 Agenda for Sustainable Development.



At the national level, the government has already aligned the SDGs and targets with its 7th Five-Year Plan. Through workshops and other activities, the UPGP has taken steps to make key local government functionaries aware of the SDGs and the 169 targets as well as the roles and responsibilities of local authorities in implementing and localizing the SDGs.

Complementary sources: Bangladesh Development Research Center (2015).

TANZANIA (1): DESIGNING AND IMPLEMENTING PFM REFORM AT THE LOCAL GOVERNMENT LEVEL

The implementation of PFM reforms in Tanzania throughout the last decades has involved the introduction of key institutions and key legislation on audits and procurement. The Public Financial Management Reforms Programme (PFMRP) specifically targets weaknesses that were identified by a PEFA exercise at the central government level. PFMRP also initiated the design and gradual roll out of IFMIS to all central level government

POLICY LESSON:

National PFM reform is an important driver for local PFM. Further capacity-building should help with PFM reform implementation at the local government level.

agencies and many local governments. The present reform effort (PFMRP IV) covering the period 2012–2017 aims to introduce comprehensive and integrated management tools for the whole budget cycle. Ultimately, the

PFMRP IV goal is to attain a sound financial management system in order to ensure public service delivery for the achievement of sustainable development. Compared to previous phases, PFMRP IV focuses on critical PFM actions that aim at improving coordination between revenue management, fiscal policy, budget expenditure and planning.

While a central Government-led exercise, PFMRP has supported policy and institutional reform that enhances local government capacities for procurement, including broad legal reforms and the development and select rollout of IFMIS at the local level.



The central Government has recently also sought to strengthen the management and control of public finance. Article 348 of the Public Finance Act has been reviewed to empower the Paymaster General and the Accountant General to manage and monitor PFM at the local government level. It has created the post of Assistant Accountant General responsible for management of finances of local government authorities, thus enabling the implementation of the intended objective of these changes. PFMRP has taken over responsibilities for an increasing amount of PFM related capacity-building tasks at the local government level. Yet, in part due to shortfalls in donor funding, it currently works without sufficient resources and personnel to effectively implement these tasks.

NEPAL (3): ASSESSING NATIONAL AND LOCAL PFM

In 2015/16, the Asian Development Bank (ADB) supported a subnational PEFA exercise. This document states: “Although local governments in Nepal have traditionally spent a low percentage of the overall national budget (around 9 per cent), they serve a critical role in delivering essential public goods and services to local communities. Furthermore, as Nepal develops its federal structure, it is likely that more services (such

POLICY LESSON:

Local governments in Nepal faced a host of challenges that impeded PFM reform and their effectiveness. These included irregular central government transfers, inadequate staffing, weak enforcement of regulations and the lack of fully applicable diagnostic tools. However, despite these challenges, the performance-based grant system and PEFA proved resilient tools that maintained a degree of stability and effectiveness in local governance.

as primary health and education) to which local government already contributes will be devolved to the control of local government authorities along with additional resources.”

The central Government added 133 additional municipalities in 2014 and 26 in 2015, which increased the total number from 58 to 217. The new municipalities were established partly with a view to increasing local sources of revenue from local property taxes and other incomes and

increasing the self-sufficiency of more prosperous localities. The ADB concluded that “it is

therefore of critical importance that the local governments’ financial management capacity is improved so that local bodies can make the best use of limited resources.”

This first local government PEFA assessment in Nepal was carried out focusing on the three types of statutory local bodies, District Development Corporations (DDCs), Village Development Committees (VDCs) and more autonomous municipalities (including those designated as Metro and Sub-Metro areas). The local PEFA assessment followed two central government assessments, the first conducted in 2005-06 and reported in February 2008 and the second conducted in 2013-2014.

The latest PEFA scores have shown that at the central government level, Nepal has made substantial progress in deepening PFM structures and processes, particularly through the use of information technology in PFM processes. However, at the local government level, although there has been some investment in locally designed technology, progress has been slower. There are many reasons for varying performances at the local and central government levels.

First, small local governments often operate with only one paid official in a very resource-constrained local environment. Second, local bodies have often seen unstable political environments, characterized by frequent changes of local chief executives and local development officers with limited formal

accountability of local officials to their local communities. However, this trend has been mitigated by developing an accountability culture through performance-based grants that delegates management of some capital projects to user groups at the community level. Third, heavy reliance on central government grants negatively affects local PFM if those transfers are not timely, sufficient and predictable. Fourth, local government financial regulations do not currently require budgeting within a medium-term perspective.

While the applicability of PEFA to the local level in LDCs is still limited, it is a useful exercise. For example, in the case of Nepal, the major conclusion was that currently, the overall PFM system at the local government level generally exhibits weak financial control, weak or non-existent internal audits, ineffective external audit and low levels of internal management supervision. The absence of accounts committees and frequent turnover of local officials has materially contributed to an environment in which financial management is not a priority and in which essential aspects of a good PFM system (such as regular bank reconciliation, budget execution reports and follow-up of audit recommendations) are not demanded. This should not be taken to mean that large amounts of funds are being wasted or misappropriated or that projects are not by and large being implemented as planned. Rather, it means that the PFM system itself does not offer reassurance that expenditures and revenues are being managed in the



best interests of local communities and their financing stakeholders.

The PEFA results also point to the need to develop, implement and adequately resource an information technology strategy for PFM that is not simply an aggregation of individual donor-funded projects which may inevitably not allow for proper implementation or rollout. The new strategy would need to take into account the development of the central information technology finance systems, as well as the relationship between local bodies and central government.

Complementary sources: ADB (2016); Government of Nepal (2017).

SOUTH SUDAN: IMPLEMENTING LOCAL PFM REFORM IN A FRAGILE ENVIRONMENT

A recently completed local PFM project in South Sudan provides some important lessons for PFM reform in fragile states. It has reaffirmed the virtues of a gradual approach to dealing with PFM-related challenges. For example, integrating payroll reform into the overall PFM work from the outset was an overly ambitious endeavour, especially when taking into consideration the tight target time frame (18 months) for implementation and

POLICY LESSON:

PFM reform is possible in the most challenging of circumstances if objectives, expectations and timelines are adapted to realities on the ground and local governments are firmly in charge of the reform process.

the reform readiness at state and county levels. Indeed, for many counties it is simply not feasible to modernize their payroll systems any quicker due to capacity constraints and lack of human resources. Some targeted counties could not meet the most basic criteria, such as

access to an electric grid or computers.

Taking these lessons into account, relevant donors and local stakeholders concluded that the priority for South Sudan should be to build human capacity and implement more straightforward computer-based systems.



In line with these lessons, recent PFM reform efforts in South Sudan have set up local implementation teams to facilitate reform interventions, direct contact, on-the-job coaching and mentoring that is a very needed aspect of PFM reform in the present situation in South Sudan. There is also a convergence of views that increasing local accountability will be a prerequisite for successful PFM reform in South Sudan. In the long term, however, it is essential to empower local governments and ensure that the current parallel service delivery system ultimately supports the functioning of local systems. Building trust between counties and central government officials is important in this regard.

Complementary source: Ecorys, 2016.

Chapter 4 **URBAN REVENUE MOBILIZATION**



The size and scope of local revenue depends

to a large extent on the prevailing intergovernmental fiscal arrangement in a country. In theory, levels of autonomy can range from fully empowered local governments that set and administer their own tax systems to fiscal arrangements where the central government retains all taxes and shares proceeds with local governments through intergovernmental transfers (often also referred to as central government transfers or grants). In addition, there is the possibility of assigning certain taxes exclusively to local governments or sharing revenue from specific centrally collected taxes with local governments.

Country-specific and historical factors such as inherited legal systems, demographics, geographic constraints, and political and economic forces can shape fiscal arrangements between local and central governments, which may also be a hybrid of the above arrangements. Consequently, inconsistencies in the overall fiscal framework are not uncommon. These may appear in the form of insufficient harmonization of central and urban taxes. Weak incentives for urban revenue generation are also common in intergovernmental transfer programmes, which may undermine urban borrowing even by fiscally capable urban governments.

Experts have argued that there are three criteria that should be followed in assigning urban revenue (Smoke, 2013). First and foremost, there must be a reasonable division of revenue sources between central and urban governments according to a set of generally accepted principles. Second, individual

revenue sources should be designed to follow a set of principles in a consistent way. Third, a revenue system must be effectively implemented on the ground.

Finding the most welfare-enhancing combination of local and central government taxes is a politically difficult balancing act. Even where such a combination is found, central governments must still provide incentives to encourage effective collection of all taxes at the local government level. To do so, some central government fund transfers have been linked to a reform agenda. However, such transfer systems have led to little improvement in own source revenue collection in most cities (UN Habitat, 2015). Frequently, wider political considerations may impact the way local governments are empowered to raise their own revenues (see the case study on Lesotho).

Common revenue sources for local governments in LDCs

In general, revenue mobilization and management is very challenging in LDCs both at the national and local levels due to narrow tax bases and lack of tax collection capacity. Common urban revenue sources in LDCs include user fees and charges, taxes/levies, as well as intergovernmental transfers or tax sharing arrangements, sometimes financed or supplemented by foreign aid.¹² These sources can also be supplemented by investment income, property sales and licenses.

User charges and fees are mostly levied where people pay for the benefits and utilities

12 Many publications on urban finance list borrowing as a source of income. This paper treats borrowing separately. Borrowed money is not income unless the loan or debt is forgiven. For example, a debt/income ratio, an important measurement of financial health, does not make sense if income includes debt.

they receive (for example, water supply, sanitation, energy, and parking spaces, among others). At the same time, local taxes are frequently applied to a range of essential services provided by the local authority (such as, police, ambulance, fire-fighters, and lighting of public spaces, to name just a few). The benefits of such services cannot be directly assigned to individual consumers. Consequently, taxes are more appropriate choices as they target the entire community that stands to benefit from the service.

Taxation at different levels of government

Similar to the overall fiscal arrangements, the appropriate choices of which specific taxes to impose at the local level, how much to charge, and how to structure them depends on a wide range of factors such as the geographic size, level of economic development, demographic composition and population size of the local authority. Across LDCs, there exists a wide array of local taxes at both the national and local levels (see table 3).

Table 3: Taxes assigned to/levied by different levels of selected LDC governments

Country	Tier of government	Tax authority
Burundi	National	Customs duties, VAT, excise duties, PIT, BPT
	Local	Vehicle tax, real estate tax
Mali	National	Customs duties, VAT, excise duties, PIT, BPT
	Local	Regional and local development tax, income tax from local civil servants, property taxes, other taxes
Rwanda	National	Customs duties, VAT, excise duties, PIT, BPT
	Local	Property tax, rental income tax, and trading licenses
Tanzania	National	Customs duties, VAT, excise duties, income tax
	Local	Development levy, property tax, service levy, business license, fee on trade, crop and livestock cess, other fees and user charges
Uganda	National	Customs duties, VAT, excise duties, PIT, BPT
	Local	Rents, rates, royalties, stamp duties, crop and livestock cess, fees on registration and licensing and other fees and taxes that parliament may prescribe (property taxes, license and user charges)
Afghanistan	National	Customs duties, withholding tax, business receipts and CIT, PIT, capital gains tax
	Local	Vehicle registration tax, toll tax, advertisement tax, property tax, road tax

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Country	Tier of government	Tax authority
Bangladesh	National	Customs duties, excise duties, supplementary duties, PIT, CIT, VAT, capital gains tax
	Local	Tolls, lighting rates, conservancy rates, holding tax, vehicle tax, animal tax, marriage tax
Bhutan	National	Customs duties, excise duties, PIT, BIT, CIT, sales tax
	Local	Property taxes, property transfer tax, land taxes, cattle tax, grazing tax, advertisement tax
Cambodia	National	Customs duties, excise duties, VAT, CIT, PIT, stamp duty
	Local	Property taxes, administrative fees (civil registry functions), user fees and charges, land taxes
Lao PDR	National	Customs duties, excise duties, VAT, CIT, PIT, stamp duty
	Local	Property taxes, vehicle taxes, fuel taxes, fees and administrative charges
Myanmar	National	Customs duties, excise duties, CIT, PIT, stamp duty, capital gains tax
	Local	Property taxes, land taxes, development affairs organization fees (public services including water, sewage and trash collection), wheel tax
Nepal	National	Customs duties, excise duties, CIT, VAT, capital gains tax
	Local	Property taxes, municipal business tax, municipal tax on vehicles, local development fee
Timor-Leste	National	Customs duties, excise duties, CIT, PIT, petroleum tax
	Local	NA
Yemen	National	Customs duties, excise duties, PIT, CIT, general sales tax
	Local	Property taxes, municipal business tax, administrative service fees

Sources: Khadka (2015); Urban Management Centre (2010); World Bank (2015); Karim (2013); IMF (2013); IMF (2010); Huda and Hasan (2009); Taliercio (2005); Crowe Horwath International (2015); Dickenson-Jones et al. (2015); Shrestha (2002); Romeo (2015).

Notes: BIT: Business Income Tax. BPT: Business Profit Tax. Cess: a tax introduced in colonial times, often levied on livestock and produce. CIT: Corporate Income Tax. PIT: Personal Income Tax. VAT: Value-Added Tax.

Over the years, many attempts have been undertaken to evaluate the potential and political adequacy of local revenue sources according to a set of key principles (Smoke, 2013). Such principles include the following.

- Revenue adequacy: Is the set of taxes imposed adequately covering urban budgetary needs?
- Revenue buoyancy: Are revenues growing in proportion to the economy and expenditure needs?
- Stability: Is the revenue source stable, since large fluctuations in revenue yields would undermine the ability of urban governments to provide services?
- Correspondence between payments and benefits (including limiting tax exporting): Do taxpayers experience a tangible benefit through the way tax revenues are spent?
- Distortionary impact: Are revenue sources designed to minimize differentiated base assessment and rates, which may lead to distortions of economic decisions made by individuals and firms?
- Autonomy and accountability: Is the revenue source allowing urban governments

the discretion to make independent decisions (creating a link between revenue generation and service delivery)?

- Administrative feasibility: Are revenue sources administratively feasible, that is, not too complex or expensive to implement?
- Political feasibility: Is the revenue source politically feasible, in order to maximize the likelihood of its acceptance by the paying local citizen? Do citizens see value for money, fair treatment, and find its practical implementation acceptable (for example, through small payments over time versus large lump sums)?
- Equity: Does it ensure fair treatment among equals (horizontal) and across different groups?

Finally, it is important that the full set of urban revenues is consistent with the rest of the national fiscal system. That is, local authorities and central governments must coordinate carefully to limit any overlap between local and central taxes. The challenges to implementing these principles in LDCs are outlined in table 4.

Table 4: Challenges to implementing principles for urban taxes in LDCs

Principle	Major challenge
Revenue adequacy	Determining overall revenue adequacy (including intergovernmental transfers), is not simple since functional assignments for local authorities from the central government are often vague, inconsistent and may not be fully adopted at the local level. Where functional assignments are clear and local revenues are deemed inadequate, typical challenges that may lead to low local revenues include low intergovernmental transfers, low functional capacity in tax administration and outdated valuation of the tax base as well as a low overall revenue base due to low per capita income and large informal sectors.

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Principle	Major challenge
Revenue buoyancy	Adequate revenue buoyancy is often elusive due to a lack of administrative capacity to ensure growth of the revenue base (e.g., revaluing and indexing property assessments to ensure a fair and up-to-date property tax rate).
Stability	Revenue stability requires good administration and a strong commitment to enforce collection during more difficult economic times or periods of political pressure, such as during periods leading up to subnational elections.
Correspondence between payments and benefits	The correspondence between payments and benefits can be compromised by differential treatment of taxpayers or sectors in pursuit of policy objectives, as well as poorly developed or enforced assessment and collection and tax exporting, i.e., the ability to shift tax burdens to people who live outside the city.
Local autonomy	Local revenue autonomy varies considerably in LDCs, but it is often limited by the central government. At the same time, subnational governments may fail to take advantage of autonomy that is granted because of capacity constraints. Alternatively, disincentives in the fiscal system or political conditions may undermine the motivation of subnational governments to exercise their revenue powers.
Administrative feasibility	Administrative feasibility may be compromised by pursuing non-revenue raising objectives and/or adopting poorly defined or unduly complex administrative procedures.
Political feasibility	Political feasibility is often difficult to determine and the effective adoption of subnational taxes may be challenging, especially in the poorest countries where citizens are not used to receiving and/or paying for services.
Equity	Equity can be affected, for example, if there is preferential treatment of certain taxpayers or groups due to subnational tax regulations and weak or selective administration.

Sources: Smoke (2013) and Bird (2010).

Challenges in introducing non-tax revenue sources: user charges, fees and licenses

User charges and fees comprise service charges (for example, water, sewerage and parking), administrative fees (building permits, registration) and business license fees. User charges are typically defined per

unit of consumption. They can promote an optimal level of consumption when the price equals the cost of providing an additional unit of the service, which is also referred to as marginal cost pricing. Some have therefore argued that, “(whenever) possible, local public services should be charged for rather than given away” (Bird, 2001). However,

getting prices right is easier said than done where the infrastructure and capacity to set prices, measure usage, and collect fees are heavily constrained and where many users live in abject poverty. Consequently, in a number of LDCs, user charges are frequently set below costs, infrequently revised, and often inefficiently billed.

When setting their tariff structures, local governments typically try to take social justice concerns into consideration and facilitate access to low-income households. Cross-subsidies, where richer segments of the population subsidize access to services for the poor, have shown success in some countries. One popular mechanism for cross-subsidies is a pricing system, whereby the per unit price of consuming a municipal service, such as electricity, increases as more of it is consumed and may even be free up to a designated level. Cross-subsidies are also possible between sectors. For example, cross-subsidies are frequently used to reduce or eliminate user charges for health services, since these tend to have a particularly detrimental effect on the poor (Lagarde and Palmer, 2008). The elimination of user charges for health services has led to significantly higher health system utilization rates. While better access to health care is likely to pay large dividends in the future, including through greater tax revenues, the challenge for local governments is to replenish the lost revenue in the short and medium-term through instruments like sectoral cross-subsidies, additional taxes or donor contributions.

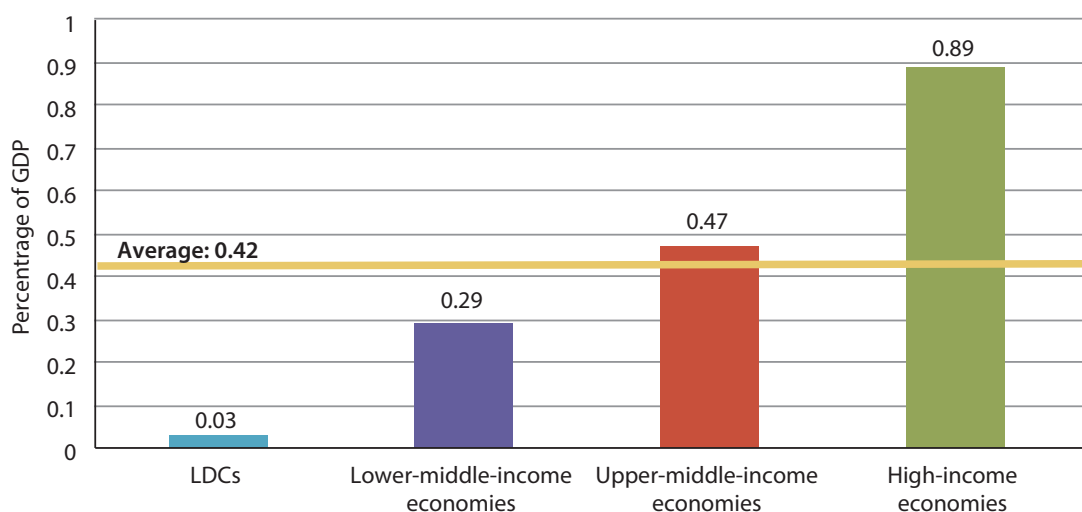
Whereas economic theory suggests that marginal cost pricing is the most efficient pricing method, it works only in perfect market conditions where providers have

complete information on the cost of the product, as well as its opportunity cost. More practical methods include average cost pricing, where expenditures required for providing a service are divided by the number of consumers or the volume sold and average incremental pricing, which calculates how much it would cost to serve an additional consumer based on the average cost price. There are also multipart tariffs, similar to those discussed earlier, which include fixed charges for basic consumption and higher charges for greater consumption and thus effectively cross-subsidizing the consumption of low-income customers. Where a clear pricing strategy is applied, average cost and multi-tariff bundling are more widespread than marginal cost pricing, since these are easier to calculate and administer (Farvacque-Vitkovic and Kopanyi, 2014).

Challenges specific to different tax types: the example of property taxes in LDCs

Although the general challenges outlined above are applicable to almost all revenue mechanisms, there are also specific challenges to different revenue sources. Some of these are particularly pronounced in LDCs. For example, property taxes are generally seen as a promising revenue tool for local governments. The strongest argument in favour of property tax is that it meets the principle of “correspondence between payments and benefits” as its burden is borne by residents in the jurisdiction where the services financed by property taxes are provided. However, despite their promise, the revenue potential of property taxes remains underutilized in LDCs. There are limited data but evidence suggests that the share of property taxes to gross domestic product in

Figure 4.1: Local government property tax revenue as per cent of GDP



Source: IMF Government Finance Statistics Database.

