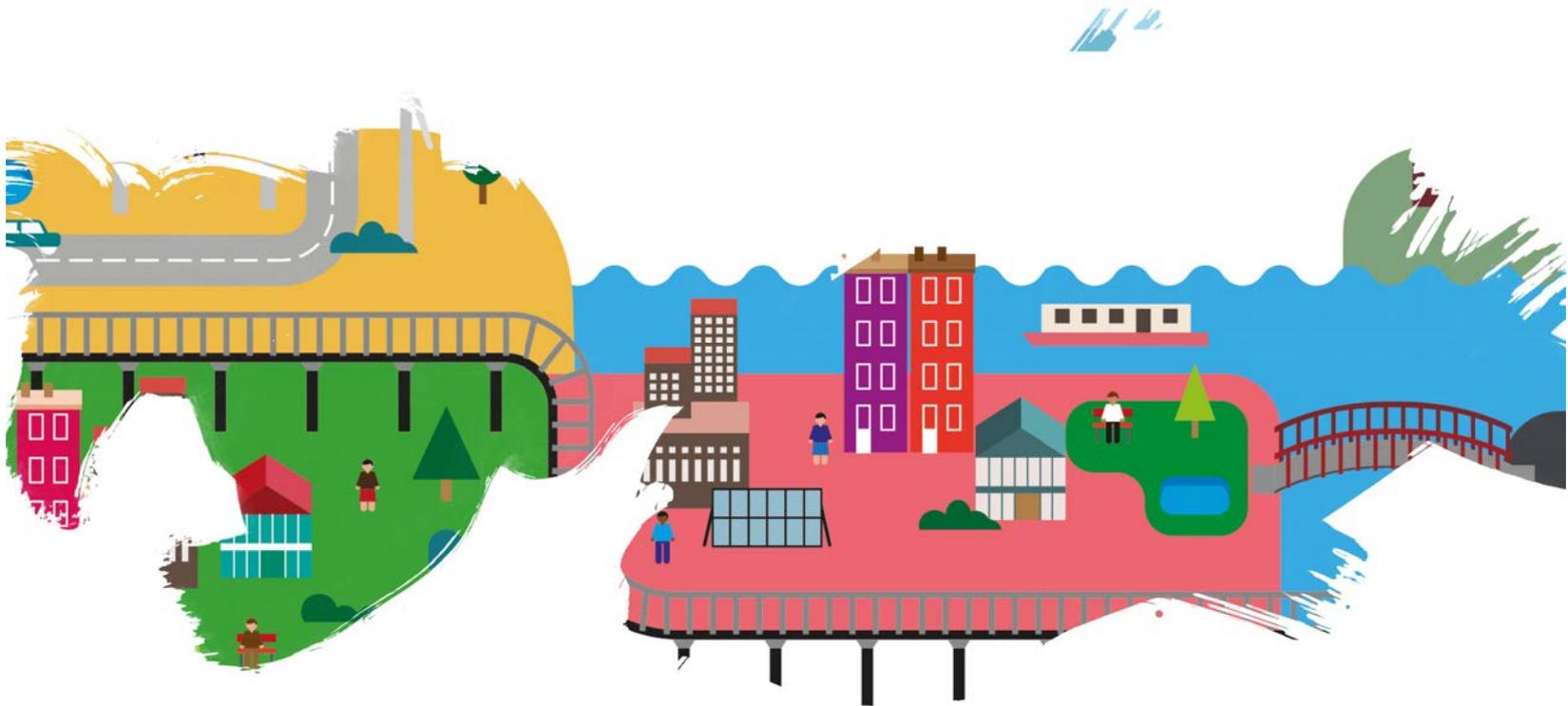




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INTERNATIONAL URBAN COOPERATION
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OVERVIEW OF FINANCIAL SOURCES AT NATIONAL LEVEL

INTERNATIONAL URBAN COOPERATION PROGRAMME

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INTRODUCTION

This second publication of the International Urban Cooperation (IUC) financial series aims to give an overview on financial sources at national level that are available for urban development, helping to understand the range of options accessible on the market, and inspire the exploration of innovative solutions.

