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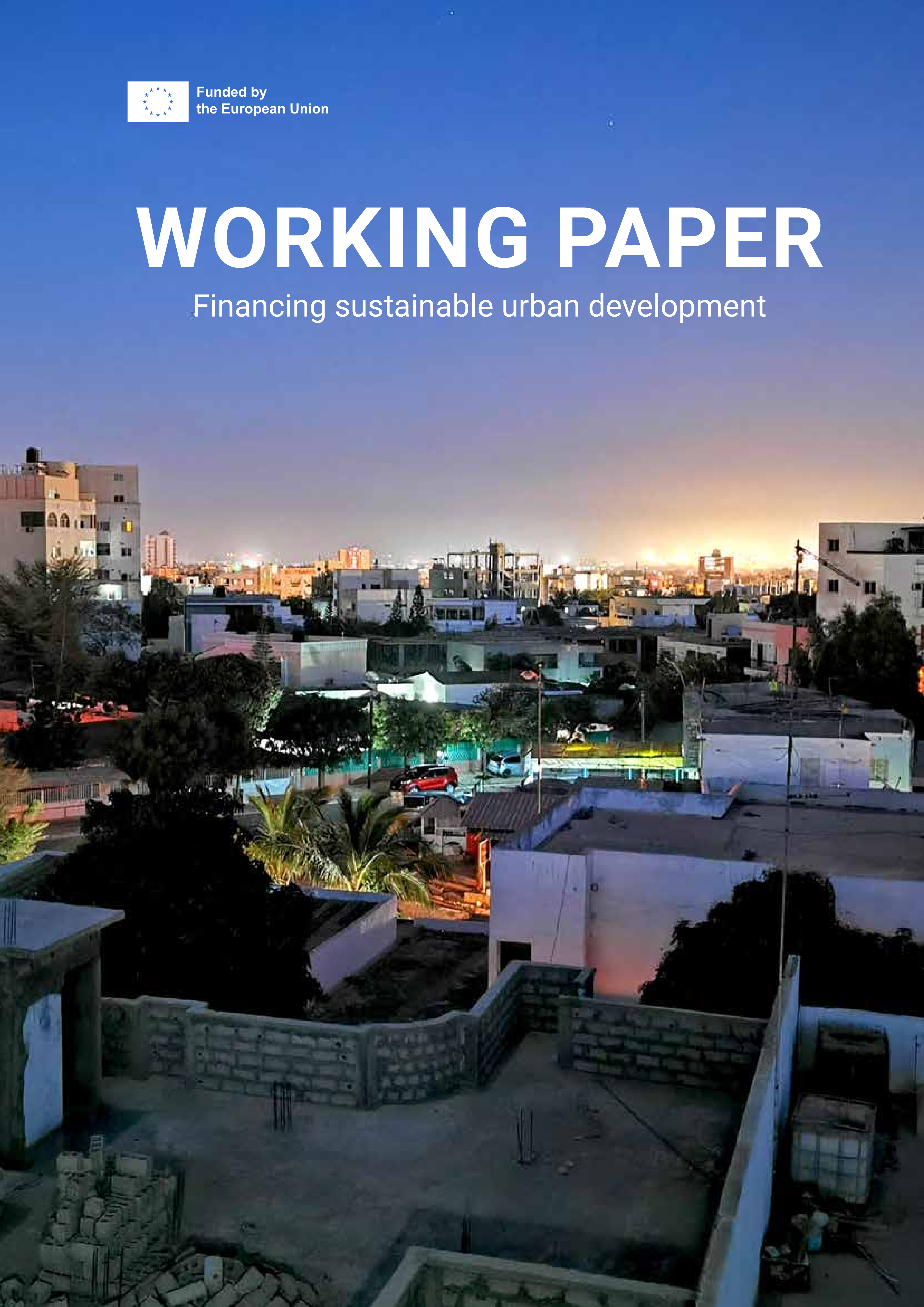
WORKING PAPER

Financing sustainable urban development



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Supporting the Urban Dimension of Development Cooperation: Increasing the financial capacities of cities in developing countries to deliver productive and sustainable urban development

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UN-HABITAT FOR A BETTER URBAN FUTURE

European Commission — Directorate-General for International Partnerships

European Investment Bank — The EU bank

IGC International Growth Centre

Cover photo: View of Senegal by Night © Shutterstock

List of abbreviations

African Sustainable Cities Initiative (ASCI)

Cities Climate Finance Leadership Alliance (CCFLA)

Excellent Design For Greater Efficiencies (EDGE)

Global Fund for Cities Development (FMDV)

Euro (EUR)

Gross domestic product (GDP)

Local Governments for Sustainability (ICLEI)

International Development Association (IDA)

International Finance Corporation (IFC)

International finance institutions (IFIs)

Kampala Capital City Authority (KCCA)

Kisumu County Government (KCG)

Malawian Kwacha (MWK)

Nigerian Naira (NGN)

Own-source revenue (OSR)

Public Financial Management (PFM)

Public-private partnership (PPP)

Resilient City Development (RECIDE)

South African Rand (ZAR)

Ugandan Shilling (UGX)

United Cities and Local Governments (UCLG)

Rapid Own Source Revenue Analysis (ROSRA)

1. Background

This working paper is the outcome of the initiative "Supporting the Urban Dimension of Development Cooperation: Increasing the financial capacities of cities in developing countries to deliver productive and sustainable urban development" requested by the European Parliament as a pilot project and funded by the European Union.

The intention of the initiative is to identify lessons on how to strengthen urban finance, building on a range of city case studies from countries selected to represent different levels of urbanisation and structural transformation[i], examples, and discussions with key stakeholders.

The working paper seeks to synthesise findings from fact-finding missions as well as deliberations at the meetings of the Advisory Group, and other engagements with experts and city leaders. It integrates the informed views of decision makers at various levels of government, as well as the expertise of development cooperation practitioners and academia on why it has become increasingly urgent to escalate investment from all sectors and sources in cities in developing countries, and to identify concrete and actionable measures that could help alleviate constraints on mobilising finance for sustainable urban development. We do not find all solutions in these case studies. However, they provide us with insights about various challenges faced by different types of cities and countries. Analysing the challenges, we consider and point out different areas worth focusing on in further work.

Much of the analysis in this working paper is based on the situation in sub-Saharan Africa, but many of the principles are considered also relevant to other developing countries, and complementary examples from other regions have been discussed at expert group meetings and are included as well.

The paradigm underpinning this working paper has been best expressed by Prof. Sir Paul Collier at the High-level Meeting at the European Parliament in November 2019: "Properly governed, urbanisation may serve as a crucial driver for development and economic growth. Harnessing urbanisation is the key prerequisite for African cities to become engines for productivity and liveability."

Urban development is often narrowly defined as provision of key urban infrastructure and services (water and sanitation, energy and mobility). In this working paper, however, it is understood in the comprehensive sense of governance, encompassing a wide range of actors engaged in steering urban development at multiple levels, with a broad sectorial scope that includes infrastructure, real estate development, housing and services, and closely linked to local development.

The working paper lays out its argument in the following sequence:

Severe lack of balanced and systematic investment in urban development in key urban infrastructure jeopardises the potential productivity and liveability of cities in developing countries. This has resulted in housing and scarce employment becoming overwhelmingly informal, and the formal segments excessively expensive. Adding pressure to this is the surge of population growth, fired by demographic factors as well as rural-to-urban migration.

Development of productive and equitable cities requires an array of conditions, which promote the availability of funds for investment, clear responsibilities, effective coordination, and efficient collaboration by governance systems. This is needed to ensure coherence and synergies of public and private spending. This working paper focuses on investment conditions and drivers, recognising the importance of flexibility to cater to a wide variety of contexts. It suggests some critical areas of support with a view towards strengthening urban finance and, in a broader sense, developing productive, liveable and equitable cities. Finally, the paper suggests the next steps needed to enhance the knowledge base on this critical area of reform.

i Case study reports have been produced under this initiative for Kisumu, Kenya; Mzuzu, Malawi; Dakar, Senegal; Hargeisa, Somaliland, Somalia; and Kampala, Uganda.

The positive relationship between urbanisation, productivity and finance

Urbanisation drives productivity through improved division of labour and specialisation, economies of scale, and agglomeration. The effectiveness of urbanisation in driving productivity depends on cities providing the setting for clustering of interdependent firms and value chains, which, in turn, transform the economy.

Public goods are needed to support this transformation, such as land markets, energy grids, connectivity and mobility. A productive city also needs to be liveable through the provision of basic services, sewerage, land rights, etc., to attract talents and skilled labour that allow for a specialisation in knowledge, skills, and management capabilities.

Good urbanisation stimulates structural transformation that can deepen the division of labour and specialisation, provide shared and efficient infrastructure and services, and facilitate the scaling up of effective markets. Such urbanisation pathways improve productivity, the quality of economy and the value of cities, enhancing their capacity to manage higher-level economic activities and productivity.

However, urbanisation can also occur in the absence of economic growth and productivity. For example, in some Sub-Saharan African countries, urbanisation has, to a large extent, occurred independent of economic development and without structural transformation. In such contexts, financial instruments alone cannot change the future of cities. For example, own source revenue (OSR) mobilisation in cities can only be realised through enhanced productivity and economic growth that enables citizens to pay taxes and fees.

If we want to enhance the financial positions of cities, we need to shift the priorities towards financing the productive assets of cities, and productivity factors in combination with better urban planning, sound budgetary management, and more stable and predictable revenues. It is key to support the structural transformation of countries through better-governed urbanisation. Achieving economic growth provides a sound foundation and power for low- and middle-income countries and cities to generate revenue and will increase their own capacity to finance such better-organised urbanisation. This, in turn, helps improve economic and social productivity and sustainability, thus creating a positive cycle of urbanisation, productivity and finance.

Farmer's market in Kampala, Uganda © Shutterstock

2. Why a strengthened focus on sustainable urban development?

This chapter introduces urban development in the context of overall economic development of cities in low- and medium-income countries with the example of sub-Saharan Africa. It explains why, in achieving sustainable urban development, it is particularly imperative to address the challenges of financing in a timely sort of way.

In sub-Saharan Africa, challenges of sustainable development are immense. It is the least urbanised region in the world (40.4 per cent) and has the highest urban growth rates; population in urban areas is projected to almost triple to 1.26 billion by 2050.1 In most cases, both central and local governments are ill-prepared for this extraordinary growth. Internal urban population grows fast, creating a youth bulge. In addition, with predominantly poor populations migrating to urban areas looking for income, the combined growth fuels uncontrolled and informal urban sprawl. Rapid land-use change on the outskirts of cities and towns increases their need for basic infrastructure and services, which are not delivered. With a lack of urban planning and management capacity, and weak financial mechanisms, the resulting socio-economic inequalities will undermine the aims of the Sustainable Development Goals (SDGs) without immediate action to prepare for the future.

Today, Kinshasa, Abidjan and Dakar are the largest francophone agglomerations in the world after Paris; Cairo is the largest agglomeration in the Arab World, and Lagos and Johannesburg are among the 10 largest English-speaking agglomerations. However, it is the continued emergence of thousands of small towns and intermediary cities that is profoundly transforming African societies.[2] Contrary to widely held assumptions, Africa is urbanising fast mainly because of its growing towns and intermediate cities. Between 2000 and 2010, urban agglomerations with fewer than 300,000 inhabitants accounted for 58 per cent of Africa's urban growth; agglomerations with 300,000 to 1 million inhabitants accounted for only 13 per cent, while those with over 1 million inhabitants made up the remaining 29 per cent. Between 2010 and 2030, the small agglomerations are forecasted to make up 51 per cent of urban population growth, with intermediate ones making up 16 per cent and the largest, 33 per cent.[3] The biggest increases are in West and East Africa.[4]

Whilst extreme poverty has been decreasing in Africa,[5] poverty in cities is rising.[6] In the short run, increases in poverty are likely to be exacerbated by the lockdowns due to the COVID-19 crisis, and the resultant shift in public spending priorities.

The impact of COVID-19 on municipal finance in developing countries

Globally, urban areas are the epicentres of the pandemic, accounting for most of the confirmed COVID-19 cases.[7] The COVID-19 risk factors are acute in cities in the developing world, in part due to the largely unplanned and poorly managed urbanisation process that has resulted in widespread informal settlements, and severe infrastructure and service deficits.

From a macroeconomic perspective, most measures are financed by public debt. According to the IMF, in 2020, global public debt will be around 101 per cent of Gross Domestic Product (GDP) – six times larger than the year before. In high-income countries with available vaccines and a recovering economy, the productive sector will slowly restart but probably not to a level that can support repayment. In developing countries, some debt relief and support from financial institutions will be called for in the next years to balance economies.[8]

At the urban level, enterprises and sectors have undergone drastic reductions and closures, especially small and medium enterprises, which require prolonged physical human contact in customer service. Widespread loss of employment income has been registered, with informal sector workers being especially vulnerable. With many households predicted to fall back into the poverty trap, it may become a pervasive feature of urban areas. Other challenges include elevated risks of eviction and homelessness, food insecurity and information inequalities, especially among women. “As first responders in tackling the urban impacts of COVID-19, local authorities are key actors in taking measures to tackle the crisis, yet many face capacity constraints, including a loss of up to 60 per cent of their revenues.”[9]

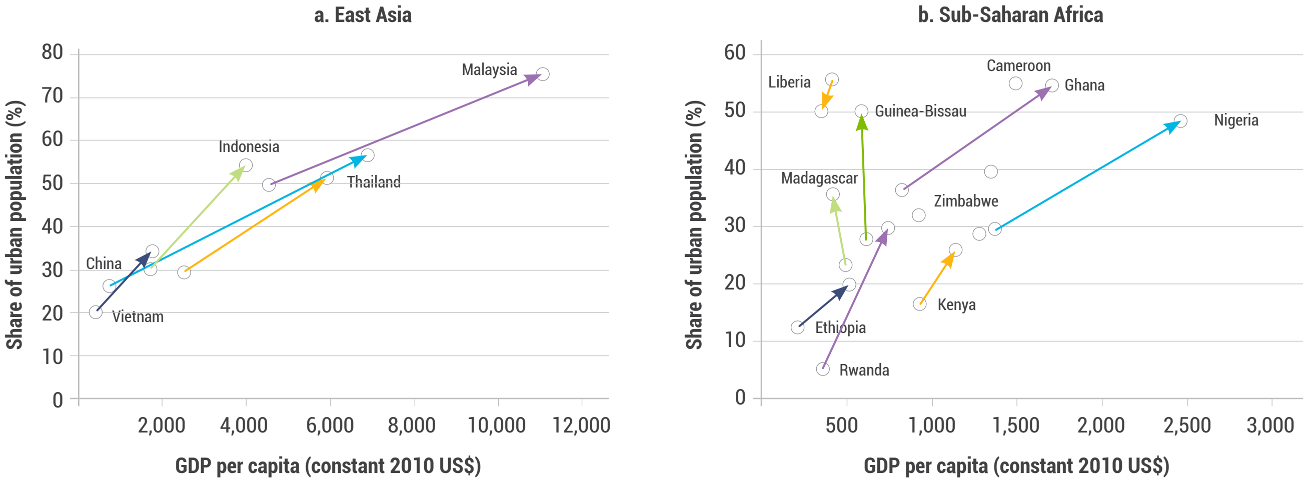
The pandemic has deepened financial shortcomings, putting additional pressure on already strained local and regional budgets. The resources of a majority of local and regional governments have been severely affected by the non-collection of taxes, charges, and user fees due to the cessation of economic activities and a sharp drop in household incomes.

COVID-19 has also increased uncertainty about local revenues. There are risks that transfers may be affected as national governments face their own budgetary constraints. “This lack of visibility over future local revenues, combined with record sovereign debt levels, may further reduce the possibility for local and regional governments to directly access external financing.”[10]

Stable multi-level governance systems that foster proactive collaboration are an important precondition for effective response in this crisis, including when it comes to resource allocations. Coordination and cooperation between actors are essential, and the COVID-19 pandemic highlights the fact that functioning multi-level governance maximises responses and enhances effectiveness. National, sub-national (regional/metropolitan) and local governments have appreciated the magnitude, complexity and urgency of the challenge that the pandemic presents and are engaged in multi-level governance to complement each other’s activities and streamline their responses. All levels of governance have a role in response, and whilst these roles may differ in different settings and circumstances, vertical coordination and cross-jurisdictional collaboration is essential to achieve effectiveness of response to the COVID-19 crisis.[11]

Productivity of African cities remains low in part because of insufficient infrastructure.[12] In addition to the lack of basic infrastructure, inadequate public services, and unaffordable housing, both living and doing business in African cities is relatively expensive,[13] making them even less competitive globally. Between 2000 and 2018, the productivity ratio of Africa to Asia decreased from 67 to 50 per cent.[14]

Figure 1: Urbanisation and economic development in Asia and Sub-Sahara Africa



Source: Keynote speech by Prof. Ivan Turok, deputy executive director, Economic Performance and Development, Human Science Research Council at the UN-Habitat Governing Council in Nairobi, Kenya, in April 2013 (http://www.hsrc.ac.za/en/review/hsrc-review-july-2013/releasing-the-transformative-power-of-urbanisation)

Another set of (more difficult to measure) factors causing low productivity is the fragility of the rule of law, weak institutions, and low governance transparency. Some financial institutions conclude that these "infrastructure deficits are the result of decades of underinvestment, which, in turn, can be attributed to institutional and regulatory limitations (e.g., inefficient land markets, overlapping property rights and insufficient urban planning processes)"[15]. "As Africa's rapid urbanisation continues apace and as its nascent democracies become more consolidated, the intersection between governance and service delivery will undoubtedly become more pronounced."[16]

More than half of the urban population in sub-Saharan Africa lives in informal settlements, even if this share has decreased from two thirds of the population 30 years ago.[17] Yet, the informality of a city is not limited to its housing. Urban population growth that has not been accompanied by a similar growth in urban formal sector jobs has led to urban poverty and the proliferation of informal, low-wage, and vulnerable employment. It is estimated that at least three quarters of the urban workforce in Africa is informal.[18] Unemployment and underemployment in African cities are difficult to estimate due to lack of reliable data, but sources suggest that "each year, between 12 and 14 million young people enter the labour market, while only between two and three million of these find jobs"[19]. Such prevalence of informality has wide-ranging implications for housing conditions, job security, health, and unemployment benefits. It is also one of the reasons for the low competitiveness of African cities relative to their global peers.

Among both international financial institutions (IFIs) and developing country governments, there is an increasing interest in harnessing the informal sector with a view to expanding the revenue base. Even if informal employment and housing grow in the cities and contribute to the economy, this growth increases the need for additional infrastructure and services. Increased cash flows from the informal sector do not contribute to revenues, thus making the ratio of need for investment to the availability of public funds even worse, generating a vicious circle.

