Africa Expert Consultation

Implementing the Addis Ababa Action Agenda and the Sustainable Development Goals: The Importance of Strengthening Municipal Finance

Hyatt Hotel
Dar es Salaam, Tanzania
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INFORMAL SUMMARY

Organizers: United Nations Capital Development Fund (UNCDF) and Financing for Development Office of UN-DESA, in co-operation with the Government of Tanzania

Session 1: Opening/Introductory remarks: Introducing the project, setting the agenda for the meeting.

Organizers welcomed participants to the expert consultation and opened the consultation with a brief overview of the overall context of the meeting: the share of Africans living in urban areas is projected to grow from 36 percent in 2010 to 50 percent by 2030. Facing the highest urbanization rate in the world, African cities must confront enormous challenges as they are at the forefront of providing essential public services and ensuring that the 2030 Agenda for Sustainable Development can be achieved. At the same time, cities lack critical resources, infrastructure and capacities to fulfill these tasks, especially in LDCs. This is often the result of poor progress in the implementation of inter-governmental fiscal reforms that are critical for an effective political and administrative decentralization effort. Consequently, there is an urgent need for strengthening municipal finance in the context of implementing the 2030 Agenda for Sustainable Development. While governments recently acknowledged the important role of local governments in the Addis Ababa Action Agenda and the Paris Agreement on climate change, empowering and enabling local authorities to deliver on their sustainable development objectives remains the true challenge. In this connection, organizers invited participants to share their lessons learned from successes and failures experienced during their efforts to strengthen sustainable development finance at the local level.

The scene for the workshop was then set by a keynote speech, which highlighted some of the crucial challenges for local governments related to financing local sustainable development. These include the often difficult relations between local and national governments, cumbersome bureaucratic processes imposed on local authorities, dynamics of the local political economy, limited political mandates and borrowing opportunities at the local level, and slow implementation of decentralization reforms.

Five key mechanisms were identified to address these challenges: first, local governments have to increase local revenue generation by ensuring citizens' willingness to pay taxes and user fees through the provision of public goods and services as well as transparent and accountable structures and processes. Second, fiscal transfers from central to local governments have to become more predictable and increased in volume, potentially linked with performance based incentives. Third, the access of subnational governments to long-term finance needs to be facilitated through risk mitigation and strategies to strengthen creditworthiness. Fourth, international cooperation needs to localize by streamlining its activities and making resources available directly to local governments. Fifth, national governments should rebalance their resource allocations according to the level of endowment of local governments.

Session 2: Development context and economics: Strengthening municipal finance and rural-urban linkages in the context of increasing urbanization.

Session 2 explored the development context and the economics of increasing urbanization, particularly in the developing world, which define the environment and conditions for strengthening municipal finance and rural-urban linkages. Experts emphasized that urban areas are the drivers of economic growth in African LDCs; however, the current supply of urban infrastructure and public services is insufficient to reap the full benefits of the growth process and ensure equal participation. It was highlighted that the analysis of the political economy is an important aspect of understanding whether institutions and processes in place enable local governments – including through the availability of sufficient resources - to act on these shortfalls.

In this context, preliminary findings from a new survey on the effectiveness of African local government institutions show weak results for the provision of basic urban services. One explanation for this is the weak devolution of power and authority from the central government to the local level. Central governments appear to overlook the role of local governments and financing in managing urbanization and building resilience. There is an ongoing and uneven struggle for political power between the different levels of government, resulting in constrained political and fiscal space for local authorities.

The presentation of the Tanzanian case study provided a helpful illustration to understand some of the challenges and opportunities associated with decentralization processes. Tanzania initiated its decentralization process in 1998. It focused on giving local governments more authority and decision making power; empowering local governments to manage their own human resources; giving local levels the authority to manage their own finances and fiscal affairs and to collect revenues as well as balancing the relationship with central government and implementing the principle of subsidiarity. Initially, fiscal space for local government increased, but in 2004 the central government abolished 14 sources of revenue for local governments. Today, the central government provides discretionary block grants that allow local governments to take their own spending decisions according to their needs. However, these remain unpredictable and insufficient. Furthermore, local governments, in theory, can access additional loans and grants, issue municipal bonds and initiate public-private partnerships. The experience has been sobering: local governments still need to seek approval from the central level to borrow through a process that can take a long time and does not always turn out to be successful. The issuance of municipal bonds has not worked so far due to the low capacity at the local level, a lack of investor confidence and shallow financial markets with little demand for new financial instruments. Generally, the introduction of new revenue sources has been a cumbersome and time-consuming process.