LDCs is significantly lower than that of other country groups (see figure 4.1).

One of the major challenges with levying property taxes in LDCs is the lack of proper titles for residential premises and tax exemptions for low-value properties. For example, it is estimated that less than 10 per cent of land in Africa, where most LDCs are located, is properly documented (Byamugisha, 2013). Moreover, given the lack of suitably qualified staff and resources for local governments in many LDCs, rising land values are not regularly assessed, leading to substantial revenue shortfalls as old property values remain on the books. Consequently, where property taxes are levied, they often do not keep pace with economic development. For this reason, some countries in Africa have not established direct property taxes and instead tax only rental income (Cameroon) or apply a simplified occupancy tax (Burkina

Faso). Property taxes also suffer from broader challenges that affect other types of national taxes such as low nominal tax rates and low collection rates.

Where title registration systems and fiscal cadastres (such as, comprehensive and perpetual inventories that describe and assess the value of landholdings) are not well developed, “street addressing” (that is, giving streets names and/or numbers) is a constructive first step towards determining the tax base and increasing tax revenues. Street addressing allows locating residents and greatly facilitates municipal service provision. It also helps enforce the collection of user fees for water and electrical utilities. The building of fiscal cadastres and street addressing should be seen as complementary practices. Indeed, the reconciling of street indices with fiscal registers can lead to substantial local revenue increases (UN Habitat, 2015).¹³

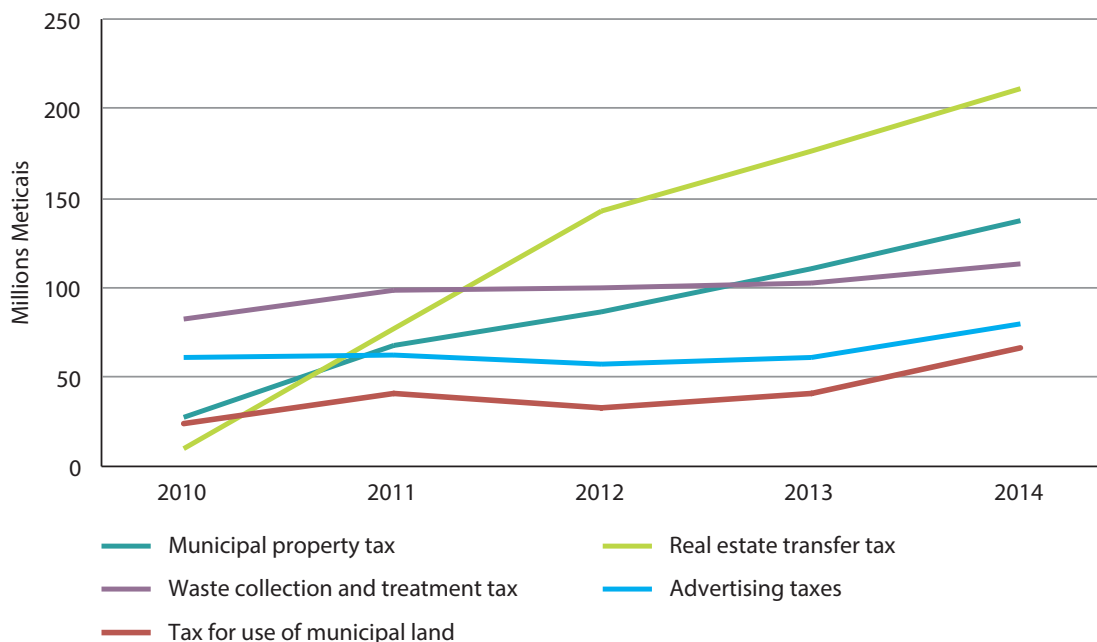
13 In the context of Sub-Saharan Africa, some non-LDCs like Botswana, Namibia and South Africa have well-developed property markets. Their experience could help African LDCs with their property market reforms.

A property tax reform approach that places emphasis on updating the property tax roll through building a fiscal cadastre and improving the accuracy of property valuation is generally referred to as a “valuation-pushed reform.” Such a reform sometimes assumes that non-valuation administrative processes are functional and effective and improving property valuations would bring about a major improvement in property tax revenue (Enid, 2015). Most academic literature, however, favours a “collection-led” to a “valuation-pushed” reform in LDC countries (McCluskey, 2015). It is argued that in these countries non-valuation administrative functions are frequently not fully functional, that is, efforts should be placed on improving collection and ensuring practical enforcement of tax legislation and legal systems rather than on valuation. Yet, over the past decades, reforms in

LDCs have focused primarily on valuation (McCluskey, 2015).

What then, is the right reform sequence? It depends on the local context. Whereas both approaches are essential components of a holistic reform effort, it is important to find the right balance and appropriate sequencing of reforms (see the Lao PDR (1) case study). While valuation-based reforms may make sense in large cities in LDCs, their applicability may be more limited in smaller urban and rural jurisdictions with limited local administrative capacities and no central administrative support. Contrary to the current trend to push new valuation techniques, secondary cities and smaller local authorities in LDCs may therefore think about directing their scarce resources towards “collection-based reform efforts” first, especially where institutional capacities are weak.

Figure 4.2: Tax and fees coverage in the municipality of Maputo (millions Meticais)



Source: Cumbe (2016).

In larger cities, where local governments may prioritize a valuation-pushed reform, it appears prudent to move ad hoc property valuation to standardized full market valuation at a deliberate pace, for example, by gradually phasing in assessment ratios and tying them to announced improvements in service delivery. In addition to high administrative demands, the property tax poses political challenges. Unequal distribution of land and a strong division between the elite and disadvantaged segments of the population in terms of political influence in LDCs also pose implementation challenges. In many cases, influential businesses and taxpayers have exerted their political power to limit their property tax obligations.

Despite these caveats, important progress has been made in some LDCs in the collection of property taxes. For example, the performance of property taxes has improved significantly in recent years in Maputo, Mozambique (figure 4.2 and the Mozambique (2) case study).

Perspectives on land value capture

Urbanization and rapid urban economic growth cause land value appreciation, particularly in critical hotspots throughout a city such as better served locations (for example, transport transit areas) or neighbourhoods in high demand by the rising middle and upper classes. Indeed, the literature has long established a highly positive correlation between land value and infrastructure investment (Zegras, 2003; Ayogu, 2007; Moreno and Lopez-Bazo, 2007; Peterson, 2010; Ingram and Brandt, 2013; Keil, 2013). However, urban infrastructure investment is capital-intensive and upfront construction, operation and maintenance normally require substantial cross-subsidies from other municipal revenue sources. Land taxation and similar charges have the

potential to capture and redistribute part of the associated benefits and cost of infrastructure financing.

Land taxation has certain comparative advantages compared to other forms of taxation.

- Land is an immovable and visible asset that requires comparatively low administrative effort.
- Land is very often the largest asset owned or administered by local authorities and hence it has the potential to broaden the municipal tax base and to generate more sustainable long-term revenues.
- Land taxation is particularly suited to fund local investments as it is mainly borne by local residents.
- Land contains substantive potential to provide public goods and value-sharing.
- Land taxation tends to be progressive and hence can improve equity toward more vulnerable urban populations.

At the same time, land taxation has downsides.

- As a broader caveat, land sales and similar instruments are typically not sustainable revenue tools in the long term, as resources are finite. Consequently, land value capture instruments are particularly unsuitable for financing recurrent (operating) expenditures.
- Land administration is historically weak in LDCs, often due to limited experience and low capacities.
- Land can be an asset administered by multiple agencies and levels of government, hence requiring a level of coordination that is difficult to attain,

particularly when different parties or interest groups are in charge.

- Valuation of land can be done in different ways but requires regular updates and consistent assessment methods.
- Property is considered a natural right by many swathes of the public and there is often resistance to various modalities of land taxation.

Table 5 describes a number of concrete revenue tools that may capture land value (besides the traditional property tax).

Perspectives on local business taxes

A local business tax is another tax commonly levied at the local level. The tax is imposed by the local authority to grant the privilege of engaging in or managing a business. In economic theory, business taxes at the local level are often seen as inefficient mechanisms of own source revenue generation. The argument goes that such taxes may discourage business formation, have adverse effects on growth and investment, and lead to distorted capital allocations. At the same time, urban entities may compete in lowering their

Table 5: Summary of main land value capture instruments and related requirements

Type of instrument	Description	Modality	Key requirements
Recurring land and building value taxes	Recurring tax based on an estimate of the value of land or building	<ul style="list-style-type: none"> ■ Assessed annually ■ Can be collected in instalments ■ Levied on either the land-owner or the occupant 	<ul style="list-style-type: none"> ■ Functioning land administration and up-to-date cadastre
Sale of public land	Payment received in exchange for freehold title of public land	<ul style="list-style-type: none"> ■ Collected once from the buyer 	<ul style="list-style-type: none"> ■ Technical competence of municipality in land valuation
Lease	Payment received in exchange for right to occupy and use public land	<ul style="list-style-type: none"> ■ Permitted land use is specified ■ Normally up to 99 years ■ Assessed and collected once or on recurring basis depending on the contract specifications ■ Levied on the lessee 	<ul style="list-style-type: none"> ■ Good inventory of assets ■ Good monitoring capacity of the municipality
Betterment levies	Charges levied on specific infrastructure improvements	<ul style="list-style-type: none"> ■ One-time collection ■ Levied on landholders whose property benefits from the improvements 	<ul style="list-style-type: none"> ■ Functioning land administration and assessment system

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Type of instrument	Description	Modality	Key requirements
Impact fees/ developer exactions	Charges levied on development approval	<ul style="list-style-type: none">■ One-time collection as project is implemented■ Imposed on land developers	<ul style="list-style-type: none">■ An appropriate legal and institutional environment with clear divisions of roles and responsibilities between different layers of government, clear eminent domain rules, and speedy and effective dispute resolution mechanisms■ Effective and transparent land value assessment system■ Effective and transparent tax administration■ Administrative and planning capacity of the municipality■ Capacity of the municipality to sell development rights and monitor LVC-based contracts.
Land value increment tax	Tax assessed as a share of the increase in land value due to public investment, land use planning decisions, or general market trends	<ul style="list-style-type: none">■ One-time collection on the original title holder or the new title holder, if the property is being sold	<ul style="list-style-type: none">■ Strong planning capacity and capacity to value land■ Strong investment execution capacity
Sale of development rights	Payments received in exchange for permission to develop at higher density or changed land use	<ul style="list-style-type: none">■ Rights can either be sold at auction or at fixed price■ Rights may be transferable to other locations or resold■ Collected once from the development rights user	<ul style="list-style-type: none">■ An appropriate legal and institutional environment with clear divisions of roles and responsibilities between different layers of government, clear eminent domain rules, and speedy and effective dispute resolution mechanisms

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Type of instrument	Description	Modality	Key requirements
			<ul style="list-style-type: none"> ■ Effective and transparent land value assessment system ■ Effective and transparent and tax administration ■ Administrative and planning capacity of the municipality ■ Capacity of the municipality to sell development rights and monitor LVC-based contracts

Source: Based on Habitat (2016).

business taxes in a “race to the bottom” that erodes the tax base and revenues.

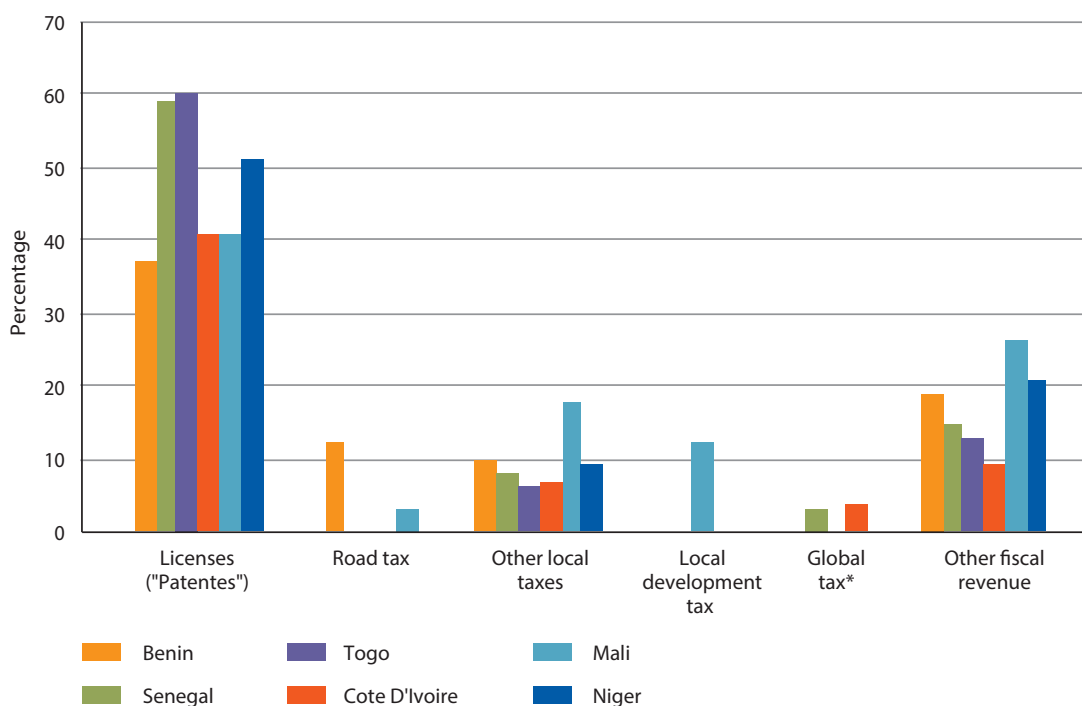
However, there is no solid empirical evidence that business taxes have a negative impact on economic growth, and in practice, many countries, including LDCs impose some sort of business tax, either by central or local governments. Indeed, there are efficiency, equity and political arguments that support the case for a local business tax (Bird, 2006). The efficiency and equity rationale is captured in the principle of benefit taxation. If firms receive identifiable, cost-reducing benefits through public sector services, they should pay for the costs incurred in the provision of such benefits, such as, wear and tear from large trucks on a road or waste disposal expenditures. In this connection, business taxes can be efficient in that they ensure that someone pays for the costs related to providing a particular service. At the same time, they can be equitable and fair in that they ensure that firms pay for a service rendered by local authorities and not just their citizens. In addition, taxing larger domes-

tic and foreign businesses or corporations may make political sense since negative externalities, such as environmental costs, may outweigh positive effects, such as local job creation or skills transfers, as is sometimes the case with extractive industries. Local business taxes are also easier to administer and more elastic than property taxes, that is, their rates can be set more flexibly and do not depend on continuous market updates of the tax base. If carefully implemented, business taxes therefore hold significant revenue potential for local authorities.

Examples of popular local revenue sources in LDCs

In many LDCs, business taxes are widely used. In West African LDCs, the “patente,” a differentiated set of fixed tax rates that is based on size of premises, type of business, and number of employees, has made up for a sizable share of local revenues (figure 4.3). In East Africa, Tanzania levies a local business tax named “City Service Levy” at a fixed percentage on a firm’s

Figure 4.3: Composition of local tax revenue in West African LDCs (averages, 1995-2008)



Source: IMF Government Finance Statistics.

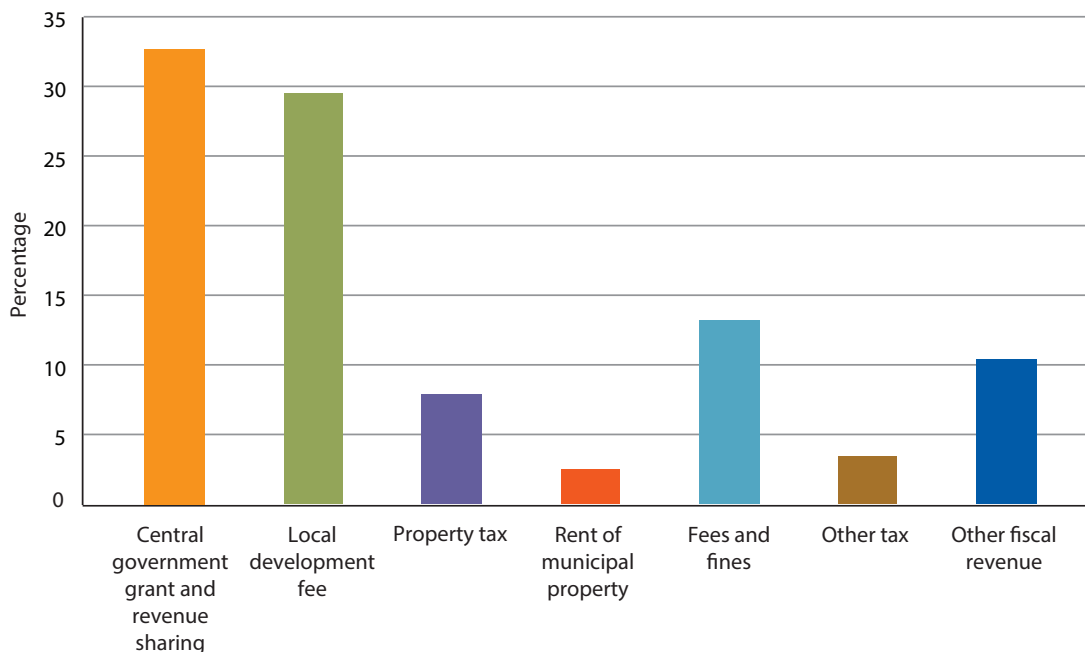
* The global tax (impôt synthétique) is levied on small businesses and combines taxes on commercial and industrial profits, business licenses and value-added tax.

turnover. In the rest of Anglophone Africa, local business licensing generates between 5 and 30 per cent of local government own revenues in urban councils (Fjeldstad and Heggstad, 2012). More research is needed on how local business taxes should be imposed, structured and administered in order to maximize their revenue potential and effectiveness. Such research must also acknowledge that corporate tax evasion remains a major challenge for imposing local business taxes, especially in the case of transnational companies that may apply methods such as transfer or trade mispricing to deceive national and local tax authorities (United Nations Economic Commission for Africa, 2015).

As shown in figure 4.4, one-third of municipal income in Nepal comes from central government grants and revenue sharing. The second largest source of municipal income in Nepal is the Local Development Fee, which is collected by the central government at the rate of 1 per cent on certain imported goods (Lamichhane, 2012).

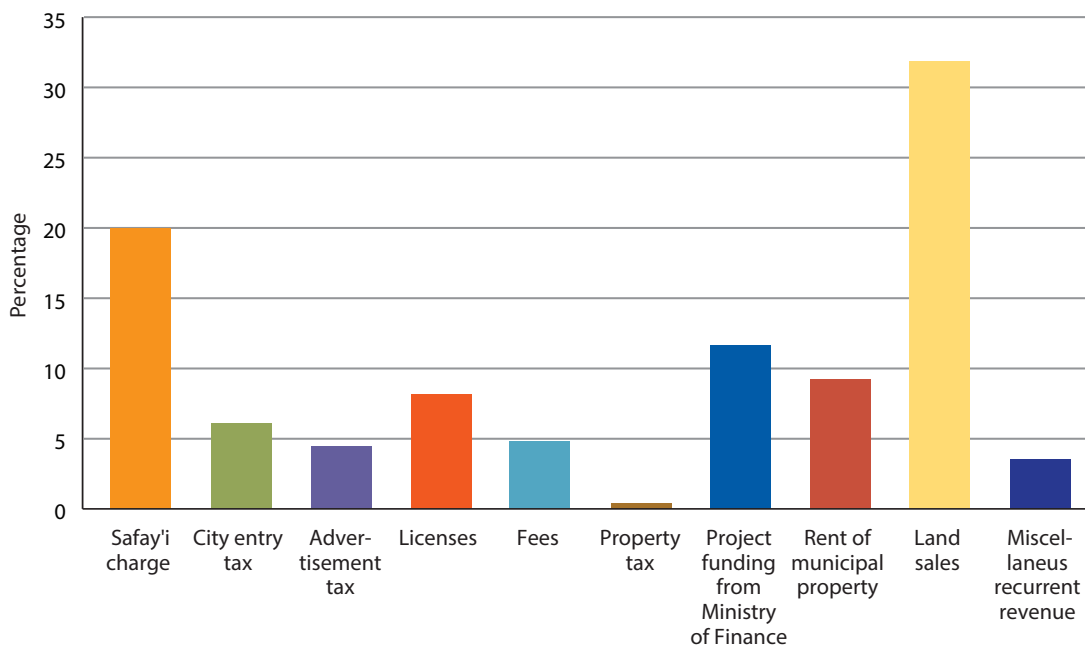
In Afghanistan, many municipalities raise their own revenue by selling locally owned land. As shown in figure 4.6, nearly one-third of local revenue in Kabul comes from land sales. The second largest source of local revenue is the Safay'i tax, a fee collected for each house or business for waste collection

Figure 4.4: Source of income of municipalities in Nepal, 2006/07



Source: Lamichhane (2012).

Figure 4.5: Kabul municipality revenue by source* (averages, 2009-2012)



Source: USAID (2013).

* Licenses include business license and vehicle license fees. Fees include market and parking fees and construction fees.

and management services. The Safay'i tax demonstrated significant revenue potential, particularly when coupled with relevant waste management programmes and improved property databases. When the Afghanistan Subnational Governance Program (ASGP) introduced municipal waste management programmes and Safay'i tax object databases in 30 municipalities in different regions between 2007 and 2010, it resulted in an average increase of 40 per cent in municipal revenues. Central government transfers accounted for an average of 11.7 per cent of Kabul's revenue between 2009 and 2012 through project funding provided by the Ministry of Finance (USAID, 2013).