For example, the case study of Hargeisa in Somaliland, Somalia, shows that high levels of unemployment and informality characterise the city. In 2012, estimates showed the informal economy accounting for about 77 per cent of total employment in the city. One of the critical drivers of informality is a lack of development in the formal financial sector, which constrains the ability of businesses to access finance. While mobile money systems allow for transfers, most of financial services are provided by informal Islamic banking systems that offer short-term deposit schemes and no interest on payments. At the same time, informality also results from the crippling cost of doing business. In 2012, Hargeisa was one of the top 15 most expensive cities in the world to start a business, with 50 per cent of the expense arising from the local business license cost.

Currently, locally collected revenue in most developing cities remains inadequate due to low-income populations, informality, poor financial management and administration, and a lack of tax authority or the political will to use it. Information and systems are often out-of-date and cumbersome to navigate, and manual tax collection leaves room for pilferage, and increases the cost of levying each tax. Kampala, Uganda, prides itself on having automated its processes, moving away from manual collection, and introducing massive taxpayer sensitisation, thus improving compliance, which is now estimated by Kampala Capital City Authority (KCCA) to be slightly above 50 per cent. Although high for many tax-restrained cities, this still represents significant lost revenue and subsequent expenditure. Many improvements can be suggested, following good practice elsewhere. For example, Freetown in Sierra Leone just introduced a new way of taxing property, as part of a revamped and more progressive system, based on awarding points to determine the amount of the tax. The revised arrangement places a greater onus on the richest and could increase the capital's tax revenue five-fold.[20] However, as the case study of Kisumu, Kenya, demonstrates, sometimes such systems may look good on paper, and yet fail to deliver real improvement on the ground.

Intergovernmental organisations and IFIs note that "African countries are still chasing other developing countries in almost all measures of infrastructure coverage. Access to water, road transport and electricity are particularly limited. Quickly closing the infrastructural gaps would boost growth"[21]. Urban Africa fares better in the coverage of basic services, especially in comparatively richer countries. Country level access to services rates is the highest in the capital and other major cities. It is suggested that infrastructure provision gains across countries are driven by rural (low service provision) to urban (higher service provision) migration. Only 35 per cent of the population has access to electricity, with rural access rates less than a third of urban rates. Transport infrastructure is likewise lagging with sub-Saharan Africa being the only region in the world where road density has declined over the past 20 years. Access to safe water has increased, from 51 per cent of the population in 1990 to 77 per cent in 2015.[22] Yet, compared to 43 per cent in 1990, only a third of the urban population had piped water on premises in 2015.[23]

Researchers observe that infrastructure deficits and malfunctioning constitute one of the largest obstacles to sustained economic growth and accumulation. The regimes of infrastructure technological design, operations and management are determined by vested interests, and this is reinforced by institutional inertia. In most African contexts, dominant ruling political parties completely control public priority setting and resource allocation.[24] Infrastructure deficits attract an inordinate amount of political and technical attention, not least from international actors on the financing side of the development industry, always carrying a political charge.

Kisumu is one of the most urbanised Kenyan counties, with around 50 per cent of the population living in urban areas. Its lakeside location and international airport bear the potential to make Kisumu a tourism and trading hotspot in Kenya and the region. Despite favourable overall conditions, its economic growth has slowed down over the past few years to around 3.4 per cent, placing it well below the national average of almost six per cent.[25] In the context of inadequate policies and implementation of land management, spatial planning and financing, rapid population growth and urbanisation have created large informal settlements, which house nearly 40 per cent of the urban population. Only around 58 per cent of the county has access to water and 46 per cent to electricity.[26] With only 15 per cent paved roads, Kisumu also requires significant investment in infrastructure to decrease transportation costs of agricultural produce and attract private investment in the county's underutilised rural areas. Investment is also needed in education, vocational training, and the creation of job opportunities for its young and rapidly growing workforce (around 40 per cent of the population is between the ages of 15–35). Of this young population, 60 per cent are formally unemployed. The informal sector now employs 60 per cent of the total workforce.[27]

Prof. Edgar Pieterse said at the Cities and Experts meeting on 29 October 2020: "One of the core issues is the profound shift in the young demographic across cities and towns. Political leaders need to understand that a vast majority of jobs are informal, and we expect the labour force to triple in the next 30 years. There are too few decent jobs, and informal work opportunities don't facilitate social mobility. People in cities are close to economic opportunities but cannot access them. The de facto urban development model in Africa undermines economic productivity.

First, across the continent, we continue to invest in a sprawled and inefficient urban form. Second, we bifurcate our cities by aggregating investments in elite developments and new towns, which sometimes get a 'green wash' (eco-green towns), but only for the top 10 percent of the urban population, while the majority lives in informal settlements. Third, cities are marked by unreliable and very expensive basic services because of the way that the transaction costs are structured.

Dramatic economic improvement has to imply radical diversification of the economic base accompanied by large-scale job creation – the two components of structural transformation."

Even if the issues with informality, institutions, services and infrastructure could be resolved with political determination and enough investment over time, the underlying constraint of development in sub-Saharan Africa is the slow structural transformation of economies coupled with the fast growth of employable workforce.

"National development and economic planning should apply an urban lens to establish growth strategies that prioritize resource allocations across economic sectors, programmes and investments. This would enable the acceleration of structural transformation that unlocks the potential of cities and urban systems as drivers of sustainable and inclusive growth."[28] The case of Malaysia (see box on urbanisation and economic growth in Malaysia) illustrates these dynamics very well. In sub-Saharan Africa, growth of jobs will be "mainly in the services sector and non-tradable industrial sector (construction, utilities) rather than in manufacturing"[29]. It remains to be seen if the structural transformation of Africa will be less dependent on manufacturing relative to other continents, and how fast it can occur. However, for the goals of this initiative, it also means that getting cities ready to attract firms that bring about rapid growth of productivity is important, but this will be economically sustainable only if the structural transformation of economies provides for the emergence of those firms at scale and enables sufficient specialisation.

Urbanisation and economic growth in Malaysia

(Based on a presentation by Mr. Hamdan Majeed, Director, 'Think City' at the 29 October 2020 Cities and Experts meeting, complemented by literature)

Malaysia has sustained rapid and inclusive economic growth for close to half a century. Real GDP growth has averaged 6.4 per cent annually since 1970, outperforming most of the country's regional peers.[30] Sub-Saharan Africa can learn from the successes but also new challenges of Malaysia's urban trajectory.

From a low-income country and rural economy in 1975, with poverty rates at 70 per cent, the country underwent a major transformation through a series of structural reforms. Malaysia's urbanisation and economic growth are highly interrelated. In transitioning from a largely agrarian to an industrialised and diversified economy, with an urbanisation rate of 74 per cent in 2015, the benefits of urbanisation were unlocked.

Malaysia's development was enabled by four factors: policies encouraged rural-urban migration (e.g., New Economic Policy 1971, National Development Policy 1991, National Transformation Policy 2011); deregulation, liberalisation, and macroeconomic management in the 1980s accelerated infrastructure development; the Malaysian economy matured from an agrarian base to a manufacturing and services economy; the liberalisation of the Malaysian economy increased trade and catalysed economic growth.

While in recent decades, many countries have implemented decentralisation drives to increase efficiency and responsiveness, Malaysia is an exception. Its federal system is more than 50 years old and has a powerful central government and state governments with diminished responsibilities. Rather than decentralising, the country has pursued a sustained centralisation drive.[31]

Since independence, Malaysia has practiced a system of centralised economic development planning with five-yearly development plans. Development planning is the responsibility of the Economic Planning Unit in the Prime Minister's Department, which formulates the plans through an interactive process involving a broad range of stakeholders.[32] In Malaysia, the urban sector plays an important role in the National Development Policy and the government sees the importance of the urban economy as a driver of gross national income (GNI) growth. This is evident in the latest plan (Eleventh Malaysia Plan (2016-2020): Anchoring Growth on People). Of the six innovative approaches that have been identified to accelerate Malaysia's development ("game changers"), investing in competitive cities is one of them (see figure below).[33]

Game Changer: Investing in competitive cities

Why? Important to Malaysia

Cities played an important role in a nation's growth by providing investment and trade opportunities, as well as improving connectivity with rural or suburban areas

How? will this be achieved

City Competitiveness Master Plans will be developed for four major cities Kuala Lumpur, Johor Bahru, Kuching and Kota Kinabalu as a start, based on key principles that increase liveability and stimulate economic growth...

What? Will success look like

Four major cities in Malaysia will have undergone a step-change in their economic growth, importance as talent hubs, and liveability

City residents will be able to afford urban housing, have adequate public transportation systems, enjoy green and open spaces and have access to economic opportunities that will enable them to providet their children with a better future

Strategies

Developing city competitiveness master plans

- Enhancing economic density
- Expanding Transit-oriented Developmen(TOD)
- Strengthening knowledge-based clusters
- Enhancing liveability
- Adopting green-based development and practices
- Ensuring inclusivity

Strengthening corridors to fuel regional development

- Strategic review of the corridor development master plans
- Increased investment
- Improved infrastructure
- Improved talent and skill development

Image redrawn from: Malaysia Federal Department of Town and Country Planning. Ministry of Urban Wellbeing, Housing and Local Government. (2016). Malaysia National Report for the 3rd United Nations Conference on Housing and Sustainable Urban Development (HABITAT III).

Decades of growth have led to the nation's economic maturity, reduction in poverty, and wide provision of housing and basic amenities for its population. However, Malaysia now faces new challenges caused by the externalities of rapid urbanisation. These include a middle-income trap, uncoordinated development, congestion, climate change, growing inequality, as well as air pollution. Malaysian cities are highly car-centric, with transport costs taking up a relatively high share of household incomes. Despite growth and development, Malaysian cities have a low built-up area and low job density, with city centres emptying out and urban sprawl challenging the ability to achieve sustainable urban development. This has led to a relatively flat and inefficient urban form, contributing to low economic density in comparison to cities in neighbouring countries.

The next steps in building more resilient, interconnected, and inclusive urban areas for national prosperity are therefore: the prioritisation of a compact city approach to improve residents' access to jobs, services and amenities, and to reduce infrastructure capital cost; advancing a polycentric approach of a metropolitan network of cities, within and across national borders, with middle-sized cities as points or nodes that are linked by communication and mobility infrastructure to enable better flows of capital and people; developing a strong vision and a long-term plan to develop the country, adopting a more integrated approach to regional and city-level development; and promoting equitable economic growth distributed across the nation through spillovers from cities.

View from monorail station at Bukit Bintang in Kuala Lumpur, Malaysia © Shutterstock

When cities have effective, transparent, and accountable governance institutions and efficient infrastructure, they are a locus of productivity and economic growth, providing employment opportunities and access to basic services. Yet despite the role of cities in economic development, low-income countries have many other priorities for investment and expenditure, ranging from providing health and education to improving agricultural productivity. With comparatively low levels of public revenue, and political bias towards other priorities, governments of low- and medium-income countries chronically underinvest in transformative urban development: key infrastructure, basic services, accessibility to affordable housing, and support to creation of formal, equitable employment.

To address the current and future economic, societal and environmental challenges, prioritising investment into sustainable urban development can be a vehicle for achieving the top-tier goals of the international community, but also of the governments and the cities. These goals include eliminating the root causes of migration by improving life conditions in the source regions, enabling equitable productivity coupled with job creation to increase employment-seeking populations by bringing more firms to the cities, creating a greener economy and a cleaner, healthier and safer environment by providing basic infrastructure and services to urban dwellers.

There is considerable urgency to get this right. As the United Nations Economic Commission for Africa (UNECA) highlights, "There is a time window during which the urban transition takes place, when urban advantages need to be unlocked and exploited, and long-term growth patterns are set. In the context of Africa, the prevalence of informality and the huge backlog of investment needed to decongest and improve urban functionality make managing the urban transition uniquely challenging"[34].

Prof. Sir Paul Collier notes that with two thirds of the urban population by 2050 set to move into urban spaces that are not yet built, African cities have a short window of opportunity to make these investments, crowding in the mutually reinforcing benefits of productivity, sustainability and liveability for years to come. Without these public goods, cities become mega-slums that are neither productive nor liveable. The transformation of cities into productive and liveable places requires targeted public policy at national and subnational levels to support sustainable urbanisation – a process that is at a relatively early stage in most low-income countries, particularly in terms of implementation, and is always contingent on the specific context.

3. Common challenges and critical areas of support to improve financing of productive and sustainable urban development

"A good city puts in place physical and institutional infrastructure to attract firms. This requires effective investment in energy and water supply, sanitation, and mobility, but also a functioning land market and land rights, the capacity of cities to raise tax, as well as ability for urban planning and enforcement." (Prof. Sir Paul Collier, presenting this initiative at the High-level Policy Session at the European Parliament, November 2019).

Some authors suggest that the emphasis on the role of infrastructure in enabling growth is excessive[35], and that human development and "cognitive capital"[36] are equally important. Others warn that infrastructure development serves investors more than local populations.[37] We also recognise that, as identified by researchers, there are international trends focusing on infrastructure development, and that the consequences go beyond increasing productivity in developing countries. Indeed, they affect much broader processes in those countries, from domestic investment focusing on real estate development to shifts of economic power within countries[38]. This working paper does not question the importance of investing in human capital, or the need to design infrastructure so that it serves the needs of the citizens; it focuses instead on enabling sustainable urban development, which is impossible to achieve without infrastructure and basic services. Prof. Edward Glaeser stressed while discussing this working paper that analysts and practitioners must focus on the goals, irrespective of the level of authority or sector providing them, saying, "We must focus on fundamental outcomes making our cities more habitable, and there is not only one right way of achieving this. We should be wary of trying to shoehorn city building into a preconceived ideological notion".

Recent literature recommends focusing on several key issues to increase the productivity of cities in low-income countries. This chapter captures the findings of expert meetings, consultation/advisory meetings, case studies, and fieldwork. It covers examples of challenges that the low- and middle-income countries confront in financing sustainable urban development. It illustrates the systemic variety of challenges, and focuses on improvements in financing investment, improving coordination between levels of governance vertically and various types of revenues and expenditure horizontally, and what different groups of stakeholders can do to advance this agenda.

An example of the perceptions of key actors outlines a broad picture:

Manuel Lopes de Araújo, Mayor of Quelimane, Mozambique (Cities and Experts meeting on 29 October 2020): Many politicians still see cities in Africa as engines for trouble, not engines for growth. Yet, growth of population can be an opportunity and engine for growth if is well understood. A common challenge is a lack of understanding at the national level regarding the drivers and dynamics of urbanisation. There is a need to improve capacity to understand the dynamics and the logic of economic development and urbanisation at the national level, because local leaders are left to deal with the consequences of national level policies.

There is a constant failure of the postcolonial state in understanding the reasons for rural-urban migration and economic development. A historical example is Mozambique: Five years after independence, the government was faced with the challenge of unemployment in the city. Its failure to understand the reasons for rural-urban migration (being the collapse of the agricultural sector) led to the policy 'Operação Produção' that forced surplus labour towards the rural areas, with dramatic social, political, and economic consequences.

At the subnational level, a common challenge is a lack of urbanising strategies by local leaders. COVID-19 and extreme events such as cyclone Idai in 2019 have highlighted the importance of equipping mayors with the necessary tools to understand and manage challenges created by nature and/or the lack of policy understanding and implementation. These challenges are not just common at a local level, the interconnected system of global cities also make them common at an international level.

As Jan Olbrycht, Member of European Parliament, highlighted in the High-level Policy Session at the European Parliament in November 2019, there is a need for improved cooperation on urban development issues relevant to European cities and those in developing countries. The virus causing COVID-19 spreading through poor water provision or overcrowding in developing cities is also of importance to their global counterparts. In terms of financing, local governments suffer from a lack of financial autonomy. This is exacerbated by a lack of cooperation and understanding of priorities at the local and national level, hence necessitating constant and streamlined dialogue. There is a lack of financial infrastructure at local, national, and regional levels, and most African cities don't have a credit market and the capacity to borrow from the private or banking sector. Further, a lack of trained people hampers access to financial resources available at the national, regional and international levels. In this regard, the scarcity of ability to design and implement bankable projects is one of the biggest vulnerabilities.

3.1 Multi-level coordination and collaboration for financing effective investment in sustainable urban development

The lack of coordination and collaboration among the rich variety of actors, and a lack of capacity are common challenges that pervade urban governance in Africa. "The governance of most issues is characterised by fragmentation and a lack of coordination between governance actors; in the case of government actors, the ability to enforce regulations is usually quite limited. Skills and resources seem to be more thinly spread and diffused than is the case in the global North, meaning that one or two urban governance actors acting in isolation are seldom able to address many key urban challenges. As a result, key problems, such as inadequate infrastructure in marketplaces, traffic congestion and inadequate waste disposal systems are not addressed, and the problems persist and grow over time."[39] We know that the structure of a particular economy determines outcomes, shapes and constraints at the city scale, and we need to understand better how this happens. Development finance assessment could help us understand it better: countries could make use of the Integrated National Financing Framework Knowledge platform[40] to determine the structure and sectors of an economy as binding constraints and enablers of urban development. Here, we suggest three most important institutional conditions that underpin successful urban development in the long term. This chapter focuses on coordination and collaboration challenges, and what can be done to address them.

3.1.1 Enabling conditions: policies, harmonised goals and institutions

Ample research literature focuses on insufficient and dysfunctional infrastructure and basic services in Africa. It is not just the lack of funds that causes these deficiencies but also the underlying issue of the inability of governance systems to manage planning and delivery brought about by a lack of coordination and collaboration between levels, sectors, and actors of government. To improve access to finance for sustainable urban development, important enabling conditions must be put in place that relate to policies and the institutions implementing them.

First, **for sustainable urban development to serve as a driver of productivity and a vehicle to a country's top-tier development goals, it must be integrated in national development policies and meaningfully related to priorities of structural transformation**[41]. "Cities and other settlements play a central role in the objectives of the African Union's Agenda 2063. These include goals related to inclusive and sustainable development, and continental integration, unity, and renaissance. The vision for Agenda 2063 is to develop cities and other settlements as hubs that enhance access to social services and improved living standards, while also creating a network of interconnected cities. Agenda 2063, therefore, prioritises critical investments in economic and social infrastructure required to accelerate structural transformation."[42]

Edlam Yemeru, Chief, Urbanisation Section, United Nations Economic Commission for Africa (UNECA), at the 29 October 2020 cities and experts meeting: Domestic resource mobilisation is considered the main way in which African countries will implement the SDGs. However, urban revenues are too often not connected to domestic resource mobilisation agendas. National governments must explicitly and deliberately integrate urban finance into their national domestic resource mobilisation agendas, recognising the huge potential of local revenues, and the enormous role of local governments and cities in advancing the national resource mobilisation agenda and priorities.