Given the strong linkages between national and international finance, this edition strongly builds on the first publication, "Overview of international financial sources and institutions". With international institutions providing loans and other financing facilities for urban development, local governments must determine the appropriate funding instrument to generate revenue and pay back this financing.

In addition to presenting traditional approaches and forms of municipal finance, this study also seeks to outline innovative solutions for revenue mobilization for local and subnational governments, using case studies for illustration.

Given the length of this publication, it is not possible to delve deep into all topics, and some areas, such as innovative financing mechanisms and options, like green bonds, public-private partnerships and crowdfunding, will be described more in detail in the third part of the IUC financial series. For the same reason also references are provided throughout the study for those seeking more information on specific topics or countries.



1. SOURCES OF FUNDING

While traditional forms of municipal finance, including own-source revenues such as fees and taxes, loans, grants and subsidies retain their importance, the role of new financial instruments and the private sector becomes vital due to the high level of investment required for ensuring local sustainable development. The sources of national finance can be grouped as revenue coming from/supporting the use of own-sources, financial support received from the central government, and financial tools provided by the private sector.

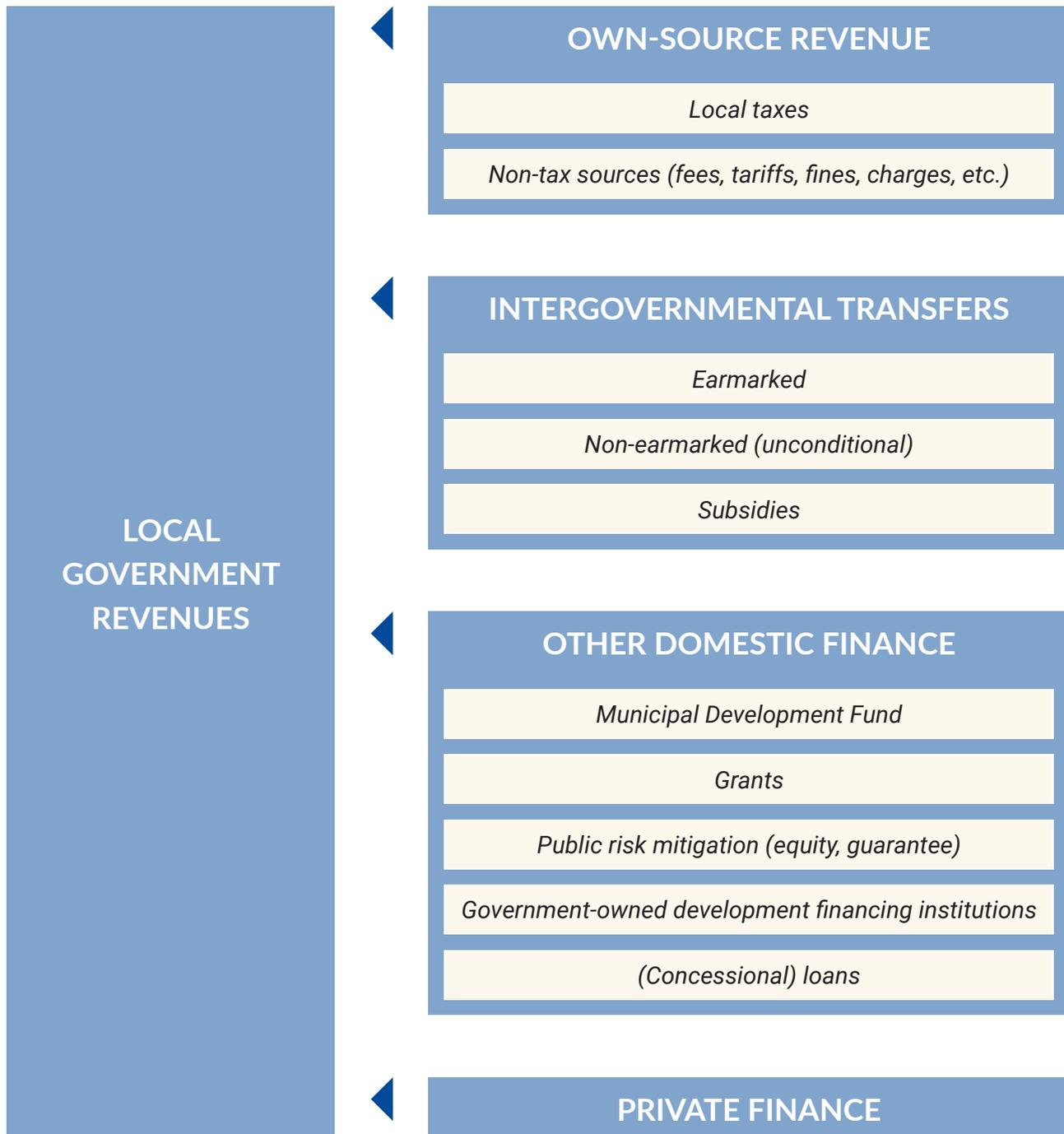


Figure1. Sources of finance at national level

1.1. PUBLIC SOURCES

1.1.1. OWN-SOURCE REVENUES

Well-functioning revenue collection systems enhance local fiscal autonomy by providing reliable revenue sources for city governments.

The own-source revenues of a local government are usually made up from user fees, charges, and taxes.

Although own – source revenues have a high potential, the scale in which they are used depends a lot on the institutional system of the country, and statistics show that in the developing world, in particular where local governments (LGs) cannot collect sufficient revenues, LGs remain highly dependent on external funding, such as national government transfers.

Taxes

This revenue source is of strategic importance, as its control usually pertains to subnational governments. Taxes can be charged on property, income, sales, business activity and other goods or activities. The revenue generated depends on the value or size of the underlying product or activity¹.

