Promoting Subnational Financing for Cities

Urban 20 White Paper

A French Development Agency (AFD), International Finance Corporation (IFC), The United Nations Human Settlements Programme (UN–Habitat) and Inter-American Development Bank (IDB) White Paper for the Urban 20 (U20)

U20

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About Urban 20

Urban 20 (U20) is a new city diplomacy initiative developed under the leadership of Horacio Rodríguez Larreta, Mayor of the City of Buenos Aires and Anne Hidalgo, Mayor of Paris and Chair of C40 Cities Climate Leadership Group (C40). Launched on December 12, 2017 at the One Planet Summit in Paris, the initiative is chaired by the cities of Buenos Aires and Paris, and convened by C40, in collaboration with United Cities and Local Governments (UCLG).

What U20 seeks, is to highlight the expertise of cities in a range of global development challenges and to raise the profile of urban issues within the G20. U20 will offer solutions and clear recommendations to national leaders for their consideration ahead of the 2018 G20 Summit. The first year of the U20 initiative will culminate in the inaugural U20 Mayors Summit in Buenos Aires, October 29-30. With this event, U20 will remain a stepping stone toward ensuring an ongoing dialogue between cities and the G20.

In 2018, 26 cities have participated in Urban 20: Barcelona, Beijing, Berlin, City of Buenos Aires, Chicago, Durban, Hamburg, Houston, Jakarta, Johannesburg, London, Los Angeles, Madrid, Mexico City, Milan, Montreal, Moscow, New York, Paris, Rio de Janeiro, Rome, São Paulo, Seoul, Sydney, Tokyo, and Tshwane.

For more information, please visit: www.urban20.org

About the White Papers

Urban 20 is proud to present a series of White Papers from our Strategic and Advisory Partners that highlight the most relevant topics on the cities development agenda and the forthcoming urban trends. These papers define the challenges that local governments are currently facing and offer open recommendations supported by relevant, up-to-date research and data. The intention of this work is to broaden the understanding and perspective of decision makers and stakeholders as to enhance their ability to tackle these most pressing issues. The White Papers also represent the hard work and dedication of these agencies and organizations to keep the public well informed about the ongoing efforts to address the present and future challenges we share as humankind.

Image: Orbon Alija

Promoting Subnational Financing for Cities is a White Paper prepared by AFD, IFC, UN-Habitat and IDB as a voluntary contribution to enrich the discussions of the Urban 20 process.

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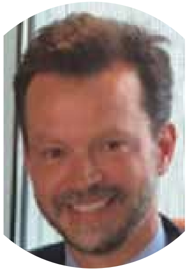

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AFD is an inclusive public financial institution and the main actor in France's development policy. It makes commitments to projects that genuinely improve the everyday lives of people, in developing and emerging countries and in the French overseas territories.
AFD works in many sectors fully in line with the Sustainable Development Goals (SDGs)– energy, health, biodiversity, water, digital technologies, training – and supports the transition to a safer, more equitable and more sustainable world: a world in common.

IFC, a member of the World Bank Group, is the largest global development institution focused on the private sector in emerging markets. Working with more than 2,000 businesses worldwide, we use our capital, expertise, and influence to create markets and opportunities in the toughest areas of the world. In FY16, we delivered a record $19 billion in long-term financing for developing countries, leveraging the power of the private sector to help end poverty and boost shared prosperity. For more information, visit www.ifc.org.

The United Nations Human Settlements Programme (UN–Habitat) is the United Nations agency working on normative and operational areas of Urban Planning, Municipal Finance, Housing and Slum recovery among other themes related with sustainable urban development.
UN-Habitat leads implementation of the New Urban Agenda and the SGDs, in particular SDG11 on cities. Its global headquarters is in Nairobi, Kenya and its Executive Director is Maimunah Mohd Sharif since January, 2018.