Positioning sustainable urban development requires overcoming the rural policy bias still present in many African countries, as highlighted above by the historical example of Mozambique.

The case study of Malawi further illustrates this bias in the national governments institutional design: the supervision of local government and rural development is housed under one Ministry, while urban development falls separately under the Ministry of Lands and Housing. The result is that the development of local government is synonymous with uplifting rural areas, while urban agendas often fall between the cracks of the two Ministries. Most of the Malawian population (over 80 per cent) is still rural, hence national government efforts focus on uplifting rural districts. The four cities in Malawi – Lilongwe, Blantyre, Mzuzu, and Zomba – are therefore left mainly to their own devices in terms of providing essential services for their citizens and investing in future urban growth.

"Considering the significance of urbanisation in Africa in terms of scale and impact, it is of paramount importance to accord it an elevated, strategic and multisectoral focus in national development planning. Only then can the enormous advantages of Africa's rapid urban transition be harnessed to accelerate national growth and transformation priorities"[43].

Prof. Sir Paul Collier notes that "national development plans are uniquely suited to address the role of cities and urbanisation in development. Development happens in places, and even if a society is predominantly rural, those places are predominantly urban. This is because economic development depends upon bringing people together to reap economies of scale and specialisation. This transformation in productivity can only happen in cities, but cities need active and far-sighted planning." "While sector policies, subnational development strategies, and national urban policies can address urban issues and can play a role in implementing the vision of the national development plan, the national development plan is the only policy framework that can align economic and spatial planning under a common vision."[44] With strong renewed interest in national development plans and strategies over the last decade, there is a need to ensure an adequate focus on how these will be financed. Integrated national financing frameworks are a tool to finance national priorities and operationalise the Addis Ababa Agenda at the national level.[45]

"In Africa, there is a notable lack of interest on the part of central governments to tackle urban development. Perhaps this is a result of the stigma of rural-urban migration. The central governments need to pay more attention and offer more support to sustainable urban development. A change of perception needs to happen, and that requires a significant push." ***Amadou Oumarou, Director, Infrastructure & Urban Development, African Development Bank at the first Advisory Group Meeting***

South Africa's National Treasury City Support Programme[46]

In response to the challenges and opportunities of rapid urbanisation in South Africa, the National Treasury set up the Cities Support Programme in 2011. Recognising cities as 'critical national assets', it was established as an intergovernmental platform (including eight metropolitan municipalities, national departments and provincial governments) to support more inclusive, sustainable and productive urban reform. It also partnered with external stakeholders, including the major development banks and other implementation agencies.

There were five thematic focus areas, including core city governance, human settlements, public transport, economic development, and climate resilience. And within these, there were three key areas of support:

1. **A strong fiscal framework** to ensure efficient management of resources, including stronger performance incentives for intergovernmental grants to reward integrated planning and development.
2. **An enabling inter-governmental environment** through policy and regulatory reforms, including appropriate devolution of responsibilities.
3. **Implementation support**, including specialised technical assistance, peer-learning opportunities, and collaborative performance reviews.

A differentiated approach was taken depending on the size of the municipality, the budget and their capacity to deliver.

The structure of the programme within the government avoided duplication and absorbed existing efforts, while its location within the National Treasury allowed for synergies with wider departmental processes of policy and fiscal reform, and provide greater legitimacy to the initiative. However, it also meant that some stakeholders were reluctant to engage due to perceived meddling of the national government.

Despite a number of successes, there have also been areas for improvement. As a result, a strong sentiment of experimentation or learning-by-doing was instilled in the programme, and it underwent frequent reviews to iterate and adapt based on feedback and outcomes.

"National urban development strategies can succeed when a government identifies the priorities that contribute the most to the country's long-term development strategy. Priorities must be few, to avoid scattering resources, and place-based so as to avoid the lack of co-ordination often induced by purely sectoral approaches."[47]

Second, **implementing these policies requires functioning institutions that govern development and its financing in a country at all levels of governance.**[48]

Prof. Edward Glaeser notes that "infrastructure needs institutions to surround it – not only to be effective and to be reasonably maintained, but to be built properly first. Infrastructure and the institutions regulating and managing it are deeply intertwined, and I have trouble imagining how you could ever do infrastructure without the institutional component of it. I am happy with an 'infrastructure first' approach in the sense that I do not think you need eight centuries of common law before you can build a water system, but you will inevitably face the need for institutional design and institutional reform as part of the infrastructure provision process itself. In that sense, they can never be separate."

Infrastructure, incentives and institutions as a healthy and effective nexus[49]

Both the history of clean water provision in 19th century New York City, USA, and modern Lusaka, Zambia, illustrate that engineering and infrastructure provision alone are not enough for infrastructure to function effectively. In New York City, the availability of health-related infrastructure and public services (water and sewerage) was not enough to persuade a majority of residents in some areas to connect with the infrastructure, until regulations were instituted requiring their connection and fines were introduced for non-compliance. The core problem with health-related infrastructure in Lusaka and in most cities in the developing world today is that the average cost of this infrastructure exceeds private ability and/or willingness to pay, leading to a "last-mile problem". Adoption can be encouraged through incentives, either with fines imposed on non-adopters or with subsidies for adoption or both. Yet, weak institutions can make both approaches costly, because subsidies can generate waste and corruption, and fines can lead to bribery and extortion. The ability to impose penalties fairly and effectively depends on institutional strength. The capability to run a subsidised sewer system without massive waste and corruption also requires executive competence. The efficacy of new infrastructure, therefore, depends significantly on institutional strength, in either the judicial or executive branch of the government.

Implementing coordinated, integrated multi-sectoral policies and employing urban development for economic growth requires functioning multi-level and multi-sector governance and sufficient financial mechanisms to ensure adequate management, operations and maintenance. Such governance can be ensured only by transparent and effective institutions – both in governance and in implementing policies and regulations – that can harness the required capacity. The existing capacity may be found dispersed across the national and subnational levels, and across public, parastatal and private sectors, and it may be worth seeking coordination, complementarity, and coherence of such capacity first to ensure efficient collaboration. Missing elements can then be introduced where they fit best rather than building a full range of capabilities at one level and/or institution, which may result in overlaps and would thus call for a review of authority to avoid them.

Third, **functioning institutions must harmonise goals of development territorially and coordinate their implementation at all levels**. An essential function of a governance framework is the ability to plan and implement government policies across strategic, economic, and territorial dimensions so that planned infrastructure serves these goals simultaneously, creating synergies, rather than targeting a single problem, however important it may seem.

These enabling conditions take a long time to introduce, make practicable, and mature. In the short window for responding to the urgency of building infrastructure in response to the population surge, an important question arises of whether investment should be put on hold until at least some degree of these conditions is in place. **There must be some mechanisms to guide where and how essential infrastructure is being developed in spatial and economic harmony**, otherwise, as Prof. Edward Glaeser warns, a huge amount of money may be wasted really fast.

A similar concern has emerged in shaping investment in large infrastructures. It has been well analysed in an OECD-ACET paper[50]. While addressing construction of major infrastructure instead of urban development, the paper seeks an answer to the duality of any possible response to investment urgency, noting that "while mainstream development agencies are engaged in many innovative approaches to infrastructure provision and can sometimes join together in large-scale programmes, the support by external actors for infrastructure is seen to be stuck in a duality, juxtaposing the priority for building sound institutions of government that take time to develop with the expedient need for financing and constructing services for the delivery of major infrastructure within a foreseeable future." The paper also refers to a recent book[51], which "explains that one strategy in infrastructure development is to give priority to strengthening governance institutions and regulatory reform. This is essentially the stance of traditional development partners, stemming from their conceptual frameworks and their accountability towards their taxpayers and shareholders. Another strategy, taken by Chinese actors, is to work with the current political and institutional environment on the basis that speed and getting infrastructure in place is paramount in moving the development process forward, with institutional development part of a longer-term learning-by-doing process." A similar duality exists in shaping investment in urban development, and merits further investigation and consideration, as discussed in Chapter 4 of this paper, along the same intention of looking for ideas to explore "how the above two contrasting approaches can be combined"[52].

A single large investment project in urban infrastructure can be parachuted in to solve a single problem without a conducive framework of governance – for example, building a bridge in a large city divided by a river will improve conditions for economic development, no matter who decides to build it with whom and how it is paid for; however choosing the optimal place for the bridge and preparing mobility, communication and infrastructure networks to make use of it requires at least some spatial planning and cost/benefit analysis.

The requirement for an effective enabling environment does not mean that protracted periods of institutional development and planning need to delay urgent investment in infrastructure development endlessly. **Whilst few low-income countries have these conditions fully developed and functioning, this should not stop governments and development partners from investing in urgently needed urban infrastructure, as long as the newly developed infrastructure is guided by robust spatial planning, sound cost-and-benefit analysis, transparent procurement and predictable financing. In conjunction with urgent investment, the opportunity should be taken to use infrastructure development programmes as vehicles to foster these conditions by institutional development and capacity building**.

3.1.2 Coordination and collaboration between different levels and sectors of government

Many national governments – including those in low-income countries – prefer to retain control on planning, financing, and implementation of major urban development projects rather than entrusting them to subnational city authorities. The reasons quoted are several: lack of planning and management capacity at the local level, the need to manage national debt, unwillingness of local authorities to take responsibility, and the desire to take political credit for development.[53] For example, researchers note that in Kenya, "many national ministries also play a direct role in Kisumu; for example, the National Ministry of Land and Housing allocates land within the city area."[54]

National-local relations are important not just for facilitating stable and predictable intergovernmental transfers and coordinated governance, but also because the key legislation that frames most decisive mechanisms for city finance is often ultimately adopted at the national level.

In many low-income countries, the lack of coordination and collaboration can be observed on the level of state planning, where planning of national development and implementation of these plans is seldom coherent and does not always define the role of sustainable urban development. A similar incoherence can be observed at the metropolitan and city planning level. The roles of various sectors of governance of urban development are not always clearly defined, and when defined, the sectors are sometimes not adequately empowered, making both vertical and horizontal collaboration difficult.

Harmonisation is also required among different sectors of policy: decisions taken in other sectors not directly associated with urban development (such as development of industrial parks and free economic zones) may immediately change the dynamics of local financing.

Many sources and a wide array of development actors have been arguing about lacking decentralisation as an obstacle to better funding of urban development, referring to insufficient political autonomy, inadequate funding, and deficient administrative capacity at the subnational levels of governance. Research indicates that emphasis in Africa has shifted over time, but that fiscal power of cities is still limited: "Emphasis moved from a focus on the structures, powers, and functions of local government in the early years after independence, to a focus on the management of urban services, including transport, garbage disposal, housing, water supply, and street cleaning. […] policies have given more powers to cities and local governments since the 1980s even though financial support for cities is still weak."[55] The African Development Bank has noted that "although African cities generate 80 per cent of national tax revenues, they receive less than 20 per cent of the resources. Consequently, they are reliant on central government for around 80 per cent of their operating revenues. In sum, local governments lack the power and incentives to raise (and retain) their own revenue streams."[56]

Whereas this initiative has not specifically focused on this issue, we note that an analysis of available data on tax authority at subnational level worldwide does not offer a conclusive proof that decentralised tax authorities alone foster development[57].

The need to coordinate authority over revenue, expenditure and investment does not mean that any degree of fiscal autonomy is more effective. For example, in OECD countries, some governments collect a smaller part of taxes and also allow subnational levels to spend a larger part of it. In Denmark, although the central government collects the largest portion of taxes, the local level spends 64 per cent, while central governments in other countries collect almost all taxes and let subnational governments spend only a small part of the revenues. In Ireland, the national government collects 95 per cent of taxes, and the subnational level spends only eight per cent of total public expenditure[58]. There seems to be no one-size-fits-all solution in which certain types of taxes are most suitable for use by each level of government.[59] Furthermore, "share of expenditures is not always a good indicator of the decision-making authority of subnational governments in the selection, prioritisation, funding and execution of infrastructure projects. The several stages and decision-making steps that need to be coordinated across levels typically give rise to a complex web of accountability over results. Not surprisingly, outcomes have been mixed and vary widely from country to country and from region to region in the same country."[60]

Literature on decentralisation in Africa emphasises that "decentralisation is commonly treated as an unambiguously desirable phenomenon that can alleviate many problems of the public sector, or sometimes, as an invariably destructive force that frustrates effective government. We know that decentralisation can also have negative effects and decentralisation proponents must recognise this. Too much or inappropriate decentralisation, for example, can undermine macroeconomic control and worsen interregional income disparities. […] Making progress requires that a number of major challenges be confronted. One is defining an intergovernmental system that makes sense in the context of a particular country. A second is to create mechanisms for coordinating activities of the multiple actors invariably involved in decentralisation and to ensure that linkages among the key dimensions of decentralisation will be built. A third is to develop an appropriate strategy for implementing decentralisation."[61]

In some places, devolving tax authority may lead to efficiency losses and duplication of government tax structures across levels of government. Whilst in some circumstances, expenditure decentralisation allows central authorities to force subnational governments into more fiscal discipline by cutting central transfers, which, paired with borrowing rules, may force effective fiscal discipline on subnational governments. It is the design of fiscal decentralisation that matters most: two important elements of that design are low levels of vertical fiscal imbalance and binding borrowing and fiscal rules.[62] What seems certain is that **whilst highly dependent on the overall context of governance, whatever the degree of decentralisation, coherence and coordination assure more effective financing of urban development and management**.

The case studies and discussions presented below suggest that **clarity of authority of the institutions at different levels of governance, coordination of activities to achieve coherence and complementarity, and collaboration of levels and actors of investment are essential. Where lacking, they need to be promoted and supported**.

Approaches and experiences in the governance structure of cities identified by this initiative vary. It is important to note that "[e]very country has a different understanding of local government in terms of perceived roles and responsibilities between the local and regional level, politicians, officials and citizens, local government and other institutions, executive and judiciary bodies. It is of importance to gain a contextualised understanding of governance structures before employing 'magic bullets' in terms of legal and financial tools from one culture to the other". (Matthew Glasser, Extraordinary Research Fellow, Law, Justice and Sustainability, North-West University, Potchefstroom, South Africa, at the 29 October 2020 Cities and Experts meeting).

In Europe, academics are looking for innovative approaches to territorial governance, revisiting the concept of decentralisation. One possible direction suggested by French think tank Terra Nova is, rather than conceiving decentralisation according to a principle of constant specialisation of competences according to the level of government, to rethink territorial public action on the basis of programmatic 'territorial agreements', established over specific periods of time, according to the projects on the political agenda, and the sharing of roles between all levels of government.[63]

In Senegal, the latest Decentralisation Act has left a gap between the decentralisation of responsibilities and the fiscal decentralisation needed to finance those responsibilities, as well as a lack of clarity over the specific roles of various players. Legislation and engagement to better clarify positions and align incentives in the collection of local taxes would help enhance Dakar's financial position. Encouraging the central government to optimise revenue collection for local governments is an area highlighted for development partner support.

In Somaliland, as the country aims to decentralise, the Ministry of Finance actively coordinates revenue reform activities, and together with the Ministry of Interior, advocates for adequate central government funding for local governments.

In Uganda, a twin track has been chosen: while Kampala is managed by KCCA, under the Ministry of Kampala and Metropolitan Affairs (a member of Government of Uganda), the other subnational authorities of the country are under the Ministry of Local Government. But even within Kampala, the situation has been confused by multiple and overlapping sources of authority. The Ministry of Kampala, the Lord Mayor of the Kampala City Council, and the Executive Director of the KCCA all have an authoritative role in the governance of Kampala, but their respective responsibilities were never made explicit. The KCCA Act has therefore recently been revised in an attempt to strengthen the Lord Mayor's office and to streamline roles and responsibilities, clarifying the organisational setup; however, it is too soon to verify its effect. Cross-territorial coordination also remains a major challenge. Considerable urban population growth in recent years has seen the city of Kampala merge with surrounding districts to form the Greater Kampala Metropolitan Area, incorporating the districts of Mpigi, Mukono and Wakiso. Each of these districts has its mayor and own local government. Significant efforts of coordination are required to plan and implement large projects that expand spatially across these different administrations. However, to date, there is no formal metropolitan governance structure, which is often the reason projects become too administratively complex to take further. In addition, daily working commuters to Kampala from the surrounding districts increase the city's population from 1.8 million at night to around four million during the day. This jump puts incredible strain on the taxpayer-to-services ratio in the KCCA's jurisdiction, as taxes are paid to the municipality one lives in, but citizens utilise services elsewhere.

State-led urban infrastructure financing in India

In India, local and state government overlap heavily, and many urban services are provided by agencies under the central government.

India is comprised of 29 states and seven Union Territories. The states have considerable autonomy, while the Union Territories are governed centrally. Within India's federal structure, the states determine the powers, functions, and revenues of local governments (urban local bodies, ULBs). Local government powers and functions vary from state to state, but most Indian states have not devolved significant authority, functions, and revenues to these bodies. Indian ULBs largely depend on intergovernmental transfers, yet most states do not provide ULBs with stable, predictable and adequate revenue. Some ULBs also impose utility taxes, property transfer taxes, and development charges, but these generate little revenue.

Most infrastructure is installed through state-controlled channels, and most subnational borrowing is state-level borrowing. Often, parallel authorities, districts, and entities are charged with building urban infrastructure. These entities borrow to finance investments and are controlled by the state.

Indian ULBs, like many local governments in sub-Saharan Africa, represent alternative centres of power with leadership from opposition political parties. As a consequence, an anti-urban bias is present at the national level. To side-step this difficulty, since the need for urban public services is still paramount, states have set up parallel financing channels with state-controlled entities. The state-controlled entities have planning and investment powers within the boundaries of ULB. Such entities include development authorities, industrial development and investment corporations, water and sanitation enterprises, and urban rail and transport authorities. They receive financial support from the state, leading to relatively higher creditworthiness, and have their own revenue instrument, enabling access to finance.

The success of these urban-focused state instruments is exemplified by the largest municipal bond in India being issued not by a city, but instead by the Andhra Pradesh Capital Regional Development Authority. The proceeds were utilised for infrastructure delivery and development of the new capital, Amaravati. [64]

3.1.3 Coordinating revenues and investments at the local level

"The process of urbanisation in Africa is influenced by poor planning, which then, in turn, influences the implementation." ***(Dr. Ernest Nsabimana, Deputy Mayor of Kigali in charge of Urbanisation and Infrastructure, at the World Urban Forum (WUF 10) event in 2020 related to this initiative)***

"It's not just about cities and regional or central authority. There are good and bad taxes (regardless of whether they are devolved or central) and there are good and bad projects (regardless of devolution)." ***(Prof. Anthony Venables, University of Oxford, in discussions of this working paper)***.

