



Funding Capital-Intensive Urban Projects: Enabling Cities to Employ Municipal Finance Tools

Issue Brief

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March 8, 2016

INTRODUCTION¹

The Third United Nations Conference on Housing and Sustainable Urban Development (Habitat III), is scheduled for mid-October 2016. This gathering of heads of state, planned to take place in Ecuador, has been called to “reinvigorate the global political commitment to the sustainable development of towns, cities and other human settlements, both rural and urban.” The outcome of this summit will be the “New Urban Agenda,” which will set a new global strategy around urbanization for the next two decades. As the lack of financing for projects poses one of the greatest challenges for cities around the world, municipal finance practitioners have a rare opportunity at Habitat III; to present compelling reasons for heads of state to support cities in the developing world to employ best practices from the developed world. Essentially, decentralization of borrowing authority to sub-national government and fiscal sustainability at the national level are two issues in permanent tension in public financial management. On the one side of the argument, it is desirable to give sub-national authorities room for raising their own financial resources in order to finance capital investment. On the other hand, the lack of institutional capacity, history of sub-national government defaults in some decentralized systems, and the political lack of effective controls give central or national governments substantial arguments to restrict sub-national autonomy.

In the months leading up to Habitat III, the international community has the opportunity to consider the challenges, obstacles and potential answers that can help to unlock financing for the core needs of municipalities. This financing will be crucial for the successful delivery of Sustainable Development Goal (SDG) 11, on Sustainable Cities and human Settlements, but stimulating financial success in cities will also lead to collective delivery of many of the other SDGs (including poverty, hunger, clean water & sanitation, decent work & economic growth, and others).

The HIII Thematic Conference on Financing Urban Development (9 – 11 March) represents one of the first opportunities for the world’s leading policymakers and practitioners of municipal finance to dialogue with each other on some of these

¹ The United Nations Sustainable Development Solutions Network has commissioned Professor Jeremy Gorelick of the Johns Hopkins University to advise its staff and associated donors/supporters in the development of a set of resources for cities that can benefit from a comprehensive repository of information and best practices as part of a larger effort to source financing for capital-intensive projects. The following is a synthesis of his research and comments from esteemed colleagues at a conference on municipal finance hosted by SDSN and coordinated by the Ecological Sequestration Trust at the Rockefeller Foundation’s Bellagio Centre in Italy in March 2016.

thorny issues. The United Nations Sustainable Development Solutions Network (SDSN) plans to help stimulate the debate and to provide evidence and practical policy recommendations on municipal finance to aid the discussion. Over the coming months, SDSN will sponsor an ongoing dialogue on municipal finance to help frame some of these concerns. Topics for discussion will include how to:

- 1) **Advance the agenda:** Some argue that the language adopted at Habitat II empowered cities to a greater extent than the ideas suggested for Habitat III. Is this a valid argument? If so, what edits on ideas/language should experts propose?
- 2) **Differentiate between cities:** Municipal finance cannot, and should not, be approached with a “one-size-fits-all” framework. Although many typologies for sorting cities can be suggested, some options provide better answers than others. To achieve the best sample, which characteristics should be used to describe cities? Does this definition reflect the current traits outlined under the SDGs and Habitat III?
- 3) **Allay the concerns of central governments:** To mitigate the fears of central governments relative to borrowing by local governments that may, constitutionally, appear as a balance sheet obligation of the national treasury, the constitution may set debt limits for sub-sovereign borrowers. Is this a reasonable mechanism? Does this type of “paternalistic” engagement by the sovereign create an implicit guarantee for sub-sovereign governments, creating an unsustainable system that is rife with moral hazard?
- 4) **Manage expectations from financiers:** What are the pre-requisites that public financial institutions expect from cities seeking financing for capital-intensive projects? How do these differ from the expectations of private financial institutions/individual investors? What role can central governments play in helping cities to meet these expectations?
- 5) **Ensure transparency and empowerment in decision-making:** Even after a city successfully develops a compelling proposal for a capital-intensive project requiring external finance, there is no guarantee that municipal leaders will make decisions in the best interest of the city’s long-term financial needs. This most often occurs when cities’ priorities are re-directed by development finance institutions and private funders offering available capital for initiatives that do not reflect those priorities identified by the city’s leadership or its constituents. What is the role for an independent, “honest broker” in the system? How can the international development community assist cities to make more informed decisions about the most appropriate financing tools to ensure long-term sustainability?
- 6) **Ensure environmental and social sensitivity:** While all of the SDGs are vitally important, many members of the international community are concerned that unfettered access to financial resources for municipal projects, particularly infrastructure initiatives, can occur without responsible consideration of damage (whether intended or unintended) to the environment, in violation of climate action (SDG 13). What protocols should cities adopt to guarantee that cities develop sustainably (SDG 11), incorporate elements of affordable and clean energy (SDG 7), and maintain or improve the balance of our ecosystems both below water (SDG 14) and on land (SDG 15)? Further, what protocols can cities adopt to encourage improvements in economic and social sustainability, including more economic opportunities (SDG 8) and an end to poverty (SDG 1)?