IDB works to improve lives in Latin America and the Caribbean. With a history dating back to 1959, IADB is the leading source of development financing for Latin America and the Caribbean through financial and technical support for countries working to reduce poverty and inequality, with the aim to achieve development in a sustainable, climate-friendly way. . The Bank's current focus areas include three development challenges – social inclusion and inequality, productivity and innovation, and economic integration – and three cross-cutting issues – gender equality and diversity, climate change and environmental sustainability; and institutional capacity and the rule of law.

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Executive summary

If cities are to play the major role they are assigned in the fields of development and struggle against climate change, their funding capacities need to be rapidly and massively increased.

This crucial development depends heavily on the political will of the cities themselves, but also of the states, as well as the quality of the dialogue between these two levels.

States must indeed ensure that the institutional and fiscal framework for decentralization is strengthened, and accepting the emergence of strong local governments, especially cities, endowed with human and financial resources to enable them to fully assume their competences and enabling the states to rely on them as partners with which they can improve the action of public authorities in favor of a balanced development of territories.

Cities must work on the strengthening of their capacities, in order to improve their credibility and that of their projects vis-à-vis their potential funders.

DFIs and UN agencies have to intensify their support to this necessary and fruitful dialogue between states and cities, and enhance the effectiveness of this support with more co-financed programs or TA combination. They also have to continue developing new tools to contribute to the increase and the diversification of funding sources for cities.

Glossary

ADB
Asian Development Bank

AFD
Agence Française de Développement

CICLIA
Initiative Villes et Changements Climatiques

COP
Conference of the Parties

DBSA
Development Bank of South Africa

DFI
Development Financial Institution

FEC
Fonds d'Equipement Communal

FINDETER
Financiera de Desarrollo Territorial

IFC
International Finance Corporation

IDB
Inter-American Development Bank

LED
Local Economic Development

LG
Local Government

NDC
Nationally Determined Contributions

PCG
Partial Credit Guarantee

PEFA
Public Expenditure and Financial Accountability

UPFI
Initiative pour le Financement de Projets Urbains

Introduction

Local governments and especially cities are the most representative of the multidimensional aspect of the needs of the population, constitute the relevant scale of intervention for balanced urban development and are at the forefront of concrete responses to the impacts of climate change.

Their role in development and climate change issues was clearly recognized in 2015 (Conference of Addis Ababa on financing for development and COP 21 in Paris) and 2016 (adoption of the New Urban Agenda at the Habitat III conference), but the challenges they have to face are huge. Urban population is growing fast: according to the United Nations (UN)[1], an estimated 54.5% of the world's population lived in urban areas in 2016 and will reach nearly 70% by 2050 according to the World Bank's forecasts. This trend requires rapid adaptability and capacity for anticipation in public service delivery and urban planning to avoid uncontrollable sprawling, with a growing part of the population living in slums or informal settlements with no access to basic services, and highly exposed to natural disasters and climate change risks, especially in coastal areas.

And the paradox is that cities often remain weak actors, with insufficient resources to face these challenges. Despite the favorable conditions for long-term investments (low rates, abundant funds), the gap between funding needs and observed financing of urban infrastructures is growing.

The challenge is therefore to have cities:

- With clearly defined competencies and responsibilities, in articulation with the State level,
- Adequately endowed in terms of financial resources, as with proper project and financial management capacities,
- Able to deliver efficiently services to their population and in position to fund and manage the operating of local infrastructure,
- In capacity to anticipate the needs in terms of urban planning and natural risks management,
- In a position to become catalysts for local economic development (LED).

[1] The World's Cities Report, UN-Habitat, 2016.


Source: Jorge Cardoso pour l'Agence Française de Développement

I. The necessary prerequisites for increased subnational financing: strong and effective decentralization frameworks and robust cities capacities

1. How DFIs and UN Agencies can contribute to the strengthening of decentralization processes

i. Why support decentralization?

Decentralization is both a modality of institutional organization and a process of reform, that defines the distribution of powers between national and local levels.