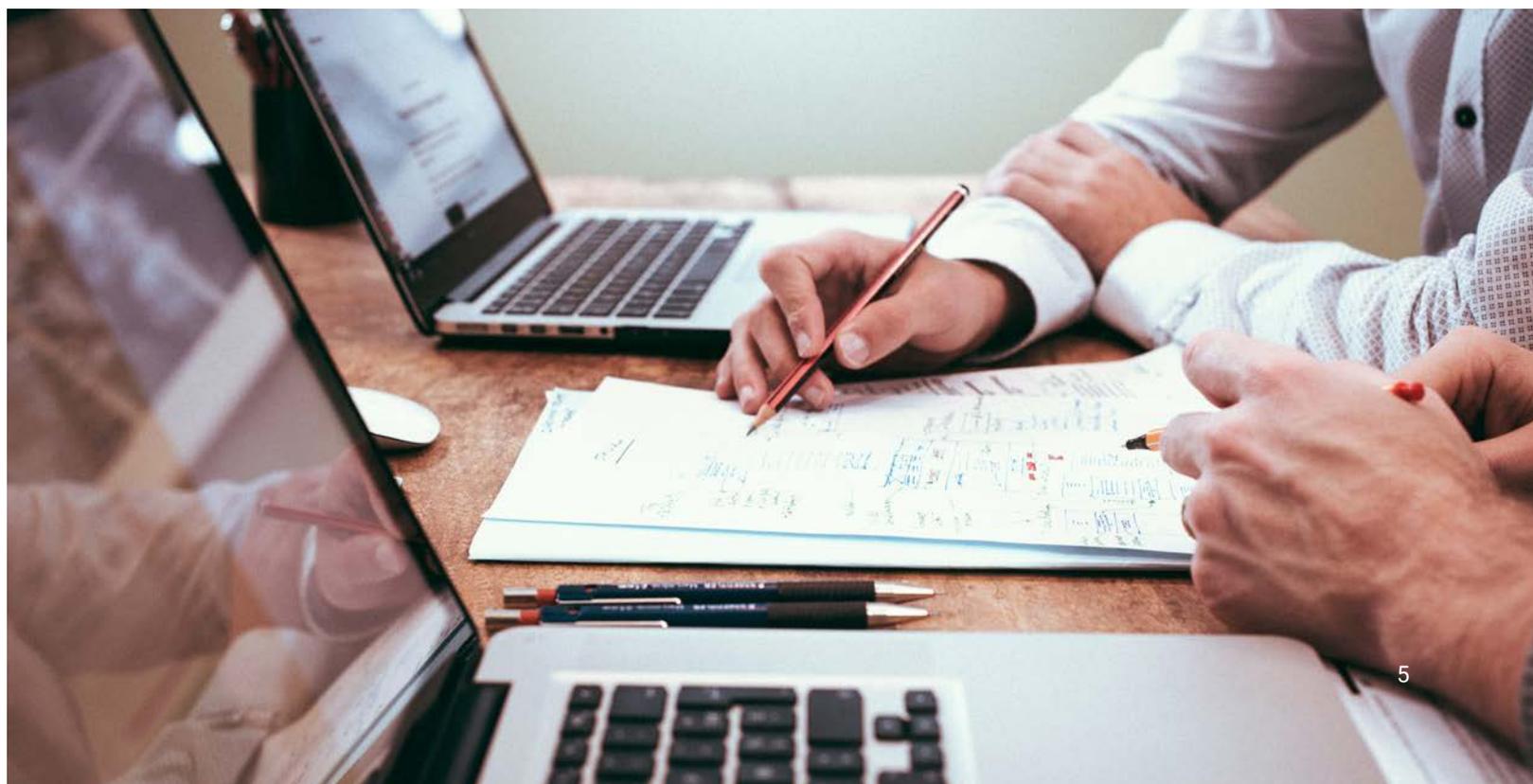
Characteristics of a Good Local Tax

1. The tax base should be relatively immobile so that local governments can vary the tax rates without losing a significant portion of the tax base.
2. The tax yield should be adequate to meet local needs, increase over time as expenditures increase, and be relatively stable and predictable.
3. The tax should not be one that is easy to export to non-residents.
4. The tax base should be visible to ensure accountability.
5. Taxpayers should perceive the tax to be reasonably fair.
6. The tax should be relatively easy to administer.

Source: Bird (2001a)

Local and regional governments usually have a mix of taxes, which also gives the flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, etc.

1. Challenges and Opportunities for Urban Climate Finance – Lessons Learned from eThekwin, Santiago de Chile and Chennai, GIZ, 2017



An innovative way of taxation is the **land-value capturing**.

Public regulation, planning or investment can increase the value of land. For example, improving road infrastructure will increase the value of land in suburbs. “Up-zoning”, i.e. changing an area for more intense development and commercial use, will increase the demand for such areas, thereby also increasing its value. Land-value capturing allows the public sector to financially participate in such a value increase².



Land-value capturing - The Hong Kong metro system (MTR)

The MTR Corporation is comprised of 91 km, 53 stations and deploys over 1000 rail cars with an average weekday patronage of over 2.5 million. The construction of the MTR was announced in 1973 with an initial cost of HK\$ 5000 million, and the Hong Kong government, which was the only shareholder, provided one third of the initial capital investment, and the rest of the investment was raised by other financial mechanisms.

In the case of Hong Kong all land is state property and the government leases the land based on a specific land contracting system. On average, lease revenues accounted for 17% of total government revenues.

In 1982 the system was already showing profit, partly due to the increase in land value along the metro line. The financial performance of the MTR Corporation presently leverages the railway assets by including rental of station retail units, advertising in trains and stations, developing residential property, and owning shopping centres and offices.