In considering the best way to support the decision-makers at Habitat III, experts should not forget the language of the Istanbul Declaration on Human Settlements adopted from the deliberations in Turkey that states (in paragraph 12, bold added):

We adopt the enabling strategy and the principles of partnership and participation as the most democratic and effective approach for the realization of our commitments. Recognizing local authorities as our closest partners, and as essential, in the implementation of the Habitat Agenda, we must, **within the legal framework of each country, promote decentralization through democratic local authorities and work to strengthen their financial and institutional capacities in accordance with the conditions of countries, while ensuring their transparency, accountability and responsiveness to the needs of people, which are key requirements for Governments at all levels.** We shall also increase our cooperation with parliamentarians, the private sector, labor unions and non-governmental and other civil society organizations with due respect for their autonomy. We shall also enhance the role of women and encourage socially and environmentally responsible corporate investment by the private sector. Local action should be guided and stimulated through local programmes based on Agenda 21, the Habitat Agenda, or any other equivalent programme, as well as drawing upon the experience of worldwide cooperation initiated in Istanbul by the World Assembly of Cities and Local Authorities, without prejudice to national policies, objectives, priorities and programmes. The enabling

strategy includes a responsibility for Governments to implement special measures for members of disadvantaged and vulnerable groups when appropriate.

To foster development in practical terms and to help heads of state to ensure that the sub-sovereign governments are well-equipped to make responsible decisions and understand how best to make decision about funding capital-intensive projects, SDSN is developing a set of tools for cities eager to embark on municipal finance programs. The following pages contextualize SDSN and its mandate as well as summarize much of the general discourse on municipal finance, particularly within the context of the developing world.

GLOBAL CONTEXT

Urbanization is causing a historic global demographic transformation that will be one of the biggest drivers of economic growth in the 21st century. Today, one-half of the world's population lives in cities that generate more than 80 percent of global Gross Domestic Product (GDP).²

One-third of the world's urban population resides in developing countries, and this portion is growing rapidly. The share of the national population that is urban in lower-middle-income countries stood at 39 percent in 2015 and at 30 percent in low-income countries. By 2050, these figures are expected to be 57 and 48 percent, respectively. While only about one-tenth of the world's largest urban areas are in the world's Least Developed Countries (LDC), thirty of the thirty-five most rapidly growing large cities worldwide are located in LDCs.³ In other words, the world's fastest expanding urban agglomerations are now in the Global South.

Of course, the challenges of municipal finance are not limited solely to developing countries. As evidenced in the United States democratic presidential debate (6 March 2016), the degradation of municipal infrastructure in cities like Flint, Michigan, are emblematic of a crumbling of urban services around the world. Cities in the developed world face equally difficult challenges in attracting investments to close the gap between critical infrastructure needs and available resources.