The "city entry tax" used to be a popular tax applied in every major municipality in Afghanistan. In Kabul, the city entry tax contributed to 6 per cent of total revenue between 2009 and 2012. However, the Afghan government expressed concerns that the city entry tax hindered the development of commerce and presented a potential source of corruption. Thus, the tax was briefly abolished in November 2012, but reintroduced in February 2013 (USAID, 2013). Ideas on converting the city entry tax into a municipal road toll are still under consideration. Supplementary revenue sources include licenses, property taxes and other fees.

Tax sharing

Due to the limited administrative capacity of cities to collect taxes and small tax bases, the central government frequently shares a small percentage of taxes with local governments in the form of "tax sharing". Tax sharing faces its own particular challenges, especially in LDCs, where the central government may suffer from a lack of administrative capacity and face a very large informal sector that is hard to

tax. Moreover, for certain taxes like the value-added tax, data on the level of consumption by local jurisdiction may not be reliable, making fair and equitable revenue division more challenging than with other taxes. As a result, both the type and the amount of taxes that are shared vary widely from country to country.

Surcharges

Surcharges are a hybrid between a tax-sharing arrangement and a local tax. They can be understood as a form of urban "piggybacking" on national or regional taxes, like income taxes. In the case of local surcharges, a higher level of government defines the tax base, collects both the tax and the surcharge and remits the surcharge revenue to the local government. While the national government collects the tax, surcharges are set and spent by local governments.

This approach has its merits, since it avoids the problems that occur when urban jurisdictions define their tax base in conflicting ways, use different apportionment formulas, and/or administer the tax in different ways. For example, two local authorities may try to impose taxes on the same company since there are different opinions as to where and in which urban jurisdiction the firm operates. In such cases, it is more practical for higher government levels to define the tax base and forward a share of the revenues to the local authorities. However, surcharges are not a substitute but rather a complement to intergovernmental transfers, since they do not provide for vertical or horizontal redistribution among urban jurisdictions. Looking ahead, more data and research is needed on how and to what extent local surcharges are used effectively in LDCs.

Box 4: Lessons learned from UNCDF efforts to improve local revenue collection in West African LDCs

In order to strengthen the self-management capacities of local authorities, especially in rural areas, the United Nations Capital Development Fund (UNCDF) developed the Local Authorities Financial and Institutional Analysis System (LAFIAS). The system was first introduced in three West African countries, Guinea, Mali and Benin. The initial experience with the programme highlights the strong effect of improved public financial management on revenue raising capacity. The following recommendations on own source revenue generation are highlighted in the report:

1. A minimum level of organization and capacity of local authorities (own services and personnel) is essential for local development.
2. A minimum level of information on the potential resources in their territorial jurisdictions is important for local authorities to play a more important role in mobilizing own source revenues.
3. Local tax systems in West African LDCs—Mali is a prime example—include many rural taxes that are difficult to mobilize and that yield low revenue in the urban context, while the largest potential resource—urban property—remains largely untapped. In addition, a simplification of the tax code and flat-rate taxation could be explored to further strengthen revenue collection.
4. Quality beats quantity. It is important that levies/taxes not be too numerous and dispersed to avoid high transaction costs.
5. Great resource potential lies in market activities and facilities (markets, terminals and other income-generating infrastructures). Proper management of these facilities will allow the authorities to diversify and considerably improve their resources.
6. The existence of economic infrastructure is a determining factor in resource potential and consequently, the revenue of local authorities. For example, a lack of economic infrastructure explains the challenges of the Socoura commune, which has the largest population in the standard communes in Mali, but has the lowest level of local revenue.
7. The LAFIAS analyses showed the limitations of true economic development within the rural areas under the jurisdiction of local authorities. Creating inter-community cooperation between local authorities based on “development hubs” or “local cooperation territories” can help take advantage of the socio-cultural, geographical, historical and economic opportunities that two or more local authorities can share.
8. Finally, investment per se cannot stimulate improvement in local finances; it must be supplemented by taxation support measures, but also communal management and local governance.

Source: UNCDF (2012).

The rationale for central government (intergovernmental) transfers

There are no urban governments in the world, let alone in LDCs, that can fully function without a certain level of financial support from the central government. As discussed in the first chapter, finance often does not follow function, that is, fiscal decentralization has not advanced at the same pace as its administrative and political counterparts. Consequently, central governments across the globe frequently give local authorities more expenditure responsibilities than they can fund from their own revenue sources. Significant differences in the level of dependency from the central governments can be observed between developed and developing countries. Generally, a greater capacity to generate revenues make urban governments in developed countries less dependent on support from higher tiers of governments than those in developing countries. Resource flows from higher to lower tiers of governments average 70 to 72 per cent of local government funding in developing countries and 38 to 39 per cent in developed countries (Alam, 2014). Central government support can be provided through a variety of mechanisms, from tax sharing to surcharges to more simple resource transfers from central to local governments.

The traditional rationale for direct central government (intergovernmental) transfers is the idea that a welfare maximizing government should reallocate resources between richer and poorer local jurisdictions in order to reduce both horizontal (same tiers of government) and vertical (different tiers of government) imbalances, and correct for externalities. However, the actual drivers for intergovernmental transfers can vary. Public finance literature explores factors

that are shaped by equity and efficiency considerations such as the correction for vertical and horizontal imbalances. Public choice theory highlights how transfers can become tools for political influence. Frequently, electoral concerns determine the distribution of fiscal resources to local jurisdictions (Boex and Martinez-Vazquez, 2005). Political economy research focuses on how intergovernmental transfers are shaped by political influence through the impact and bargaining power of political interest groups. There is robust empirical evidence that local governments with higher political representation per capita benefit from greater intergovernmental transfers (Caldeira, 2011).

The impact of intergovernmental transfers on local revenue generation remains under debate. Some have argued that large unconditional intergovernmental grants lead to lump-sum tax reductions or lower the incentives for local governments to collect fees and taxes, thus “crowding out” own source revenue mobilization. Others argue that most fiscal transfers are spent on the provision of public goods and services, increasing local economic development and tax compliance, and consequently, “crowd in” local tax revenues. Studies that highlight the crowding out effect mostly focus on more developed countries with relatively well-developed fiscal systems and significant own source revenue generation (Kalb, 2010; Zhuravskaya, 2000).

However, such capacity is highly constrained in most LDCs. In cases where local capacity to generate own source revenue is weak, intergovernmental transfers are a crucial lifeline and may further crowd in local revenue generation. For example, evidence suggests that in Tanzania, a 1 per cent increase in

intergovernmental transfers leads to an extra 0.3-0.6 per cent increase in own source revenue generation for local government authorities (Masaki, 2015). Moreover, intergovernmental transfers are often the only regular source of local revenue, because of political interference in own source revenue generation. Local governments are frequently dependent on central government approval for taxes, fees and charges they wish to impose. In certain cases, local governments may wait for years or even decades to get such approvals (see the case study on Lesotho).

Intergovernmental transfers versus own source revenue generation

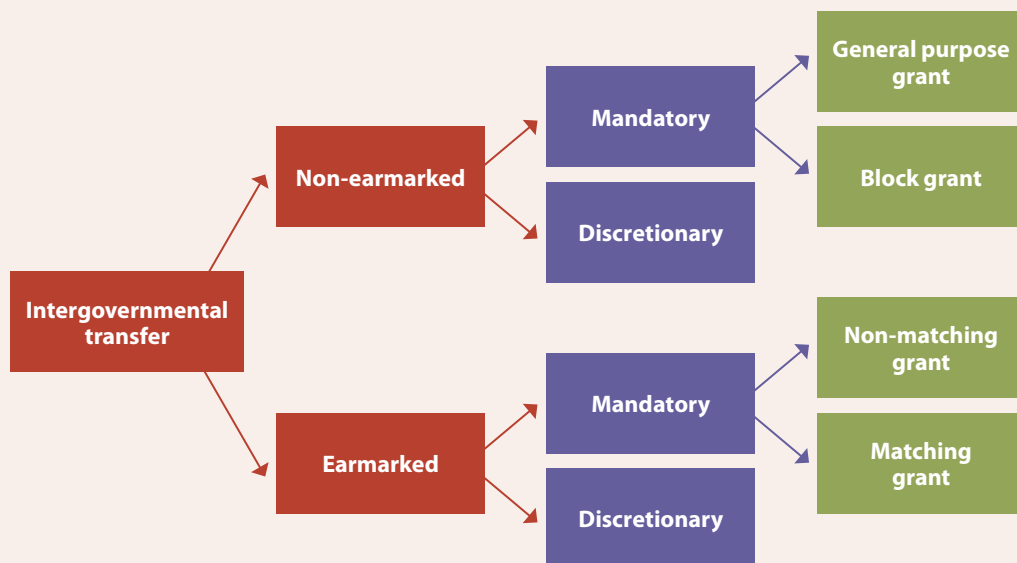
Intergovernmental transfers make sense as part of a smart division of responsibilities between the central and local government based on their core advantages and competencies. As argued by Smoke (2015a), “central governments have inherent advantages in generating revenues and local and regional governments have inherent advantages in providing certain key services, invariably necessitating intergovernmental transfers.” At the same time, local authorities must be able to raise an adequate share of the resources to (i) reduce demands on central budgets, (ii) create a fiscal linkage between benefits of local services and the costs of providing them, and (iii) help repay loans on long-term capital investments (Smoke, 2015). Regarding the last point—the repayment of long-term loans—intergovernmental transfers can, of course, also play a catalytic role. Reliable and predictable intergovernmental transfer arrangements will help assuage investor concerns over possible defaults as much as strengthened revenue generation. However, design matters a great deal. Although intergovernmental transfers can help leverage long-term investment, they

can also provide a disincentive for raising private capital, as elaborated in the next chapter. Moreover, the design of intergovernmental transfer systems in general needs a periodic overhaul and review due to the tendency to evolve, integrate additional functions, and thus, become more complex. For example, Uganda’s Local Government Finance Commission noted in its 2013 local government financing study that the low levels of financing under the unconditional grant and the equalization grant led to less discretionary funding for local government. This, coupled with the fall in local revenues, undermined the operational efficiency of local governments, their ability to supervise service programmes and to maintain infrastructure stock. As a result, the focus has been more on minor repairs leading to a backlog of rehabilitation and reconstruction, which was partly the cause for the slowdown of large public infrastructure investments such as bridges, boreholes and roads. Studies have also attributed the increase in central government transfers as a factor contributing to the declining trend in locally generated revenues by reducing the incentive for local government to collect taxes, creating a culture of dependency on central government. As a result, Uganda is taking action: the intergovernmental transfer system introduced in 2016 consolidated 36 previously operational conditional grants into 11 grants. It reduces the number of discretionary grants to two (one rural and one urban discretionary development equalization grant) and introduces one set of rules and processes for managing all development grants.

Types and design of intergovernmental transfers

Intergovernmental transfers can be broadly classified into general purpose (also called “unconditional”) transfers and

Box 5: Typology of intergovernmental transfers



Source: Bergvall, 2006.

The figure above shows that grants can be either earmarked or non-earmarked. Earmarked transfers can only be used for a specific purpose determined by the central government, while non-earmarked grants can be spent in line with locally determined priorities. Both earmarked and non-earmarked grants can be either mandatory or discretionary. Mandatory transfers represent legal obligations for the central government. Where transfers are mandatory, local governments can appeal to a judicial authority in case the central government fails to deliver. Discretionary grants are not legal obligations and may therefore vary widely in terms of size and conditions, since these will be determined in an ad hoc fashion. They are often temporary and may be tied to specific projects or emergency outlays, for example in the case of natural disasters.

Non-earmarked, mandatory transfers can be general purpose or block grants, with the main difference being that block grants are usually tied to a minimum standard of service delivery or results framework, with the explicit aim of improving efficiency in the use of resources at the local level. General purpose grants can be utilized to fund any local activity.

Finally, earmarked mandatory grants can be matching or non-matching. Matching grants complement local expenditures or local revenue collections that are tied to concrete local services. All mandatory earmarked transfers that are not given complementarily to local contributions are considered non-matching

specific purpose (also called “conditional” or “earmarked”) transfers. The source of the transfers is usually the general budget of the central government or a share of taxes collected by the central government. Box 5 explains the different forms of intergovernmental transfers to local governments.

Common challenges for intergovernmental transfer systems in LDCs

Most central government transfers in LDCs are of a mandatory nature, that is, they represent the obligations of the central government. However, in most LDCs, central government transfers, whether obligatory or not, remain insufficient in size to meet local needs that are not covered through own source revenues. Several LDCs, especially in Africa, have even seen reductions over time. There are other common challenges intergovernmental transfer systems in LDCs are facing, independent of their typology. In addition to their low volume, transfers are often not focused on the neediest local governments, perpetuating horizontal fiscal imbalances. Also, central government transfers are frequently unpredictable making financial planning, especially for long-term investments, difficult. More generally, and quite similar to PFM reform challenges, it is hard to find the right balance between sufficient local autonomy and ensuring oversight, accountability and proper incentives for better results when designing transfer systems. Incentives to improve local service delivery may also decrease when parallel systems are in place, especially where those systems are not tied to concrete efforts to build capacity at the local government level.

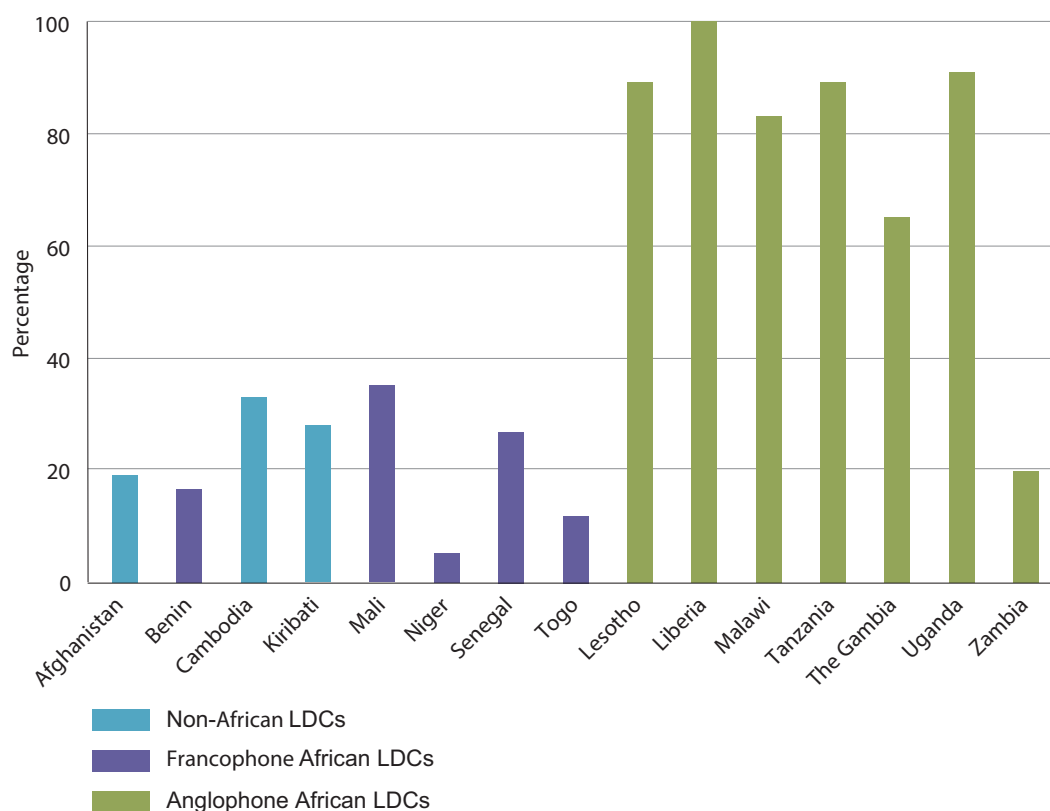
Based on these trends and experiences, experts and practitioners commonly agree on overarching principles that should be met when designing intergovernmental transfer systems, such as the importance of the following.

- Keeping the objectives of transfers clear and transparent
- Using transparent formulas instead of ad hoc/arbitrary criteria
- Addressing disparities in fiscal capacity and expenditure needs across local governments
- Supporting prudent revenue mobilization and budget execution and providing strong incentives to improve performance
- Ensuring a limited number of harmonized transfer systems and avoiding conflicting modalities of transfers
- Promoting a needs-based allocation of transfers
- Enabling local flexibility within national policy
- Ensuring timeliness and predictability by linking transfers to local budget processes
- Adjusting the size of transfers in line with changing local needs
- Keeping systems simple, understandable and administratively feasible

The scope of intergovernmental transfers in LDCs

For most LDCs, it does not seem to matter whether the major source of urban income

Figure 4.6: Intergovernmental transfers in per cent of total local revenues in selected LDCs



Source: IMF Government Finance Statistics Database.

comes from intergovernmental transfers or local taxes—local revenue remains grossly inadequate. Figure 4.6 illustrates the widely divergent sizes of intergovernmental transfers in LDCs, in particular in Francophone and Anglophone Africa. Most Anglophone LDCs receive the majority of their income through direct intergovernmental transfers. However, a review of several LDCs, including Francophone LDCs, reveals that the ratios of total local resources to total public resources are some of the lowest in the world (IMF, 2015b). Although striking at first glance, such numbers reveal more about data constraints and the complexities of measuring central government support than local financial

autonomy. For example, whereas it is true that Francophone countries tend to rely more on local taxes, such local taxes do not represent true “own-source revenue generation.” They are more similar to central government transfers or tax sharing agreements, since these taxes are mostly set, collected and disbursed by the central government; thus, they are not “true” local taxes. Aside from data constraints, the low levels of transfers may also be, at least partially, the result of sectoral policies and central government investments that may have local dimensions but provide little resources for local authorities, thus limiting the local authorities’ resources and functions (UCLG, 2009).

Although LDC fiscal arrangements may differ, the practical challenges they face are similar. In countries with low direct central government support, local revenue generation does not fill the resource gap. For example, in the case of Senegal, revenues at the local government level have increased in recent years but remain at a mere 6 per cent of central tax revenues. As a result, local resources are insufficient to provide local basic public services. Moreover, horizontal fiscal imbalances have become a problem. The resources of the ten poorest communes represent 1 per cent of the resources of the five richest ones (Caldeira, 2011).¹⁴ In Mali, local taxes generate insufficient revenue and they include a wide range of obsolete taxes that are particularly difficult to collect.

LDCs with extremely large shares of intergovernmental transfers like The Gambia, Lesotho, Uganda and Tanzania, on the other hand, also continue to struggle to meet their expenditure needs. Succinctly speaking, the fact that LDCs with widely different fiscal arrangements continue to face similar development challenges at the local government levels suggests that design alone cannot fix the local finance challenge.

Reducing intergovernmental transfers does not make sense where own source revenue generation cannot fill the gap or vice versa. Mobilizing additional revenue must therefore remain the key objective, both at the national and local levels. This lesson applies as much to national governments as it does to the international community. International financial institutions, especially those that focus more on overall macroeconomic

stability than development, have frequently put pressure on LDCs to reduce intergovernmental transfers in an effort to reduce central government deficits. Such a recommendation must be weighed carefully against the adverse effects of lower transfers on access and quality of basic services, especially where the capacity for own source revenue generation is low.

Experiences with performance-based transfers in LDCs

UNCDF pioneered the introduction of performance-based transfers (captured as non-earmarked, discretionary block grants in box 6) in LDCs in the 1990s and these remain important instruments, both in national intergovernmental transfer systems (Bangladesh, Uganda) and internationally (for example, World Bank projects in support of urban development in East Africa—Ethiopia, Tanzania, Uganda—integrate a performance component in the grant allocation formula). The experience has demonstrated the importance of performance-based grants particularly in the early stages of fiscal decentralization or in the introduction of a programme to induce the desired changes in the performance of urban and higher-level local governments and improve their compliance with the relevant legal and regulatory provisions. However, in some cases performance-based grant systems have demonstrated diminishing marginal returns over time, thus underlining the need for periodic revision to reflect and integrate new requirements. In more general terms, it is important to review and update intergovernmental transfer systems to ensure they remain relevant and effective over time.

14 Senegal is divided into eleven regions (régions), which are subdivided into 67 communes and 43 communes d'arrondissements, which are further divided into 320 communautés rurales (Caldeira, 2011).

KEY MESSAGES

- Local revenues in LDCs are insufficient to meet urban development needs. In terms of own source revenue mobilization, important progress has been made where revenue mechanisms embrace a set of key principles, including revenue adequacy, buoyancy, stability, correspondence between payments and benefits, reduced distortionary impact, autonomy and accountability, as well as administrative and political feasibility and equity.
- Improved registration processes, the building of fiscal cadastres, automation and utilization of information technology systems, including online payment options, are helpful mechanisms to increase compliance with tax laws and to promote greater willingness to pay local taxes.
- Intergovernmental transfers are essential for local governments. They are a part of the division of responsibilities between the central and local government based on their core advantages and competencies. Central governments have inherent advantages in generating revenues and local and regional governments have inherent advantages in providing certain key services, invariably necessitating intergovernmental transfers.
- If properly designed, intergovernmental transfers can provide incentives for own source revenue mobilization and increase flexibility in intergovernmental relations. There are certain overarching principles that should be met when designing intergovernmental transfer systems related to the timeliness, adequacy, predictability, underlying incentive structure and modalities of transfers.