Source: Francesca Romana Medda and Marta Modelewska: Land value capture as a funding source for urban investment, 2011

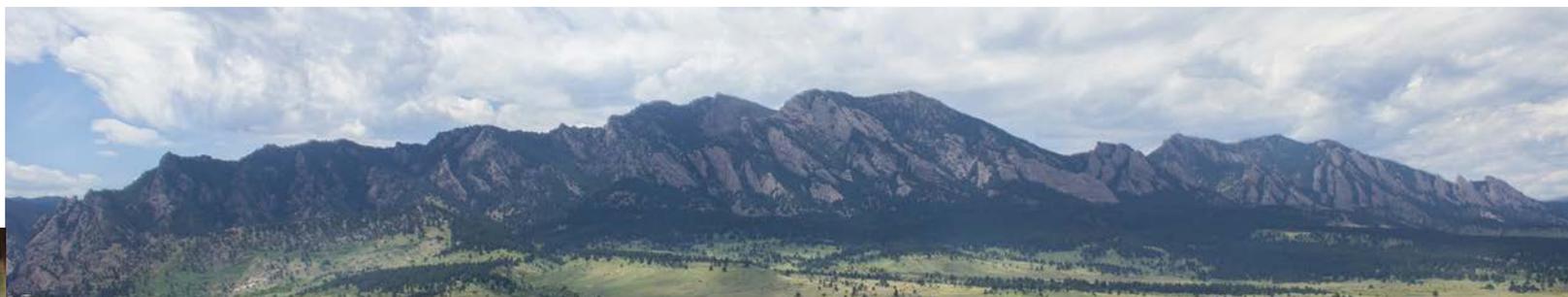
Cities wanting to benefit from land-value increases can, for instance, raise taxes for nearby land or properties, levy betterment fees, or sell special building rights. Land-value capturing requires local governments to have strong institutional capacity. Besides the capacity to collect taxes and manage projects, local governments also need to conduct detailed assessments with good data, and clearly communicate the potential economic and environmental benefits of any infrastructure project to property owners³.

In addition to the benefits in terms of public finance, many authors point out that land-value capture can also help to improve the economic efficiency of municipal investments, contribute to social equity, and serve as a tool for urban growth management and land price control, as well as reduce uncertainty for private developers about the timing of project approval and infrastructure provision⁴.

2. Kamiya, Marco 2016: New solutions to close the gap on municipal finance

3. Godfrey, Nick and Xiao Zhao 2016: Financing the Urban Transition for Sustainable Development

4. The Potential of Land Value Capture for financing urban projects, Inter-American Development Bank, 2017



Boulder, Colorado, USA

In November 2006, voters in Boulder, Colorado passed what is said to be the first municipal carbon tax. It is a tax on electricity consumption (utility bills) with deductions for using electricity from renewable sources. As of 2015, the Boulder carbon tax is estimated to reduce carbon output by over 100,000 tons per year, and allows the city to collect \$1.8 million in revenue that is interjected back into the city. Those funds are infused back into the community by providing bike lanes, energy efficient solutions, rebates for business and homeowners to further invest in green energy, and community based programs to further bring awareness to the movement.

Source: <https://insideclimatenews.org/news/02112015/boulder-taxed-its-way-climate-friendlier-future>
<https://www.smartgrowthamerica.org/app/legacy/documents/Boulder-Carbon-Tax.pdf>

“Economists like to argue, about climate change as much as anything else. [...] But on the biggest issue of all they nod in agreement, whatever their political persuasion. The best way to tackle climate change, they insist, is through a global carbon tax.”

— The Economist, 28 November 2015

A **carbon tax** is a tax levied on the carbon content of fuels and, like carbon emissions trading, is a form of carbon pricing. As of 2018 at least 27 countries and subnational governments have implemented carbon taxes⁵. Research shows that carbon taxes effectively reduce greenhouse gas emissions. Carbon taxes offer a potentially cost-effective means of reducing greenhouse gas emissions, and carbon tax revenues can be spent on urban development projects.

Non-tax sources

Other sources of local revenue include, for example, charges (e.g. water, electricity, public transit, parking, road use, waste collection), rental income, traffic fines, licenses and permits, and entrance fees for use of local facilities. These fees-for-service are intended to fully or partially recover the cost of service provision and accordingly should be one of the most appropriate tools for financing public services.

This is a type of non-tax revenue for the subnational entities that offers important advantages for management and diversification of their revenue structure. It is a reliable, fair, and efficient revenue source because payment is directly linked to use by the beneficiary and also because it allows cost recovery by the service providers, if properly managed. Additionally, local governments also have a certain autonomy over its management, fee structure, and collection (IDB, 2017).