Moreover, the United Nations Department of Economic and Social Affairs (UN DESA) noted in its 2014 Revision of the *World Urbanization Prospects* that

In 1990, there were ten “mega-cities” with 10 million inhabitants or more, which were home to 153 million people or slightly less than seven per cent of the world's urban dwellers. In 2014, there were 28 mega-cities worldwide, home to 453 million people or about 12 per cent of the world's urban dwellers. Of today's 28 mega-cities, sixteen are in Asia, four in Latin America, three in Africa, three in Europe and two in Northern America. By 2030, the world is projected to have 41 mega-cities each with 10 million inhabitants or more.

Regardless of the part of the globe under consideration, the magnitude of the urban demographic shift is staggering. Rural to urban migration, combined with the effects of urban population growth, could add another 2.5 billion to the world's urban population by 2050. Close to 90 percent of this increase will be in Asia and Africa.⁴ Further, urban growth is not limited to capital cities, but is having a profound impact on secondary cities and towns as well. UNDESA reports that close to half of the world's urban dwellers reside in settlements of less than 500,000 inhabitants (compared to around one-eighth living in mega-cities with over 10 million inhabitants).⁵

The future development of emerging markets now depends significantly on how well urbanization is managed in cities and towns. If well managed, cities can be engines for economic growth and for expanding access to basic services for

² McKinsey Global Institute, *Urban World: Mapping the Economic Power of Cities*, 2011.

³ United Nations Department of Economic and Social Affairs, *World Urbanization Prospects: The 2011 Revision*.

⁴ United Nations, Department of Economic and Social Affairs, *World Urbanization Prospects: The 2014 Revision*.

⁵ UN, *World Urbanization Prospects: The 2014 Revision*.

large sections of the population. But while the developing world is urbanizing faster than the developed world, to date, the correlation between urbanization and economic growth has been weaker in developed countries.⁶

Urban life offers benefits compared to rural life, and these are driving urbanization. Economic opportunities are more diverse (especially in countries where agricultural employment is declining), education and health care are more accessible, and gender roles may be less restricted. But urban life also has its drawbacks, including crime, crowding, and the cost of living. And while cities offer individuals unique opportunities to build resilience, their growth can also create new vulnerabilities to a range of hazards.

As a result, managing cities and urban growth has become one of the pressing development challenges of the 21st century. It will be a major factor in the success of the Sustainable Development Goals and in propelling the transition of countries from low-income to middle-income status.

There is abundant evidence that developing countries are unprepared for the scale of urbanization that is taking place and are struggling to face the challenges of urban growth. Urbanization takes place in the average emerging city without control of land use or provision of adequate services; traffic congestion wastes productive time and pollutes the air; poor populations are concentrated on sites subject to a myriad of hazards; and disparities between rich and poor create social tensions and insecurities that can turn the hopeful vision of life in a modern city into a nightmare, especially for the poor. The economic potential of cities will not be fully realized until city governments have both the tools to manage the development challenges being thrust upon them and the resources to improve economic, environmental, and social conditions.

FINANCING NEW INFRASTRUCTURE AND SUSTAINABLE DEVELOPMENT IN CITIES: THE INVESTMENT OPPORTUNITY

Traditionally, cities have financed their operations, including infrastructure needs, through taxes collected by the entire population (either own-source revenue or through redistribution from a higher level of government). Increasingly, to cover non-operational investment needs, institutional investors, companies and foundations have been providing a large source of private capital. The link between different private actors, particularly when considered relative to sustainable development, has varied widely.

Through the investment chain (graphically depicted in Private Sector Investment and Sustainable Development⁷), institutional investors connect with urban infrastructure and sustainability issues through the projects and companies in which they invest, by providing capital and by engaging as active owners. As companies, markets, and economies become more global and interdependent, businesses and investors are becoming increasingly aware of the overlap between public and private interests. They realize that their ability to prosper and grow depends on the existence of a sustainable society. Conversely, they see that social and income inequality, as well as environmental damage, are already having negative material impacts on supply chains, capital flows and employee productivity.