Lacking coherent and integrated planning of urban development is a major issue not only in Africa. Susan Goeransson, Director for the Municipal and Environmental Infrastructure team at the European Bank for Reconstruction and Development, presenting this initiative at an event at the World Urban Forum (WUF 10) in 2020, highlighted the issue of uncoordinated investment in cities, and of poor investment coordination between different sectors and different levels of government.

We emphasise the importance of the interface of urban planning and municipal finance – **links between long-term urban, spatial and physical planning, and financing of urban**

investments – as being of instrumental importance in a strategic and long-term approach of urban development, in contrast to the “ad hoc” approach we often see today in reality. Such an approach helps in setting necessary priorities and phasing, embedding long-term investment needs in the budgeting cycles of ministries and municipalities, but also to identify early how, for instance, land value capture could become an embedded mechanism in implementing the planned development.

While proper planning is important, execution is equally critical. Municipalities and municipal entities must build a suitable supply chain management system for infrastructure delivery, that is, a control framework for the planning, design and execution of infrastructure projects, the tracking of projects, and the monitoring of performance which is better able to deliver value for money, seeking optimal use of resources to achieve intended outcomes while minimising the scope for corruption.

It is crucial to move beyond financing projects and programmes, and to focus on building sustainable domestic systems for financing urban infrastructure. These systems should include strong domestic financial institutions, municipalities that rely on a meaningful social contract with their citizens through accountability and transparency, enabling regulatory frameworks, as well as independent financial advice.

Instead of looking at projects in isolation, there is a need to focus on creating integrated city plans, making the case for investments that create overall direct and indirect returns across the city. These should clearly reflect city-level priorities and be combined with individual development partner agendas, rather than replaced by them entirely. Kisumu, Kenya, is an example where “limited skills and resources available for dealing with urban problems in a secondary city have been pooled together and used to leverage more resources, and different interests have been brought together to develop strategies that are more holistic, inclusive and sustainable”[65], and where substantial funds were raised for a range of physical upgrading projects, such as the redevelopment of marketplaces. Central to this were attempts at improved coordination, initially through the multi-stakeholder Kisumu Action Team that was later transformed into the Kisumu Local Interaction Platform, a consortium of Kisumu City, Kisumu County, the Civil Society Coalition, the Chamber of Commerce and two local universities.

The World Bank notes that “Research […] supports the value of early investments in neighbourhood infrastructure and services. But coordination among these investments is equally crucial, given that cities are both path-dependent and interdependent. Large infrastructure projects carry high sunk costs: Like any large structures, they depreciate very slowly over decades or even centuries. And the costs of developing housing, infrastructure, and industrial premises depend on sequencing. Consider the relation of new transport systems and industrial zones. If not coordinated with one another, and with land markets and land use regulations, these projects can put cities on a counterproductive development path.”[66]

IFIs can provide technical support to cities to turn integrated plans and strategies into implementation plans, and help to determine the sequencing of projects, identify the right structures of projects, including those generating revenues, potentially financed by private sector or through public private partnerships, and projects that will not attract the private sector that are financed by the city itself in collaboration with other public sector partners. Support may be given to identify which regulations could open up opportunities without the city needing to use their own funds, such as the example of building regulations: if a city’s building codes allow to build higher, the feasibility of a project can be impacted.

To achieve progress in financing sustainable urban development, to increase effectiveness and efficiency, one should look for coherence of policies and mechanisms across strategic, economic and territorial dimensions, so that planned infrastructure serves these goals simultaneously. The pace of urbanisation is fast, the priorities are many, the resources very limited, the inertia heavy, and concepts aplenty. It is necessary to look for synergies, which can only be achieved by coordination and collaboration, yet the quest for synergies must be proportional to expected benefits, and it should not delay investment in urgently needed transformative infrastructure beyond satisfying essential requirements of spatial and economic harmonisation. Prof. Edward Glaeser notes that we should not hold on to basic services such as water supply until we can have all possible synergies, saying, “I would not urge anyone to be against coordination, yet as long as we talk about things that have certain urgency and as long as you are convinced that you have a cost-benefit analysis that shows you would want to do this, you should start doing it and while doing it you should also think about the synergies. But the skeletal infrastructure comes first.”

In the next chapters, we will look at the elements individually, but the maxim of coherence must be kept in mind when considering how to get the best out of using these elements in complementarity.

3.2 Improving internal finance

In the previous chapter, we looked at the importance of integration of policies, institutions, approaches, and financial mechanisms for sustainable urban development. The next chapter looks at some key financing mechanisms separately. We focus on intergovernmental transfers and own source revenues (OSR) because state agencies were not in the scope of the discussions with experts, or in the case studies.

There are four broad mechanisms in financing urban development: investment projects implemented directly by state agencies (national direct investment); unconditional, conditional and capital intergovernmental transfers from central government to subnational levels; subnational governments collecting OSR; and external funding from the private sector and donors. This section focuses on intergovernmental transfers and OSR. It outlines some of the challenges around these two revenue sources and how they can be optimised.

Diverse models of urban finance implemented by state agencies

Rwanda

The ways in which a national state invests in urban development are sometimes rather complex. The case of Rwanda illustrates this well. The former Tristar Investments Ltd, with interests in food processing, real estate, engineering, construction and services, has grown into Rwanda's largest conglomerate, now called Crystal Ventures Ltd. It is privately held, but is, in part, owned by the government of Rwanda and Rwanda's leading political party, the Rwandan Patriotic Front (RPF). Another major local investor, The Horizon Group, owned by the Rwanda Defence Force, has interests in agriculture and agricultural value addition, manufacturing (chemicals), engineering, logistics, real estate and construction. Given their connections to the state and the ruling elite, they are considered controversial by some, and have been the subject of negative media reporting. However, they are said to have made important contributions to the overall private sector development in the country, to employment creation, and to the exchequer's revenue mobilisation. Their investment flagships include hotels, housing estates mainly for the well-to-do segments of society, and office buildings. There have been opinions voiced that they crowd out private investment, yet they are said to operate as private businesses and experience the same, and sometimes even more, constraints as their local competitors.[67] At the same time, the Government of Rwanda financed and built Karama Integrated Model village in the outskirts of Kigali "in collaboration with Rwanda Defence Force (RDF) Reserve Force".[68] The government recently passed housing development regulations and funding schemes that aim to promote access to affordable houses for the low- and middle-income inhabitants of Kigali. Finally, the Second Rwanda Urban Development Project has been launched, which combines an IDA grant and loan with government funding to improve access to basic services, enhance resilience and strengthen integrated urban planning and management in the City of Kigali and the six secondary cities of Rwanda, investing in basic services and institutional capacity building.[69] The example of Rwanda shows that models of investing in urban development by a national government can be very diverse even in one country.

South Africa's Strategic Integrated Project (SIP) 7: Integrated urban space and public transport[70]

Recognising a national gap in infrastructure and its strategic importance in driving economic development, creating jobs and reducing inequalities, in 2012, the South African government adopted a National Infrastructure Plan. The Presidential Infrastructure Coordinating Committee (PICC) was established to oversee this and develop a framework for implementation that would outlive political administrations. 18 Strategic Integrated Projects (SIP) were developed, with one, SIP 7, focusing explicitly on integrated urban space and public transport, including housing, bulk water, sanitation and waste management, bulk roads as well as parks and cemeteries. Twelve of the country's major cities were chosen as recipients for their demographic and economic significance, and an investment of roughly ZAR50 billion (US$ 3.3 billion) per year has been put towards it since 2016.[71] While the national government has made the funds available and the PICC maintains supervision to ensure strong coordination and accountability, implementation powers were given to the cities themselves to align with existing local efforts and priorities.

3.2.1 Intergovernmental transfers

Intergovernmental transfers are a vital part of local government finances, even if over-dependence on these transfers is not always ideal in the context of fiscal decentralisation. Improving the management of transfers often requires complex and timely reform at the national level, but ultimately, this reform is critical to set the right incentives for local governments.

Intergovernmental transfers are, in many cases, the backbone of financing sustainable urban development as the subnational authorities have limited financial instruments and mechanisms for revenue generation of their own. Dependence on transfers is more pronounced in developing countries which generate around 2.3 per cent of GDP from own revenues, compared to 6.4 per cent in developed countries. At the global level, intergovernmental transfers usually represent the primary source of revenue for subnational governments (51 per cent, on average). They range from an average of 48.9 per cent in OECD countries to 57.6 per cent in African countries. Intergovernmental transfers represent 90 per cent of local government revenues in Kenya, Tanzania and Rwanda, up to 96 per cent in Uganda, around 25 per cent in Senegal, Namibia and Eswatini, and barely four per cent in Zimbabwe. Hence, the situations are very diverse.[72]

In Senegal, there are two main instruments through which the central government contributes to local authorities: the Local Government Endowment Fund and the Capital Investment Fund, which transfers 5.5 per cent of VAT. In the 2020 budget, the former contributed CFA 165 million (US$ 270,000), and the latter, CFA 850 million (US$ 1.42 million). In addition, the central government allocates resources to deliver on mandates such as education and health under the transferred Consolidated Investment Budget. Local authorities also receive rebates from the annual vehicle tax, tax on oil (50 per cent), and property transfers (50 per cent of margin on profit). Central government contributions are allocated in line with pre-determined formulas, allocating more to less fortunate localities in an attempt to equalise revenues, given that Dakar is home to the majority of economic activity. The result is that for Dakar, these central government contributions make up a minuscule proportion of the budget, far less than one per cent.

Dependence on transfers in and of itself is not wrong. Not all subnational governments have the same tax potential, and so, there is a need for intergovernmental transfers to balance support to development across the system and the country. As a result, smaller or less-developed local governments tend to have smaller tax bases, and therefore, tend to also be more dependent on the central government (see Table 1 below).

Table 1: The decentralisation of expenditure authority in selected African countries

Ethiopia	**2010/11**	**2011/12**	**2012/13**	**2013/14**	SNG's have role in most functions including police, education and courts.
National	60.77%	57.07%	52.35%	45.85%	
Sub National	39.23%	42.99%	47.65%	54.15%	
Uganda	**2011/12**	**2012/13**	**2013/14**	**2014/15**	SNG's play a prominent role in education, health, and public administration.
National	79.81%	77.67%	78.84%	81.11%	
Sub National	20.19%	22.33%	21.16%	18.89%	
Mozambique	**2013**	**2014**	**2015**	**2016**	SNG's have lead role in education and support health, public administration, and social services.
National	64.58%	64.22%	57.13%	62.68%	
Sub National	35.42%	35.78%	42.87%	37.32%	
Kenya	**2013/14**	**2014/15**	**2014/15**	**2015/16**	SNG's have service delivery role on several programs and have minor role in edcuation, police, and courts.
National	84.30%	81.53%	80.26%	81.73%	
Sub National	15.70%	78.47%	19.74%	18.27%	

Source: Government of the Republic of Kenya, The National Treasury and Planning (2018), Comprehensive Public Expenditure Review. From Evidence to Policy, p. 51 (https://www.unicef.org/esa/sites/unicef.org.esa/files/2019-05/UNICEF-Kenya-2017-Comprehensive-Public-Expenditure-Review.pdf)

The traditional theory of fiscal federalism prescribes a very limited tax base to subnational governments, and following from it, government transfers seem inevitable. The reason for this is that local taxes can lead to competition among subnational governments and a "race to the bottom". It could also cannibalise revenues at the national level, exacerbate income inequalities across regions, fail to incorporate externalities,[73] lead to inefficient duplications of government structures, and enhance corruption.[74] Indeed, it is difficult to dispute that national governments can leverage economies of scale in tax collection processes with inherent advantages of centralising information and processes.[75] Given this reality, national governments sometimes tend to devolve more expenditure responsibilities than tax authority. Even in high-income countries, local governments are not fully financially autonomous. As noted above, in practice, dependence of subnational governments on transfers differs widely, and hence, systems may also follow different reasoning. But the key insight that justifies devolving the receipts from national tax revenues to the cities in which the taxes are generated is that it gives the city government a powerful incentive to grow the local economy, since it may now capture a share of this growth. Hence, the city government learns to pay attention to the needs of local businesses, thereby accelerating the generation of productive jobs.

The central government can benefit from economies of scale in the provision of goods and services with positive externalities that cut across jurisdictions in a way local governments cannot. Indeed if, for instance, flood water management was devolved, with positive externalities for jurisdictions downstream, there would be an underinvestment in upstream flood management. Table 2 below summarises some of the other criteria for decentralisation. Ultimately, however, there is no blueprint for a solution. Political decisions are needed to prioritise among different decentralisation criteria, and the level at which services should be provided.

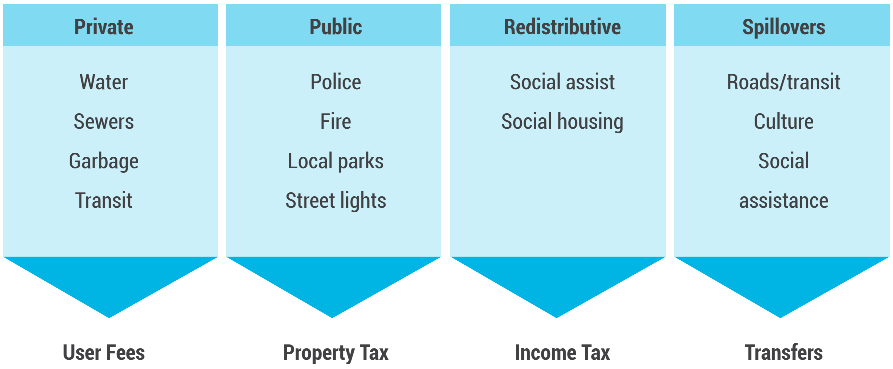
Lastly, there are also local expenditures that are best paid for via transfers. According to the benefit model of local government finance, local government services, wherever possible, should be paid for on the basis of the benefits received from those services.[76] The extent to which municipalities will be able to apply the benefits-received principle, however, depends on the nature and characteristics of the services they provide.[77] There are devolved services, the benefits/costs of which extend outside the jurisdiction of local governments. In these instances, there may be an under-allocation of resources to that service because the local government providing the service would base its expenditure decisions only on the benefits captured within its own jurisdiction. The local government would not consider the benefits that accrue to populations outside its own jurisdiction. In these instances, transfers can ensure that expenditure meets overall social benefits. Furthermore, transfers are more appropriate to fund services that have a redistributive function (such as welfare assistance, health, and social housing). Using OSR streams such as user fees would defeat the purpose of redistribution, and property taxes are more regressive than income taxes and thus are not appropriate for financing redistributive services.[78]

Table 2: When should services be devolved?

Criteria	Centralize
Preferences	In homogenous contexts
Economies of Scale	Yes
Negative Externalities	No
Positive Externalities	Yes
Decision Costs	If costs decrease with group size

Source: Adapted from Dafflon B and T Madiès (2009) Assignment of powers to different levels of government, Decentralization: A Few Principles from the Theory of Fiscal Federalism, Agence Française de Développement, Paris, Notes and Documents No. 42, p. 18.

Figure 2: **Different financing tools for different services**



Source: UN-Habitat (2009) Guide to municipal finance. Human settlements financing tools and best practices series. UN-Habitat, Nairobi, p.18. The term private in this figure is used to describe that the good itself is private, i.e., it is not a public good (rivalrous, excludable). It is not meant to describe that the private good is or needs to be provided by a private company.

Despite the importance of transfers, managing transfers in an effective way, so they set the right incentives and fulfil the functions outlined above, is not easy. Transfers need to be allocated equitably across territorial jurisdictions to overcome regional disparities and avoid political backlash. They also need to be well-aligned to the mandates of the cities, which, thus, must be decentralised cautiously. Unless considerations from the local level are properly formulated and conveyed to the national level and are duly taken into account there, central governments' stringent control over spending and conditionalities tied to intergovernmental fiscal transfers may carry the risk of forcing local governments to spend funds in ways that do not match local needs, undermining a key objective of decentralisation. Transfers also need to be allocated according to transparent and predictable mechanisms. When transfers are unpredictable in both timing and size, it can result in great difficulties in planning as well as haphazard delivery, and in case of lopsided political and administrative decentralisation, bring about unfunded mandates.

To date, development partners have not focused on transfers, as the allocation of intergovernmental transfers is generally politically sensitive and takes long time horizons to adjust. There is a need to focus more extensively on the design elements of these transfers, ensuring transparency of allocation and making them commensurate to decentralised mandates, whilst holding the city accountable for good financial management. The former requires a concerted effort to develop systems that encourage predictability in size and timing of payments so that cities can rely on the funds to plan and commit to longer-term investments. The latter requires this system to be predicated on certain performance indicators such as efficiency and effectiveness in expenditure, progress in OSR generation, and overall adherence to public financial management (PFM) standards at all levels of government. More incentives for good financial management are needed at the national level, and one of the ways of doing this is through transfers. If local governments do not comply with basic PFM regulation, then this should probably be reflected in reduced national transfers. The politically controversial question here is about power and authority. If local governments do not manage their finances in a transparent and appropriate manner, what are the consequences? On the one hand, the national government should be given more control to prevent mismanagement, and on the other, it may be seen as an infringement on the autonomy of local governments, and thus potentially a step in the wrong direction.

This latter point is particularly important since transfers ultimately help define the incentives that local governments face in leveraging other sources of financing. Given the importance of OSR, as we shall see in the next section, and the overall tendency of local governments to not fully leverage it due to its political unpopularity, it is important for transfers to depend to some extent on OSR performance of local governments. Given the importance of OSR in enhancing the financial position more broadly, it would be a loss not to use this powerful resource lever as way of incentivising more serious optimization of OSR reform and concomitant solidification of the rule of law, the social contract and government accountability.

3.2.2 Own-source revenue

Optimising OSR is critical to enhance the financial position of cities in a sustainable manner. Opportunities for OSR optimisation often revolve around streamlining tax policy and enhancing compliance, both of which are impacted by digitisation and the strengthening of the social contract. However, none of these changes can happen if there is no political buy-in and ability to overcome vested interests.