5. "Carbon Taxes: What Can We Learn From International Experience?", Econofact, 2019-05-03

1.1.2. INTERGOVERNMENTAL TRANSFERS

Resources transferred from other levels of government (generally the national) are a predominant source of revenue for numerous Local and Regions Governments. Yet, many local governments depend heavily on intergovernmental transfers, and many suffer from unstable or inadequate transfers⁶.

Depending on the legal provisions and the transfer structures of each country, intergovernmental transfers can be unconditional or conditional and they do not have to be paid back. Nevertheless, there are several disadvantages linked to the high dependency on transfers. For one, if transferred resources are from the national or federal budgets, their availability is subject to the macro-economic trends that may impact these budgets. This makes transfers a vulnerable, unstable, and a less predictable source of financing that jeopardizes the ability to do medium and long-term planning at the local level. Also, when transfers are earmarked, subnational entities may not be able to use them in their areas of greatest priority (IDB 2017). Transfers also may not be used to their full potential due to lack of dialogue across sectors and alignment of medium long-term strategies and priorities.

Conditional (earmarked) transfers

Earmarked transfers have to be used for specific, pre-defined purposes. If conditional grants are not fully spent, it depends on the characteristics of such funds and the national context whether they can be used to fund other climate-related activities.

Unconditional (non-earmarked) transfers

Non-earmarked transfers can be used to fulfil any purpose, usually basic municipal functions.

Subsidies

Subsidies are generally seen as a privileged type of financial aid and are usually in the form of tax reduction. Via subsidies the government encourages developments that are not being effectively supported through the actions of the general economy, or may be undercut by activities in rival economies.

1.1.3. OTHER DOMESTIC FINANCE

Government-owned Development Financing Institutions

Government-owned Development Financing Institutions can provide grants, loans, equity and guarantees to reduce the risk of local investments and attract additional private capital. Development banks and funds can also extend funding to commercial banks, which then lend to local governments or private investors⁷.

Municipal Development Fund (MDF)

Many local/regional governments set up their own development fund dedicated to urban development. MDFs aim to raise additional resources for public investment.



Green Municipal Fund (GMF), Canada

The Green Municipal Fund was established in 2000 by the Federal government. Since then, it has grown to a \$500 million endowment under the Federation of Canadian Municipalities (FCM). Today, GMF supports municipal projects that advance innovative solutions to tackle environmental challenges. Its primary purpose is to help municipal governments leverage investments in municipal sustainability projects, and provide grants, loans and/or loan guarantees to eligible recipients for eligible projects.

Source: <https://fcm.ca/en/programs/green-municipal-fund>

6. Guide to Municipal Finance, UN-HABITAT, 2009

7. Smallridge et al. 2013: The Role of National Development Banks in Catalyzing International Climate Finance



Less Carbon Climate Fund, Almada, Portugal

In 2009 the Portuguese city of Almada set up the “Less Carbon Climate Fund” which aims at reducing Almada’s carbon footprint by financing energy efficiency and renewable energy investments.

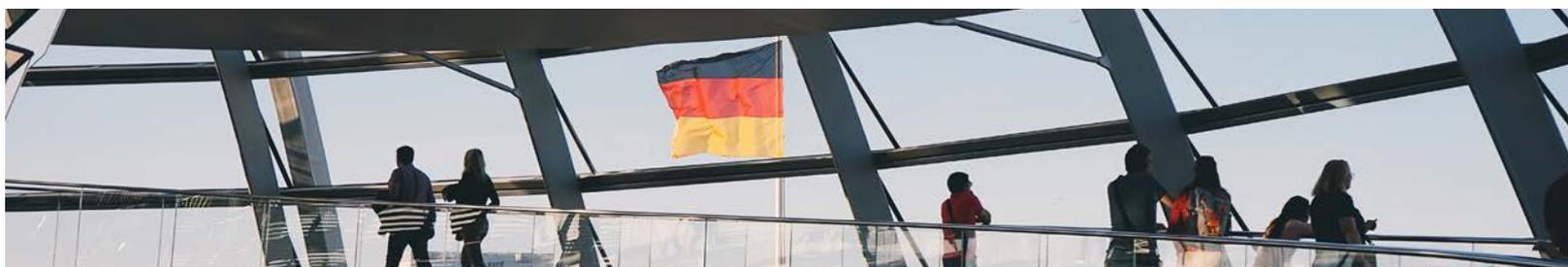
The Almada Less Carbon Climate Fund is a voluntary financial scheme supported by a simple economic valuation of the carbon emissions generated by the municipality’s regular activities. The fund ensures that costs associated with carbon emissions are internalized and contribute to their compensation.