Another case study of Mali demonstrated the importance to understand the differences in country contexts and inadequateness of one-size-fits-all approaches. Mali has its own unique system of local governments, with groups of villages having diverse structures, as well as legal and budgetary processes to undertake development efforts. Regional cooperation through ECOWAS has increased the harmonization of approaches to some extent in recent years. For the future in Mali, it will be critical to take a more long-term approach and improve the availability and usage of data.

During the discussion, experts highlighted the general importance for both central and local governments to adapt principles for adequate and long-term planning, accountability and setting priorities. Instead of aiming to access international capital markets, which could expose local authorities to large and unpredictable exchange rate risks, local governments in LDCs should focus on less complex local capital markets, even though they are often underdeveloped. Given their liability structure, pension funds are in a prime position to take a leadership role in investing long-term in their own domestic markets and support the development of sustainable local finance instruments. More research is needed to ascertain why their involvement in infrastructure finances remains very low in most countries and how their engagement could be strengthened.

Key messages:

- Cities will be important drivers of future economic growth in Africa. Yet, their full economic potential remains underutilized because of serious shortfalls in infrastructure and public services. Unless investment in these areas will be dramatically stepped up, inclusive and sustainable economic growth will remain elusive for most African LDCs.

- Delegation of authorities from the central to the local level remains generally weak in many African countries. The dependency on fiscal transfers from the central to the local level remains high, yet, in the large majority of cases those transfers are inadequate to meet local development needs. At the same time, the capacity and political authority to raise local revenue sources is limited.
- Capacity-building, improving local planning processes through applying long-term approaches and increasing accountability will be critical to strengthen municipal finance.
- Local capital markets, including pension funds, need to be strengthened significantly to turn into a potential source of private funding for long-term investments at the local level.

Session 3: Local Fiscal Space: Promoting local revenue sources for sustainable development to ensure financial sustainability and affordability of services

In session 3, participants discussed the importance of local fiscal space and how local revenue sources can ensure financial sustainability and affordability of services. The case of Maputo was used to illustrate the opportunities and challenges for local governments in promoting local revenue services. Since 2010, the total revenue generated from virtually all municipal taxes has increased and it currently accounts for about 37 percent of the overall municipal budget. Within the set of municipal taxes, property taxes represent the highest share. Maputo has widened the tax base of the property tax by improving the database and the registration of all districts within the municipality. Also, digitalization of billing systems, as well as the simplification of tax legislation, has facilitated revenue increases. Limits in the technical capacities for revenue and fee collection were cited as critical challenges, as well as low awareness among taxpayers. Furthermore, critical infrastructure is lacking to further expand the tax base.

The Government of Rwanda adopted its National Decentralization Policy in 2001 as a mechanism to achieve good governance and to bring quality and accessible services closer to the citizens. The policy has been implemented in successive phases of five years. For each phase the government defined key strategic orientations, based on an evaluation of the previous phase. Phase I (2001-2005) established democratically elected structures at the local level and institutionalized decentralization. Phase II (2005-2010) focused on devolving more resources and ensuring territorial restructuring. Phase III (2010-2015) focused on consolidating past achievements in governance and service delivery and on scaling up on local economic development.

In Rwanda, districts had similar experiences to Maputo with fees on the lease of land and rental taxes being among the most important sources of revenues within the mix of own revenue sources (other sources being transfers from central government, grants from donors and borrowing). Digitalization helped in achieving a collection rate close to 100 percent. District budgets witnessed steady growth in the last decade, though not at the same rate as the national budget. Yet, the actual revenues collected are still low compared to the potential in most districts. Districts are financially autonomous and their plans and budgets are approved by their respective councils. Critical recommendations to close the gap are additional reforms to address weaknesses in tax administration, closing loopholes and raising certain currently underperforming taxes. Representatives from Maputo and Rwanda agreed on the suggestion to replace the land lease system with a fixed asset tax system – combined with strengthened property valuation mechanisms - to create stronger incentives for efficient land use.

The Kampala city government, which was directly appointed by the central government, implemented a comprehensive fiscal reform, which included the automatization of processes, professionalization of staff, as well as the establishment of an asset register. As a result, all inherited non-current liabilities have been settled, central government funding has increased, and the asset register grew more than tenfold from 2011 to 2015. Also, local revenue generation almost tripled from 2011 to 2015 to about USD 30 million. Key challenges remain, e.g. limitations to municipal fiscal space due to allocation decisions by the central government, failure in realizing the full potential of local revenues because of low compliance levels, the limited range of available revenue collection instruments and difficulties in expanding revenue sources such as land value capture.