It is widely accepted that successfully devolving political authority and service delivery responsibility to lower levels of government requires local governments to develop their OSR systems.[79] OSR here refers to the revenue streams (taxes, licenses, charges and fees) that are controlled and levied directly by local governments. OSR is needed to fund current expenditures, maintain large infrastructure investments that require external finance, and ensure that the government can carry on functioning in the event of untimely national transfers. OSR also enable local governments to respond to the demands of citizens in a more direct and flexible manner. It increases creditworthiness and facilitates access to external finance. Greater reliance on OSR will commonly also strengthen the accountability of local governments and incentivise improved service delivery and/or representation in exchange for tax contributions.[80]

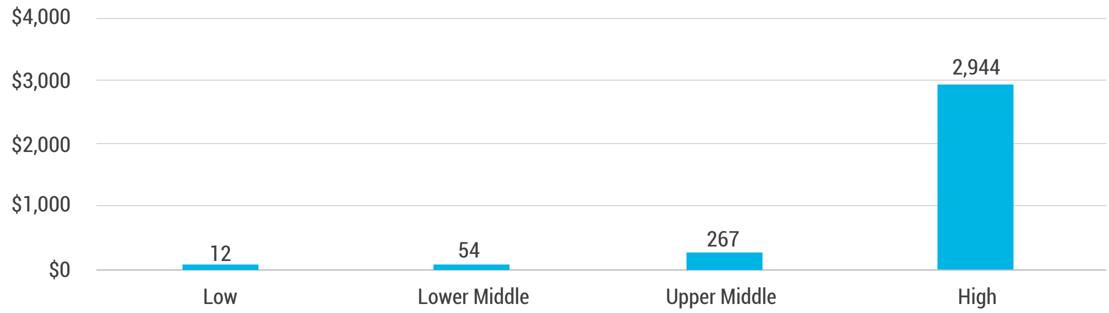
While the merits of OSR are well known, using OSR systems in an effective and efficient manner remains a challenge for many local governments, especially in developing countries.[81] Low-income countries generate around US$ 12 per capita per year from OSR in local governments, compared with US$ 2,944 per capita per year in high-income countries (Figure 6). Local OSR systems are often also found to be economically distortionary, costly to administer, coercive, and corrupt.[82]

The literature on OSR outlines some of the key drivers of sub-optimal usage of OSR systems, including insufficient tax authority,[83] lack of tax capacity and concomitantly poor tax policy.[84] The recommendations emanating from existing literature thus tend to be centred on revising tax policy, e.g., focusing collection efforts on a reduced number of OSR sources,[85] simplifying existing rates and exemptions,[86] increasing public participation,[87] enhancing visibility of expenditure,[88] leveraging digital payment options to reduce tax collector malpractice,[89] and/or carrying out new valuation rolls to update property values.[90]

In outlining these policy recommendations, the literature also commonly emphasises on the important role of political leadership for successful OSR reform.[91] It suggests that leadership is needed to overcome vested interest in the status quo, since effective OSR policies and institutions may not be in the interest of tax collectors, politicians or economic elites who benefit, in one form or another, from tax loopholes, lack of enforcement or reduced business/property tax rates.[92]

There are several key components that support increased OSR. Certain cities, such as Kampala, have shown that local administrative reform, even without widespread policy change, can have a significant impact on increasing OSR, therefore enhancing the creditworthiness of the city. Ena-

Figure 3: OSR per capita of local governments by country GDP (income category)



Source: Based on data from UCLG and OECD (2016) and the ICTD/UNU-WIDER Dataset (2020)1. This data may exaggerate the inadequacy of local OSR systems, since low OSR per capita naturally is also the result of lower GDP per capita in developing countries. However, even after accounting for GDP per capita, low-income countries generate roughly one tenth of the OSR in high-income countries.

bling cities to get this right before central government transfers are increased or external finance is provided is essential to avoid creating perverse incentives and inhibiting the development of local institutions, capacity, and autonomy. Key administrative reforms include automation and digitisation of OSR processes, streamlining the number of taxes, and sensitising taxpayers or building the social contract. Some city networks make a point that another issue is the leeway given (or not given) by national governments to local and regional governments to set tax bases and tax rates. Strengthening OSR also depends on the institutional environment provided by national legislation for cities to develop their fiscal autonomy. If cities do not have tax authority, then, of course, there is no optimising of OSR to begin with, and we need to devolve more authority first. However, this should not be the default starting point for reform. A lot of governments have sufficient OSR authority but are not leveraging it. We argue that this is the bigger problem than the lack of authority. If there is authority but it is not used, then we argue that we should use it properly first before providing additional revenue authority.

Hargeisa: Streamlining the number of taxes

In Hargeisa, new digital systems known as the Accounting Information Management System (AIMS) and Billing Information Management System (BIMS), both funded by UN-Habitat, were introduced in 2008 and 2010 respectively. AIMS has allowed revenue to be allocated to specific budget items, and split capital and current expenditure to ensure provision for longer-term investment in addition to meeting daily needs. BIMS has provided the first electronic link from central Hargeisa accounting to individual/neighbourhood level billing. Together, they have dramatically improved analysis capabilities, transparency, and accountability in the city, underpinning much of Hargeisa's financial improvement. While Hargeisa has made progress, there is still a long way to go. More taxes don't equate to more revenue, instead governments should increase efforts on those with the most potential.

Malawi: Cost of levying taxes outweighs the amount collected

In Malawi, a few initiatives for the digitisation of processes are under trial in several cities, including the start of basic automation of revenue systems and the use of GIS. More notably, electronic ticketing has been piloted in Zomba to enhance transparency in the collection of market fees, ground and city rates and business licences. The system reduces the chances of fee collectors skimming some of the revenues collected. One year later, the system had increased revenue collection by 53 per cent.

In Malawi, city-owned property and infrastructure often require investment and maintenance before they can become revenue-generating, and the city councils do not have enough upfront capital to invest in this. Illegal vending prevents the city from collecting the required market fees. Also, the operational costs of many markets are much higher than the money coming in from them. Business licenses are better as the costs of collection are lower. Compliance in numerous fees and taxes are low. Most cities are severely lacking in by-laws to enforce this, given the cost and technical expertise it requires. The tax base is under constraint by the fact that 60-70 per cent of the urban population in Malawi lives in low-income or informal settlements.

UN-Habitat's Rapid Own Source Revenue Analysis (ROSRA)

The ROSRA methodology diagnoses the problems of OSR systems and provides decision makers from subnational governments with strategic recommendations on how to optimise OSR. The methodology essentially consolidates international "best practices" on OSR systems and links these to a problem diagnosis. Essentially, the methodology consists of a revenue-gap analysis per revenue stream, a profitability analysis per revenue stream, and more granular process deconstruction of important revenue streams to better understand dependencies and determine useful reform entry points.

The application of this methodology in Kisumu led to findings that provided the necessary evidence to justify a strategic refocus of the revenue department away from user fees to land rates (property taxes). Among other things it found that

- The Kisumu County Government (KCG) was only collecting around 19 per cent of its total OSR potential in financial year 2018/19;
- Land rates (property taxes) received less than five per cent of the tax collection effort, while constituting nearly 40 per cent of the overall revenue gap;
- Unstructured revenue streams (user fees such as parking, bus park, and market fees) consume 75 per cent of the tax collection effort but constitute less than 15 per cent of the tax potential;
- Non-compliance of high-net individuals was the key driver of non-compliance more broadly with 90 per cent of land tax arrears being owed by the top 10 per cent wealthiest landowners, accumulating to a total of around nine times the total annual OSR of Kisumu;
- Low- and middle-income groups almost pay more in OSR than upper-income groups, with middle-income groups paying nearly twice the amount paid by higher-income groups.

Improved compliance is another major precondition for OSR optimisation. Local tax compliance in Kampala, for instance, is estimated to be slightly above 50 per cent. Stakeholders interviewed for the case studies in Hargeisa, Mzuzu and Kampala, as well as the participants at the Cities and Experts meeting in Dakar related to this initiative (for example, Freetown in Sierra Leone) highlighted that building and maintaining the social contract through participatory planning and visible service delivery is essential in increasing compliance rates. For that accountability mechanism to work, it is key to increase the visibility of OSR and the services that the local government provides with OSR. If citizens do not know whether services are paid via grants, loans or OSR, they will not demand better services for the local taxes that they pay. According to Paul Smoke, OSR compliance requires that citizens understand what their taxes are being used for.[93] However, when expenditure mandates are very complicated, and even at the local level, different services are provided by different levels of government, it becomes difficult for citizens to understand what their taxes are being used for, which, in turn, undermines compliance. Thus, where possible, the link between taxes and services received needs to be clear.

Kampala: Increasing tax compliance via digitisation

Kampala has greatly improved its revenue collection from around US$ 1 million in financial year 2010/11 to US$ 25 million in financial year 2018/19 (contributing to 24 per cent of KCCA budget). What led to this success? The process flow was improved from a manual, paper-based system that created non-compliance to an automated process that reduced turnaround time from weeks to hours. Taxpayers and local government staff were sensitised on revenue collection aspects (its nature and what they are being used for), and training KCCA staff (revenue collectors) on laws that govern tax administration, specifically local government laws. Massive taxpayer sensitisation also improved collection, coupled with KCCA-conducted revenue audits to ascertain revenue defaulters, which helped improved compliance. Regular enforcement and allowing taxpayers to pay in instalments also helped. Samuel Sserunkuuma, Director, Revenue Collection, KCCA, described the long-term merit of such actions, saying, "With administrative change and by enhancing business processes, we deliver continuity [which] requires systems and processes to live beyond your office time."

These administrative reforms are critically dependent on strong leadership and the will and ability to overcome vested interests of parties like landowners, tax officials, taxpayers, and local government politicians, all of whom have an interest in leaving taxes small or OSR unleveraged to exploit tax loopholes for private gain. As the Kisumu case study shows, adequate data management, reporting and control systems are critical for overcoming vested interests. Inadequate information systems make it difficult for government decision makers, as well as the public, to hold lower-level government officials accountable. Lack of information also makes it difficult to understand what is happening, and to identify culprits and financial malpractice as well as to identify, to recognise and to share good practice. In such an environment, decision makers will find it difficult to defend the need for reform initiatives, as they lack the evidence to describe the gravity of the need for reform. They will also struggle to identify the key reform entry points to quickly show results and support reform initiatives with needed legitimacy and will lack the tools to understand why reforms are not meeting the intended targets and adjust them accordingly.

To achieve this, revenue departments should be made as transparent and conducive to analysis as possible. Analyses of leakages should not be carried out as a once-off strategic capacity building initiative but should rather be streamlined into the monthly reporting systems that help expose malpractice and strategic blunders – but also improved performance and good practices – on a continuous basis. Control and monitoring should not only serve to police and punish, but also to highlight what is being done well and encourage progress. Yet, the lack of transparency is often not a capacity constraint but might be present by design. Therefore, data should be made as publicly accessible as possible. Records should be cleaned up to facilitate analysis, and ways should be found to integrate taxpayer information stored in separate records or digital platforms to gain a comprehensive understanding of tax evasion. Reforms aimed at increasing compliance by sanctioning non-payment will benefit from integrated taxpayer records.

In a similar vein, internal information systems must be strengthened. Technical reform will face challenges if not accompanied by a management reform of tax collectors. Irrespective of the quality of the digital system or the number of devices used for revenue collection, additional management reform is needed to ensure successful implementation. Reforms undertaken to automate payments need to be embedded in management systems that estimate daily revenue targets based on realistic potential of revenue stream and hold collectors accountable to achieving the pre-defined targets. While doing so, historic revenue figures should not be used to define revenue targets, as these are unlikely to provide trustworthy baselines. Instead, it is advisable to use proven methodologies, such as top-down approaches (see box on UN-Habitat ROSRA), bottom-up revenue mapping (literally counting the tax base), or manual testing. Manual testing would entail engaging new and potentially more objective tax collectors for a short time span (for example, one week) and define targets based on the amounts they collected.

Increasing OSR at subnational level is viewed by some as a stepping-stone that may help unlock access to external finance and private capital. The sustainable financing of cities and local governments will ultimately require building OSR institutions and municipal finance foundations. Gaining a better understanding of the conditions for successful OSR reform will thus help determine when the development of effective OSR institutions can be seen as a stepping stone (among others) to enhance the financial position of cities, and when it actually should be seen as a prerequisite, without which facilitating access to external finance is not advisable. OSR is essential to sound urban development; indeed, secure, predictable, and transparent OSR are strong indicators of good financial management and effective investment, making the city more creditworthy. It also gives the city autonomy to invest themselves and build a strong relationship with its citizens.

Whilst critical for good financial management, OSR is certainly not sufficient to provide enough investment in urban development. The main sources of revenue for municipalities will remain 'transfers' (conditional, unconditional and/or contractual) from the national to the local level through revenue sharing formulae.

3.2.3 Leveraging underutilised land-based financing options

Land-based finance is one of the most promising OSR streams that is underutilised and can be leveraged to strengthen urban management more broadly. Technological innovation has further enhanced the implementability of these mechanisms. Nonetheless, fully leveraging these tools will require local governments to build capacity, show willingness to experiment, and overcome resistance from powerful landowners.

One of the most underutilised and promising sources of own revenues for local governments is generated from one of the most valuable assets in cities: urban land. When correctly managed and utilised, land and property taxes can provide a fair and efficient form of taxation by capturing some of the rise in land values resulting from rapidly increasing urban populations and public infrastructure investments. These revenues can then, in turn, be reinvested, further driving up land values and potentially creating a virtuous cycle of urban development. For example, Samuel Sserunkuuma, Director Revenue Collection, KCCA, Uganda, noted at the Cities and Experts meeting in Dakar in February 2020: “Cities must account for the increasing value of property due to proximity to roads. Once roads are paved, the increased value of property can be taxed, creating a virtuous circle.” It can also be an important tool to tackle rising inequality, provided measures are taken to ensure that land value increases resulting from public investment accrue to the wider public in the form of equitable provision of infrastructure and services, rather than only to service the interest of land-holding elites.

On average, property tax accounts for 22 per cent of subnational tax revenue in developing and least developed countries, far less than in the upper and lower middle-income countries, where it accounts for over 39 per cent of subnational tax revenue.[94] Taxes can also be considered according to their relative stability or elasticity during economic crises. Property taxes are known to be rather inelastic, in that they are less likely to be unpaid or reduced drastically even in times of economic difficulties. On the contrary, taxes on economic activity are elastic, i.e., more dependent on fluctuations in national or international economic cycles.

As promising and valuable as these mechanisms may seem, they are difficult to implement. To generate revenue from land and property where cadastres are out-of-date or non-existent, with complex and informal land tenure systems, often lacking tenure security, lack of effective property addressing systems, and insufficient professional capacity in surveying and valuation, is extremely challenging. In trying to overcome these challenges, many cities and development partners are exploring innovative ways to register land, value properties or facilitate tax payment. The use of GIS mapping provides a new, rapid and cost-effective means of geo-locating properties and creating up-to-date and digitised land and property records. Simplified valuation methods have also enabled cities to start the process without the need for accurate data from functioning property markets.

The benefits that result from successful implementation of land-based finance mechanisms can also extend beyond mere revenue generation. They can extend to improved urban planning and management (e.g., addressing issues such as urban sprawl), can be used to improve land administration, finance the upgrading of tenure security in poorer neighbourhoods, and ultimately also function as a means of strengthening land rights, and/or facilitating access to credit.

The area-based system in Hargeisa

In Hargeisa, rather than using the standard market value-based property tax system requiring complex calculations and often expensive expert valuers, the city uses a simple and low-cost area-based system instead: the building’s size multiplied by a rate based on location, requiring only information on the building’s width and depth, the number of floors, and the location band as set out by the City Council. This simplicity makes it far easier to maintain and update the register on a more frequent basis, and revenues have increased by a factor of four since 2008.

The points-based system in Mzuzu

The Revenue Mobilisation Programme was rolled out in Mzuzu in 2013. The process involved the identification and registration of properties in the city with GIS, and the application of a points-based method of Computer-Aided Mass Valuation to derive property tax revenues. This system is more nuanced than a basic area-based valuation but is more straightforward to administer than a comprehensive market-based system. While there is no absolute value, points are added for positive features such as paved roads and security features, and points are deducted for negative features such as a lack of electricity. The relative values derived matched the market values very closely. Together with reforms in billing, collection processes, and sensitisation, the process resulted in a seven-fold increase in property tax revenues, and notably, the ability to capture revenues from those living informally without accurate market valuations. Despite its success, the programme is not sanctioned legally, nor has it been rolled out to other cities in Malawi due to resistance from the Surveyors Institute of Malawi. The Local Government Act stipulates that a registered valuer should do the market valuation. The Surveyors' Institute also claimed that this process was regressive and that it did not solve the fundamental challenges of property tax collection in Malawi, namely, the lack of capacity and political will to conduct valuations.

Innovation in land-based finance is not limited to valuation and registration of land. More recently, there has been a proliferation of different land-based finance and other support tools, which extend beyond the more traditional taxes on land and/or property. These additional instruments help address a range of different financing challenges applicable to different landowners and users. Some of these tools may focus on recovering the costs of planned infrastructure investments from landowners who directly benefit from that investment (betterment levies), while others may target developers and/or landowners and require the latter to provide in-kind or cash contributions to cover the costs on public infrastructure that emerge as a result of the investment (developer exaction). These tools essentially provide additional instruments for cities to capture land-value increases that arise from public investment or recover the costs on the public purse that result from private investment. They also provide a useful means of paying for urban expansion and ensuring its well-planned nature.

Innovative land-value capture in Hargeisa

In Hargeisa, to plan for and capture the gains from rapid urbanisation, the city government has implemented a system of "in-kind" land-value capture or exaction. With this system, landowners on the outskirts of the city who apply to convert their land from rural to urban land use must provide the city government with 30 per cent of the asset if their application is approved. In this way, the city can access land for needed public infrastructure to service a growing city. At the same time, rent from this land can offer the city a valuable source of additional income to pay for the required infrastructure. The Hargeisa case study also shows that planning for future expansion is not only useful for capturing the gains from rapid urbanisation through exaction, but also improves future urban investment.

Malawi: Leveraging publicly owned land

As per the updated Land Act of 2016, land in Malawi is designated as public, private or customary ownership. For public land, the central government is always the principal landlord. However, the central government is required to transfer all land within the city's jurisdiction to the custodianship of the city council. The city council then has control over the management of that land, as well as the financial benefits that accrue from investments in it. However, the full transfer of land to cities is not currently being practiced. In Lilongwe, it is asserted that the national government charges the city councils the same rate to rent the land as a private developer, even when the land is utilised to provide public infrastructure. Traditional authorities still maintain rights to large tracts of land in the city centres, and the private sector too owns parts of the city's land as a result of extensive privatisation of land during the IMF structural adjustment programmes. In the meantime, a cabinet paper is being prepared to push forward the idea that all land in cities should be transferred to the respective city council. This proposal includes dealing with the improper transfers of land to the private sector, as well as providing the necessary compensations to transfer urban land from traditional authorities. If passed, this legislation could have a dramatic benefit in aligning incentives for urban development.