That said, unfortunately, the world at large still under-invests in its infrastructure. To cope with massive population growth, urban migration, and climate change as well as to sustain economic growth and productivity, more needs to be done to boost and retrofit infrastructure capacity. In 2013, the McKinsey Institute asserted that, on a global basis, US\$ 57 trillion needed to be spent on transport, water, and telecommunications infrastructure by the year 2030 to meet global needs. Compared to historic rates of investment into infrastructure, the world must invest over USD\$ 1 trillion more per year to meet basic infrastructure needs.⁸ These figures translate into global infrastructure needs of 3.8 – 4.5% of GDP: 3.8% in the global north, 6.6% in the global south. Note: the most widely used analyses compare historical and

⁶ Ibid.

⁷ Page 6, Private Sector Investment and Sustainable Development, UN, 2015, Available at: <https://www.unglobalcompact.org/library/1181>

⁸ McKinsey Institute, Infrastructure Productivity: How to Save \$1 Trillion a Year, 2013.

programmed levels of infrastructure expenditure against estimated infrastructure investment needs to derive the so-called infrastructure investment gap (the shortfall between funds available and funds needed for infrastructure).

In recent years, the International Financial Institutions (IFIs) community has intensified its efforts to assess regional infrastructure investment landscapes, in large part due to the World Bank's mainstreaming of infrastructure into its approach to development. According to the Latin American Development Bank, Latin America needs to invest between US\$200 and 250 billion annually into its water and wastewater, transport, electricity, and ICT infrastructure from 2010 to 2030, equal to 5% of GDP. Current annual investment levels iterate around US\$120 billion or 2,8% of GDP, leaving a cumulative 20 years' infrastructure gap between US\$1,5 to 1,875 trillion.⁹ The Asian Development Bank estimated that Asia collectively needs to invest US\$8.22 trillion from 2010 to 2020 into electricity, transport, telecommunication, and water and sanitation infrastructure; equivalent to 6.52% of annual GDP. Current funding levels leave an aggregate 10 years' investment gap of US\$748billion.¹⁰ The World Bank led a comprehensive analysis of Sub-Saharan Africa's infrastructure investment landscape published in 2010; according to this report, the region needs to invest annually US\$93 billion, equal to 15% of regional GDP, into electricity, water, irrigation, transport, and ICT infrastructure. Annual funding levels approximate US\$45 billion, equal to 5-6% of GDP. The annual infrastructure gap totals US\$48 billion, equal to approximately 6% of regional GDP.¹¹

Finance for infrastructure is as much a challenge in developed markets as in developing ones. In 2011, the European Commission estimated that, from that point until 2020, Europe needed EUR1.5 to 2 trillion investments in transport, telecom, water, and energy infrastructure, with energy displaying the biggest needs. While a systematic gap analysis for Europe has yet to be produced, its historic annual average of infrastructure investment equals 3.6% of GDP; or EUR650 billion.¹² For example, in 2014, London commissioned an analysis of its infrastructure investment needs. From now until 2050, the metropolis will have to invest between GBP2 and 2.5 trillion into its urban infrastructure capacities.¹³

Creating value in urban areas: An Opinion Piece (by Eugenio Leanza, European Investment Bank)

In an economic perspective, cities should be seen as functional urban areas. Thus, in analyzing urban economic dynamics, it is of overwhelming importance to identify the features and composition of job markets among various industrial, service activities as well as to define a clear role between the private and public sector. Cities' performance is closely connected to their capacity to operate as integrated platforms in which the various types of capital: human, natural, fixed, financial create synergies and scale/agglomeration economies in a spatial dimension. In last instance the value creation potential of a city is closely interconnected to their performance, including their ability to act as export hubs for goods and services over time.

⁹ CAF & IDeAL, 2012. Infrastructure in the Development of Latin America. Available at: http://publicaciones.caf.com/media/33151/ideal_ingles_feb8.pdf.