Almada has been successfully using the fund to increase energy efficiency investments, resulting in a clear net financial benefit for the municipality. Additional benefits include improved resource efficiency, lower energy bills and management costs, as well as enhanced local green economy activities.

Source: <https://www.covenantofmayors.eu/news-and-events/news/1387-almada-portugal-a-revolving-fund-for-less-carbon.html>

Grants

Grants are non-refundable sources. The big advantage of grant finance is that there are no financing costs associated. On the other hand, grants are time limited and not always sustainable once the project ends.



Urban development grants, Germany

Programme year 2017: 790 m. Euro federal funds for urban development grant programmes

The “Social City” programme is one component aiming at:

- Investments in urban development in order to improve housing and living conditions, social infrastructure
- Interdisciplinary approach and collaboration (Know-how, funding), together with other partners
- Encouragement and participation of residents
- Neighbourhood management
- Integrated development strategy of neighbourhoods

Source: Tilman Buchholz, Federal Ministry for the Environment, Nature Conservation, Building and Nuclear Safety, EUKN Policy Lab for Spain, Madrid, 2017

Concessional loans

Concessional (soft) loans have more favourable terms than market-rate loans from private lenders. They often have low interest rates and long repayment periods. They are mostly used for large-scale capital expenditures for infrastructure that is expected to create revenue streams or cost reduction.

Guarantees

A public guarantee is a financial instrument that encourages financial institutions, i.e. commercial banks but also public banks, to offer loans. Guarantees do not provide cash support or any kind of credit, but rather ensures that debt is paid back in case the original lender has financial difficulties and cannot repay.

The guarantee functions as a promise by the guarantor to the lender, that in the event that the borrower defaults on payment, the guarantor will repay the lender a specified proportion of the foregone principal. In other words, guarantees will be given by a guarantor to pay all or part of the loan in the case of borrower payment default.

1.2 PRIVATE SOURCES

Major investments require significant capital expenditures. Revenues from public sources as listed above (taxes, user fees, and intergovernmental transfers) for this are unlikely to be sufficient, and LRGs may need to access private financing.

Commercial loans

Commercial loans are lent by commercial banks and other financial institutions. Per definition, a loan is given in exchange for future repayment of the loan value amount, along with interest or other finance charges. A loan may be for a specific, one-time amount or can be available as an open-ended line of credit up to a specified limit or ceiling amount.

Due to LRGs limited borrowing capacity and debt limitations, borrowing is generally a minor source of local government revenue in developing countries. To apply for loans creditworthiness is usually a pre-condition. A great advantage of using this type of external funding is that it allows financing projects the local government could not fund on its own. Loans can also be used for making large capital equipment purchases to facilitate growth that the local government couldn't afford otherwise.

On the other hand, it should not be forgotten that lenders require a return on their investment. Interest adds to the overall cost of the investment and can make the external funding more of a financial burden than originally planned.

Loans can be also used in an innovative way and for example paid back through the fees paid by the users.

Equity

Equity financing can attract capital from (also early stage) investors who are willing to take risks in an investment. Equity financing is also an important method to create and ensure investors ownership. One of the advantages of equity financing is that the money that has been raised from the market does not have to be repaid, unlike debt financing which has a definite repayment schedule.

2. CONCLUSIONS

The amount of funding available to local governments is an important determinant of the quantity and quality of services that they can provide. Where locally raised revenues are limited, urban government expenditures suffer.