Despite the potential of the various new land-value capture instruments, they remain largely unused in Africa. This is partially due to the remaining legal uncertainty over their implementability. They also require new and additional skills for tasks like, for example, assessing the resulting cost of a private investment on public infrastructure. Often, these assessments are somewhat subjective, which makes them susceptible to public criticism and resistance. It is this latter point that is particularly problematic not just for land-value capture tools, but for the more classical land and property taxes. Land-based finance instruments are particularly visible, and given their annual payment, are particularly problematic for residents from a cash-flow perspective. Local governments are also, by definition, much "closer to the people", and are thus susceptible to the interests of powerful landlords. Taxing powerful developers or investors may be equally challenging for local governments who fear otherwise losing the investment altogether to a neighbouring locality.

Many African countries do not have proper systems or regulation to register and allocate the property rights of multistorey buildings or apartments (such as condominiums). This may have a serious impact on property taxation and also on access to finance for individuals. This is a very peculiar situation of Africa vis-a-vis other regions. Exaction and impact fees (licenses and fees) could also be mentioned as part of land-based finance in contexts where there are increasing real estate interests and investments in urban development interventions. These planning instruments can also contribute as a source of additional financing. Land readjustment is of importance as a tool, especially when the city government needs to acquire land for infrastructure development.

Successfully implementing these land-based finance tools requires a mix of administrative reform, capacity building, technical innovation, and strengthened political incentives. Some legislative processes needed to leverage land-based finance may thus benefit from being re-centralised so that national governments pass the necessary legislation for local governments to leverage land-based finance, as opposed to every local government passing its own legislation. Where there is necessary political will to introduce land-based finance mechanisms, it is important for administrations to introduce changes at the start of an administrative cycle to ensure their completion before the onset of a new administration. Similarly, reforms should aim for incremental changes and introduce transparency in the land-processes to harness the support of the smaller landowners.

Kisumu: The challenge of vested interests of landowners

Kisumu, as many of its peers, has not managed to fully leverage its revenue potential from land. In fact, nearly 70 per cent of landowners have outstanding arrears in land rates. To act upon this, the Kisumu County Government in 2016 decided to update the 2008 valuation roll, an exercise that led to an eight-fold increase in land value in Kisumu – from US$ 127 million to just over US$ 1 billion. It also increased the number of registered parcels from 25,284 to 55,000. Despite the rise, the valuation roll was never officially approved by Council. The third party that undertook this exercise withheld the GIS components of the roll citing repeated delays in payment. The Local Rating Act that is needed to validate this roll has also been awaiting approval since 2014. As is the case the world over, vested land interests likely have a role in halting these reforms, illustrating the importance of incentives at high political levels to enable local authorities to push through land reform.

3.3 Improving access to external finance

Initially, we did not intend to undertake a broad investigation on external finance in this initiative. However, in the course of developing the case studies, after finding little activity in this area, we realised that there are huge expectations of various experts in this direction, especially in subnational borrowing, often without sovereign guarantee. We thus briefly touch upon the findings and recommend that these mechanisms be analysed in greater extent and detail during the next steps of the initiative.

Despite the strong link between financing urban infrastructure and achieving top-tier global development goals, finding ways to attract private and/or foreign capital into public infrastructure investments through loans, municipal bonds, and public-private partnerships, especially in low-income country contexts, has proven to be difficult. "While different types of financing are available, the conditions necessary to attract capital to urban infrastructure projects are often not. Institutional and private investors need to see that cities can generate reliable sources of revenue to service debt, finance bond instruments and maintain equity investments."[95] Some of the key bottlenecks, as well as the role of development partners in overcoming them, are discussed below.

3.3.1 Legal bottlenecks to borrowing at the city level

Subnational borrowing is often restricted by regulations guarding against unsustainable debt obligations, as examples from the case studies illustrate.

The Local Government Act in Kampala placed a cap on borrowing until early 2020, which restricted the city from borrowing more than 10 per cent of the previous year's OSR. This amount did not allow the funding of any meaningful investment in urban infrastructure. At current collection rates, this would be about UGX900million (US$ 240,000), which would cover just 14 metres of a Bus Rapid Transit line in the city, according to a recent feasibility study.[96] In 2020, Kampala was exempt from this borrowing cap through a dispensation in the KCCA Act, while other local governments remain restricted.

In Malawi, the Public Financial Management Act stipulates that local governments cannot take loans without prior approval from the National Government Financial Committee. The Ministry of Finance accepts the risks of all loans and is, therefore, hesitant to encourage borrowing by local councils.

In Dakar, although municipal autonomy is limited with central government maintaining control over local finances, it is unusually free to take on subnational debt with few legal restrictions. The city has been able to enter into agreements with both concessionary and commercial lenders on its own accord. However, an attempt to launch a municipal bond in 2015, despite receiving pre-approval, was over-ridden by the national government at the last minute, over cited fears of large debt obligations and lack of precedence in this area. There have been discussions on their legal authority over-ride the local government's decision.

There are other regulatory challenges over and above the ability to borrow. In most developing cities, the lack of historical precedence with external financing tools, and the under-developed laws and institutions that govern them, significantly limit their ability to explore these options. For example, in Kampala, the issue of municipal bonds sits between two laws (the Companies Act and Capital Markets Act), which have competing approaches, and so the Credit Markets Authority have had to develop an interim set of guidelines to fill the gap. One of the reasons for relative investor security in Dakar was that regional regulations were already available through the West African Monetary Union, which had a process in place for dealing with investor relations and disputes, among other things.

3.3.2 Achieving creditworthiness

In many developing countries, even where borrowing is legally permitted, many cities still lack the revenue streams, financial management capacity and creditworthiness to take on debt. In this regard, the case studies show mixed results.

While Somaliland's decentralisation policy recommends authorising local governments to borrow for capital investment, none of its cities meet the requirements set out in Law 23. Therefore, they are unable to undertake longer-term borrowing at affordable rates. UN-Habitat is currently supporting a Local Government Finance Policy, which provides further guidance on borrowing and debt management.

In Kampala, many of the reforms to revenue systems and administration were centred on achieving the goal of the KCCA becoming creditworthy and reducing the risk of investment. These reforms started in 2012, building on efforts of the World Bank Public Private Infrastructure Advisory Facility Sub-National Technical Assistance Programme's 'Financial Recovery Action Plan' aimed at reducing the city's level of indebtedness and achieving clean audit reports. As a result, in 2015/16, the KCCA was given a national scale rating of A- in the short term, and A in the long term by The Global Credit Rating Co, boding well for the progress it had made within the national context.

In Dakar, building creditworthiness was a fundamental part in preparing for the bond. The Bill and Melinda Gates Foundation provided a grant of US$ 5 million for a six-year programme (2011–2017) to improve financial management systems, alter its approach to city planning, and influence investors' perception of its creditworthiness. The international ratings agency, Moody's, was brought in from the outset to provide a confidential credit rating for the city. This was used as a benchmark against which to measure improvements before obtaining the official public rating, and provided a roadmap for improvements. Key areas for reform included the quality of debt recording and reporting, as well as poor debt sustainability analysis. A local ratings agency, Bloomfield, was then selected to conduct the follow-up rating. In September 2013, Dakar received an investment grade A3 short-term rating and BBB+ long term rating.

As highlighted in the case study references above, development partners were crucial in facilitating creditworthiness reform, both in terms of technical and financial assistance. It can become difficult for a city to justify investing in internal creditworthiness reforms year after year since their returns to the public are long-term, and thus leave minimal potential for short-term political gain. By providing technical and financial assistance, development partners can help lay the groundwork such that external finance becomes a more feasible option.

It should be noted here that in Dakar, despite the launch of the municipal bond being barred, creditworthiness reforms have greatly increased the city's potential for accessing both commercial and concessional loans. Mourade Dieye Gueye, Secretary General, Dakar Municipality, commented on this point during the Cities and Experts meeting in Dakar in February 2020: "Thinking of other ways for funding helped a great deal in revenue collection and allowed the city to move its mindset from operating mode to investment mode. Financial management reform saw a 30 to 70 per cent split of capital investments/operations changing to 60 to 40 per cent. This change was driven mostly through controlling operating expenditures."

3.3.3 Project preparation

Designing bankable projects remains an often-cited challenge for national and city governments as well as financing organisations. Many city governments neither have the capacity to put forward a viable business case, nor the experience to understand what investors are seeking. Despite Kampala overcoming its regulatory challenges and achieving a national investment grade rating, many stakeholders believe the city will continue to struggle in attracting external finance without building the capacity to develop bankable projects. The capacity gaps highlighted include a lack of continuity and foresight in strategic plans, an inability to develop (trustworthy) feasibility studies, a lack of expertise and experience in preparing financial models, and immaturity in utilising internal controls and financial management systems.

Another issue is implementation. A 2014 analysis by Ernst and Young and the Infrastructure Consortium for Africa showed that with funds available and projects started, the gap is being closed. But it found that work had yet to begin on two-thirds of identified projects. Africa does not need to identify new sources of funding but rather ensure that planned projects are completed within a reasonable timeframe. This will ensure projects deliver returns to investors and help to attract new investment. Africa needs to remove barriers to finishing projects by lowering the cost of doing business."[97]

Public space with exercise equipment in Dakar, Senegal © Shutterstock

Climate finance initiatives: The Gap Fund

Cities too often struggle with developing climate-friendly and resilient infrastructure. Especially in the global South, cities frequently lack the capacity, finance and support needed for the early stages of project preparation. This leads to impasses where cities cannot move project ideas to late-stage preparation and implementation.

Launched in September 2020, the City Climate Finance Gap Fund (the "Gap Fund") paves the way for cities to deliver ambitious infrastructure development for low-carbon, resilient and liveable cities. The Gap Fund will support projects in cities in low- and middle-income countries, in East Asia and the Pacific, Europe and Central Asia, Latin America and the Caribbean, the Middle East and North Africa, South Asia and the rest of Africa.

The Gap Fund support will:

- Strengthen interventions in urban planning and financial management to reduce cities' carbon footprint and improve climate change resilience;
- Provide early-stage project preparation support for investment in projects compatible with limiting temperature rises to 1.5 degrees. Such projects could include investments in energy efficiency, green buildings, sustainable cooling, nature-based solutions, local renewable energy, sustainable mobility, waste management and circular economy, and wastewater and water management. The fund will also support climate change adaptation activities that enhance resilience (e.g., in urban water and wastewater systems, energy, urban transport, public spaces and other infrastructure).

The Gap Fund's support can cover a variety of activities ranging from city climate strategy development to project concept definition, components of pre-feasibility studies, strengthening the financing approach to improve bankability, identification of innovative or scalable financing approaches as well as matchmaking with additional support sources for later stages of project preparation. Projects supported by the Gap Fund will result in secondary social and environmental benefits, such as improvements in quality of life, clean air, health, social inclusion, the circular economy and job creation.

The Gap Fund is an initiative of the German Government and the Global Covenant of Mayors for Climate and Energy, in partnership with several other key players in the climate finance arena, including C40, ICLEI, and CCFLA. The initial donors are Germany's Federal Ministry for the Environment, Nature Conservation and Nuclear Safety and the Federal Ministry for Economic Cooperation and Development, as well as Luxembourg's Ministry of the Environment, Climate and Sustainable Development. Support to cities and related work is provided through two implementing agencies, the World Bank and the European Investment Bank (EIB), the latter in partnership with Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).

For more information: www.citygapfund.org

In many cases, project preparation could be facilitated through external assistance in structuring and developing feasibility studies and capacity building. The key to this assistance being successful in the long term, as with all external assistance, is in working collaboratively so that the ability to build bankable projects going forward is built internally. A good example for building internal capacity is Uganda, where the Ministry of Finance has now developed an entire unit devoted to assisting with the development of bankable projects. They have also tried to make projects more transparent to investors, moving to a disclosure-based system whereby investors are given all the information instead of just the merits of the investment, reducing information asymmetries and enabling them to make a more clearly informed decision. Here, the more constraining issue appears to be in establishing the underlying conditions of creditworthiness.

The **International Municipal Investment Fund** (IMIF) set up by the United Nations Capital Development Fund (UNCDF) and United Cities and Local Governments (UCLG) in collaboration with the Global Fund for Cities Development (FMDV) supports intermediary cities in developing countries, including the least developed countries, in accessing national and international capital markets. It will provide cities and local governments with reimbursable funds to finance investment projects and programmes of general interest. The Fund is managed by Meridiam, a private asset manager, with a target capitalisation of EUR350 million at first closing. Through a Technical Assistance Facility (IMIF-TAF), the UNCDF-UCLG-FMDV coalition will help cities finalise the preparation of their projects and provide the necessary support to ensure that the city meets the requirements for accessing financial markets.

Serge Allou, Technical Advisor, UCLG, said at the 29 October 2020 Cities and Experts meeting, "The experience of blended finance, guarantees, and developing cities' access to financial market shows that, in some cases, there is a disconnect between project preparation facilities and the investors. This gap should be tackled, and development partners can play a role here. Including private sector in the conversation upfront would be a key element for this."

Examples of how development partners have started addressing issues of project preparation and implementation are mentioned in the boxes on the Gap Fund, IMIF and ASCI. Another example, which does not solely target cities, is SOURCE[ii], a multilateral platform of the Sustainable Infrastructure Foundation that is led and funded by international development banks. The initiative enables promoters to assemble project information that can be accessible to a range of IFIs and other entities involved in project financing and preparation.

While donor and IFI assistance is important, it does introduce a few challenges of its own. The cities in the case studies noted that access to donor assistance requires specific know-how for each of the donors. The lack of coordination also extends to projects implemented with multiple donors overlapping in their assistance. For example, the city of Kampala has had more than three unique feasibility studies for a Bus Rapid Transit conducted on their behalf. More progress could have been made if they had aligned and tackled separate challenges. There is also an issue of donors tending to skew local priorities and plans to map to their own agenda. This overrides the very important planning process in cities that they aim to foster. Finally, it can also result in incentivising cities against adequately developing their own internal financial management and revenue generation. Initiatives are underway to try to make development support easier to access; for example, the Cities Climate Finance Leadership Alliance has been working to harmonise application forms for urban climate finance across the calls issued by IFIs and city networks.

Challenges are many, diverse and often specific to the particular context, and there are choices of financing for mainstream infrastructure: for instance, presumably richer, formally developed areas can largely either pay for privately developed and managed provision through user fees themselves or cover it through tax revenue. These areas are normally addressed first. However, a fundamental challenge is around financing long-term debt for infrastructure in poor and informal areas where the population has little ability to pay and contributes little tax revenue.

With its **African Sustainable Cities Initiative** (ASCI) the European Investment Bank seeks to enhance access to finance for investment for secondary cities in sub-Saharan Africa. Secondary cities have been chosen as the focus because they generally have high needs and lower capacities, and donor funds tend to target larger cities. ASCI supports secondary cities in accessing finance for their sustainable urban infrastructure needs through i) strengthening their capacities in municipal finance and supporting the development of municipal financing strategies and plans, ii) providing financial and structuring advisory services to a selected number of projects, and iii) increasing connections to potential investors and supporting knowledge sharing in general. The main focus of ASCI is on financial advisory services and the intention is to use other complementary facilities, such as the City Climate Finance Gap Fund, for technical advisory services. At the same time, ASCI can also support limited technical advisory work.

ii https://public.sif-source.org/source/

As highlighted in chapter 3.1, it is crucial to remember, though, that focusing only on revenue-generating, “bankable” projects, may lead to ignoring the need for public or social goods, where direct monetary returns may be small or zero, but the overall public benefit is important. Where development partners become involved in project design, they may wish to promote transformative projects that are financeable, such as green or pro-poor agendas that may not, in fact, be bankable in that context. For example, in Dakar, numerous stakeholders believed that the market to be funded by the planned municipal bond was designed to meet the pro-poor objectives of the Bill and Melinda Gates Foundation, and would not have yielded a strong return on investment had it gone ahead.

3.3.4 Reducing investment risk

With stable and transparent OSR and intergovernmental transfers in place, access to external finance becomes far more feasible. Together with other creditworthiness initiatives such as financial management and developing capabilities in designing bankable projects, the risk and therefore the costs of investment may be reduced.

However, some risks, such as currency exchange and other macroeconomic risks, are out of the city’s control. For instance, Uganda’s international credit rating has consistently stood at around B+ (Fitch), B2 (Moody’s), and B (Standard & Poor´s), which are all below investment grade. Blended finance and guarantees have been used as tools to reduce both the real and perceived risk of investing and therefore reduce the costs of investment, as investors are assured a minimum repayment.

Carla Montesi, Director, Green Deal, Digital Agenda, Directorate-General for International Partnerships of the European Commission said at the 29 October 2020 Cities and Experts meeting, “The financial instruments in the External Investment Plan are blending (providing grants combined with public or private loans) and guarantees (to de-risk investment and attract private sector) through international financial institutions. In relation to the urban sector, blending has been used to support solid waste management, sustainable urban mobility, water supply and sanitation, with a view to make loans more affordable to the cities. A key element for blending is preparation of a good pipeline of projects (that integrate the green and social agenda) that can be presented to the financial institutions. Unfortunately, not enough sustainable projects have been submitted to the financial institutions.

In terms of guarantees, we are still exploring how to optimise and streamline this tool for cities. Three key examples of how guarantees can be used include supporting resilient cities to facilitate public private partnerships (RECIDE[iii]); guaranteeing repayment to local banks to expand lending to cities, as well as lending in local currency, and de-risking currency risks; and offering guarantees to absorb part of the financial losses that an urban investment fund (small portfolio) may have to reduce investment risks.”

Budget support is one of the mechanisms used for example by the European Union as a means of delivering effective aid and durable results in support of EU partners’ reform efforts and the Sustainable Development Goals (SDGs).[98] In a decentralised context budget support can be a catalyst to tighten the economic and budgetary framework and strengthen the investment and business environment, to reduce investment risks, enhancing sector policies, institutions, and regulatory frameworks. Therefore, it is essential to exploit synergies and complementarities with other tools such as blending to increase their effectiveness. Subnational application of Public Expenditure and Financial Accountability and Tax Administration Diagnostic Assessment can trigger useful reforms aimed at improving financial management and tax administration and therefore increase creditworthiness.

In developing their municipal bond, the City of Dakar secured a 50 per cent guarantee from USAID under its Development Credit Authority (DCA). This meant USAID would repay at least half of the investor’s capital if actual revenues from the project did not match expectations. Since it was a non-sovereign bond, the DCA could not provide a full guarantee, and instead required the City of Dakar to create a reserve fund to finance the initial repayments. The city thus placed a coupon amounting to one year’s interest on the bond in a private bank account, which provided a first loss guarantee to investors and ensured limited liability for the central government. The wide-ranging creditworthiness reforms, combined with investment guarantees, saw the municipal bond of US$ 40 million become viable at an annual interest rate of 6.6 per cent with a seven-year maturity.

iii Resilient City Development Guarantee under European Investment Plan; https://ec.europa.eu/eu-external-investment-plan/projects/resilient-city-development-recide_en.