CASE STUDIES

MOZAMBIQUE (2): STRENGTHENING PROPERTY TAXATION IN BEIRA AND MAPUTO

The municipal property tax (Imposto Predial Autárquico—IPRA) in both Maputo and Beira is levied on the resale value of an urban building that is regarded as infrastructure and built on the municipality’s urban land. To improve the performance of IPRA, the cities had to overcome a wide range of challenges. The territorial areas covered by local offices responsible for property registration often did not match the jurisdiction of its local councils.

POLICY LESSON:

Successful property taxation requires political leadership and commitment that ensures comprehensive reform efforts. Reforms should include institutional measures (better title registration systems and fiscal cadastres), functional improvements (improving local administrative capacities and enhancing communication between local and national tax authorities), as well as educational measures to improve the willingness of citizens to pay.

Moreover, some local councils did not even have a property registration office where transactions could be recorded. In other cases, both the local branch of the national tax authority and a local tax authority collected the IPRA. Through well-sequenced and comprehensive reform efforts, both cities have overcome many of these challenges. In particular, efforts were made to ensure better communication and coordination between the local and national tax authorities to avoid double taxation



and to ensure property registration that corresponds to local jurisdictions.

These reforms also contributed to the successful introduction of a new real estate transfer tax known as “ISISA” (Imposto Autárquico de Sisa). ISISA collection was devolved to the local government level less than 10 years ago. It is levied on the transfer of ownership of urban property in a municipal territorial area. While not a property tax per se, ISISA relies on many of the same prerequisites that are necessary for successful property taxation, including reliable property registration. Overall, clear



tax policies, better coordination among stakeholders and greater investment into the country's fiscal registry system, led to significant increases in revenues from IPRA and ISISA. As a result, both revenue sources make up a growing contribution to municipal tax revenues both in Beira and Maputo.

- Beira pioneered the reform of property taxation in Mozambique. Indeed, it was the first city to which ISISA was fully devolved. Driven by a proactive mayor, Beira pioneered specific measures geared towards:
 - Improving information sharing among relevant stakeholders of property taxation such as the Registry office, the national and local tax offices of Beira
 - Monitoring the transactions market and property values
 - Requiring tax collectors to carry official receipt books rather than their own personal logbooks for easier tracking
 - Introducing stamped receipts for each taxpayer to more effectively track how much tax each collector had received from the public
 - Promoting tax education and literacy by advertising taxes in newspapers and on television to educate business-people on specifics about how and when to pay taxes
 - Soliciting financial support from donor agencies and multilateral institutions.

LAO PDR (1): LAND TITLING AS A ROAD TO BETTER PROPERTY TAXATION

In 1996, the national government of Laos, with donor support, began a land titling project to provide a system of clear and enforceable land-use ownership rights and develop a land valuation capacity. The project also supported national and provincial governments in systematic land registration through mapping, computerization of land records, development of a land registration system and extensive training of government officials in the process

POLICY LESSON:

Land titling should be introduced in the context of broader policy and regulatory reforms if it is to have a sustained impact on local revenues.

of land titling. It originally covered the Vientiane capital as well as urban and semi-urban areas in four provinces. Four additional provinces were subsequently added. A second project, also with donor support,

built upon the original efforts by further developing land policy and the regulatory framework, educating government officials, instituting a land registration system, and accelerating land titling through systematic registration. It also broadened the scope to all provinces in the country.

The first project resulted in the Law on Land of 1997, which formally established regulations for land registration and administration. It also led to the registration of roughly 190,000 parcels of land, though this fell short of the original goal of 300,000. Efforts were hampered by initial shortages of government staff, technical issues, and lack of government



funks. The nominal figures found in the World Bank Implementation Completion and Results Report (ICR) suggested there was a large increase in government revenue from land taxes and land-related fees between fiscal years 1995/1996 and 2004/2005; however, high inflation in Laos over the same period resulted in a real gain in revenue of only 1.6 per cent over the nine-year period. Land-based revenue shrank from 0.2 per cent to 0.14 per cent of gross domestic product at the end of the period. The second project exceeded projections and led to the titling of approximately 382,000 parcels of land. It also coincided with an 86 per cent rise in real land-related government revenue (FY



2002/2003—2008/2009); however, the rise was related primarily to increases in land value unrelated to titling, and the project design did not collect sufficient data to discern how much of an impact land titling had on government revenue. Indeed according to the data, anywhere between 4 and 60 per cent of the revenue stayed at the village level. Of this amount, 60 per cent was used to pay the tax collector's salary and 40 per cent to cover administrative expenditures. At the district level, the money was used mainly to pay for recurrent expenditures, including salary and operational costs. A key challenge identified in World Bank evaluation reports was the wide range of registration fees both between and within provinces, and the fact that they were not always clearly stated. Another issue was that the projects were donor-dependent throughout their implementation.

A number of policy lessons emerge from this example. For a land titling project to successfully impact government revenues from

land and property, governments, from the local to national levels, must first respect the integrity of land rights, use eminent domain rationally and responsibly, and have clear legal and regulatory systems in place to promptly settle disputes. Additionally, a government must commit to a long-term programme of land administration and set up a transparent and well-funded body to ensure a sustainable impact. Fees and taxes should be clear and uniform, and all concerned levels of government should be mindful of administrative costs and have a plan to translate enhanced revenues into better service and infrastructure delivery. Lastly, in order to judge the impact of a land titling project, land values alone will not suffice; rather, a baseline survey, comparisons between titled and untitled land, and data on the number of registered land transactions are necessary to determine whether and how much titling matters.

Complementary source: World Bank (2006; 2010a; 2010b; 2016a; 2016c).

MOZAMBIQUE (3): FACILITATING INTERGOVERNMENTAL TRANSFERS THROUGH THE IMPLEMENTATION OF A TREASURY SINGLE ACCOUNT

Over the past 18 years, Mozambique has embarked on a country-wide effort towards municipalisation in order to bring the decision-making process for many government functions closer to the people affected. When Mozambique began the process in 1998, 33 municipalities were established. This rose to 53 municipalities by 2013. In Mozambique, municipalities are locally elected bodies that govern their electorate directly. Responsibilities

POLICY LESSON:

Unifying public revenue and expenditure data through an electronic system allows central government officials to better track where money is sent and makes national-level legislators and officials more comfortable with the idea of increasing government transfers to the local level.

generally include areas such as service infrastructure, public parks, public hospitals, and local roads. Mozambique has also strengthened and expanded its use of districts governments, which are appointed by the central government and are responsible for implementing national policies at a more localized level.

One of the main issues for Mozambique's municipalities since decentralization has been finding a way to match new revenue to new responsibilities. Under current law, municipalities are expected to make own source revenue two-thirds of their total revenue, but revenue generation remains a challenge due to the lack of human, material and financial resources, which result in difficulties with tax administration. The



consequence of this is a lack of funds and implementation capacity for basic services including water, sanitation, electricity, roads, and housing; 45.5 per cent of urban residents lack access to electricity, and 57.6 per cent lack access to improved sanitation.

The national government's response has been to put into place enhanced systems of government transfers and accountability. It has established the Municipal Compensation Fund, which is a provision in the national budget that designates a minimum of 1.5 per cent of fiscal revenue for non-conditional use by cities, as well as the Investment Fund for



Municipal Initiative, which designates another 0.75 per cent of national fiscal revenue for conditional use, considering municipalities' infrastructural needs and justifications for funding requests. Taking into account the dual and gradual approach of the decentralization policy, one of the main drivers behind the central government's push for fiscal decentralization has been the implementation of a treasury single account known as e-SISTAFE, a unified electronic system that tracks the allocation, management, and spending of government funds across all levels, from the Ministry of Economy and Finance down to district governments. In 2007, the legislation authorizing the development of e-SISTAFE was implemented by all ministries at the central and local levels, as well as 31 districts that possessed the necessary infrastructure. This number increased to 50 districts out of 128 in 2008.

E-SISTAFE allows officials to better track where money is sent, helps budgets better align with regulations, and makes ministries at the central and local levels more accountable for the money they receive. This has helped make national-level legislators and officials more comfortable with the idea of increasing government transfers to the districts. State-to-local government transfers went up from \$23.4 million (1.17 billion Meticaís) in 2010 to \$60 million (3.13 billion Meticaís) in 2015. Moreover, the transparency e-SISTAFE provides has increased the willingness of international donor agencies to provide general budget support to Mozambique's government, rather than sector-specific or project-specific funding.

Complementary sources: Pattanayak and Fainboim (2010); World Bank (2016c); Dabán and Pesoa (2007).

UGANDA (1): THE ROLE OF GRANTS AND INTER-GOVERNMENTAL TRANSFERS IN A SECOND-TIER CITY

Busia Municipal Council is one of the youngest of Uganda's 22 municipal councils. It is located 200 km east of the Ugandan capital city of Kampala, and its population is about 100,000. The council receives intergovernmental transfers from the central government on a quarterly basis. Conditional transfers target road maintenance, health expenditures, school facilities, and other interest groups. Unconditional transfers facilitate council

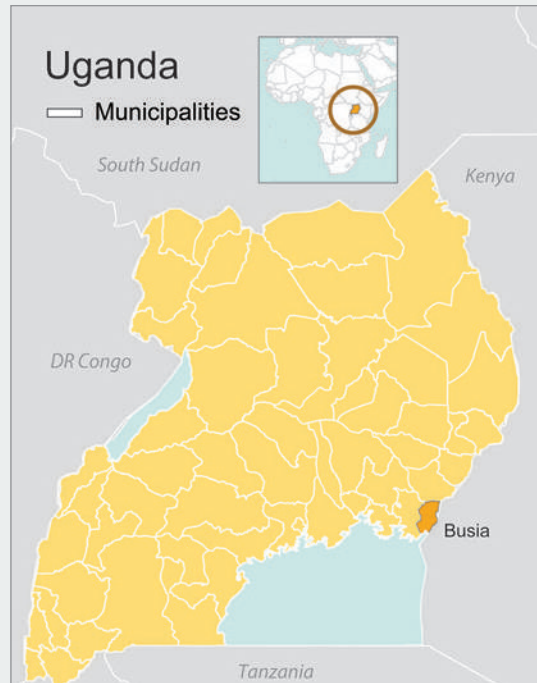
POLICY LESSON:

Intergovernmental transfers and donor support could be more effective if they were less rigid, better timed and designed in line with local needs and priorities.

sittings, garbage management, servicing of equipment and vehicles, and office management. Intergovernmental transfers are complemented by own source revenues that come from trading licenses,

tendered out revenue sources of markets and transport terminals, property taxes, local service taxes, hotel taxes, land registration tax, and building plan approval fees. The Council also receives limited direct donor support for youth development and traditional city functions like garbage disposal.

As a recipient of intergovernmental transfers and donor assistance, Busia has encountered a variety of challenges. First and foremost, conditional intergovernmental transfers, which constitute about 85 per cent of all local funds, and only cover a small portion of the funds needed for wages and salaries as well



as service deliveries, which are particularly underfunded. Second, transfers are too rigid as they do not allow municipalities to reallocate funds to new and emerging local priorities. Only if the Council gets permission from specific line ministries can funds be reallocated for new purposes and such permission involves a lengthy bureaucratic process. Another challenge is represented by the delayed release of the funds. Frequently, transfers are only received one month before the close of the financial year, and as a result, a significant portion is returned. As regards donor funds, most donor project support lacks local government involvement at the design stage which can lead to project failure and abandonment later. Moreover, there is also a tendency to impose projects



on local authorities that are not necessarily perceived as top priorities. To overcome these challenges, the Council has recommended the following actions to the Ugandan Government and interested donors: conditional grants should be flexible and allowed to adjust to local priorities and realities, the general

budget allocation for local governments should increase from 12 per cent to 30 per cent of the national budget and funds should be released in a timely fashion, and donors should fully involve all stakeholders at the project design stage.

LESOTHO: LOCAL GOVERNMENTS AND REVENUE GENERATION IN LESOTHO—LEGALLY EMPOWERED BUT POLITICALLY CONSTRAINED

Lesotho is divided into ten districts, which are further subdivided into constituencies that consist of 64 local community councils and 11 urban councils. The prime agencies for collecting local revenues at the district level are community and urban councils. The Lesotho Local Government Act (1997) legally empowers councils to raise own revenues. Such revenues include taxes, rates and charges, licenses and permits,

POLICY LESSON:

Even where municipalities are legally empowered to raise revenues and borrow, political inertia can stand in the way of effective fiscal decentralization.

finances and penalties, property taxes, and other commercial income generated from the sale of district council assets including natural resources. The law provides that “the Minister shall publish in a gazette a list of items from which

councils may collect revenues by way of tax or levy of charge.” However, to date, the Minister of Local Government and Chieftainship has never published such information. Consequently, district councils have had no own source of revenue. The councils only act as collection agents for the central government. If a new source of revenue is identified, the local authority is obliged to notify the central government, which will provide guidance on rates and application. The role of the councils is limited to recording and reporting revenue receipts and to remitting local revenues to



the central government. According to local authorities in Lesotho, the lack of power and autonomy over sources of revenues has significantly limited their incentive to maximize revenue collection. With support from UNCDF, UNDP, the European Union and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), the government formulated and passed a new decentralization policy in February 2014. The policy proposes local fiscal autonomy with zero tolerance for corruption and strict adherence to laws. Maseru, the capital, serves as a pilot for the new programme. Five line ministries, including health, social development, forestry, local government and energy have gazetted functions for



devolution to the local government level under the Local Government Regulations from 2015. Political commitment from the

central government will be critical to include other ministries and expand the policy to other districts.

Chapter 5

LONG-TERM FINANCE FOR CAPITAL INVESTMENTS



Urbanization has led to enormous municipal infrastructure financing needs around the globe. Although own source revenue generation and sound public financial management are crucial, they will by themselves not generate sufficient capital for long-term investments by local governments.

Currently, large infrastructure projects in LDCs almost always involve the central government, a non-commercial banking institution like a Municipal Development Fund and/or international donors. This seems to be the case even if the infrastructure in question is clearly of a local nature, such as being concentrated in one municipality or metropolitan area. Even relatively small infrastructure projects often do not involve local governments, either in terms of financing or implementation. For example, in Guinea, 33 municipalities received water infrastructure upgrades in 2012. The investment, a total of \$15.7 million, was

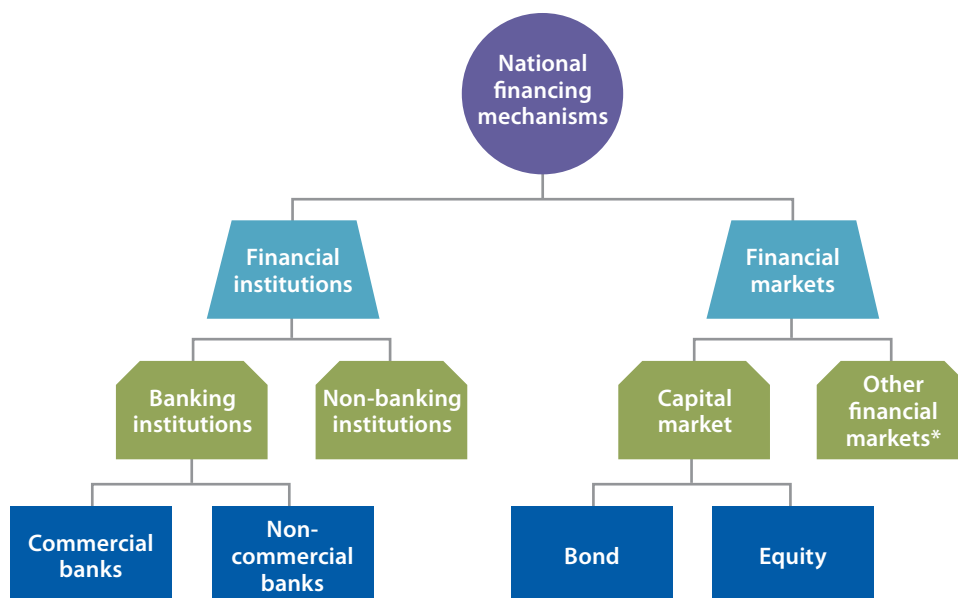
funded by the Islamic Development Bank (IBD) and implemented by the central government. Similarly, a relatively small scale 2016 project without donor involvement to expand piped water access in specific communities in and around Liberia’s capital of Monrovia for \$7 million was approved and will be implemented by the central government.

While these types of financing arrangements are the norm in LDCs and remain important, they are unlikely to be sustainable in the long run as they rely on external support.

The potential for market-based finance

Given the enormous long-term financing needs that are unfolding in an era of rapid urbanization and an ambitious new development agenda, it is therefore time to look beyond existing financing mechanisms and

Figure 5.1: National financing mechanisms



Source: Authors’ elaboration.

* May include money markets, foreign exchange markets, derivatives market and over-the-counter markets (depending on how well-developed the financial sector is).

to explore the potential of new market-based options, albeit at a careful and deliberate pace.

Parts of the domestic financial system, as captured in figure 5.1, may offer additional opportunities for local authorities to leverage their budgetary resources to invest in infrastructure. Specifically, financial institutions and financial markets present two potential avenues for local governments to access credit, namely through bank lending and capital markets. Capital markets, hitherto largely untapped in LDCs at the local government level, are concerned with raising capital for long-term investment—the type of investment needed for local infrastructure improvements. Such capital for long-term finance can be raised in the form of equity and bonds.

Equity finance

Raising finance for project owners by selling equity to private investors can be a complex and expensive task. It essentially requires a municipal company or a special purpose vehicle to sell equity to interested investors. However, such financial infrastructure is rarely in place in developing countries, let alone at the local level in LDCs. As argued by Pozhidaev and Farid (2016), private equity may also be attracted through targeted support mechanisms. For example, in Busia, Uganda, a private entity has committed equity to a new infrastructure project through a project-based partnership arrangement with a municipality facilitated by UNCDF (see the Uganda (2) case study).

Public-private partnerships with local governments

Subnational capital investments can also be financed through public-private partnerships

(PPPs). PPPs can take on many different forms with many levels of risk exposure. For example, in the case of management contracts, the private partners have very limited or no capital expenditure. On the other hand, in the case of a Design, Build, Own, Operate, Transfer contract, the private partners are responsible for the design, building, operation, and financing of a capital asset. In such a PPP, private partners receive payment from the local government (at regular intervals), user charges, or both for delivering the services.

Figure 5.2 presents variations of PPPs in terms of the distribution of responsibilities between the public and private sectors, asset ownership, and the associated degree of public sector risk. It is important to note that the chart does not say anything about the ultimate welfare benefit of different PPPs to the public. For example, while greater private sector responsibility will reduce public sector risk exposure by default, a badly designed PPP of any type can carry significant risks for the public in terms of reduced coverage, poor quality of service, or contingent fiscal liabilities (Jomo, Chowdhury, Sharma and Platz, 2016). Figure 5.2 distinguishes between “core PPP types” and “related arrangements”. Core attributes for PPPs have the following characteristics: they represent a long-term agreement between a government entity and a private company, under which the private company provides or contributes to the provision of a public service (World Bank, 2012).

The private company receives a revenue stream—which may be from government budget allocations, from user charges, or a combination of the two—that is dependent on the availability and quality of the contracted service. The agreement therefore

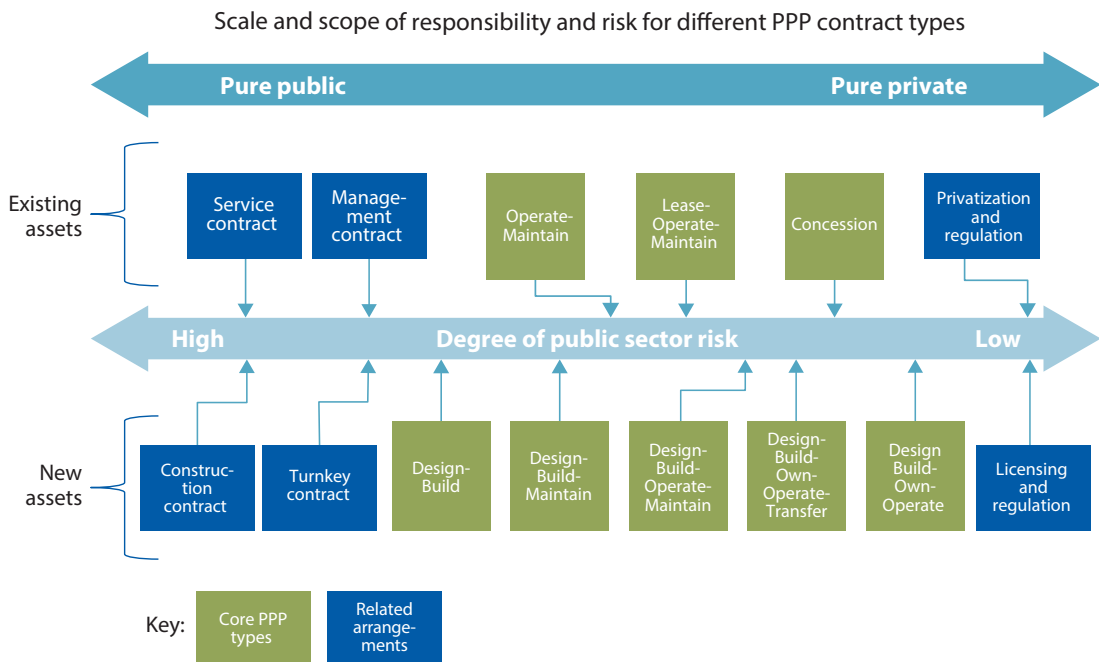
transfers risk from the government entity to the private company, including service availability or demand risk.