Key Messages:

- Local fiscal space is limited through political constraints imposed on local authorities by central governments, low capacities of tax administrations at both the local and central government levels, and unpredictability of own-source revenue generation, as well as inadequate transfers from the central government.
- Instead of attempting to establish new revenue sources at the local levels, the focus should be set on strengthening existing ones to realize their full potential.
- Improved registration processes, the building of fiscal cadasters, automatization and utilization of IT systems, including online payment options, are helpful mechanisms to increase compliance with tax laws and to promote greater willingness to pay local taxes.

Session 4: Grants and intergovernmental fiscal transfers

Session 4 concentrated on grants and intergovernmental fiscal transfers. Intergovernmental transfers are the most important component of subnational financing, they account for more than 60 percent in transitional and developing countries, while in certain countries such as Tanzania and Uganda they constitute more than 90 percent.[1] One explanation for the dominance of intergovernmental transfers in developing countries is that most types of taxes, i.e. revenue collection, are imposed by the central government. Grants from the national level are frequently insufficient in size and unpredictable, which results in negative impacts on planning and budgeting processes. Poorly designed and managed accountability and reporting systems increase the burden on administrators and citizens. Some noted that transfer designs often neglect incentive structures, which can lead to unintended consequences and does not push local governments to improve their performance. At the same time, caution was expressed towards a tendency to treat municipalities as profit maximizing or entrepreneurial entities. Many of the goods provided by municipalities are public goods that are inherently unprofitable. A certain level of intergovernmental transfers will therefore always be required. Indeed, even the richest cities in the developed world are not financially sustainable without support from the central government.

Notwithstanding these financial constraints, performance-based grants have delivered encouraging results in setting the right incentives for local governments to improve their performance in key public service areas, while simultaneously increasing the amount of available funds and contributing to capacity building at the local level. They can also promote a reform of intergovernmental relationships away from tight control mechanisms by the central government to more flexibility and independent decision-making.

Uganda adopted its decentralization policy in 1992. Since then, intergovernmental transfers from the central level strongly increased. However, it has been predominantly salary grants that have increased, while non-salary and development focused grants in fact decreased – resulting in an

[1] It was noted that in some, mostly West African countries, intergovernmental transfers constitute only a small percentage of local revenues. More research is needed to identify the reason for these exceptional cases. Some experts speculated that the low share of transfers is due to regulations set by the West African Monetary Union to limit central government grants, as well as the exclusion of local salaries in the accounting of intergovernmental transfers. Nonetheless, even in the exceptional cases where the ratio of central governments transfers to local revenues is low, own-source revenue generation remains inadequate to meet local development needs.

ever-growing funding gap. Overall, more than 95 percent of the grants are still earmarked, which is against the principal idea of decentralization. Also, grant reception is unpredictable and amounts are insufficient to cover the needs. Further reform to the fiscal decentralization architecture and a review of the grand allocation formula will be required.

Local government revenues, which are an important supplement to the transfers from the central level, have also increased overall in the past years, even though there is a certain degree of volatility. Challenges for local revenue generation include gaps, inconsistencies and overlaps in policies, legislature and regulatory frameworks; insufficient data on local revenue sources; and limited capacity of local governments. Furthermore, tax evasion and political interference increase the burden on local governments.

Key messages:

- Intergovernmental fiscal transfers remain the most important source of funding for local governments in Africa. However, problems result from insufficient amounts, low predictability, and inopportune timing of transfers.
- Accountability structures and reporting systems need to be streamlined to reduce the workload for local authorities and to improve control options by citizens.
- In certain circumstances, performance-based grants are effective tools to strengthen incentive structures and increase flexibility in intergovernmental relations.

Sessions 5 and 6: Local fixed capital formation: Enhancing subnational access to long term-finance for capital investments, including through innovative local finance instruments

Sessions 5 and 6 started with a discussion of the experience of the Commercial Bank of Ethiopia, a leading public bank in Ethiopia. It contributes to subnational housing finance through the purchase of corporate bonds which are issued by the city government of Addis Ababa and other regional governments, while guarantees are offered by the Ministry of Finance. Similar structures are applied in the transport and energy sector. The bank further provides loans to contractors of municipal governments and micro-finance institutions targeting the local manufacturing sector. However, challenges lie in the mobilization of foreign and domestic liquid deposits, as well as project preparation and implementation, including supervision.