Another critical element in the design of the bond included a two-year delay in principal repayments to save the city from having to allocate other revenue sources, such as property tax, to repay investors, which would have added significant financial pressure on the budget and constrained their ability to deliver on ongoing service delivery needs. However, the bond only had a seven-year maturity, like many other subnational loans. This creates considerable difficulty since typical infrastructure project life cycles are between 20 and 30 years. Development partners can play a role in helping extend debt cycles to match project life cycles.

While ring-fencing a project so that its income and expenditure are separate from the rest of the city budget is vital in assuring investors that revenues generated will not be spent elsewhere and ensuring that other sources of city income continue to be used for critical service delivery, it also has its downsides. For instance, imposing user fees to recover costs can render services inaccessible to the urban poor. Even amongst more affluent parts of the population, user fees require strong sensitisation, given the lack of historical precedence.

The experience shows that in low-income countries, attracting external investment through all kinds of instruments can become risky and costly for both debtors and creditors. The issuance of bonds at local level is especially risky. Long-term debt should only be contracted for the purpose of capital expenditure on property, plant and equipment, and be denominated in local currency and not pegged to foreign exchange. Debt transparency and disclosure must be mandatory. Issuance of guarantees may remain problematic and can generate significant implicit contingent liabilities.

Gerry Muscat, Head of Urban Development Division, European Investment Bank, said at the 29 October 2020 Cities and Experts meeting, "The evolution of stable and predictable transfers has been one of the key ingredients in enabling cities in Europe to have creditworthiness and ability to borrow in their own right. While encouraging this, we should not wait for this trajectory to happen in developing countries but try to find ways to leapfrog and transition and go forward with urban investment, using other resources and guarantee instruments. It is especially relevant in times of the COVID crisis when municipal budgets are constrained, and grants and capital expenditure support from central government are under pressure, too. IFIs can add value by trying to mitigate risk both by blending grant financing into projects, and by using catalytic capital as grants to provide a first layer in a fund that supports private investment in the urban sector. IFIs can also play a role by providing technical support. EIB focuses on the project level financing and linking support to creditworthiness in relation to investment. Through facilities such as ASCI and the Gap Fund, the improvement of credit quality at local level can be supported. Yet, there is a long way to go. Where possible, IFIs should focus on where the cash flow of projects is and try to finance at the most local level, whilst making use of national support. In many cases, IFIs will be unable to change the regulatory framework and have to achieve municipal financing within the existing framework."

3.3.5 Municipal bonds versus loans

Municipal bonds have been promoted by some development partners; however, one needs to be careful about what prerequisites are required for this instrument to work well. Even South African experts in KwaZulu Natal consider municipal bonds premature for the vast majority of municipalities as "there is wide agreement that without an effective regulatory framework, subnational borrowing may lead to fiscal and debt crises and significantly contribute to an unstable macroeconomic environment".99 The bond issuance in Lagos, Nigeria, for example, was likely to be successful given the size and state of development of the city, which is very different from many others on the continent. In January 2020, the State of Lagos issued a US$ 275 million bond for investment in infrastructure at the clearing price of 12.25 per cent per annum fixed rate in naira, (NGN), the Nigerian currency. This was not the first of its kind; an infrastructure bond of a similar scale maturing in 2024 was issued three years ago. At US$ 1.2 billion, Lagos state accounted for 10.9 per cent of the country's total domestic debt stock at NGN 4.04 trillion (US$ 11.17 billion) as of 30 September 2019, according to a recent report by the Nigerian Bureau of Statistics.

The tenets of the success of a municipal bond may be worth exploring in the next phase of this initiative. So far, evidence from the Dakar case study shows that development partners can play a critical role in de-risking municipal bonds and ensuring the terms are viable both for investors, and for the city. Further, when planning to float a municipal bond, ensuring that the denominations are low enough to enable citizens to buy in is important for strengthening the social contract.

IFIs, for example the European Investment Bank, also warn that a loan, as opposed to a bond issue, is generally much more flexible in case of non-performance, when it can be renegotiated and restructured; a bond, on the other hand, can tie up municipal revenue for years, or in the worst case, be defaulted with little possibility for the municipality to negotiate a new debt repayment schedule. Concessionary and commercial loans are therefore likely to be a better fit for many circumstances than municipal bonds, especially in less mature markets. The loans can be adapted to meet the needs of cities and have fewer transaction costs. However, local governments may also struggle to borrow from commercial banks for several reasons. Financial safeguards (increased capital requirements, increased liquidity) in response to the financial crisis of 2007-09 put in place by Basel III[iv] forces commercial banks to charge higher margins and shorten loan maturities. There is also a lack of competition among and regulation of financial service providers who do not offer competitive interest rates, although some countries have successfully introduced requirements for loan financing to be tendered, which can increase the competitiveness for loan pricing but may also limit flexibility. Poor credit ratings of local governments make interest payments unsustainable, whether they be for bond coupons or loan repayments. We did not find enough examples in the current scope of our case studies and may need to look at this issue in the next phase.

Starting with the more favourable, smaller, flexible terms of concessionary loans and building up to commercial loans with larger, fixed and longer-term costs can be a useful model for local governments to smooth cash flow and demonstrate creditworthiness for additional financing. Only once cities have achieved a certain level of development and built financial management capacity through smaller loans, should they look to take on a municipal bond. Bond markets can also be accessed on a wholesale basis by municipal credit institutions such as municipal banks, which have more experience with financial market instruments and can potentially issue debt against pooled risk and pass on resultant pricing to municipalities; indeed, this is how most municipal banks function in Europe.

iv Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks. *https://www.bis.org/bcbs/basel3.htm*

3.3.6 Public-private partnerships

Public-private partnerships (PPPs) are seen by many cities as the answer to a multitude of infrastructure needs, but all types of partnerships with the private sector – from relatively straightforward ones such as full divestiture and concessions, to really complex ones such as joint ventures – require transparent and well-enforced regulations and accountable institutions at all levels of governance.

The EIB notes that we often talk of PPP, but PPP is about "partnership". The "private" sector operating in a regulated framework is sometimes simpler, where there is no specific PPP contract, but rather a robust regulatory framework in which the sector operates urban services or infrastructure. Affordable housing can work in this way, purely privately, rather than through a PPP. Similarly, there are some types of PPP that are simpler than the others (e.g., DBO vs DBFO[v]) and can yield efficiency benefits. In many countries, authorities still lack the capacity required to plan, coordinate and manage such projects, and are at a strong disadvantage in negotiating with private service providers equipped with experienced legal, financial and technical advisors. This often may lead to skewed or unbalanced contracts, chronic cost overruns, and often the need for national-level bail outs. The Bank concludes that cities are also often not well equipped to ascertain whether a PPP would bring efficiency gains over other types of procurement over the life of an investment.

PPPs for urban infrastructure suffer from all problems listed above and more. For instance, in Nigeria, access to finance constitutes one the most challenging problems of housing delivery. "Numerous private developers in the programme lack the required financial capacity to deliver their projects. Insufficient funds and structural weakness in the country's financial market constitute major causes of delay in completion of the housing projects"[100].

As per Kisumu's 2018-2020 County Integrated Development Plan II, PPPs are expected to yield around US$ 75 million to finance the County's ambitious development. While this may seem like a relatively small amount, it is equivalent to around 75 per cent of the Kenyan

v Design Build Operate (DBO) contract is a project delivery model in which a single contractor is appointed to design and build a project and then to operate it for a period of time; Design Build Finance and Operate (DBFO) contract in which the contractor also finances the project and leases it to the client for an agreed period (perhaps 30 years) after which the development reverts to the client.

County Government´s (KCG) annual budget. It is also a considerable amount given that the KCG has historically not managed to share the financial burden of infrastructure provision via PPPs. There have been several PPPs in Kisumu, but these did not feature the KCG as the contracting authority. The Kisumu Sea Port completed in 2019 and worth US$ 80 million was managed via the Kenya Ports Authority. The Magwagwa Multipurpose Dam Development that amounted to US$ 835.6 million, is managed by the Lake Basin Development Authority. The Transmission Grid Expansion programme worth US$ 434 million is, similarly, managed by the Kenya Electricity Transmission Co. Ltd.

The challenge of creating PPPs according to the KCG is that the PPP process is overly complex. However, the challenge of putting in place PPPs cannot be addressed by further easing PPP regulations alone. While there is certainly room for improvement in PPP regulation, the key bottleneck is arguably elsewhere. Lack of county level PPPs needs to be tackled by addressing the inability of county governments to create conducive investment environments, adhere to existing PFM regulations, and increase OSR. By developing these foundations of municipal finance, the KCG is likely to create a more appealing environment for investment and build up internal capacity to prepare bankable projects and PPPs more quickly.

In Uganda, the PPP Act was passed in 2015, opening new opportunities to leverage private sector investment. However, lack of experience on the part of contracting authorities, weak cooperation between government institutions and little knowledge of best practices continue to restrict implementation. Currently, no projects in Uganda have gone through the process outlined in the Act but were rather negotiated and concluded under prior guidelines and frameworks. To remedy this, the national government has set up a specific PPP unit, which helps build capacity, particularly in structuring partnerships and contracts.

However, sound project development is still a preliminary issue that needs to be overcome before PPP mechanisms can be explored. PPPs require a strong authorising environment with the ability to coordinate, and research shows that they are typically only feasible for large-value projects over US$ 50 million given the high transaction costs incurred in structuring the deal. Similar to other investment structures, they also require capacity to build bankable projects, and also face issues surrounding the affordability of user fees and resistance from the community to pay these.

PPPs are not a panacea and require very strong governance to deliver better results than traditional procurement processes. It is important to reiterate that the stage of development in the city is crucial in determining which of these options are viable. For the most part, there needs to be a focus on getting the fundamentals right and building capacity before moving on to innovative external investment tools such as municipal bonds or various forms of PPPs.

3.3.7 Pooled financing and financial intermediaries

Financial intermediaries play an important role in coordinating investments, facilitating and managing relationships, and building the financial capacity of developing cities over time. They can be as important as the investments themselves by helping avoid duplication, poorly planned or uncoordinated infrastructure, and reducing the information gap between investors and cities. Many countries have local development funds, housed with national governments, to coordinate investments from multiple donors and central government, and are usually presented to cities as grants.

As discussed in previous paragraphs, efficient lending through municipal investment banks needs a stable revenue base. The stability of the local revenue base should be a part of large decentralisation measures, with OSR being a dominant source of revenues. The cost of delegated responsibilities should be covered by the revenue base with a margin, and this margin, called the “operating surplus”, is really the long-term sustainable repayment source of municipal loans.

An important issue in creating a municipal investment bank or any other pooled credit facility is to ensure strong corporate governance and risk allocation. With time, when municipal lending becomes a well-established business, commercial banks will enter this segment and will compete with the specialised institution. It is therefore important to

UCLG's Africa Territorial Agency

Following the request of members, the General Secretariat of UCLG Africa has proposed the creation of the Africa Territorial Agency (ATA), a financial institution dedicated to the financing of infrastructure and equipment of African cities and territories. The creation of the ATA will be done in two stages: (1) the establishment of a cooperative institution of the founding members of the ATA, bringing together the first 100 cities and territories that each subscribed EUR100,000 in order to release the 50.1 per cent that the cooperative institution brings to the capital of ATA; the remaining 49.9 per cent is to be sought from financial institutions in the region, among which the African Development Bank is expected to be the reference investor with a contribution of 33.3 per cent in the capital of ATA. The cooperative institution will ensure the political governance of ATA, and thus, serve as the ATA's supervisory board; (2) the establishment of a financial institution, which will be responsible for the technical management of ATA, and the management of which will be provided by a fund manager chosen after an international call for applications. The financial institution will be responsible for raising funds by issuing bonds on the financial market on the one hand, and on the other, for making loans to cities, and local and subnational governments according to commonly accepted rules.

The ATA's interest lies in the pooling the requests of the cities and local and subnational governments of Africa, and to allow each one of them to individually access the financial market at preferential interest rates. None of them, with rare exceptions, can reach levels of bond issues likely to be of interest to the financial market. The other expected advantage is that the main shareholder of the ATA is the cooperative institution made up exclusively of cities and territories in Africa, which appoints the supervisory board of the ATA and consequently ensures that the decisions made by the financial institutions are always in the interest of cities, and local and subnational governments in Africa.[101]

enable such institutions to remain financially sustainable in a competitive market. This would mean ensuring it reaches certain size, so that it can develop other profitable business segments, or be sold to private investors and become a segment in private banks' lending portfolio. These financial sustainability requirements should be taken into account when designing such institutions.

In Somaliland, the Ministry of Planning acts as a coordination mechanism for international development partner support. It is the first point of contact as well as the coordinator for development partners. A necessary delivery vehicle upon which this coordination takes place is the **Somaliland Development Fund**, which was established in 2012. This single fund ensures two important outcomes: first, that external development partners support the country's development goals, and second, critically, that all delivered development partner projects are aligned with Somaliland's National Development Plan.

In Senegal, the central government invests in cities through the National Local Development Programme and the Municipal Development Agency (ADM). Both are under the *Ministère des Collectivités territoriales, du Développement et de l'Aménagement des Territoires*, and were put in place to help smaller communes. Their aim is to assist the communes pull together their resources, identify objectives and goals, target their spending, and also get support on legal issues to ensure they are complying with the law. The ADM is a vehicle for the national government to coordinate and raise funds from various donors and allocate them to specific communes. The national government manages the investment process on their behalf, saving communes from having to negotiate with private partners, especially those that do not have the power and internal structures to go to international markets. However, it does take away their autonomy, as the national government makes the decisions and projects are simply "placed" in the commune. To rectify this, the communes could be involved in these projects to reflect local priorities, build technical capacity as well as to create capacity for maintenance and project management.

Initiatives like the **Development Fund for Local Authorities** (DFLA) in Malawi take this a step further, expanding on the coordinative role played by local development funds by providing the funds collected from donors and central government to city governments as low-cost loans with favourable terms. They also offer capacity building on project design and financial management, with a strong incentive structure in place so that cities cannot borrow again until they have paid off previous loans and improved their practices. In this way, the structure aims to support cities to incrementally build creditworthiness in preparation for more substantial commercial borrowing. The DFLA is a revolving fund with seed capital initially provided by the World Bank in 1992. It provides both short-term commercial loans, as well as longer-term infrastructure loans. Since its inception, it has had a steady recovery rate. This recovery is likely because repayment terms are favourable, with a repayment period of up to 10 years and a 14.5% interest rate – the same as the Reserve Bank of Malawi. In contrast, commercial bank rates are around 26%. In 2017, the fund was transferred from management by World Bank consultants to management by a local CEO and team, which has reignited interest in it as a viable “lender of first resort” for local authorities. It is now actively looking to recapitalise, as there have been no injection of funds since its inception. This larger capital base would allow them to assist with larger infrastructure projects in addition to the small operational needs it currently serves.

The **Town Development Fund** (TDF) is a similar autonomous financing institution established by the Government of Nepal (GoN) in 1989. TDF is the only financial autonomous intermediary institution in the country presently providing debt financing to local governments. Several donor agencies, including the German development cooperation (GiZ) and development financing institutions (KfW), the Asian Development Bank, and the World Bank have worked with TDF since its inception. Local governments in Nepal, especially municipalities and fast-growing emerging towns, are its main clients. The GoN, especially the Ministry of Finance and the National Planning Commission view it as a key institution that has an important role to play in the urban infrastructure development of the country. The TDF finances long-term urban infrastructure development projects through its loan and grant funding102. Maniram Singh Mahat, the TDF Director during a webinar on 29 October 2020 highlighted that since its establishment, the TDF has financed over 13,000 projects and was key to increasing access to piped clean water from only 30 per cent to 90 percent of Nepalese people in 20 years.

Local finance institutions also play an important role in developing countries by possessing a good understanding of municipal frameworks. They can thus take local currency risks better than cities when these borrow in the market. IFIs can support them by providing long-term funding and helping them improve their credit procedures and showing them how to distinguish between corporate risk and municipal risk. A good example of this is the *Fonds d’Equipement communal* in Morocco, which lends to municipalities and regions but also channels central-local transfers and has a strong credit mechanism.

Municipal investment banks are a useful tool to build access to local credit. They have three key roles: channelling and coordinating finance, reducing investment information gaps, and building subnational capacity. With specific focus on urban investment, they can manage both national, international and development finance at a local level in a way that would otherwise be too onerous if managed individually.[103] These entities are shown to mitigate coordination problems and inaccurate targeting of needs.[104] They can potentially align better with national urbanisation plans as well.

With highly centralised systems of credit and finance, the costs for monitoring are large and thus inefficient for anything except large loans. As municipal development banks have closer relationships with municipalities, they can work together to close information gaps, which would otherwise result in priced risk. Finally, access to finance for city governments is limited. Only a small percentage of the 500 largest cities in developing countries can be deemed creditworthy. This is about four per cent in international financial markets and 20 per cent in local markets.[105]

Where borrowing is available, there is a role for municipal investment banks to ensure municipalities stay within the limits of debt and borrowing set out in borrowing frameworks.106 Where it is not available, the bank can move beyond financing, helping cities with capital planning, financing structuring and project evaluation. Their dual role in leveraging and coordinating existing financial flows for investment today, as well as preparing municipalities for investment tomorrow, highlights their importance in enabling access to finance.

Successful municipal credit markets: The Tamil Nadu Urban Development Fund (TNUDF)

The TNUDF is a global leader in designing systems to attract new financing sources. It is a PPP in the urban sector between the Tamil Nadu government and three private infrastructure, financial and housing corporations. The TNUDF's mandate is to provide project services and capital expenditure financing for urban infrastructure services, such as water, sanitation, solid waste management, roads, and transportation.[107]

Most recently, the fund issued a 15-year bond equivalent to US$ 300 million, which sold on the domestic market to finance a ring road in Madurai. New security mechanisms to de-risk investment for investors included a) earmarking toll revenues in a separate third party (escrow) account, b) establishing an independent corporate trustee and c) certifying a backup guarantee from regional government to cover any revenue shortfall.[108]

As Tamil Nadu is a state of India, the fund also encourages the pooling of financing from smaller government units, its municipalities. In the past, 12 municipalities designed water and sanitation projects, each underpinned with tariffs for payback. The resultant pooled bond could be backed by the reserve fund, a central government back up intended to replenish any tariff shortfall. Furthermore, there is also an external guarantee covering 50 per cent of principal repayments. This interaction outlines the urban benefit from municipal, state and central government coordination.[109]

The streets of Madurai, Tamil Nadu, India © Shutterstock

4. Recommended focal areas for governments, development partners and IFIs

Why is there so much knowledge about financing urban development in developing countries, but insufficient progress on the ground? In current discourses worldwide, emphasis is often laid on resolving all issues with urban development either by decentralisation, or by access to external – especially, private sector – funding rather than improved coordination across levels, sectors, actors, and territories. Yet, examples show that sometimes cities develop stronger capacity to manage finance in less decentralised settings, and that a functioning multi-level system of finance is needed in the countries before they can benefit from accessing external opportunities. In debates around financing sustainable urban development, the role of OSR is sometimes exaggerated and calls are made for unconditional intergovernmental transfers and unrestricted subnational borrowing as the answers to many of the problems in financing urban development, rather than seeking vertical and horizontal integration of these financial mechanisms.