The private company must generally make an investment in the venture, even if it is limited, for example, to working capital. In addition to budget allocations, the government may make further contributions, such as: providing or enabling access to land; contributing existing assets; or providing debt or equity finance to cover capital expenditures. The government may also provide various forms of guarantees that enable risk to be shared effectively between the government and the private company.

At the end of the PPP contract the associated assets normally revert to government ownership.

The wide range of contractual arrangements paired with the lack of clarity and variations in definitions make it difficult to generalize findings about PPPs. However, it is safe to say that PPPs are typically complex arrangements that require lengthy and highly technical contracts between the public and private sector. Efforts to design and evaluate such contracts often go well beyond the scope of the capacity of central government (let alone a local government). They usually require third-party legal consultants whose pay may reach several million dollars when it comes to infrastructure PPPs. For this reason, many PPPs with local governments in LDCs have not been successful. Local PPPs remain especially rare in Africa and are concentrated in only a few countries (Paulais, 2012). The example of the water PPP in Dar es Salaam shows the complexities involved in ensuring a

Figure 5.2: Variations of PPPs and distribution of risk



Source: Jomo, Chowdhury, Sharma and Platz (2016).

successful PPP at the local government level (see the Tanzania (2) case study). However, as of late, so-called second-generation PPPs have emerged that include different types of partners, particularly local businesses, and focus on long-term relationships between residents, local officials and their private sector partners (see the Lao PDR (2) case study). Many experts see some promise in these new arrangements, especially for LDCs (Paulais, 2012). Meanwhile, donors can play an important role in lowering the transaction costs of PPPs in infrastructure both at the national and local government levels. For example, the Rockefeller Foundation and the International Finance Corporation (IFC), a member of the World Bank Group, launched a facility that provides grant funding to support legal, technical, and financial advice to governments working with the IFC on infrastructure projects that help cities build resilience and support poor and vulnerable people.

Municipal bonds

Municipal bonds belong to a set of government financing options (table 6) that are typically applied in more advanced financial economies with diverse and mature financial sectors. While they still represent a sophisticated new market-based mechanism for low-income countries, especially LDCs, they may hold potential given the growing domestic practical markets in many LDCs. Municipal bonds are arguably less complex instruments than equity finance or different forms of public-private partnerships arrangements. Indeed, one LDC almost saw the first successful municipal bond issue in 2015 (see the Senegal (2) case study).

A snapshot of the current state of the municipal bond markets across the globe illustrates its potential and points to regulatory, political and financial factors that have shaped its development.

The great outlier in the world of subsovereign debt is the United States, which boasts a \$3.8 trillion municipal bond market, representing more than 22 per cent of its GDP. In the United States, even the smallest towns have raised millions of dollars in bond issuances.¹⁵ A market of such size remains unique. Canada comes in a distant second with outstanding local debt on the order of 2.7 per cent of its GDP. In middle and low-income countries, urban access to capital markets remains limited and applies mostly to selected larger cities.

Among the BRICS countries (Brazil, Russia, India, China and South Africa), China holds the greatest potential for a functioning municipal bond market in the near future. After an urban borrowing crisis in the early 1990s, municipalities were not allowed to take out direct credit. As a result, a plethora of semi-autonomous local government investment vehicles emerged that borrowed on behalf of local authorities. Local government debts issued through these financing vehicles amounted to CNY 18 trillion (\$2.9 trillion) in 2014, more than a quarter of China's GDP. To bring urban borrowing out of the shadows, a handful of cities, including Beijing, were authorized to issue almost CNY 600 billion (\$90 billion) in bonds in 2015. Whereas for the time being the Chinese municipal bond market remains small, representing only 1.3 per cent of China's GDP, it could grow significantly.

15 <https://www.sec.gov/spotlight/municipalsecurities.shtml>

Compared to other developing countries, India has a longstanding history of municipal bonds. In 1998, Ahmedabad became the first Indian city to sell municipal bonds to finance infrastructure improvements. Yet, the municipal bond market has remained in a nascent stage. In the past 15 years only 25 additional municipal bonds have been issued. However, many observers have argued that the central government-sponsored Jawaharlal Nehru National Urban Renewal Mission (JNMURM) programme has limited the development of the market. JNMURM has channelled grants and soft loans to those cities that would have been most likely to access the local credit markets, that is, cities that have successfully implemented modern accounting systems, improved property tax collection, and ensured better cost recovery for water supply, sanitation and solid waste management.

In Brazil, the central government authorized 21 states to borrow up to BRL 60 billion (\$25 billion) from 2013 through 2014. The move ended a ban on municipal debt that dated back to 1997, when an urban debt crisis required a federal bailout. Yet, only one year after the ban was lifted, it was reinstated when two large international banks provoked a central government backlash by collecting a federal government guarantee and charging the state of Minas Gerais more than if Brazil would have sold its own sovereign bonds (collecting \$140 million in fees in the process). Brazil's experience illustrates the importance of moving forward at a deliberate pace in developing a credit market and paying due attention to the regulatory environment.

In South Africa, municipal debt makes up less than 2 per cent of bonds listed on the

Johannesburg Stock Exchange, with only four metropolitan areas—Johannesburg, Cape Town, Pretoria and eThekweni—able to access the market (albeit with government guarantees). Similar to the case of India, it has been argued that other creditworthy cities have not been incentivized to follow suit, mostly due to cheaper access to finance through government-sponsored credit institutions.

Finally, in Russia, the volume of the municipal bond market amounts to roughly RUB 500 billion (\$8.43 billion), less than 1 per cent of its GDP. As most of the economic powerhouses outside the Organization for Economic Cooperation and Development (OECD) have only gradually entered the municipal bond market and have done so at a deliberate pace (perhaps to avoid pitfalls, such as federal bailouts from the past) it comes as no surprise that municipal bonds in developing countries are far and few between. For example, there is no subnational bond floating in the market in Africa outside of Cameroon, Nigeria and South Africa. Table 6 provides an overview of subnational bond issuances in developing countries. Overall, 15 developing countries (out of 134) have experiences in issuing bonds at the subnational level.

Yet, given the enormous financing needs linked to the 2030 Agenda for Sustainable Development, it is worthwhile to explore the potential of market-based financing mechanisms in the developing world, including in LDCs. As alluded to earlier, there is often an inherent tension between government-subsidized lending and incentives for market borrowing that must be carefully addressed and taken into consideration as local authorities explore new funding options.

Table 6: An overview of subnational bond issuances in developing countries¹⁶ in the past 25 years

Country	Total outstanding subnational bonds (\$ millions)	Outstanding dollar or euro-denominated urban bonds (\$ millions)	Outstanding local currency subnational bonds (converted to \$ millions)
Argentina	1406	1406	0
Belize	10	0	10
Bosnia and Herzegovina	284	0	284
China	1531	30	1501
Costa Rica	14	0	14
El Salvador	43	0	43
India	7379	3500	3879
Nigeria	1664	0	1664
Paraguay	7	0	7
Peru	220	0	220
Philippines	120	0	120
South Africa	1359	0	1359
Viet Nam	875	0	875
Totals	14912	4936	9976

Source: Based on data and information from multiple sources, including central banks, ministries of finance, ratings agencies and investment banks.

Looking ahead: Perspectives for market-based debt in LDCs

The capacity to support urban debt depends on the ability of the borrower to maintain a reliable surplus of revenues over expenditures. As previously discussed, the revenue potential of taxes in LDCs is often low. Consequently, strengthening the revenue base and improving municipal management are fundamental prerequisites for sustainable market borrowing. Once a municipality is creditworthy enough to take out long-term loans, it should

avoid potentially costly risk exposure to exchange rate fluctuations driven by external factors. Local revenues are earned in local currencies. Consequently, debt should be geared towards the domestic investor community and taken out in local currency. Central government bonds in local currency (as opposed to those issued in international currency) are important benchmarks for market borrowing, including through municipal bonds. As shown in table 7, there are quite a few LDCs that have not accessed international markets but have

¹⁶ There is no clear definition of what constitutes a developing country. At the UN, members of the Group of 77 and China consider themselves developing countries. Mexico, which has issued a significant number of subnational bonds, especially at the state level, is not included in the table. Due to a lack of comprehensive data, the table does not include at least three other developing countries that have issued subnational bonds in the last 25 years, including Brazil, Cameroon and Zimbabwe.

issued government bonds in local currency on domestic capital markets. More specifically, as of 2016, 18 out of 48 LDCs have floated bonds. Only seven have raised funds internationally. Other LDCs (for example, Burkina Faso, Cam-

bodia, Democratic Republic of the Congo, Lesotho, Solomon Islands and Uganda) have taken preparatory steps to float bonds in the foreseeable future, including through applying for international credit ratings.

Table 7: List of LDCs with government bond issuances, both domestic and/or international within the last decade

LDC	Comments	Major agency ratings	Total outstanding bonds (\$ millions)	Local currency outstanding bonds (equivalent in \$ millions)	Foreign currency outstanding bonds (\$ millions)
Angola		Moody's: B1 S&P: B Fitch: B+	6145	3645	2500
Bangladesh	Plans for bonds in US Dollars discussed by ministry of finance in 2013, but now stalled.	Moody's: Ba3 S&P: BB- Fitch: BB-	15763	15763	0
Benin		N/A	1387	1387	0
Bhutan		N/A	15	15	0
Burundi		N/A	49	49	0
Chad		N/A	356	356	0
Ethiopia		Moody's: B1 S&P: B Fitch: B	1000	0	1000
Guinea		N/A	55	ND	ND
Guinea-Bissau		N/A	11000	0	11000
Lao People's Dem. Republic	4 issues since 2013 in THB.	N/A (rated by a Thai agency)	759	577	182
Madagascar		N/A	850	ND	ND
Mozambique		Moody's: Caa3 S&P: CCC Fitch: CC	727	0	727
Niger		N/A	574	0	574

(continued)

(continued)

LDC	Comments	Major agency ratings	Total outstanding bonds (\$ millions)	Local currency outstanding bonds (equivalent in \$ millions)	Foreign currency outstanding bonds (\$ millions)
Rwanda		Moody's: B2 S&P: B Fitch: B+	400	0	400
Senegal		Moody's: B1 S&P: B+	3139	2139	1000
Togo		N/A	913	913	0
United Rep. of Tanzania		N/A	600	ND	ND
Zambia		Moody's: B3 S&P: B Fitch: B	3843	843	3000

Sources: Amadou (2015); Tyson (2015); DiBiasio (2015); Khmer Times (2014); Janssen (2015); Kerdchuen (2015); Hammond (2015).

While the presence of local capital markets, where government debt can be bought and sold by domestic investors, is an important prerequisite for issuing a municipal bond, a bond issuance requires a wide range of preparatory steps, some of which may pose capacity or financial challenges, especially in an LDC setting. The typical steps are:

- (a) compilation of a corporate plan and capital improvement plan;
- (b) completion of a feasibility study;
- (c) identification and involvement of all essential stakeholders, including underwriter, legal advisor, financial advisor, auditor, trustee/paying agent, notary and guarantor (if needed);
- (d) completion of a public audit;
- (e) preparation of documents, including an offering circular that presents the basic terms of the transaction to potential investors (prospectus), financial information on

the issuer and a fiscal agency agreement (trust indenture), containing legal rights of investors and obligations of issuer;

- (f) obtaining a rating from a national or international credit rating agency;
- (g) registration with the responsible capital market supervisory agency; and
- (i) public sale or private placement of the bond.

When contemplating the first issuance of a bond, it is thus crucial to work with a group of independent public finance advisors that have experience in navigating the regulatory and legal landscape of capital markets. Peer-learning, an important element of South-South cooperation, is crucial, too. For example, the municipal finance team from Dakar, Senegal undertook field trips to Johannesburg, South Africa (which itself had undertaken field trips to Mexican states and municipalities) to learn from its successful experiences in issuing municipal bonds in developing countries.

Donors can play (and have played) an important role in funding such independent advice and encouraging peer learning. Also, donors may start to pave the way for more market-based finance through the introduction of targeted incentives for local governments to borrow. At the initial stages, these can include special mechanisms like subsidized lending, while later on more market-based terms are applied. Ideally, this would help local governments develop borrowing practices over time and empower them to fund the capital investment needed to meet their sustainable development objectives (Smoke, 2015).

The case study of Dakar illustrates that with a common goal in mind and well-coordinated donor support, even cities in the least developed countries can improve their finances through dedicated efforts to build fiscal responsibility and creditworthiness. However, Dakar's experience also shows the constraints imposed by a wider set of contextual factors. Central government buy-in and sustained support remains crucial when embarking on the ambitious project of a municipal bond.

Other borrowing alternatives for local governments

A number of borrowing mechanisms have been used by municipalities that are not yet investment-grade creditworthy but have undertaken significant efforts in this direction. Municipal development funds operated by national or state government entities mobilize resources from private lenders, the central government, and donor agencies, and on-lend these resources to urban governments to finance capital investment programmes (see the case study on Bangladesh (3)). Terms are normally concessional, although capacity to repay debt obligations is an important

criterion to access these funds. More complex arrangements may pursue the dual objective of financing local infrastructure investments and strengthening local credit markets. In Colombia, the FINDETER Fund used external borrowing to rediscount loans made by private commercial banks to public local authorities and local private entities for investing in urban services and utilities. The success of a model like FINDETER depends on the depth of the local financial markets and the availability of capable financial institutions that can take on credit risks related to subnational loans at a substantial scale.

In some cases, blended financing, a combination of market loans and grants, helps local authorities keep debt service affordable. In Burkina Faso, the blended financing for the reconstruction of Ouagadougou's central market after it was destroyed by fire comprised access to long-term resources from the French Development Agency (Agence Française de Développement, AFD) and a €3 million grant, without using a central government guarantee. In Tanzania, the government introduced a dedicated funding mechanism for local governments (LGs) to support investments in local development, primarily in infrastructure called the Local Government Loans Board (LGLB). The LGLB, which is a central-government body, is the primary source of debt for local governments and is financed through a mandatory 10 per cent contribution by local governments as well as from central government appropriations.

Many large cities across the globe have used land-based revenues to finance capital investments. In the case of land development, land is sold to developers for the construction and operation of an infrastructure facility. Assisted pooled financing holds potential in develop-

ing countries with heterogeneous municipalities. In this case, an independent creditworthy intermediary, such as the national or state government, issues a single debt instrument backed by a diversified pool of loans to municipal utilities and covered by a pre-established debt service fund. This scheme offers investors access to a diversified portfolio of borrowers. For example, the State of Tamil Nadu, India, used a pooled financing facility to finance water and sanitation projects for 13 small municipalities, at longer tenors and lower cost than would have been otherwise possible. However, coordination costs can be high, and highly rated urban governments may not have any real incentive to participate and share project-related risks and costs.

Finally, combining pooled financing with credit enhancements supported by donors and private sector companies to identify and put together a pool of investable infrastructure projects could allow access to local bank and capital market financing on a non-recourse basis (Bond et al., 2012).

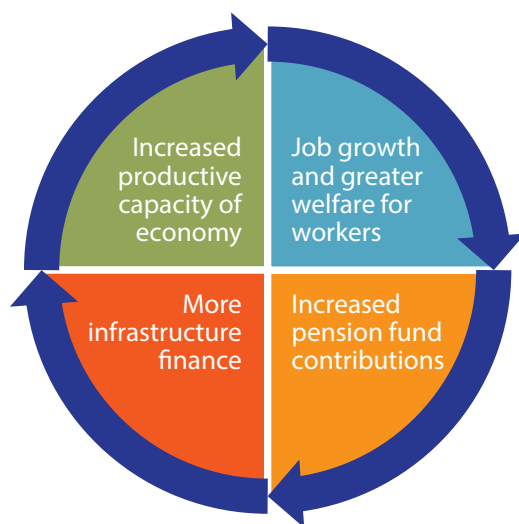
The potential of institutional investors to finance infrastructure investments in LDCs

There are three broad arguments that support the greater engagement of institutional investors, in particular pension funds, in national and local infrastructure. First, infrastructure investments are long-term investments that match the liability profile of these investors. Second, infrastructure investments have performed well in comparison with other asset classes such as equities and real estate securities; there is evidence that risks turned out to be significantly lower for infrastructure investments than those for equities and real estate (Inderst, 2009). Third, in the case of

domestic pension funds and insurers, these investments could raise the productive capacity of the economy. Infrastructure investment from a domestic pension fund can raise local economic development which in turn may provide more decent work opportunities and ultimately expand the work force. A larger and financially healthier workforce can contribute more capital to pension funds and, as a result, pension funds have larger resources to invest into infrastructure, thus setting a virtuous cycle in motion (figure 5.3). United Nations' Member States acknowledged these arguments by including a call to pension funds to allocate a greater percentage of their investment to infrastructure in developing countries in the Addis Agenda (paragraph 47).

Special emphasis has been put on pension funds since their number and size is expected to grow in developing countries, given the low effectiveness of current social

Figure 5.3: Domestic infrastructure investment and local pension funds—the potential for a virtuous circle



Source: Authors' elaboration.

Table 8: Pension fund assets under management in selected LDCs

Country	Assets under management in \$ millions
Bangladesh	4,007
Bhutan	100
Burundi	13
Cambodia*	0
Malawi	1,000
Myanmar	1,170
Nepal	1,788
Rwanda	557
Tanzania	3,800
Uganda	1,259
Zambia	1,609
Total for OECD countries	31,200,000

Sources: For African LDCs: Riscura (2015). For Malawi: Pension Markets in Focus (2015). For Nepal: Website of Employees Provident Fund (Sum of Provident Fund and Reserve Fund), accessed July 2016. For Bangladesh: Mansur (2015) (Data estimate from 2013). For Bhutan: IMF Country Report 14/178. For Myanmar: Thant (2015).

*Cambodia plans to introduce the country's first comprehensive national pension fund by 2020.

security systems and a growing ageing population. Moreover, there has also been a trend away from defined benefit and towards mostly defined contribution plans, which are typically privately managed pension funds. This trend may further raise the growth prospects for pension fund assets. While their growth prospects are significant, it is important to realize that pension funds in LDCs are still very small (table 8). Data on the asset allocation of pension funds are also not easily available for LDCs. However, available evidence suggests that pension funds in LDCs traditionally favour investing in short-term government securities, bank deposits and real estate. Pension funds in countries

with the shallowest financial sectors invest most of their assets in large illiquid assets.

Information on pension fund investment into different types of infrastructure projects remains sparse since infrastructure is not listed as a separate asset class on their balance sheets. Yet, available information and anecdotal evidence point to a low ratio. Global estimates suggest that pension funds invest less than 1 per cent of their deposits into listed and unlisted infrastructure. That ratio is likely to be even lower in LDCs where the risk profile of infrastructure investments is usually much higher than in developed countries. Yet, recent years have seen some modest headway. For example, while most pension funds in LDCs in Africa have not directly invested in infrastructure projects, half a dozen funds have invested in Harith General Partners Ltd., a Johannesburg-based infrastructure fund that holds \$630 million and has been involved in more than 70 African projects.

In addition to a conducive regulatory environment, more reliable data on the size, risk, return and correlations of infrastructure investments in LDCs would go a long way toward incentivizing pension funds and other institutional investors to allocate more of their assets in infrastructure investments at the international, national and local levels.

Concrete policy interventions to strengthen domestic supply and demand of long-term finance at the local government level in LDCs

An earlier section discussed a wide range of factors that can influence a government's capacity to access market-based long-term finance, as well as a local investor's willingness

to invest into local capital based on its risk/return profile. This section focuses on challenges that lend themselves to immediate and concrete policy interventions. Policy instruments include tools to improve local capacity for project development, the use of credit enhancements, building a local ratings agency and providing a suitable regulatory and legal environment (Platz and Painter, 2010).

Building capacity for project development

Infrastructure projects need to be carefully planned, engineered and costed to be successfully debt financed. This requires up-front investment in project development services from market demand analysis to detailed engineering design. Most municipalities and public utilities in LDCs do not have the resources to pay for this initial work. They may also lack the experience to manage the development of a project. The lack of funds and management capacity means most cities cannot translate their need for infrastructure into investible and suitable projects. To assist in overcoming this problem, specialized “project development facilities” can be created. A project development facility can take many forms and perform different roles depending on need. In smaller or centralized countries, the facility may be national in character. In larger or decentralized countries, the facility may operate at a regional or state/provincial level. For instance, in the early 2000s, bilateral donors supported the Municipal Infrastructure Investment Unit (MIIU) in South Africa, which then successfully provided financial, technical and managerial support to municipalities and public utilities. The project development facility may also help to carefully structure and market the loan instruments (for example, a subsovereign bond) to meet domestic investor community needs.

Greater project development capacities should be part of a national sustainable development strategy, which focuses on the importance of infrastructure plans, as emphasized in the Addis Ababa Action Agenda.