This was followed by a debate of the options and requirements for municipal governments to access domestic capital markets to fund public services in times of increased urbanization and globalization. Since the 1990s, only a very small number of cities in developing countries (and no city in African LDCs) have accessed capital markets directly through municipal bonds. Yet, some cities with strong medium-term fiscal frameworks have found innovative ways to mobilize long-term capital for specific sectors with the help of private financial intermediaries, as is the case in Addis Ababa. For smaller cities (and most large ones) long-standing relationships to public and private financial intermediaries that are rooted in mutual trust have remained the major source for long-term borrowing and should be further expanded. To increase direct access to capital markets, participants noted certain crucial elements of urban financing strategies, such as formula-based devolution of powers from other government levels, legal borrowing frameworks, strong domestic financial intermediaries, and affordable long-term interest rates for city infrastructure financing. Cities need to provide clear accounting reports, include clear statements of subsidies in their accounts, and provide clear information about demand, revenue flows and balances.

A representative from a private investment bank described how commercial banks could act as intermediaries and underwriters in domestic capital markets to build trust, either of other investors or between borrowers and creditors. Furthermore, private banks can help with due diligence processes, proper project documentation, and the advertisement to potential investors. Key questions for municipalities to respond to for accessing local capital markets would include reforms of borrowing frameworks to enable municipal borrowing, training of local government officials about the implementations of borrowing, and how to ensure competitive pricing to attract investors.

After that, there was an example of how banks have established a technical assistance fund and advisory services to support municipal governments in response to the observed growth in demand for investment opportunities with the preparation of financially viable projects in areas such as municipal waste or water supplies. In reaction to the needs from local governments, there is a stronger focus on project finance than on balance sheet finance, since many municipalities often do not having sufficient collateral on their balance sheets to develop viable project proposals and attract investors. Frequently occurring problems and cost drivers in the process are the lack of technical expertise among national governments, difficulties in risk analysis due to the absence of ratings or functioning market structures, project budgets on cash basis, and the lack of laws and regulations for public-private partnerships.

Enhancing the creditworthiness of cities to enable direct access to markets was also highlighted as an important step to access long-term finance. Participants suggested that local credit ratings can help accessing capital markets because they allow local investors to apply adequate risk mitigation measures. Recent estimates show that less than 20 percent of the largest 500 cities in developing countries are deemed creditworthy in their local context, severely constricting their capacity to finance investments in public infrastructure. Cities can gradually improve their creditworthiness by creating a track record of good transactions and other efforts guided by confidential ratings that help assess their financial and debt management capacity. Such an assessment could guide their objectives of facilitating capacity development, providing support for project preparation and developing capital investment plans. Similar interventions helped the city government of Kampala to be successfully rated as an investment grade issuer. In fact, the lack of autonomy from the central government was seen as a negative aspect in the rating, providing an argument for additional decentralization efforts.

Key messages:

- Weak institutions and legal frameworks, lack of substantive and administrative capacity, and underdeveloped capital markets are among the main reasons why access to long-term finance is a frequent problem of municipal governments in African LDCs.
- Financial intermediaries, including public development banks, play an important role in promoting municipal finance in developed countries and their experiences in emerging markets and developed countries offer rich lessons on how municipalities can access long term finance in LDCs.
- Targeted efforts to improve creditworthiness, including through confidential ratings, can help local governments and entities get long-term finance.

Session 7: How to bridge the funding gap (2) Enhancing access to long term capital investments: PPP

The round table discussion on public-private partnerships (PPPs) was framed around the experience in Tanzania. At the beginning, it was emphasized that PPPs do come in many different shapes across different contexts and caution was urged to avoid blueprint responses to problems and challenges associated with PPPs. Participants agreed that PPPs need clearly defined risk sharing agreements between the public and private partners involved. There have been too many examples where the risks were ultimately born by the public sector.

With respect to PPPs at the subnational level, the initiative should come from local governments, which requires capacity to identify projects suitable for public-private cooperation. PPPs need to be justified not just by fiscal constraints, but need to make clear case that they can create additional public value for the funds invested. Many examples have shown that PPPs do not necessarily create public value, but rather impose additional cost to the public. Frequent errors in planning processes are overestimation of demand and assumption of overpriced tariffs or charges for the benefit of private partners. Also, there is a risk that PPPs might undermine the creditworthiness of municipal governments due to contingent liabilities. Caution was urged on PPPs in sectors where the price of the service or good is subject to political considerations, e.g. the water sector. Community expectations towards PPPs should be managed through effective communication strategies on project time lines and benefits.