¹⁰ Bhattacharyay, B.N., 2012. Estimating demand for infrastructure, 2010–2020. In B. N. Bhattacharyay, M. Kawai, & R. M. Nag, eds. Infrastructure for Asian Connectivity. Cheltham UK and Northampton MA US: Edward Elgar, pp. 19–79.

¹¹ Foster, V. & Briceño-Garmendia, C. eds., 2010. Africa's Infrastructure: A Time for Transformation. Available at: http://siteresources.worldbank.org/INTAFRICA/Resources/aicd_overview_english_no-embargo.pdf.

¹² Inderst, G., 2013. Private infrastructure finance and investment in Europe. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359648 [Accessed September 30, 2015].

¹³ GLA, 2014. The cost of London's long-term infrastructure - Final Report by Arup. Available at: <https://www.london.gov.uk/file/18860/download?token=k1T3powh> [Accessed September 20, 2015].

Many cities in more mature economies have been affected by extensive shifts in the composition of their job markets resulting from globalization and other long-term economic trends. Some cities which had been operating as productive “workshops” have suffered a loss of manufacturing jobs towards emerging market economies and have adapted by shifting their urban functions towards models where a growing share of their job market is focused on the provision of urban amenities – including those embedded in housing and social housing schemes - and consumer services. This tendency has often been facilitated by the availability of accumulated wealth and the use of financial resources to sustain consumption levels.

The expansive monetary policies inaugurated during the 1990s, and continued during the period leading into the great recession and in its aftermath, seem to have favored a progressive shift of many urban job markets towards service activities, often supported by capture of urban land rent via the increase in real estate asset prices triggered by low interest rates. These phenomena have been favored by the growing financial interconnectedness between western and emerging economies. In this context, there is an increasingly closer nexus between urbanization and the forms of urban development on one side and the evolving features of monetary policy and its main transmission channels on the other.

These links need to be analyzed in a systematic and coherent way, especially when substantial amounts of urban investment and infrastructure are financed via financial resources external to the city or funds raised in the open market. In an urban corporate perspective, amenities have an important role in defining spatial equilibria within the urban settlement system, but risk having a poor impact on the overall economic performance of an individual city. In other words, the financing of infrastructure through external debt is to be accompanied by a parallel development on the net export capacity of the area and the related job markets. This export capacity is needed to ensure the sustainability and service of the external debt, so that economy can continue expanding over time.

Urban managers should analyze attentively the role of financial intermediaries in funding the expansion of urban capital. This should relate to the roles of the providers of equity, debt and money at the city, national (including the potential capacity of pension systems) and the external financiers’ level, respectively. These have different risk/rewards profile, timing preferences and overall commitment to long term sustainable development in the city.

Unfortunately, in the past sound land value capture mechanisms have been largely distorted by the explosive capacity of the banking system to create money in search of speculative profits driven by restrictions in land availability or poor land regulatory decisions. In this context, the contribution of land value capture processes to national/urban GDP risks being growingly disconnected from promoting the sustainable development of urban economies. An acceleration of the financialization of urban economic development underpinned by land value capture processes introduces – in the last instance – a serious threat to sustainable development by misallocating scarce productive factors and resources. As the bulk of these investment have a fixed, or impact on the optimal spatial organization of the city, the damages have often a long term nature, representing an economic “badwill” with impact on future generations.

Thus, a critical component of effective urban management is the capacity to facilitate the transformation of the local job markets, by improving and maintaining the employability and skills of the city’s human capital over time. For this purpose, new managerial skills are needed within the public and private sector as well as the financial service community, transforming and combining in innovative ways the traditional roles of city manager and infrastructure/real estate fund manager. The ability to deal with the interconnections between built environment, digital economy and spatial dynamics will be a core competence of the new urban manager.