> "The two main objectives generally assigned to decentralization are the following:
> - Improving the delivery of services to citizens with proximity and a better understanding of the needs,
> - Fostering democratic endorsement and consent to reduce political radicalism, due to more trust of citizens in local governments considered as more responsive, and the fact that accountability of policy-makers at the local level is easier".

It is a complex and sensitive issue, with a strong political dimension. It therefore has a specific meaning in each country, with institutional systems arising from national history, and sometimes more specific complementary objectives in certain countries like fight against poverty and territorial disparities, promotion of social stability in conflict or post-conflict environments (« asymmetrical decentralization» in Mozambique or in reflection in Colombia), preservation of historical, linguistic, ethnic or cultural specificities like in Ethiopia.

Globally, the level of decentralization is rather weak in developing countries, mainly because of the reluctance of central governments to transfer power and resources to local governments, which explains why cities lack clear empowerment and responsibilities, as well as sufficient financial resources and human skills.

ii. The keys to effective and fiscally responsible decentralization

The key aspects are the following:

Clarity in the division of responsibilities between the different levels of government

The clarity in the responsibilities of the different levels of government is specific to each country, but as a general rule it is to be expected that the vaguer the definition of responsibilities in the legal framework, the greater the need for intergovernmental cooperation arrangements that can resolve the needs for clarification.

Correspondence between responsibilities and resources to finance them

There must be a correspondence between the spending responsibilities of the local governments and the resources they have to finance them. There are many examples of local or regional governments that are assigned responsibilities and spending mandates that exceed their assigned revenues, where they consider that there is an implicit commitment on the part of the central government to finance these income deficits. If on the other hand, the revenues of local governments exceed their spending needs, then unnecessary pressures can be generated on the central government deficit, as well as generating incentives for inefficient spending at the subnational level.

AFD: Main instruments and projects in the field

AFD has a long experience in supporting and financing local governments and especially cities, in French overseas as well as in foreign countries. Its objective is to provide the widest range of tools to improve cities' access to financing. The three main instruments are the following:

- Policy based loans in support of decentralization processes, to increase fiscal transfers from governments to cities as well as increase of own-source revenues.

AFD has granted such loans to the Republic of the Philippines since 2009, in co-financing with the Asian Development Bank (ADB), to the Kingdom of Jordan since 2016, and to Ethiopia and Senegal in co-financing with the World Bank in 2018.

- Credit lines to financial institutions specialized in LGs, to reach second tier cities that can hardly benefit from direct loans, and giving them access to loans in local currency tailored to their needs (long-maturity loans).

AFD has financed and provided technical assistance to many of these FIs, like FINDETER in Colombia, DBSA in South Africa, CPSCL in Tunisia, or FEC in Morocco.

- Direct loans to LGs, mainly cities (or their urban operators) for projects, investment programs or policy loans, according to their capacity in terms of project

management and their financial position, accompanied by programs of capacity building.
(e.g. AFD loans to Dakar, Greater Amman, Joburg, Medellin, Guayaquil).

- Project preparation facilities to finance pre-feasibility or feasibility studies, and help cities transform their ideas into real investment projects, with climate co-benefits.
(e.g. CICLIA for Africa, UPFI for the Mediterranean).

Robust own-source revenues

The decentralization literature recognizes the benefits of local governments at least in the margin being financed with their own resources. These benefits include the following : (i) fiscal responsibility because the financing of local governments spending with own revenues allows local and regional governments to internalize the cost of their spending decisions; (ii) political responsibility because when local governments spending is financed by taxes collected by local or regional governments themselves, it encourages and facilitates citizens to monitor the authorities in the exercise of this expense; and (iii) compliance with local preferences because subnational taxation facilitates alignment between the tax structure and differences in local preferences. For example, this allows a region that has a preference for a higher level of public services or goods to finance this preference with a higher local tax pressure.

Appropriate design of intergovernmental transfers

A very important share of local governments' expenditure will have to be financed with transfers from the central government. Therefore, how these transfers are made is of the utmost importance to maintain subnational fiscal sustainability. These transfers have to be predictable, and the formula of calculation based on simple and transparent criteria (e.g: population, income of the population).