Making use of credit enhancements

Different forms of credit enhancements can help lower local default risk. Credit enhancement mechanisms can take on the form of revenue cushions for payback (such as, “sinking funds” in the United States, “federal tax-sharing grants” in Mexico, or “bond service funds” in India), partial or 100 per cent external guarantees for debt repayment (such as, USAID partial guarantees for repayment of the first Johannesburg bond), or the use of pooled financing where the debt of multiple municipalities or other urban entities are “pooled” together in order to improve credit ratings, borrow more, or lower the cost of debt. A well-structured bank loan or bond may make use of several credit enhancement mechanisms at the same time. Pooled financing in this context could be particularly promising in developing countries with heterogeneous issuers. In this scenario, a creditworthy intermediary, such as the national or state government collects the borrowing needs of a group of municipalities and their utilities and issues a single debt instrument backed by a diversified pool of loans to municipal utilities and covered by credit enhancements (such as, a debt service fund) established before the bond is issued. This technique offers investors access to a diversified, geographically dispersed portfolio of borrowers, thus limiting exposure to narrowly focused credit problems. It is worthwhile to explore whether a carefully calibrated pooled project finance approach combined with technical assistance and credit enhancements, could help generate municipal

resources in LDCs. In that context, some have proposed that local governments could follow a pooled project finance approach and work with donors and private sector companies to identify and put together investible infrastructure projects that can be financed by local banks and capital markets on a non-recourse basis (Bond et al., 2012).

Some evidence suggests that financial sector composition matters more than relative size for the emergence of a municipal debt market (Platz, 2009). Policies that help build active government and corporate bond markets provide critical investment opportunities that can serve as benchmarks for investors interested in subsovereign bonded debt. Moreover, central governments should consider the strengthening of development banks. National development banks play a crucial role as they can lend to municipalities directly under favourable conditions (both in terms of rates and maturities) when no one else does. Their investments into local authorities will enable those to build up their credit histories over the long term. When municipalities are ready to access the markets, national development banks (as well as regional or multilateral development banks) can also build investor confidence by underwriting, guaranteeing or investing into municipal debt, including securities.

Building a local ratings industry

Another challenge relates to the lack of investor familiarity with the risk profile of local capital investments. Rating agencies can help overcome this information gap. After the world financial and economic crisis, rating agencies have come under increased scrutiny. As a result, world leaders have called for increased competition, as well as measures to avoid conflicts of interest in the provision

of credit ratings. Such measures are certainly necessary and would strengthen the ratings industry. Yet at the local level, the major challenge is not related to how these agencies conduct their business but their lack of engagement in the first place. Indeed, even in developed countries outside the United States (where over 12,000 municipalities are rated by S&P alone) few urban entities are rated by any of the three major rating agencies, which together account for more than 90 per cent of the global market share of ratings. To the authors' knowledge, there is no publicly available issuer rating for an LDC from any of the three major ratings agencies at the sub-national level (figure 5.4). The relatively low number of urban ratings worldwide can be explained by the fact that most municipalities in developed countries do not access bond markets and rely on long-standing relationships with local banks or the central government for investment into capital projects. One of the major reasons these agencies have not rated local authorities in LDCs is the extraordinary cost of developing a national ratings scale and adapting the ratings methodology to data available in each country. As a result, initial fees may be in the range of several hundred thousand dollars, despite relatively small issuances. Consequently, even creditworthy local authorities in LDCs cannot afford to pay for international ratings.

The number of urban ratings further decreased in developing countries after the world financial and economic crisis. That decline may be due to a loss of confidence in the major rating agencies, less demand at the local level due to the direct adverse impact of the crisis on local finances, as well as decreased interest of rating agencies in emerging market and developing economies.

Here, international development agencies can play a critical role in lowering the entry barrier for rating agencies by paying for the first few municipal credit ratings so that the first issuers do not have to bear the potentially high costs. Such ratings may be confidential and would allow municipalities to get an independent assessment of their financial marketability without deterring potential investors (see the Senegal (2) case study). Indeed, it is strongly advisable to have confidential ratings at the earlier stages as negative ratings that are made public may cause much harm over the long term for municipalities that seek to increase investor confidence.

A strong argument can be made that international ratings are not really necessary for municipalities in LDCs. Long-term loans should not be taken out in hard currency, given the extraordinary costs of potential exchange rate fluctuations. Even one currency event over the span of a 10-15 year term loan can lead to a catastrophic default. The low activity of the ratings industry is therefore only a cause for concern when no other regional or local ratings alternatives exist. Ideally, the international community would therefore focus their efforts on supporting the growth of local rating agencies. Increased competition and greater issuer familiarity are important benefits of widening the market for local rating agencies. At first, new linkages between local and international agencies could increase the reputation of domestic ratings companies. After some time and with sufficient reputational capital, local agencies can act more independently. Once a local industry develops, fees may decrease dramatically.

Over recent years, a few regional rating agencies have emerged in Africa. Some have gained reputational capital with investors, such as the

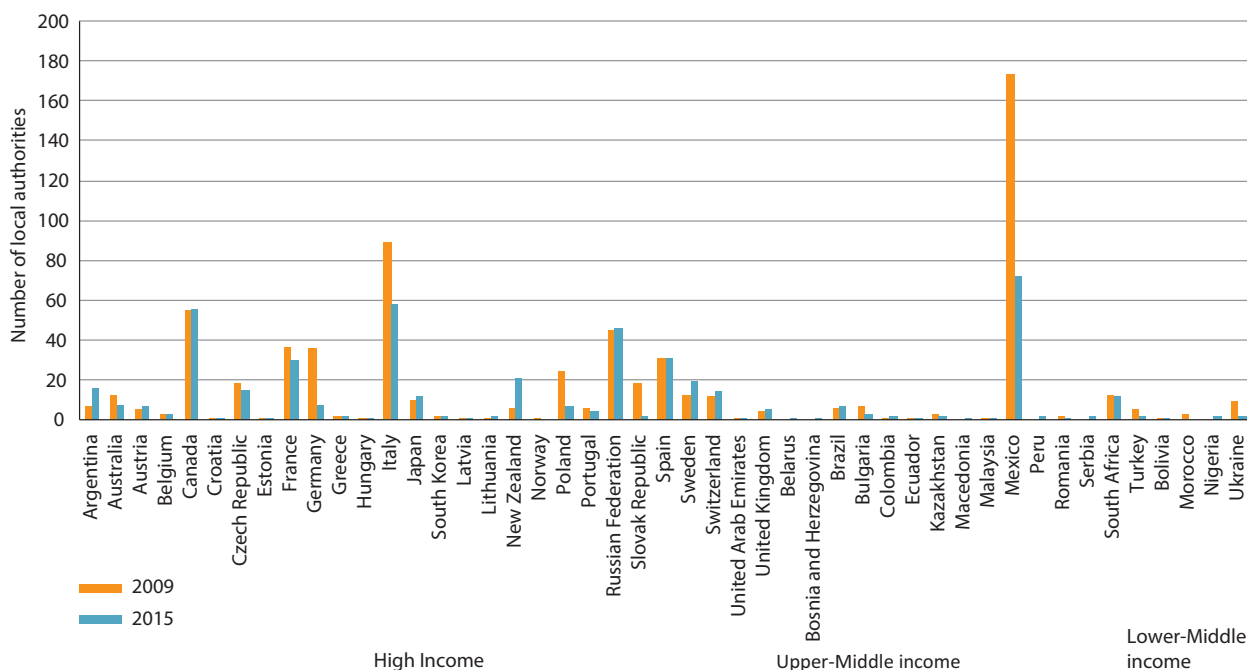
West African Ratings Agency (established in 2005) and Bloomfield Financial (established in 2007), joining the ranks of older agencies, such as Agosto and Co. (1992) and the Global Credit Ratings Company (GCR, established in 1996) Dakar (see the case study) and Kampala in Uganda have been among the cities in LDCs that have received high ratings from local agencies. Kampala received an A in the long term from GCR, its highest global rating. The high rating resulted from the significant progress the Kampala Capital City Authority has made in expanding its rates and fees base, including through an improved property registry, and licensing taxis and other businesses. Combined with improved debt collection these important steps led to a revenue increase of 80 per cent from 2012 to 2014.

Ensuring an adequate legal and regulatory environment

The proper legal and regulatory environment can promote the development of a municipal debt market. In some cases, regulations will not allow local authorities to access private or public credit at all (table 9). As a result, such countries rely entirely on capital grants from the central governments (or donor funding in the case of developing countries) to fund large-scale investments.

Abolishing such restrictions is not wise if there is no effective judicial framework in place to deal with potential defaults. For example, a government bankruptcy framework (such as Chapter 9 in the United States) helps sustain the municipal bond market by protecting the rights and obligations of creditors and debtors at the subnational level. Moreover, debt ceilings, such as those introduced in the earlier stages of the municipal bond markets in the United States, help keep municipal debt in check. However,

Figure 5.4: Number of local authorities worldwide that have received ratings from at least one of the three major global agencies, by country* and income group (2009 and 2015)



Sources: Information provided upon request by Fitch, Moody's, and S&P.

* Note: in the United States (not included in the figure) over 12,000 municipalities are rated by one of the three major agencies

Table 9: Limitations on local governments' borrowing ability in selected Asian and African LDCs

Afghanistan	Cities can only borrow from the central government.
Bangladesh	Local government (LG) borrowing from external sources is allowed with central government approval. Urban local governments can and do borrow from the Bangladesh Municipal Development Fund. However, the maximum statutory amount is rather low (around \$31,000).
Bhutan	LGs may borrow funds through the Ministry of Finance or with its approval.
Ethiopia	LGs are not allowed to borrow; regional states (federal units) are allowed to engage in internal borrowing, with the amounts to be borrowed determined by the central government and managed by the Central Bank.
Nepal	Municipalities can borrow using collateral or central government guarantees.
Tanzania	LGs can borrow internally subject to the approval of the Ministry of Finance. The main source of borrowing is the Local Government Loans Board (LGLB), a government-supported financial intermediary where LGs are requested to contribute a minimum compulsory reserve equal to 10 per cent of own source revenues, which serves as a reserve with the LGLB.
Uganda	LG borrowing from external sources (only domestic) is allowed with central government approval, in amounts not exceeding 25 per cent of locally generated revenue provided that a local government council demonstrates the ability to meet its statutory requirements.

Sources: Ellis and Roberts (2016), expert interviews.

important exceptions to debt limits may have to be made for essential revenue-generating public improvements, like water supply systems. Overly stringent credit ceilings should not impede the development of the municipal debt market, which can channel productive investment to the provision of essential local services in municipalities that would otherwise have no access to long-term finance.

Other regulations that are less market oriented may also help develop municipal

debt markets in LDCs. For example, the Reserve Bank of India is obliged to invest 21.5 per cent of assets into government-owned securities. Finally, in some countries, mandatory issuer ratings have promoted investor interest in municipal bonds and increased the access of municipalities to long-term bank loans. Regulatory changes that enhance the creditworthiness of the issuer and promote the local ratings industry are therefore important reform measures to deepen the market for subsovereign debt.

KEY MESSAGES

- Weak institutions and legal frameworks, a lack of substantive and administrative capacity, and underdeveloped capital markets are among the main reasons why access to long-term finance is a frequent problem for urban governments in LDCs.
- Financial intermediaries, including national, regional and international development banks, can play an important role in promoting urban finance in developed countries. Their experiences in emerging markets and developed countries offer rich lessons on how municipalities can access long-term finance in LDCs. However, lending instruments need to be carefully designed in order to avoid creating disincentives for market intermediaries.
- There are a wide range of policy interventions that can help pave the way for local governments to access long-term finance for local infrastructure investments, including (i) actions geared towards building local capacity for project development; (ii) efforts to improve local creditworthiness, including through sustained and well-sequenced PFM reforms; (iii) the promotion of local rating industries; (iv) the use of certain credit enhancement and risk mitigation tools; and (v) the creation of a conducive legal and regulatory framework for local finance that balances financial stability concerns with greater access to credit for local governments.
- Local governments in LDCs are beginning to explore a range of more advanced market-based finance tools that have generated both excitement and apprehension among donors and local stakeholders alike. Such mechanisms include equity finance, pooled finance arrangements, municipal bonds and public-private partnerships. Depending on the local context these mechanisms may hold significant potential. However, they are complex instruments that should be approached, designed and implemented at a deliberate and careful pace to avoid potential pitfalls with adverse effects on the local population.
- A realistic assessment of the institutional, political and financial local context must determine if and where such instruments deserve further consideration. Sustained political buy-in of all layers of governments, politically sensitive capacity-building efforts, technical assistance and a willingness of stakeholders to adjust to changing circumstances are critical when pioneering new and innovative financing mechanisms.

CASE STUDIES

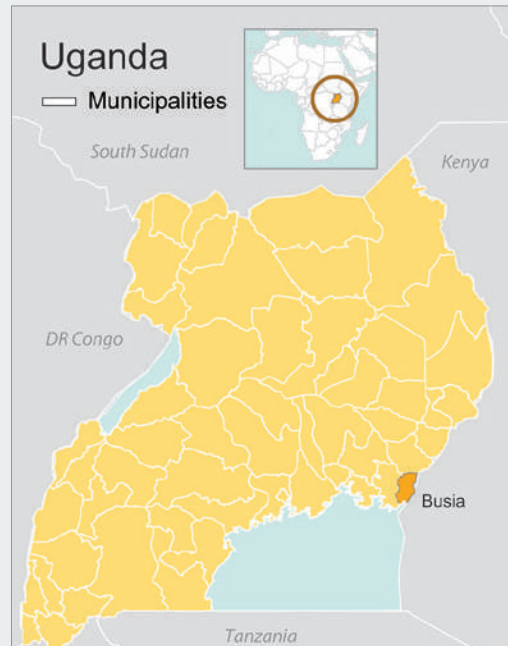
UGANDA (2): A PROJECT-BASED PARTNERSHIP TO FINANCE MUNICIPAL TRANSPORTATION IN BUSIA

In the District of Busia, Uganda (see the Uganda (1) case study for more information on the local context), UNCDF facilitated a municipal project which includes a multi-purpose parking project on the border with Kenya. The project uses the strategic border location of the district and is designed to facilitate cross-border movement and trade between Uganda and Kenya. UNCDF helped develop and design the project as a tripartite public-private partnership

among the local government, the Church of Uganda, and private investor Agility Uganda Limited. De-risking the project through local economic analyses, feasibility studies, and structuring and financial modelling resulted in leveraging 70 per cent of the total cost of the \$2.5 million project in private equity and debt.

POLICY LESSON:

In LDCs, private equity may be attracted through non-market mechanisms, such as when a private entity (including an institutional investor) commits equity to a new infrastructure project through a project-based partnership arrangement with a municipality.



The project, which was being implemented as of 2017, will greatly improve traffic flow and improve the town's environment; boost business in the region; create over 100 jobs directly or indirectly including lorry, petrol station, and shop attendants; and, in addition to the license fees collected from traders, allow the local government to receive 10 per cent of the project revenue quarterly.



BURKINA FASO: CREATING A HYBRID FINANCING SOLUTION WITH AN INTERNATIONAL DEVELOPMENT INSTITUTION

Ouagadougou, the capital of Burkina Faso, is home to more than 1.2 million residents and is a major industrial and commercial hub. Its central market was destroyed in a fire in 2003. At that time, it hosted over 2,900 merchants. In 2006, the French Development Agency (AFD) offered an innovative hybrid financing solution to help Ouagadougou rebuild this key piece of revenue-generating commercial infrastructure as well as reinforce its network of secondary markets.

POLICY LESSON:

Working with international donors to create a hybrid financing mechanism can help cities in LDCs secure long-term financing for capital projects.

AFD carried out the project's technical, economic and financial feasibility studies at the same time as a prospective analysis of the municipality's financial accounts.

Loan simulations

using various borrowing amounts determined how much of the municipality's net savings could be used without overburdening its investment capacity, and the results determined that a grant was needed to complete the capital investments without overburdening the repayment capacity of the municipality. Thus, the AFD offered a hybrid solution combining a €2 million (\$2.1 million) loan with a €3.15 million (\$3.36 million) grant. The 20-year loan began with a 5-year payment deferral, which meant that capital repayments would not start until the works were completed and the first user fees collected. The grant also covers a series of institutional projects, including actions to strengthen the mar-



kets' management authority, Régie Autonome de Gestion des Équipements Marchands.

In the long run, the operation should remain budget neutral for the local government, as yearly user fees paid by the market operator match the annual repayments of the loan. This case demonstrates that hybrid financing is an important option for larger cities in LDCs to secure financing from international development institutions, particularly when they have projects with revenue-generating capabilities. Though the loan terms were highly concessional on AFD's behalf, it was an important first step for a city without the capacity to secure commercial or bond-based financing and paves the way for future borrowing.

Complementary sources: Paulais (2012); Agence Française de Développement (2007); Panapress (2003).

LAO PDR (2): THE MORPHU VILLAGE WATER SUPPLY PROJECT: A LOCAL PUBLIC-PRIVATE PARTNERSHIP (PPP) DONE RIGHT

The geographical conditions and dispersed nature of Lao towns are suited to small-scale water supply projects. An early example of a PPP in Lao PDR concerns such a small-scale project in Morphu Village, in the southern province of Champasack. Documentation from 2004 shows that the Build-Operate-Transfer (BOT) project had a very short implementation time, with an initial meeting between the community and the private partner in June

POLICY LESSON:

Sometimes local PPPs in the water sector can add value, especially in the context of small and scattered settlements. To succeed, they should be community driven, subject to strong oversight and have access to donor support. There should also be a high degree of trust between the implementing partners.

2000, a three-month construction period in early 2001 and services commencing in April 2001 (Aphaylath, 2004). The population of Morphu Village at the time consisted of 1,032 people living in 182 households. While the relatively small size of the population rendered many water supply solutions unprofitable, it also allowed the village community to find a solution to fit their own unique

conditions. The PPP was therefore initiated by the community, who requested a private building repair and construction company, the Phonekham Construction Company (PCC), to provide a piped water supply system. PCC asked for technical support from government agencies as well as assistance with obtaining approval and permits.



A relatively simple system was constructed which consisted of a large water tank, a pump for transferring groundwater into the tank, and pipes to convey the water to houses. Each household pipe is connected to a meter. The Morphu Village water supply system was initially operated by PCC, but this role was later transferred to the village authority. Although only 30 households were initially connected to the water supply system, by 2004 water was being piped to 120 houses. Hailed as a success in 2004, the Morphu Village project recovered construction costs earlier than expected. This was attributed to strong support from the community. On transfer of management to the village, the water system contributed revenue to the village community. Further outcomes



included an improvement in villagers' health, increased free time for the community, employment opportunities, and training for some villagers. Benefits to the private sector resulted in PCC carrying out similar projects in other villages in surrounding areas. These projects are evidence of the success of PPPs

at the local level where a high degree of trust is present between partners. They also demonstrate the effectiveness of local PPPs in the Lao context of small and scattered settlements.

Complementary sources: Sakar (2014) and Aphaylath (2004)

TANZANIA (2): DAR ES SALAAM'S WATER SUPPLY— POTENTIAL PITFALLS OF LOCAL PUBLIC-PRIVATE PARTNERSHIPS (PPP)

In 2002, most of the water produced by the public Dar es Salaam water supplier, DAWASA, was lost due to leaks, non-metered connections, and illegal usage. Water supply was sporadic in many areas. Moreover, less than 10 per cent of the urban population was connected to a sewerage system. To improve services, the city actively looked for private partners to enter into a PPP. Following six years of negotiations with private companies

POLICY LESSON:

A local PPP that appears to be financially viable and is expected to lead to improved services requires considerable municipal capacity to perform due diligence in selecting the right partner and understanding the allocation of risks in the contract.

and two failed bidding processes, the German/British company Biwater and Gauff Tanzania (BGT) was finally awarded a lease. Together with a Tanzanian investor, BGT created the operating company, City Water Services Limited (CWS), of which BGT owned 51 per cent (the minimum required of the bidder) and the Tanzanian investor, Super Doll,

49 percent. The contract consisted of a lease in which CWS was obliged to provide the water supply and sewerage services and maintain assets, while DAWASA remained responsible for funding and implementing capital investments. The project was mainly financed through external loans, while CWS contributed \$8.5 million.



Unmet obligations by the private provider turned out to be the major problem of this arrangement. CWS set out to create a new customer database and new billing software. However, only limited progress was made in cleaning up the customer database (out of the 150,000 contacts in the database, less than 25,000 were active and potentially billable). At the same time, the company failed to purchase 170,000 water meters, as required by a procurement subcontract. Less than 19,000 meters were purchased and less than 2,500 installed in the first year. As a result, the company's average monthly collections were 21 per cent lower than DAWASA's had been in 2002/03. By May 2005, government arrears for water and sewerage services amounted to \$1.5 million. In addition, the company did not pay the rental fee to DAWASA regularly, periodically withheld tariff collections to pay its own operating costs, and failed to deposit



first time connection tariffs into the account for that programme. In May 2005, DAWASA served a notice of termination of the contract. However, in light of the fact that CWS would not agree to the termination, the Minister of Water terminated the arrangement and expelled its expatriate managers from the country. The experience highlights the need

for a careful consideration of key challenges that can make or break a successful PPP, such as the selection process, the allocation of risks in the contract, as well as expectations regarding financial viability and service improvements.

Complementary source: World Bank (2012).