Recently, the banking sector has faced growing difficulties in supporting urban investment outside a limited number of high-performance urban areas. In most cities, the banks’ capacity to create urban value through traditional infrastructure investments is limited. In this context, the monetary policy response has been to lower interest rates in order to increase aggregate demand through investment, “wealth effect” induced consumption and easier debt service for highly leveraged individuals and companies. Despite persistently loose monetary policy, the low capacity of

In addition, lowering interest rates to stimulate consumption has major drawbacks in situations where aggregated demand does not respond to monetary policy. Low interest rates push enterprises to invest in “efficiency”, typically reducing the labor content of tradeable goods via increased automation, thus generating further impacts on social inequality and increasing the risks of additional deflationary effects in the medium-long term. A further effect of low interest rates is also the acceleration in the migration of capital flows from low-productivity towards higher productivity areas within a country or a monetary union like the Eurozone, fueling the concentration of investment and growth into a few dominant metropolitan areas. Given the nature of the new digital technologies - in which agglomeration factors and economies of scale have much lower importance as compared to traditional general purpose technologies – new specialist research should be activated on the possible evolution of optimal settlement shape to underpin future urban sustainability.

NATIONAL AND LOCAL CONTEXT IN EMERGING MARKETS

While no country is free from the challenges of municipal finance, the dangers of a failure to act are more pressing in emerging markets, driven by two key phenomena: (i) the relatively recent decentralization of power away from central government towards sub-sovereign levels and (ii) the rapidly increasing urbanization found in the world’s least developed countries.

The growth of cities and towns from urbanization makes functional and fiscal decentralization more viable and more necessary, and in many countries, local autonomy is growing. Increasing the capacity of local officials can not only improve urban resilience and quality of life, it empowers cities and towns to contribute in important ways to national social and economic development goals.

While the responsibilities delegated to local governments by law vary considerably from one country to the next, cities in developing markets often have mandates to provide: (i) local basic services and infrastructure, including water, sanitation, public transportation, public lighting, and solid waste management, among others; (ii) resilience building, and climate mitigation and adaptation, including energy efficiency, flood management, and public building retrofitting, among others; and (iii) local social services and infrastructure, including health, education, and childcare facilities, among others.

In the past, most cities in the global south would not have had the autonomy, information technology, or knowledge of trends in the urban sector worldwide to embark on significant development projects or to prepare multi-year investment plans. But with the increasing interconnectedness of cities around the world and the growing competition among them, this has changed.

Even so, while needs and aspirations may grow, the financial options available to cities in most emerging markets have not kept pace with the growth and increasing complexity of the cities themselves. Cities are stuck in a vicious cycle of limited resources leading to a constrained response, while the population of the city and the demand for services continue to grow.

Ironically, many local government capital investments have high economic and social returns, and therefore should be prioritized. For instance, transportation signals that reduce congestion free people’s time for more productive purposes. Investments in drainage that reduce flooding in commercial areas reduce trading days lost to post-flood recovery. In these cases, domestic private capital should be available to finance municipal investments that cannot be financed through grants.

Mobilizing resources to finance investments and improve services at the municipal level is one of the most challenging aspects of local development, especially if the goal is to provide resources on market-like conditions in a sustainable manner, for instance from loans or bonds. Even when government transfers are predictable and generous (which is the exception), they are rarely adequate to finance major infrastructure improvements in growing cities. The capital investment financing that is available to local governments is often provided by national agencies whose own access to capital is highly constrained. Winning funding allocations from national budgets requires local governments to compete with line ministries and other priorities of the government in power.

The conditions required to provide local governments with capital market access are understood. The critical challenges are bringing borrowers and lenders together in a market relationship, and managing the risks inherent in this type of financing. There are countries where creating market access to investment capital for cities is not feasible. Where risks are too high, or financial markets lack liquidity or are too underdeveloped, raising local funds for municipal investments may be impossible (this situation prevails, for example, in states in crisis.)

In other countries, such financing may be feasible, especially as the financial market crisis is resolved and investors seek new investment options. It is also highly likely that, throughout the global south, viable municipal projects can be developed. Public officials and the private sector may have little familiarity with strategies to raise funds for local development projects, but through education and training these actors can be empowered and brought together to define such strategies. With collaboration and technical assistance, experience shows that national governments, local governments, and private market actors can work together to create the enabling conditions, prepare projects for financing, and mobilize financial resources.