In the past years, rapid urbanization revenues at the municipal level have not kept pace with the increased expenditure requirements. Given that local governments are largely responsible for investments in services and infrastructure, the strengthening of existing revenue sources of local budgets (e.g. own-source revenue, transfers, etc.) and the implementation of nontraditional financial instruments are crucial aspects of the region's urban development (UNH 2009).

Trends and Challenges

There is a growing trend of fiscal decentralization, meaning the transfer of financial responsibility from central governments to local governments, but this progress is still very slow in less developed countries. Decentralization requires accountability and transparency at the local level.

Through citizen inclusion in formulating the budget, [participatory budgeting](#) is an innovative way of citizens' involvement and decentralization, and improves the communication and dialogue between the local administration and citizens. It fosters social inclusion by allowing the poorest citizens to have a voice in budgeting decisions, and it empowers neighbourhood associations and small organizations. Nevertheless, it can take a long time to implement budgetary decisions, in part because it is necessary to teach citizens the details of how the process works.



Participatory Budgeting, Porto Alegre, Brazil

The first city to engage in participatory budgeting is Porto Alegre, Brazil which introduced the practice in 1989. It is now used by many municipalities in Brazil and several countries in Latin America and elsewhere. Participatory budgeting was introduced, in part, as a way to address severe inequalities in services (especially water and sanitation) and quality of life around the city.

Regular decision-making forums of elected representatives have been created at a number of levels: sixteen regional forums bring people together from different parts of the city; five thematic forums (such as health, education, housing, sanitation) bring together people from throughout the city; and a municipal budget council comprises representatives of the regional and thematic forums.

The process covers all capital expenditures which range from 5 to 15 percent of the total budget of Brazilian municipalities. In Porto Alegre, the number of participants in the budgeting process is now more than 14,000 people per year.

Source: Abers, 2001, Goldsmith and Vainer, 2002 and Serageldin et al., 2008

Although several LRGs are using a wide range of nontraditional instruments, like land-value capture and equity, their use has not yet reached its full potential, and taxes and government transfers are the most significant revenue source for local governments. Moreover, as for taxation, it is not easy to find the right balance between keeping cities economically viable by delivering high level of services and, at the same time, keeping taxes sufficiently low not to discourage businesses and acceptable for the citizens. To define the right tax rate and price the userfees require special expertise, which is lacked at many LRGs. Government transfers when too large can also undermine efficient local pricing policy.

Another challenge is that transfers are rarely a stable and predictable source of revenue. The amount of money local governments receive varies from year to year, in part depending on the fiscal state of the donor governments. Lack of predictability makes it difficult for municipalities to plan expenditures. When grants decline, LRGs have to make up the lost revenue by increasing property or other taxes, user fees, other revenues, or by reducing expenditures (UNH 2009).

Mobilizing private finance, especially in less developed countries, is low due to the risks involved for both the public and private sectors. From the lenders' perspective, constraints include the lack of a transparent accounting system at the municipal level, the absence of collateral, and the absence of project revenue streams that rarely match commercial debt costs (Cities Alliance 2005).

Using public or private sources to mobilize and operate financial instruments, and manage projects LRGs need to have a solid financial structure and bear the right skills and capacity. Investing into better financial management will reduce wasteful expenditure, improve revenue collection, and contribute to propelling creditworthiness.

THE IUC PROGRAMME

The International Urban Cooperation (IUC) programme enables cities in different global regions to link up and share solutions to common problems. It is part of a long-term strategy by the European Union to foster sustainable urban development in cooperation with the public and private sectors, as well as representatives of research and innovation, community groups and citizens. Through engaging in the IUC, cities will have the chance to share and exchange knowledge with their international counterparts, building a greener, more prosperous future.

The IUC programme is an opportunity for local governments to learn from each other, set ambitious targets, forge lasting partnerships, test new solutions, and boost their city's international profile. Its activities will support the achievement of policy objectives as well as major international agreements on urban development and climate change, such as the EU Urban Agenda, the UN Sustainable Development Goals, and the Paris Agreement.



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