Key messages:

- PPPs cover a variety of arrangements between the public and private sector that have to be understood and analyzed in their respective contexts.
- From a public policy perspective, the prime objective of a PPP is to add value for money, i.e. to improve the quality and efficiency of a given service to the citizen by attracting private resources into public services, thereby allowing public money to be diverted into other areas and alleviating long-term pressures on public finances.
- PPPs at the local level remain rare in Africa. Local authorities frequently lack the institutional capacity to develop, manage and evaluate PPPs.
- In a number of developing countries, putting in place this institutional capacity will require assistance from the international community in the form of technical support and capacity building.

Session 8: Strengthening international cooperation for municipal finance. Identifying priority areas for international cooperation on subnational finance

At the beginning of the discussion about the role of international cooperation for municipal finance, participants generally agreed that cities will play a crucial role to achieve the SDGs and therefore, international cooperation needs to allocate more resources to municipal levels. In this context, it was noted that the data situation on the use of international public finance in support of municipal governments is rather vague. According to official figures, only a small share of ODA goes directly to municipalities or local governments. Statements by participants indicated that the situation also varies in different contexts: some countries and sectors reported good donor coordination, while others identified significant room for improvement. Donors often focus on a few key sectors while neglecting the role of (fiscal) decentralization as a cross-cutting issue.

Policy coherence was identified as an important issue in international cooperation. For instance, some donors offer loans below market rate, which has an impact on creditworthiness of the receiving entity. Certain IMF requirements to limit central government expenditures, as well as donor policies to provide general budget support to central governments, can limit the financial capacities of local authorities. Several participants highlighted that city governments will have to identify ways to access climate finance, since they will be at the forefront of many implementation issues.

Participants also discussed the role of South-South cooperation, particularly city partnerships among African LDCs. It was pointed out that the experiences of many African cities are similar;

however, the opportunities for exchange of knowledge and resources need to be strengthened. Success stories, for example from Kenya, can provide valuable lessons learned for increased cooperation.

Key messages:

- Participants agreed that international cooperation needs to place a stronger focus on cities for the implementation of the 2030 Sustainable Development Agenda.
- Better data is needed on both ODA and South-South Cooperation to analyze flows of funds to different levels of government and sectors.
- There is untapped potential to increase South-South cooperation among African cities to exchange experiences and lessons learned.
- There is a need for greater policy coordination among bilateral and multilateral organizations to ensure that external support at the central government level does not conflict with local development objectives.
- Donors engaged at the local level should carefully consult with local authorities and civil society organizations to fully understand local priorities and development objectives.

Session 9: Conclusion

In the final session, it was highlighted by participants that increasing urbanization will be one of the most critical factors that will impact the path to implementing the 2030 Agenda for Sustainable Development. Participants reiterated that the Addis Ababa Action Agenda in paragraph 34 set the spotlight on the importance of municipal finance and local government capacities. SDG 11 calls for inclusive, safe, resilient and safe cities. The Paris Agreement recognized the importance of cities and regions in tackling climate change. The upcoming HABITAT III Conference will give another push to the issue of municipal finance. Experts agreed that there is no doubt that without the involvement of cities, the development challenges faced by the world in the 21st century will not be successfully addressed.

Participants then identified five areas from the discussion as critical for follow-up:

1. **Capacity development** (human resources, project management, technical expertise, etc.) at the local level is critical to ensure adequate financing for sustainable urban development
2. Urbanization rates in developing countries in Africa, especially in secondary cities, are very high. This requires immediate action to **provide essential public services** and **build the necessary urban infrastructure**.
3. The importance of **domestic resource mobilization** has increased in LDCs. In addition to developing greater capacities for own-source revenue generation, local governments need to be able to rely on a sound and predictable intergovernmental fiscal transfer system. Only with reliable revenue sources can local governments borrow from local financial and capital markets for their long-term financing needs.
4. Local governments will be at the forefront of implementing mitigation and especially adaptation efforts to **address climate change**. Local governments need to be able to directly access to international climate change funds, such as the Green Climate Fund.
5. **Fiscal, political, administrative and institutional decentralization** efforts are complex and interlinked processes that have to be properly sequenced. Their implementation should be gradual and requires considerable capacities at the local and national levels. LDCs and supporting donors must work out a pragmatic strategy for bringing a functioning decentralized system into place and must commit to adjust and support its evolution over time.

Finally, participants agreed that the expert consultation was highly beneficial to exchange views, experiences and lessons learnt among practitioners from local governments, private sector, and international organizations, and expressed interest in staying engaged on the topic.