SENEGAL (2): DAKAR'S EXPERIENCE IN (ALMOST) GETTING A MUNICIPAL BOND TO THE FINANCIAL MARKET

Dakar's experience in (almost) getting a municipal bond to the financial market provides invaluable lessons for other cities. The reason the bond has not yet been sold is due to a last-minute intervention by the Ministry of Finance, pointing to the challenges a large number of LDCs face in ensuring strong national support for urban finance innovations. However, getting to the point where Dakar is technically ready to raise

POLICY LESSON:

Issuing a municipal bond can be a rallying point for concerted efforts to improve the financial situation of a city but requires sustained political support from the central government.

market resources has been the result of a concerted effort of a specialized municipal finance team combined with targeted and well-coordinated donor support. First, through a consultative process with a wide range of stakeholders,

including district leaders and NGOs, the construction of a marketplace for more than 4,000 street vendors was identified as the bankable project the bond would fund. It was envisaged that revenue for the bond would come from affordable fees to street vendors relocating their business to the hall. A municipal finance management team was put in place to get the city's finances in order. The team could build on a track record of solvency, since Dakar has been a reliable creditor to commercial banks, the French Development Agency (Agence Française



de Développement), and the West African Development Bank since 2009.

Moreover, political stability also helped build investor confidence. Efforts by the management team were further guided by a confidential rating from Moody's, which provided an independent assessment of their work and pointed to areas of further improvement. Credit enhancements were crucial as well, including a 50 per cent partial risk guarantee from USAID as well as the setting up of a separate fund by Dakar earmarked to pay the debt. All of these factors allowed the city of Dakar to get a rating of BBB+, a middle-tier ranking that qualifies as 'investment grade' from Bloomfield Investment, a West African rating agency.



The sale of the bond would also draw on a diversified financial sector since Dakar planned to place it on the Bourse Régionale des Valeurs Mobilières, a common securities market that allows institutional and other investors from 14 Francophone countries

with common currencies to buy debt without foreign exchange rate risk. However, the unsuccessful result points to the challenges a large number of countries face in ensuring sustained political buy-in for urban finance innovations.

Chapter 6 **INTERNATIONAL COOPERATION
ON URBAN FINANCE**



Many of the challenges and policy

recommendations described in this paper suggest the need for a more concerted effort, greater coordination, and a calibrated interplay among urban finance stakeholders, such as municipal officials, relevant ministries, regulatory agencies, tax collectors, investors, creditors, and citizens themselves. How does the call for more international cooperation on urban finance, as expressed in paragraph 34 of the Addis Agenda, fit into this largely domestic agenda?

International cooperation on urban finance in developing countries can take place at many different levels. It includes knowledge-sharing, technical assistance, capacity-building and direct or indirect financial assistance in the form of grants, loans and guarantees. It may take on the form of North-South, South-South or triangular cooperation. It may focus on emerging market economies, middle-income countries, low-income countries or LDCs.

ODA targeted towards cities and local authorities

ODA to LDCs increased in 2015 for the first time in several years, marking a reversal of the decline in ODA flows to LDCs from previous years, according to preliminary figures by the OECD. Bilateral ODA to LDCs increased by 4 per cent in real terms¹⁷ in 2015 in comparison to 2014, accounting for a total of \$25 billion.

The last year with comprehensive data is 2014, in which total ODA from Development Assistance Committee (DAC) members to LDCs amounted to \$41 billion or 0.09 per cent of GNI, still far below the United Nations target of 0.15-0.20 per cent (United Nations, 2017).

The available ODA data provided by the OECD do not allow for the comprehensive tracking of flows to urban governments or the extent to which sectoral allocations support local government service delivery. In general, it is established that the majority of ODA is allocated to central governments. The DAC does however track data on ODA for some categories that specifically address challenges at the urban level (urban development and management,¹⁸ housing policy and administrative management,¹⁹ and low-cost housing²⁰). Despite some volatility, total ODA for projects at the urban level has more than doubled over the last decade, though it decreased significantly from 2014 to 2015 (based on preliminary figures). More than 75 per cent of ODA for these projects goes to middle income countries, while LDCs receive only about 23 per cent. While the amount for lower-middle income countries increased significantly from 2002 to 2014, the share for LDCs declined, especially between 2011 and 2014. In 2015, the share for both LDCs and upper middle-income countries increased. The share of ODA for urban projects in LDCs as part of total ODA for LDCs peaked in 2015,

17 Adjusted by the OECD for inflation and the appreciation of the US dollar. The currencies of OECD DAC members depreciated significantly against the US dollar in 2015. For some, the depreciation against the dollar has been in excess of 15 per cent.

18 Urban development and management according to the OECD list of purpose codes refers to integrated urban development projects; local development and urban management; urban infrastructure and services; municipal finances; urban environmental management; urban development and planning; urban renewal and urban housing; and land information systems.

19 Housing policy and administrative management according to the OECD list of purpose codes refers to housing sector policy, planning and programmes; excluding low-cost housing and slum clearance.

20 Low-cost housing according to the OECD list of purpose codes includes slum clearance.

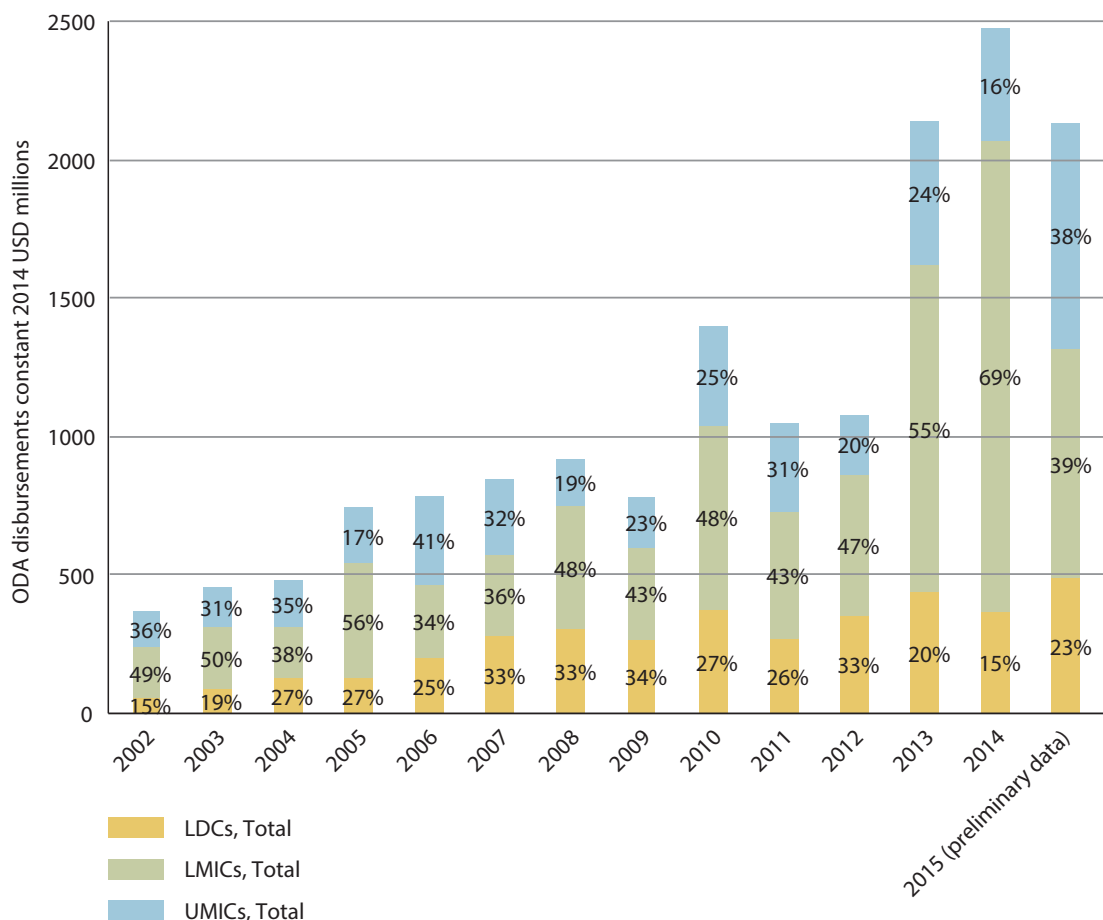
but is still less than 1 per cent. Based on the estimate that the proportion of the urban population in LDCs is expected to rise from 31 per cent in 2014 to 49 per cent in 2050, it is unlikely that current ODA allocation levels will suffice to bridge funding gaps and build the required capacities.

Furthermore, data show that bilateral ODA

from DAC countries grew at a relatively small rate and was surpassed in 2014 by non-DAC donor contributions, which show a strong increase from 2012 to 2014. However, the preliminary data for 2015 show a decrease in total bilateral and multilateral ODA disbursements for urban projects, which is mainly caused by a significant drop in the contributions from non-DAC countries.

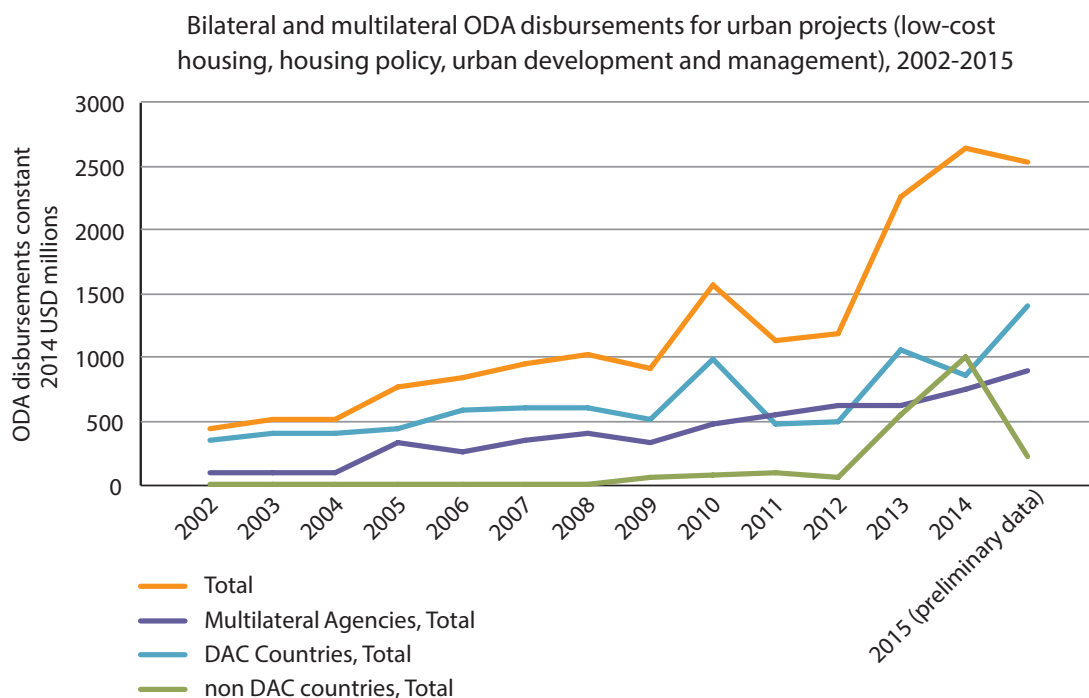
Figure 6.1: ODA disbursements for urban projects

ODA disbursements for urban projects (low-cost housing, housing policy, urban development and management), 2002–2015



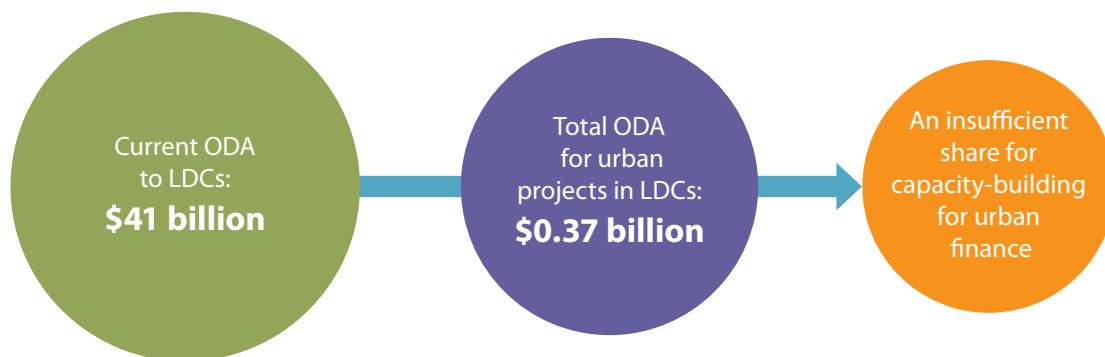
Source: OECD Creditor Reporting System, LMICs (lower-middle income countries) and UMICs (upper-middle income countries) based on the OECD DAC list of ODA recipients.

Figure 6.2: Bilateral and multilateral ODA disbursements for urban projects



Source: OECD International Development Statistics.

Figure 6.3: Current ODA to LDCs and total ODA for urban projects in LDCs



Source: OECD International Development Statistics.

Depending on the donor (bilateral and multilateral), between 5 and 25 per cent of their contributions for urban projects go to LDCs (AidData). Several multilateral organizations are active in the area of urban

finance and urban development, including the World Bank, regional development banks and the European Union. At most, these organizations allocate about 8 per cent of their overall contributions to this area.

Table 10: Bilateral and multilateral ODA disbursements for urban projects in LDCs in 2015 (constant 2014 \$ millions)

	Housing policy and administrative management	Low-cost housing	Urban development and management	Total
All Donors, Total	15.02	70.99	397.69	483.70
DAC Countries, Total	0.26	7.94	105.35	113.55
Multilateral Agencies, Total	14.76	63.05	243.39	321.20
France	–	–	38.53	38.53
Japan	0.23	–	28.27	28.49
Germany	0.03	0.71	21.16	21.90
Sweden	–	0.24	5.00	5.25
Belgium	–	2.40	1.92	4.32
Canada	–	1.11	2.99	4.10
New Zealand	–	2.72	0.18	2.91
Korea	–	0.06	2.82	2.88
United Kingdom	–	–	2.08	2.08
Norway	–	0.14	1.33	1.47
United States	–	–	0.04	0.04

Source: OECD International Development Statistics.

A closer look at the ODA figures for urban projects in LDCs in 2015 shows that the vast majority of the allocated funds came from multilateral agencies (see table 10). Bilateral and multilateral donors prioritized urban development and management in comparison to housing policy and low-cost housing. France, Japan and Germany provided the largest bilateral contributions.

However, these figures only provide a snapshot of international assistance to urban levels and actual amounts are likely to be higher. Many other bilateral and multilateral assistance projects in other sectors, such as water and sanitation, energy, health, education, and transport, among others, will have more or less direct impacts on cities.

Some estimates suggest that including these projects would roughly double the figures presented in table 10. Also, there is a lack of reliable data on South-South cooperation, which is becoming an increasingly important factor, for example through infrastructure investments, loans and knowledge exchange mechanisms.

Climate finance for urban governments

There are no comprehensive estimates available on the amount of climate finance going to urban governments. Nevertheless, some data provide an initial indication of the available resources. Mitigation accounted for 93 per cent of total climate finance in 2014,

while adaptation measures, which are often critical for cities, especially in developing countries, reached only 7 per cent (Climate Policy Initiative, 2015). A survey of nine development banks showed that about 30.6 per cent (\$19 billion) of the surveyed banks' climate finance in 2014 was allocated to cities. On average, urban climate finance accounted for 8.6 per cent of overall development bank financing commitments. Similar to global climate finance trends, development banks' urban climate finance also displayed a much higher share (72 per cent) for mitigation measures, especially in energy and transport. The remaining 28 per cent for adaptation measures was mainly spent on water and waste management. Additional data from multilateral climate funds show that of some 700 projects, 47 focused explicitly on urban mitigation or adaptation objectives. These projects had a combined value of \$842 million, or \$168 million on average per year. In total, this is just above 11 per cent of projects approved by multilateral climate funds. More than 76 per cent of the contributions are from the Clean Technology Fund. Less than 10 per cent was spent on cities in LDCs, and this share is dominated by a major infrastructure project for coastal cities in Bangladesh (Cities Climate Finance Leadership Alliance, 2015). Another critical source of climate finance for LDCs is the Green Climate Fund (GCF). Currently, 12 LDCs are listed as GCF priority countries. The GCF's rules allow for subnational access if the subnational entity has been nominated by the national government. International cooperation can support LDCs in developing mechanisms to access GCF funding. One example is UNCDF's Local Climate Adaptive Living Facility (LoCAL), which enables local governments to directly access the GCF and is supported by bilateral and multilateral donors.

In general, approximately 75 per cent of climate finance is available at market rates, while only 25 per cent is offered at concessional terms (Cities Climate Finance Leadership Alliance, 2015). However, many critical climate change resilience projects at the urban level in developing countries do not offer adequate returns deemed viable for commercial financing, or cities are not considered creditworthy. In addition to increased total amounts of climate finance available to cities, a higher share of concessional funding would be required to ensure support for resilient and environmentally sound urban infrastructure in developing countries, especially in LDCs.

South-South cooperation for urban finance

The 2030 Agenda for Sustainable Development, the Addis Ababa Action Agenda and the New Urban Agenda recognized the growing importance of South-South cooperation. As a complement to North-South cooperation, it can play an important role in the global efforts towards achieving the SDGs. South-South cooperation builds on the solidarity among developing countries and can thus promote the exchange between partners at similar stages of development or that have recent experience with the developmental process. Ideally, it goes beyond direct capital investment and facilitates the sharing of knowledge, lessons learned, and the transfer of relevant technology.

South-South cooperation is substantiated at the urban level in many different approaches and at different stages of formalization. Direct cooperation between local governments from different Southern countries has become more significant in recent years, as illustrated

by the growth in South-South city-to-city cooperation. In addition, the engagement of Southern donors, such as China, at the local level has greatly increased (see box 7).

South-South city-to-city cooperation

City-to-city cooperation is not a well-defined concept and can therefore take many shapes at the national and international level. It includes direct cooperation between two cities, but can also refer to city associations or cooperation between city associations. Organizations such as United Cities Local Governments (UCLG) offer platforms for city governments that facilitate exchange and provide structures for collaboration between cities. While cities in developed countries have long-lasting cooperation experience, South-South cooperation has become increasingly important in terms of the complexity and diversity of cooperation during the last two decades, including for cities in LDCs. City governments are not the only local actors involved in this type of cooperation. It can include other actors such as civil society, local businesses and academia. City-to-city cooperation can enable participating local authorities and other actors to share knowledge and best practices, to build capacities at the political and technical level and to strengthen their position with respect to other levels of government.

South-South city-to-city cooperation is increasingly focusing on sectors such as economic development, transport, housing, environment, as well as on topics related to urban finance, such as local taxation, financing and accounting models or organizational capacity. The strong appeal of the interactions between urban governments is that they face similar challenges as well as experiences with

transition processes. Meeting at an equal level, mutual learning and knowledge exchange are therefore core strengths of city-to-city cooperation. City-to-city cooperation can also include a strong element of solidarity in times of crisis, for example natural disasters.

An example of successful South-South city-to-city cooperation is the case of six cities from Brazil and eight cities from Mozambique that engaged in a project to strengthen local governance and participation. The project further included a component to build the capacity of local authorities. In total, the project included more than 20 actors including mayors, universities, technical experts, city networks and UCLG. Partners from the paired cities decided on the theme and scope of the collaboration. The overall focus was set on urban planning and management, which included land management and budgeting as important parts of decentralization reform in Mozambique. The project also resulted in a renewed commitment to the implementation of participatory budgeting by mayors from Mozambique. In addition, participants stated that the exchange with their peers enabled them to get a better understanding of critical planning and management processes. Furthermore, participating mayors benefitted greatly from close interactions with technical experts, resulting in an enhanced recognition of technical details by the policy makers (United Cities and Local Governments, 2016).

The project identified a critical success factor for city-to-city cooperation—the importance of continued political leadership even when new mayors are elected to office. The participation of additional actors such as other politicians or utility managers increased the overall acceptance and support for the

implementation of project results. However, since the project was based on limited funding by the European Commission, the Norwegian Government, Cities Alliance and the City of Barcelona, a critical challenge that has been acknowledged is the long-term institutionalization of the exchange.

Strengthening international cooperation for urban finance

The low level of ODA and climate finance directed towards local authorities in LDCs cannot be justified by a lack of success. In terms of their immediate development impact, the success of urban projects seems to be equal

Box 6: The role of China in urban finance and development in Africa

Connections between African countries, including LDCs, and China have strengthened significantly over the last several decades. China is the largest trading partner of African countries (with a strong focus on commodities) and more than 2,000 Chinese companies are active in Africa. This good relationship is not a one-way street: African investments in China more than quadrupled in the first decade of the current century. China overtook France in 2007 as the top ranked country of origin of international contractors in Africa. China's engagement in African LDCs has a strong focus on developing infrastructure (often with its own construction companies and workers that crowd out local companies), especially in areas like transportation, energy, water and housing. Some examples are the construction of a major ring road in Addis Ababa, Ethiopia; a bridge crossing the Niger River in Bamako City, Mali; the building of hydropower stations in Equatorial Guinea and Burundi; low-cost housing in Mozambique; and a hospital in Nouakchott, Mauritania. China also provides direct aid to LDCs.