Professor Sir Paul Collier suggests that we are intervening in circumstances of radical uncertainty. Hence, it is crucial to promote the building of a common purpose of improving sustainable urban development, and engage in local, smaller scale experiments in different contexts to determine what works and to try and scale up solutions that yield results.

The proposed focal areas derive from the chapters above. They are grouped in areas of broader policy and improved governance, and technical solutions of improving instruments of financing sustainable urban development. We look at the conclusions from the current phase of the initiative where sufficient information is available and point out issues that need more work to be better defined in the next phase of the initiative.

4.1 Improving policy and governance

4.1.1 Anchor urbanisation in national development policies

Urbanisation must be included in national development planning if it is to be properly integrated and harmonised with national priorities and used to achieve top-tier goals. Measures to address the challenges and harness the opportunities of rapid urbanisation should be clearly articulated in national-level policies and investment projects. This requires recognising the importance of urbanisation in meeting national and subnational objectives and the critical role that national level policy plays in managing it. It is especially important given that national governments are often the key interlocutor with development partners and IFIs that are willing and able to finance urban investment. Countries that have been successful in attracting urban investment and finance tend to have urban development well positioned within their national policies and priorities.

This initiative has also revealed several knowledge gaps that deserve further exploration. While it is clear that there is a need to better anchor urban policy in national development programmes, it is also important to investigate the trade-offs between rural and urban foci, regional versus urban planning, and how urban policy can promote structural transformation and productivity enhancement. How harmonisation of urban objectives with industrial development can be achieved needs to be better understood, as industrial parks and free economic zones significantly influence both urban development and OSR. We need a more explicit and clearer framework to analyse these important questions: **How does the structure of particular economy determine its enablers, constraints, outcomes, and shapes at the city scale? How is urban finance linked to structural change, and how are the linkages between the structure and the performance of the national economy, on the one hand, and the local level where economic development actually happens for communities, on the other hand?**

In the next phase, we also need to explore how urban development policies can address high intra-country variation of GDP and levels of development. In Uganda, for instance, Wakiso, an area that is part of the Greater Kampala Metropolitan Area, has a GDP of US$ 3,250 per capita, while some rural towns have a GDP of just US$ 60 per capita. We need to go beyond perpetual redistribution by intergovernmental transfers and think strategically about urban economic development in the national framework. For example, the potential of enhancing manufacturing (and processing/refinement) may be more suited for smaller cities rather than large ones, depending on the context and conditions. Perhaps more secondary, intermediate cities and more countries need to be looked at in the next phase. It would also be useful to differentiate between large and medium/small cities as the economic development opportunities may be different.

4.1.2 Use investment programmes as an opportunity to foster governance frameworks

All partners should invest in fundamental governance frameworks when addressing urgent issues. Integrated policies, functioning institutions and effective coordination are still lacking, especially in Sub-Saharan Africa. The question is whether this condition should deter governments and development partners from investing in urgently needed urban infrastructure until the frameworks are significantly improved. Given the short window of opportunity to invest in infrastructure before mass population growth and settlement occurs, it is tempting to "leapfrog" missing prerequisites and focus on investment programmes. Some donors employ what they refer to as a "non-invasive" approach: the development of infrastructure without addressing policies and institutions. However, these approaches do not have to be mutually exclusive and need neither withhold investment in urban development before capable institutions are in place, nor build urban infrastructure regardless of institutions and policies. **Development partners should use investment programmes as vehicles to foster improved governance frameworks and commit dedicated effort to institutional development, targeting a more complete system of financing. In doing so, care should be taken to ensure that investment is not be done in a way which entrenches inappropriate structures or perpetuates inadequate practices**. Investment should also be used to build and join up capacity in the institutions that require development of human capital and skills. This issue merits dedicated effort and more evidence is needed to understand how these linkages work in different contexts.

The urgency of investment in urban infrastructure and services calls for quick wins to secure the support of politicians and citizens, but such investment must also be well planned to be transformative. Focusing only on revenue-generating, "bankable" projects, may lead to ignoring the need for public or social goods where direct monetary returns may be small or none, but the overall public benefit is important. Where development partners become involved in project design, they may wish to promote transformative projects that are financeable, such as green or pro-poor agendas that may not in fact be bankable in that context. Investment decisions must also be based on sound, but not necessarily exhaustive, cost/benefit analysis and be supported by adequate regulations. A "no-regrets" approach may be required to shape such investment, targeting the resilience of cities to various risks, and implemented without much delay. It would be useful to explore how donor and private financing, especially for climate and environmental infrastructure, could help drive improved governance, and enhance urban productivity and resilience. Cities and governments that are better able to absorb climate finance will prosper. For example, the EIB is now investing in affordable housing funds in Africa and Latin America but the Bank is likely to do this only if investment programmes apply the EDGE[vi] standard, green bond principles and other criteria set out in the EU Sustainable Finance Taxonomy [vii].

Many additional questions remain to be answered: for instance, what kind of investment in infrastructure and services should governments, developing partners and IFIs be focusing on to optimise benefits to society, and can stimulate and enhance local revenue generation? How can scalability be ensured, not just investing in barebone infrastructure but in the one that has transformative potential?

4.1.3 Coordinate across levels, sectors, actors, and territories

Parallel to addressing urgent investment needs in urban infrastructure, to achieve progress in financing sustainable urban development, and to increase effectiveness and efficiency, one should look for coherence of policies and mechanisms before attempting to redistribute responsibilities across different levels within the governance system. The pace of urbanisation is fast, the priorities are many, the resources very limited, the inertia heavy, and the concepts plenty. It is therefore imperative to look for synergies – harmonizing economic, social, environmental and spatial development goals in multi-level and multi-actor governance systems across various territorial scales – which can

vi EDGE is a green building certification system for emerging markets created by IFC, with free software to verify the resource efficiency of building designs. (https://edgebuildings.com/, last accessed on 12 April 2021)

vii The EU Sustainable Finance Taxonomy is a classification tool aimed at investors, companies and financial institutions to define environmental performance of economic activities across a wide range of industries and sets requirements corporate activities must meet to be considered sustainable. (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en, last accessed on 12 April 2021) only be achieved by coordination and collaboration. In this context, urban planning, well-suited as it is to widespread informality, is key and must be promoted well in advance of expansion of cities to make sure investment is guided by coherent plans. Long-term urban spatial and physical planning, and financing of urban investments must be linked by a strategic approach to urban development that determines priorities and phasing and embeds investment needs in the budgeting cycles of ministries and municipalities.

Fiscal decentralisation is not always a solution to all problems. The answer to a lack of investment in urban areas and subnational governments should not always be increased fiscal decentralisation. Indeed, the empirical record on its efficacy is mixed, and success often depends on the specific context and the way in which decentralisation is implemented. When serving development goals, bringing governance and financing mechanisms closer to the people has significant advantages in terms of increasing transparency, accountability, and responsiveness of public expenditure. Yet, if ill-conceived, it may also lead to duplication of government structures, loss of economies of scale, and local elite alone capturing the benefits of urbanisation. Even if tax rates and tax raising remain nationally administered, some of the revenues that are generated from activities within a city can be devolved to the city authority to spend. This provides the most important rationale for fiscal decentralisation: that it gives the local government an incentive to grow the local economy by listening to the city's businesses, while avoiding the problems of tax competition and administrative duplication. The key obstacle for a functioning system of urban finance is the lack of clear roles and responsibilities across levels of government, actors, and territorial scales. Well-understood subsidiarity is not about delegating everything to the local level, but about ensuring that action, to be effective, is taken at the most appropriate level of government. Fiscal decentralisation is politically highly sensitive; if one waits for it to happen, one may be waiting a very long time. It is sometimes associated with fundamental shifts in society, for example, the fall of the Iron Curtain in Europe. Achieving change within the existing fiscal framework can still be effective, is much faster, and more likely politically acceptable to national government.

Besides fiscal decentralisation and devolution of mandates, other forms of decentralisation can be important. For example, greater involvement of local governments in decision making on local priorities for investment can lead to more efficient investment by building what people want and need, not what decision makers in the capital think they want and need. Tunisia is an example of the central government still largely controlling budgets and expenditure but enabling greater local decision-making over investment priorities.

Furthermore, although fiscal decentralisation should not be a pre-requisite for shoring up urban investment, in countries that are embarking on it, this should be robustly supported by IFIs and other development partners. An example of this is Morocco where IFIs are working with decentralised administrations (municipalities, regions, municipal service enterprises and intermediary banks) to provide financing and technical assistance that can help build on the emerging fiscal freedom.

While better collaboration among different levels of government and diverse national and international stakeholders is needed to enhance access to finance for cities, it is unclear what the specific levers are to ensure such improved collaboration. In the next phase, we need to better understand the extent to which national policy levers and intergovernmental transfers can be used to set the right incentives, aligning interests across different spheres of government, without jeopardizing their autonomy.

4.2 Focus on finance

4.2.1 Use existing potential for increasing revenue before looking for new sources

Optimisation of OSR and all locally generated revenues must include technical, management, and sometimes political reform. OSR systems are often overly complex, not fit for purpose and struggling with lacking or outdated data and information, widespread pilferage, and poor compliance. Using systematic methods to devote scarce collection resources to the most lucrative taxes and employing tools such as integrated systems and digital technologies appears to be promising in remedying these issues, but to be effective, such methods need to be embedded within broader management reform. As the Kisumu case shows, the most promising technical reforms can yield very insignificant results if there is no change in the political will and associated incentives around collection and compliance.

Increasing compliance of high-net worth individuals is often one of the more effective means of enhancing OSR even if it is politically unattainable in many countries. **OSR benefits**

can be increased by introducing participatory and accountable processes that clearly showcase the usage of OSR in public expenditure to incentivise compliance.

Land-based finance tends to be particularly under-utilised at the local level and often deserves heightened attention to update land values (valuation rolls), improve collection mechanisms, and enhance compliance by removing legal ambiguity or inability to sanction non-compliance. The economic rationale for widespread exemptions also needs to be revisited. Sometimes innovative tools for increasing property tax can conflict with national rules or policies, as the case study of Mzuzu has shown, underlining the importance of confirming these tools in terms of legal validity or conformity with national policies.

There is a need to develop a method to support local governments in determining binding constraints and more effectively prioritising reform initiatives. National governments and development partners can play a role in incentivising local governments to fully leverage their existing tax authority by making transfers conditional on OSR performance variables and/or increasing the transparency with data and reporting requirements. However, care must be taken to ensure these mechanisms are not used as a way for national governments to stall or withhold payments or development partners to push their internal priorities. Therefore, the incentives must be captured in clear and objective formulas and rules.

Local governments should also enhance expenditure efficiency before accessing private finance. This can be measured via a) actual capital expenditure as a percentage of total budgets, b) actual government salaries as a percentage of total budget, c) compliance with PFM regulations in audit reports. Expenditure efficiency is a useful indicator of creditworthiness and generally provides a measure of how accountable the local government is and whether it effectively uses additional resources that it is provided with. **It is not a function of existing budgets and thus it does not need to be repaired by providing additional external resources. Local governments should be open to public scrutiny, external evaluation, and audits of the use of their resources in return for better access to external financing, with an awareness that as they do so, they expose themselves to the consequences of any malpractice.**

In the next phase, we suggest the following focus areas: (1) Enhancing local revenue optimisation through reducing tax complexity and concentrating collection on the most lucrative taxes, (2) focusing on incentives for reform; (3) using local revenues for operations and maintenance **(even where central government controls development partners' financial support, there needs to be awareness and planning for the fact that the related infrastructure is to be operated and maintained using local revenues)**; (4) capturing land value increases to the benefit of the public interest; and (5) using private sector capacities to complement those of public authorities while keeping the public interest uppermost on their minds (for example, a 30-year concession to provide infrastructure may look good at the outset but can become extremely challenging to get out of).

We need to explore how the conditions attached to development partners' support can be **conducive to progress in national policies and frameworks, with special regard to cost recovery and tariff reform**. Technical assistance can be linked to loans and encourage policy and reforms; guarantees can offset the risk of lending to local levels. **Pricing incentives can be considered (reducing the interest or extending maturity) to demonstrate commitment to regulatory reform and enhancing the capacity of the local level**. For example, one idea that can be explored is using financing to generate a revolving fund that would take in locally generated revenues not used for servicing the loan, providing more capacity for future investments. The initiative found examples of improved land and property taxes in Kampala and Mzuzu, but mechanisms to specifically capture increasing land value were not found except in Somaliland, which is a special case. There is thus a need to further explore how the value of urbanised land is created by cities and how this can be captured for public benefit, including the potential for various forms of land readjustment.

4.2.2 Understanding the effective sequencing and the priorities of financial interventions

This working paper as well as existing literature together suggest a wealth of potential interventions to enhance the financial position of cities. While all of these interventions in their own right may help to optimise city finances, it is not clear which ones are most applicable in which contexts and where decision makers should start. In what circumstances do municipal finance foundations, i.e., OSR capacity, effective budgeting, and expenditure, need to be in place before other financial options are explored? To what extent do different interventions to enhance access to finance support each other and where is sequencing/prioritisation of interventions needed?

Carrying out all interventions simultaneously is not feasible and likely to spread resources thin across interventions as opposed to focusing on key binding constraints. Yet, the need to come up with a means for sequencing or prioritising interventions around key constraints is compounded by the fact that the **different interventions are not always complementary but may actually undermine each other**. For example, facilitating access to additional national grants, development assistance or private capital without clear conditions may undermine the willingness of a local government to pursue OSR optimisation. Besides, there are no clear conditions in place for local governments to unlock fairer, more predictable transfers or donor funding. Most transfer formulas around the world are not dependent on PFM or OSR performance. In instances where OSR optimisation is particularly necessary to achieve creditworthiness and strengthen basic accountability mechanisms at the local level, the lack of conditions may undermine the ability of the local government to effectively enhance its financial position in the medium- to long-term.

Simultaneously, **working on OSR optimisation in the context of insufficient tax authority may also not be the most critical lever to work on to improve a city's financial position**. Even at an extremely case-specific level, **determining which cities should realistically work towards the development of their own bonds or PPPs is critical** in ensuring the effective usage of reform resources. It is therefore important to understand better how to manage the trade-offs that exist between various municipal finance interventions and to explore the conditions under which different types of financial interventions are most suitable. Developing a simple typology of situations can be a good start towards gaining better knowledge of these issues. Further, it could be particularly worthwhile to explore how donor and private financing for climate and environmental infrastructure could help drive improved governance and OSR optimisation as well as advance urban productivity and resilience.

4.2.3 Improve delivery of better financing at city level

More research is needed to better understand how improved municipal finance can be achieved in both centralised and decentralised systems, and under what conditions deepening fiscal decentralisation is a useful approach, and where it may actually be counterproductive. Almost universally, actors complain about the lack of financial management capacity at the city level. Yet, does all capacity have to be held by the local government? **We need to look at methods of aggregating capacity of fiscal management dispersed across levels and sectors**. How do we address the paradox that in some less decentralised countries (e.g., Senegal) larger cities have more capacity to deal with finance than in constitutionally decentralised ones (e.g., Kenya)? Or to put it another way: how can the efficiency of urban financing be improved within a centralised governance framework?

In line with the focus on decentralisation, borrowing at subnational level without sovereign guarantee is often seen as the next "big" solution to overcome the infrastructure gap. However, tapping into domestic and international financial markets by subnational governments needs highly developed legal and institutional frameworks, a reliable system of intergovernmental transfers and significant capacity. One also needs to be aware that lending to the sovereign level and on-granting to the local level could damage efforts of local finance reform towards cost recovery, and thus, such efforts must be tailored to circumstances.

Instead of each and every urban municipality, big or small, striving to develop borrowing capacities of their own financial intermediaries can play an important role. **Efficient lending can be implemented through municipal investment banks.** Very often, a well-managed national development bank can be a very good municipal investment bank, so the **presence of a strong national development bank could mean that a government should consider developing a municipal finance function there**.

Development partners do not show much interest in intergovernmental transfers as the issue is politically sensitive and takes long time horizons to adjust. **There is a need to focus more extensively on the design elements of these transfers, ensuring transparency of allocation and commensuration to decentralised mandates.** As highlighted above, **the transfers should also be used as a lever to hold cities accountable for good financial management.** The former requires a concerted effort to develop systems that encourage predictability in size and timing of payments so that cities can rely on the funds to plan and commit to longer-term investments. The latter requires this system to be predicated on certain performance indicators such as efficiency and effectiveness in expenditure, progress in OSR generation, and overall adherence to PFM standards. More analysis on this issue is needed, as well as examples of how this has helped improve municipal finance without necessarily devolving more revenue sources.

One may wonder why Lagos has been successful with subnational bond issues and whether its experience can be replicated across the continent and if yes, how? In the USA, successful fund raising for urban development was first widely implemented through city bonds. Europe's trajectory started with a reliance on sovereign borrowing (loans, bonds), first for the central government's own purposes, then for on-lending to local authorities, which in turn took to contracting loans or issuing bonds directly, and now urban utility companies are following suit (with or without city guarantees). The evolution of stable and predictable transfers has been one of the key ingredients in enabling cities in Europe to become creditworthy and gain the ability to borrow in their own right. **Should development partners and IFIs help this trajectory to happen in developing countries, or should they seek ways to circumvent it and go forward with urban investment?** This needs to be explored in the next phase of the initiative, including developing tools to promote both approaches depending on the case-specific context. Conditions need to be classified by when cities and countries are travelling down this trajectory; should development partners and IFIs encourage them to do so and if so, how they can be supported; and when there are entrenched (normally political) barriers to this trajectory, should all actors try to find ways to improve urban financing within the existing frameworks?

This working paper has made the case that the comprehensive body of knowledge has not yet been fully translated into achieving sufficient effectiveness of reforms. The suggested key points worth attention and further action, as well as a wide range of means and approaches that development partners, IFIs and national governments may use to advance this agenda are summarised in the policy brief produced through this initiative.

Trading on a city street of Hargeisa, Somaliland © Shutterstock

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