SECTOR CHALLENGES AND GAPS IN EMERGING MARKETS

Emerging markets display a predictable set of conditions that undermine municipal financing. Addressing all of them is a long-term process that cuts across many sectors.

Lack of an Enabling Environment for Investment

The establishment of a transparent and sound regulatory framework for investment is a prerequisite for attracting capital flows. Such a framework ensures that contracts are upheld, that local governments are protected from expropriation, and that commercial disputes can be arbitrated. In the absence of this framework there is a lack of confidence in municipal capital investments among institutional and individual investors with negative implications for domestic debt markets.

Municipal Legal and Regulatory Framework

The municipal policy and legal framework makes it legal and feasible for local governments to borrow and to mobilize the resources to repay the credit, and establishes other conditions that lower risks for investors. In many developing countries, the municipal law either does not contemplate borrowing, or limits it to a very short term (1-2 years). The law also may not prevent newly elected local officials from repudiating the borrowing of their predecessors, which creates repayment risks for investors.

A framework needs to be put in place that (i) allows local governments and other local entities to raise private funds; (ii) provides the means to repay the funds, by using user fees, tariffs, or other charges and/or tax revenues; (iii) sets standards for the preparation and reporting of financial information, and (iv) provides adequate stability over time in all these dimensions.

Capital/Financial Markets Legal and Regulatory Framework

The policy and legal framework for the financial sector and/or capital market establishes the rules that permits the origination, sale (in the case of securities), and structuring (in the case of Public-Private Partnerships) of financial transactions, and governs the handling of funds repaid by the local government. Regulations also establish the recourse in the event local governments default. These rules create certainty for both investors and borrowers, and are likely to need some reform before sustainable market-based municipal financing mechanisms can be established.

The market must (i) mobilize adequate resources to invest in local governments' or other local entities' investment needs; (ii) create risk/return trade-offs agreeable to both investors and borrowers; (iii) provide a yield curve that permits the pricing and re-pricing of securities and loans; (iv) include a means for the secondary trading of securities; (v) include

capable intermediaries, analysts, and trustees; and (vi) ensure adequate stability over time in these dimensions. Emerging financial markets rarely satisfy all these conditions.

Mismatch between Investment Needs and Available Finance

Whether the investor is a bank or a bond buyer, the risks and returns requirements of the investor and the risk and cost conditions for the borrower have to match up. Establishing an effective demand depends also on: (i) investor familiarity with the municipal investments, (ii) investor ability to evaluate return and risk, and (iii) availability of appropriate funds. These conditions are often absent in developing countries due to the nascent nature of the financial markets, lack of investor confidence, and lack of tools to mitigate risks. Until market players gain experience, municipal projects in developing markets also have high transaction costs that reduce returns.

Domestic private finance in developing countries without capital markets is dominated by banks that are risk averse and either do not have funds, or are reluctant, to lend long term. As a result, lenders are unlikely to consider investing in city infrastructure projects without guarantees or the provision of funds for on-lending from development banks.

In developed countries, institutions such as credit rating agencies and investment banks help to develop municipal markets by helping to match up investor and borrower requirements. These entities either do not exist in many developing countries and where they do, they do not work with municipal governments. Public/private collaboration in market development can help to overcome these gaps.