In the last decade, China established special economic zones in cooperation with local African governments (examples in LDCs are Ethiopia and Zambia). These zones often use public-private partnerships, where local governments provide long-term land leases while the private sector develops infrastructure and takes over operational management. However, replicating the success that the model has shown in China has not always been easy given issues related to the coordination of key stakeholders (including LDC central and local governments, as well as Chinese private and state-owned enterprises), unresolved financing issues about enabling infrastructure and difficulties with the integration of the zones in the local economy (Liu and Lefèvre, 2012).

Another element of Chinese cooperation that has impacted urban development and urban finance in African LDCs was the establishment of a branch at the China Development Bank called CDB Capital. While the initial aim was to explore new models of urban development in China, CDB eventually branched out internationally. CDB Capital became the manager of the China-Africa Development Fund (CADF), whose paid-in capital was doubled to \$10 billion in 2015 by the Chinese government, and holds shares in infrastructure investments as well as in special economic zones. The domestic experience in China is a valuable source of information and lessons learned for CDB Capital. In addition to being a shareholder in the special economic zones, it supports the exchange between Chinese and African local government officials and advertises infrastructure projects to Chinese investors. This builds on various Chinese national policies that promote the internationalization and outreach of Chinese cities and companies; thus forming an important part of the cooperation between China and local governments in African LDCs.

to or greater than projects in other sectors. For example, for the World Bank's municipal development projects, performance in Africa and its LDCs is above the global average (Kharas and Linn, 2013). In addition to the development impact, strengthening urban finance, especially local public financial management, can have a positive impact on the management of donor funds. However, whereas the overall impact is high, the sustainability of urban projects has been significantly lower. The principal reason lies in the long-term financial viability of the project. Weak urban finance, such as inadequate local financial resources and capacities for asset management, may frustrate donor support. There is therefore a need to place greater emphasis on urban and rural finance. Yet, donors have paid little attention to these aspects in the design, implementation and evaluation of their development projects.

Key messages and lessons learned from the previous chapters point to several principles, that, if implemented, could significantly improve international cooperation on urban finance, as called for in the Addis Agenda. First and foremost, there is a greater need for partnership development, better coordination and a more focused division of labour in all areas of urban finance. This type of partnership requires the continuous engagement of all relevant stakeholders.

In this regard, a long-term, programmatic and well-sequenced approach to donor engagement in urban finance and development is crucial. For example, donor engagement must be structured in a way that allows for a systematic hand-off of projects to the local partner and/or other international partners to assure the sustainability and scaling up of successful interventions. A longer-term, more

sequenced approach also requires a realistic comprehensive medium-term fiscal plan both at the central and local government levels.

Equally important is a convergence of views between donor and recipient countries on the level of central government support and empowerment of local authorities, in fiscal, political and administrative terms. Often, donor interventions take place on a non-objection basis by the central government but lack its sustained political buy-in and/or fiscal support in the form of reliable, predictable and adequate transfers of resources. In the worst case, this might result in a reduction or even withdrawal of support by the central government once a donor organization is involved. It is therefore crucial to realistically assess the government's plan for decentralization, looking both at the legal framework and its actual implementation.

Moreover, the need for a careful analysis of the local context cannot be overemphasized. For example, as highlighted in the chapter on PFM reforms, donors should carefully examine whether certain more advanced models based on international standards are suitable to the situation in a specific local authority or create an additional burden on an already strained administration.

Previous chapters also conclude that international cooperation on urban finance should put a greater focus on adequate capacity-building in urban financial institutions (see Nepal and Senegal and Bangladesh (3) case studies) with sustained assistance that goes beyond short-term training and aims to help develop policy and implementation planning and management capacity at the local government level. In general, capacity-building should focus more explicitly on the urban

finance dimension as a key element supporting sustainability of programmes. Improved own source revenue generation, PFM reform, as well as judicious debt management and municipal borrowing practices are the key ingredients for urban finance reform. Another important area for greater donor engagement in urban finance is risk mitigation. For example, market risks, including foreign exchange risk, need to be carefully assessed and either hedged or removed from municipal responsibilities. Moreover, donors have a critical role to play in providing incentives to LDC municipalities to regularly undergo credit rating exercises and to help them implement an action plan between one rating exercise and the following one so as to send clear signals to their respective constituencies and to the financial markets as they prepare for possible debt issuance. Finally, donors could work together to establish clear results metrics for financial outcomes as part of more effective monitoring and evaluation.

Consequently, there are multiple entry points for more effective international cooperation on urban finance that could help pave the way for a successful implementation of the 2030 Agenda for Sustainable Development at the local level.

Using new platforms for dialogue at the international level

The strong focus on the role of local governments for achieving sustainable

development provides new platforms for national and urban governments, civil society, donors, academia, the business sector and other stakeholders to discuss critical urban finance issues. Now that the follow-up mechanisms for the 2030 Agenda for Sustainable Development, the Financing for Development process and the Habitat III follow-up are in place, they can serve as platforms to further engage on urban finance. Including local governments in the implementation discussions may reap additional benefits. For example, they can promote sustainable development by raising awareness in their constituencies. In addition, they can support their national governments with the formulation of sustainable development strategies at the national level. Also, local governments can support monitoring and evaluation efforts by providing (financial and non-financial) data.

It will, therefore, be important to ensure that the global commitments that are relevant for the urban level will be translated into concrete policy making in the coming years. For this reason, the involvement of local actors at the international level will be crucial to ensure that their positions are reflected adequately in global discussions. At the same time, the urban level has a lot to contribute to the broader international community by sharing their experiences with the implementation of the SDGs, the Addis Ababa Action Agenda and the New Urban Agenda.

KEY MESSAGES

- Total ODA for projects at the urban level has more than doubled in the last decade. However, the benefits of this trend have largely bypassed LDCs. The major share of ODA for urban projects goes to middle income countries, while LDCs receive only about 23 per cent. Less than 10 per cent of multinational climate funds were spent on cities in LDCs.
- South-South cooperation, for example, city-to-city cooperation or aid by Southern donors, is becoming increasingly relevant for local governments in LDCs.
- There is a greater need for partnership development, better coordination and a more focused division of labour in all areas of urban finance. This type of partnership requires continuous engagement by all relevant stakeholders.
- More long-term, programmatic and sequenced approaches to donor engagement in urban finance and development are crucial. Donor engagement must be structured in a way that allows for a systematic hand-off of projects to the local partner and/or other international partners to assure sustainability and scaling up of successful interventions.
- A lack of capacity remains a key issue for urban service delivery, revenue generation, financial management and project implementation in cities in LDCs. International cooperation can play a critical role through the provision of targeted measures, especially through projects that are specifically geared towards increasing financial capacity, like PFM. Capacity-building efforts should also aim for improved communication, collaboration and coordination between urban finance stakeholders, including different layers of government.
- There is a vast repository of experiences with different approaches, tools and mechanisms to strengthen urban finance in LDCs. International cooperation should further intensify efforts to learn from past successes and failures. With their focus on the role of local governments for sustainable development, the 2030 Agenda for Sustainable Development, the Financing for Development process and the Habitat III follow-up can provide platforms at the global level for all stakeholders to engage.

CASE STUDIES

TANZANIA (3): INTERNATIONAL COOPERATION IN SUPPORT OF DECENTRALIZATION AND LOCAL PUBLIC SERVICE DELIVERY THROUGH PERFORMANCE-BASED GRANTS

The Government of Tanzania launched a major reform of local governments in 1994. Part of the reform was to initiate an ambitious and complex decentralization process that aimed to strengthen local government autonomy. However, the early results of the decentralization efforts were mixed. Momentum picked up in 2000 with the launch of the

national “Decentralization by devolution” reform that aimed to improve public service delivery by local authorities. As part of the second implementation phase that started in 2009, international donors supported

the introduction of various intergovernmental fiscal transfer systems that also included performance-based elements. To tap into these funds, local governments needed to complete annual performance assessments to measure whether they had fulfilled access criteria and met performance indicators.

After 2013, the World Bank remained the largest international donor supporting decentralization in Tanzania. Part of its Urban Local Government Strengthening Program is an Urban Performance Grant that targets service delivery in 18 urban areas with a combined population of 2.6 million. The total programme budget is \$255 million,



which includes up to \$44 million for centrally organized capacity-building efforts and up to 5 per cent for capacity-building at the local level. The possible annual disbursement of the funds is based on an estimate of \$18 per capita as the amount required by cities to deliver adequate public services. Currently, cities receive only \$2 per capita through transfers from the central level.

Tanzanian government officials have confirmed their support for the performance-based grants, saying that the possibility to generate additional resources can enable local authorities to strengthen public service and infrastructure provision. Efforts to meet the performance requirements are not viewed as an additional burden on the administration. Local officials perceive the indicators

POLICY LESSON:

International cooperation can support decentralization and local public service delivery through performance-based grants.



as being aligned with the interests of local authorities, which creates positive incentives. However, there is still a need for additional capacity-building.

The experience from Tanzania shows that performance-based grants can be a constructive instrument for international organizations to support decentralization and local public service delivery. However, sufficient capacities both at the central and local government level are essential. Therefore, any programme promoting performance-based grants should include a

capacity assessment and building component with a long-term orientation and continuous monitoring at all levels. An option could be to include an indicator that measures capacity-building efforts as part of the performance assessment. Finally, any donor programme that includes financial contributions to intergovernmental transfer systems should include measures to develop options for revenue generation that can eventually replace external funding once donor engagement ends.

Complementary source: Janus and Keijzer (2015).

SENEGAL AND NEPAL: INTERNATIONAL COOPERATION IN SUPPORT OF LOCAL DEVELOPMENT (FINANCE) INSTITUTIONS

The Local Development Agency (ADL) in Senegal and the Town Development Fund (TDF) in Nepal are examples of institutions that concentrate on local development finance, with support from international donor contributions.

In 1988, the TDF Board was established as a semi-autonomous institution under the Ministry of Housing and Physical Planning, with

POLICY LESSON:

Investing in long term support in national local development finance institutions can help provide funding and capacity-building for local governments. It takes a long-term approach though to make the institutions independent from external financing.

financial and technical support from the Government of Germany, the World Bank, and UN Habitat. The 1997 Town Development Fund Act provided the legal basis for the current form of the TDF as an autonomous board. Since then, the TDF has provided loans, soft loans and grants for more than 1,000 projects in social infrastructure

(drainage, slum area improvement, public bathrooms), basic utility infrastructure projects (drinking water and sanitation, roads, bridges, municipal buildings) and other revenue generating activities (bus terminals, touristic site development, market place development). Initial loans showed recovery rates of 96 per cent; however, the recovery rate later dropped to 65 per cent. The reasons were an increased lending to higher levels of government, larger loan sizes and lending to entities other than munic-



ipalities. Because of the poor performance, the TDF Board approved a change in the business strategy with the goal of remodelling the TDF as an independent financial intermediary.

To operationalize the TDF as an independent financial intermediary, additional changes to the legal framework will be required. As an intermediary, the TDF will still rely on a capital base predominantly provided by the Govern-

ment of Nepal and development cooperation partners. However, the TDF would also be able to raise its equity capital through public offerings, as well as to tap capital markets through the issuance of bonds and deposit certificates for institutional investors. One challenge for the TDF would be to reduce its operational expenses, which have been at about 31 per cent of total income due to the extension of technical support to its clients. In addition, the TDF needs to upgrade the skills of its staff to fulfil its mandate. International cooperation could play an important role by providing technical assistance to build the required capacities.

Senegal established its Local Development Agency (L'Agence de Développement Local, ADL) in 2010 with the goal of setting up a permanent and autonomous structure for the promotion and coordination of local development (Department for International Development). ADL receives financial and technical support from the governments of Luxemburg, Germany, Canada as well as from UNICEF. Support to municipal financing is not a core ADL mandate; instead it focuses on advisory services, such as support for project implementation through the provision of planning tools. Nevertheless, the establishment of a financial intermediary structure is one of the projects the ADL is currently pursuing, which in its current early stage includes the identification of potential partners and the realization of feasibility studies.

Currently, the ADL is not able to meet the demand from local authorities—in 2014, the ADL allocated about \$800,000 for local projects but received proposals worth more than ten times that amount. With only 33 staff members, the ADL is also severely understaffed. The shortage of financial and human resources clearly limits the possible impact the ADL could have on local development in Senegal.

A study by the Global Fund for Cities Development (FMDV) examined local development organizations in several African countries (LDCs: Benin, Burundi, Madagascar, Mali, Niger and Senegal; as well as Cameroon and Gabon) and identified multiple lessons learned based on the maturity of the organization. For organizations at the early stages of development, it is suggested to develop clear strategies to tap all available sources of funding. The study also recommends establishing formal partnerships including the identification of focal points with critical actors, such as ministries of finance, local development and decentralization, among others. With regard to internal organizational structures, it is suggested that local development organizations include specific departments for partnership management and resource mobilization. Furthermore, the study proposes developing clear criteria for quality management, technical control, audits and introducing sanctions for rule violations.

Local development organizations at a more advanced stage of organizational development are recommended to aim to strengthen their role as financial intermediaries, including the ability to raise capital, which might require changes to their legal status. They are also encouraged to strengthen their ability to attract institutional investors. Another proposal is to consider broadening the range of services and financial products that are offered, for example by investigating the potential of innovative financial products. However, even more established local development organizations should be cautious about expanding their areas of business too quickly and make sure not to overburden their capacities or to jeopardize their position in the national institutional setup.

Complementary sources: Ramanujam et al. (2012); FMDV (2016).

BANGLADESH (3): ESTABLISHING A MUNICIPAL DEVELOPMENT FUND TO FINANCE LOCAL INFRASTRUCTURE

There are 313 municipalities in four major cities in Bangladesh with populations ranging from 50,000 people to 10 million in Dhaka municipality. Many municipalities lack the institutional capacity to plan, finance, implement and operate urban infrastructure services in an efficient and sustainable manner. In response to this infrastructure financing gap, the Government of Bangladesh, with technical and financial assistance

POLICY LESSON:

Establishing a municipal development fund can help depoliticize intergovernmental transfers and build borrowing capacity at the local government level, but its successful operation requires close coordination with a large number of stakeholders, project development capacity, and evidence of added value to secure sustained external funding.

from multilateral institutions, set up the Bangladesh Municipal Development Fund (BMDF) in 1999. Its primary objectives include the extension of financial support to the Urban Local Government Bodies (ULB) to strengthen their institutional and financial capacity to plan, finance, implement and operate infrastructure services, to receive loans and grants and make them available through a fund

for ULBs; to provide financial and technical assistance for infrastructure projects in ULBs; and to build local government capacity to facilitate a path to independence and self-sufficiency in the long run. The BMDF receives loans from development partners and channels the funds to the ULBs, which need to



make a 10 per cent matching contribution. Of the 90 per cent of funds received from the International Development Association (IDA), ULBs receive 85 per cent as a grant and 15 per cent as a loan. In 2014-15, BMDF reported an income of \$2.23 million and grants of \$4.87 million. BMDF's loan recovery rate is 84 per cent and loans are not written off. By mid-2014, BMDF had funded 596 projects in 154 ULBs.

The model has been fully driven by demand from municipalities, and has had limited political interference by the central government. In addition, the fund's tax revenue requirements and the competitive nature of its allocations have helped steer

municipalities towards increasing their tax revenue by an average of 17.5 per cent, though this average has fallen short of World Bank targets due to considerable variability between the municipalities. In fact, from a sample of 39 cities, 23 cities increased their tax revenues by between 48 per cent and 95 per cent, while 7 other cities reported increases of between 40 per cent and 47 per cent. BMDF's administrative costs and consulting services have been low, drawing on only 3 per cent of the seed funds. However, the Fund has also encountered challenges. Due to shortages of resources, BMDF projects have addressed only a subset of municipalities. A related challenge has been the sustainability of the Fund, which remains donor dependent. Although the BMDF has supported nearly 600 subprojects in a variety of sectors, donors cannot clearly discern the added value of the BMDF, as there is little information on the level of municipal investments (mostly financed by central government block grants) prior to BMDF engagement. Consequently, the BMDF has experienced periods when it was in danger of closure due to a lack of new capital and limited capacity. There is also a need for closer coordination between the BMDF and other government-driven local development programmes. Moreover, technical assistance at the local level must be built into projects like the BMDF, since many municipalities lack the capacity and expertise to formulate investible project proposals, especially due to a lack of engineers.

The World Bank has drawn some important general lessons from its experience providing support to the BMDF that can be relevant for similar processes to establish local finance institutions (World Bank, 2012b). First, for organizations that are newly set up, time frames should be realistic, especially if substantial policy reforms are required. Second, technical support to local governments is essential for the preparation of viable project proposals and to ensure successful implementation. The experience with the BMDF showed that a high level of flexibility is necessary for local authorities to manage projects in line with their priorities and capacities. Third, eligibility criteria for local authorities to access funds (such as the tax collection rate, demonstrated commitment to projects, preparation of financial and operational plans, among others) should be adapted to the specific country context and be commensurate with local government capacity. Fourth, in addition to better utilizing the existing institutional arrangements, it may be helpful to establish a unit or create linkages with an existing one that can coordinate capacity-building measures with other relevant efforts both by the domestic government as well as by international donors. Fifth, projects should include disaster risk management or contingent emergency response elements to avoid the need for project restructuring in the event of a disaster. Finally, all projects should be planned and implemented using participatory approaches to ensure that all relevant stakeholders are involved.

Complementary sources: Gilbert (2013).

NEPAL (4): LESSONS FROM A PROGRAMME TO SUPPORT LOCAL GOVERNANCE

Nepal has traditionally been one of the LDCs with the lowest degree of urbanization, but rates have increased in the last decades. At the same time, Nepal has also initiated a decentralization process that was ultimately reflected in a change to the constitution in 2015. This constitutional change established a federal governance system that assigns greater autonomy and responsibilities to the provincial and local levels. The ongoing reform will

POLICY LESSON:

International cooperation can contribute to the improvement of many indicators for urban finance, including the timely disbursement of intergovernmental transfers, public participation and public audits, among others.

However, projects need to consider gaps in the legal framework and the capacities of critical institutions, such as the Office of the Auditor General.

drastically decrease the number of local government units.

Against this backdrop, the United Kingdom's Department for International Development (DFID) through its Local Governance Support Programme is supporting Nepalese urban governments in the overall context of the government's Local Governance and Community Development Programme, which supports public investment, economic growth and service

provision at the local level. DFID has committed £70 million for the 2013-2017 period. One component of the support aims to strengthen accountability through public hearings and



information dissemination. Furthermore, the programme targets both the Ministry of Federal Affairs and Local Development (MoFALD) and local government bodies with capacity-building measures to oversee and strengthen financial management and accountability.

An interim evaluation of the project showed that within the first year, the number of project and budget allocations that were made based on the demands of local ward citizen forums, which promote accountability, increased by 10 per cent. The findings confirmed the need for technical and financial soundness and strategic orientation of project proposals. Another major achievement that was observed was that at least 50 per cent of local government budgets were received by the end of the second trimester of the year, which is important for timely expenditure accounting. Overall, this shows how international cooperation can contribute to improving many urban finance indicators.



A shortcoming that was recognized by the interim evaluation of the DFID programme was the quality of expenditure reporting by local government bodies. The local government bodies lack adequate reporting structures for community infrastructure, which result in insufficient quality assurance, technical support and coordination among local authorities. The new constitution does not include any detailed provisions for financial reporting and accountability at the local government level. However, the constitution strengthens the role of the Office of the

Auditor General with regards to auditing local governments, which places additional burdens on the Office. To further improve urban finance through international cooperation, DFID and other donor agencies have supported MoFALD, with the introduction of a Fiduciary Risk Reduction Action Plan that aims to promote public financial management, internal audit and financial reporting at the national and local levels.

Complementary source: United Kingdom Department for International Development (2015).

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The 2030 Agenda for Sustainable Development is an action plan that aims to bring prosperity to the people and the planet. This publication recognizes the important role local governments play in the implementation of the Sustainable Development Goals, as well as the Addis Ababa Action Agenda, and aims to illuminate the multi-faceted urban financing challenges. It particularly focusses on Least Developed Countries (LDCs), as local governments in these countries are often on the front lines in the quest to improve lives and livelihoods in complex circumstances. Through country-specific analysis, new data, and a number of country case studies, the authors provide policy makers at the local and national levels with the following lessons and recommendations to meet urban finance challenges in LDCs.

- Local governments should continue to make strides in generating greater own source revenues through the effective design and collection of user fees and taxes; improved financial management frameworks; and sound long-term investment strategies.
- Meeting urban finance challenges extends beyond the responsibility of local governments. National governments must put in place a reliable system of intergovernmental transfers. In addition, they need to provide a regulatory and legislative framework that empowers local authorities and clearly specifies their fiscal, administrative and political responsibilities.
- Technical improvements and capacity-building efforts can lead to major improvements in urban finance. However, a stronger emphasis must be placed on assessing the local socioeconomic context before reforms are undertaken; understanding the politics that ultimately drive or impede urban finance reforms; designing sensitive implementation strategies to adjust to political and economic realities at the national and subnational levels; and improving communication and coordination among urban finance stakeholders, including central and local governments, citizens and donors.
- International cooperation can facilitate subnational finance. There is much room for development partners to strengthen their support of local governments, both in terms of the quantity and the quality of their engagement. In addition, South-South cooperation at the subnational level is a promising mechanism to further drive successful urban finance reform in LDCs.



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