Lack of Creditworthy Local Governments and Bankable Plans/Projects

For most cities, achieving access to capital financing at a reasonable cost from sources other than transfers and own revenues will require sustained attention to improving the policies and practices underpinning their creditworthiness. A World Bank study found that only a small percentage of the 500 largest cities in developing countries could be deemed “creditworthy”—about 4 percent in international financial markets and 20 percent in local markets.¹⁴

Municipal transactions can either finance specific investments (such as a sewage treatment plant or commercial center), or finance an investment plan or a program of investments that vary in size and sector. With the former, local governments would often repay the transactions from revenues associated with the investment itself (sewerage fees or commercial rents); while in the latter, repayment would be from all municipal taxes, fees, tariffs, or other sources.¹⁵

Identifying sustainable bankable projects, as part of capital investment plans from creditworthy local governments, means building the local capacity to: (i) provide accurate information about the operational and financial activities of the local government; (ii) identify and prepare sustainable bankable projects; (iii) provide a strong repayment stream and demonstrate or mobilize local willingness to pay; and (iv) manage the financed projects during the life of the bond issue or other financing to ensure continued operation and maintenance of the investments, and collection of associated revenues, where relevant.

Often, local governments have only a laundry list of investment projects. What is required is to assist local governments to prepare a list of projects that supports a medium- to long-term development plan for the city, that has been reviewed by key stakeholders to ensure their support and willingness to pay for these investments, and to seek formal approval of the plan with the city council or corresponding legislative body. Providing this support may mean providing training to develop local skills in areas such as municipal accounting, local government strategic and financial planning, investment/project preparation, and cost recovery strategies.

¹⁴ World Bank, <http://www.worldbank.org/en/news/feature/2013/10/24/financing-sustainable-cities-africa-creditworthy>.

¹⁵ This difference is reflected in the distinction often made between revenue bonds that are repaid from the revenues associated with a single project, and general obligation bonds, which are repaid from general municipal revenues.

Lack of Capacity to Accurately Assess Financing Options

Even if a city is successful in creating the template for a bankable project (either independently or with technical assistance from an outside agency), municipal leaders are often at a disadvantage when considering the most appropriate financial instrument to use to deliver their long-term financing goals. Approached from all sides by development finance institutions, investment banks and other well-meaning but often contradictory advisors, cities are challenged by the need to make swift and responsible decisions without being accused of corruption or other undue influence.

NEXT STEPS AND CONCLUSION:

SDSN is committed to working closely with its peers in the development finance arena to help cities to access the capital required to meet their sustainable development goals. In support of this endeavor, the network plans on working to:

- Confirm that the framing of the current challenges, as represented by the questions at the beginning of this document, are comprehensive and phrased correctly;
- Answer, with the help of international financial experts, these questions through an ongoing iterative process, revisited through intensive sessions at regular intervals; and
- Propose solutions based on the questions posed and answers provided.

Over the next few months, financial experts and development practitioners should hone convincing and compelling arguments that help to make a case for each of the following stakeholders:

Central governments should empower municipalities to collaborate in the achievement of the SDGs. This can best be achieved if heads of state set forth the terms and conditions, in each of their respective cases, under which municipalities can design SDG-focused capital-intensive projects and subsequently effectively raise the funds required to realize them. In particular, central governments can consider amendments to their legal framework or the introduction of debt limits to clearly delineate the powers of municipal governments.

The **financial sector**, whether public or private, needs to view cities as fully empowered borrowers that have the managerial and financial wherewithal to meet their debt service requirements. Accordingly, cities need to demonstrate that their proposed initiatives provide financial returns commensurate with the private sector's concept of the associated risk. Specifically, cities can overcome this challenge with well-structured projects that, in the case of the world's developing markets, contain credit enhancements in the form of guarantees, sinking funds or other safeguards.

Municipal governments should play the central role in charting their own financial destinies but are often co-opted by the prerogatives of central government or the financial sector. With empowerment from central governments and sufficient internal capacity development to conceive and assess funding options for capital-intensive projects, city leaders can both assist their central governments in delivering on the SDGs and improving the quality of life for their constituents.

In conclusion, the gathering of world leaders planned for October at Habitat III presents an incredible opportunity to test the global commitment to delivering the SDGs through a pledge for a more balanced partnership between central and sub-sovereign levels of government. Collective and concerted efforts from institutional stakeholders and their individual representatives at upcoming international conferences leading up to Habitat III can provide the necessary contextualization for decision-makers considering how best to encourage central governments to empower their cities.