To minimize the risks of subnational fiscal indiscipline, the good design of the transfers between levels of government must safeguard the objective of not generating perverse incentives. International experience shows that the best way to incorporate these conditions in the transfer mechanism is through formulas based on indicators of need for spending and capacity to generate own revenues. Ideally, the formula should use a set of indicators of expenditure needs and fiscal capacity at the level of each jurisdiction. In general, jurisdictions with higher spending needs and / or lower relative fiscal capacity will receive a higher level of transfers per capita. In this regard, a design condition of the greatest importance is that the indicators of the need for expenditure and / or fiscal capacity used are "exogenous" to the jurisdiction receiving the transfer. This means that local governments cannot manipulate the value of such indicators through autonomous decisions, with a view to skewing the allocation mechanism in their favor. The same applies to indicators of fiscal capacity indicators, where it is better to use structural variables that estimate their potential income.

Fiscal Responsibility Framework

The financial market has been generally ineffective in regulating subnational debt with the exception of countries with a long and proven history of hard budget constraints such as the US. This is because the market normally expects that local governments cannot go bankrupt and that in the event of financial difficulties they will be rescued by central governments and therefore willing to provide credit beyond the local governments' repayment capabilities. This explains the growing emergence of sub-national fiscal rules. The most appropriate combination of controls on sub-national indebtedness depends on the specific circumstances of each country, although in most cases it has to involve: a combination of well-designed and strongly applied fiscal rules in a uniform manner; and institutional reforms that make it possible to increase the effectiveness of market discipline over local governments (in particular, measures to improve the quality and transparency of sub-national fiscal accounts, elimination of privileged access channels for local governments to credit, and use of independent risk rating systems).

UN-Habitat: Case Studies on Subnational Finance

UN-Habitat has broad experience integrating operational and normative projects on municipal and subnational finance at a global scale. The agency works on urban planning and design, municipal finance, legal; framework, land and regulations, basic services and integrates local revenues with planning.

UN-Habitat aims to achieve sustainable and productive urbanization, with municipal finance s key part, but there won't be results if municipal finance is not strongly linked to legislation, and to urban planning [2]. One practical example: our project in Kiambu County in Kenya; starting with revenue enhancement, basic ICT network, and basic financial management. But to support land registration, an understanding of planning and logistics in the city is needed, to properly establish public space, rules and regulations are required. To design small private investment in local services, a specific set of by-laws need to be provided. To retrofit urban planning and expand the city with planned city infills, a feasibility analysis, financial business cases with costs, and cost-benefit analysis are necessary. In all cases the integration of local finance, laws, and planning is essential. With small resources, however, and patient work, Kiambu county was able to show results by increasing revenues by more than 50% in two years. Those additional revenues are now reinvested in basic services, and currently the county requires support to set up a municipal corporation and design local infrastructure funds.

Several partner cities that have adopted programmes and strategies for improved urban and municipal finance in coordination with UN-Habitat. The Kiambu County Government in Kenya could increase its revenue generation by 50 percent between 2014-17 period as a result of technical assistance provided by the agency. In Somalia, an automated municipal finance system established in 15 districts has improved transparency, accountability, and financial procedures of local governments with some districts increasing revenues by over 300 percent between 2008 and 2015.

In Afghanistan, improved methods of land surveying, land registration, tax invoicing and collection have resulted in a 15% revenue increase, on average. The Urban Economy Branch, in addition, is and has provided support to cities as diverse as Kampala, Dar-Es-Salam, Accra (Ghana), Al-Alamein (Egypt), Port Au Prince, Buenos Aires and Mendoza, Havana (Cuba), and has countrywide support to cities in Saudi Arabia, Egypt, Uganda, Tanzania, Mexico, Myanmar, and several cities in China, notably Beijing, Shenzhen and Guangzhou.

[2] See UN-Habitat: Salat, Kamiya, Bourdic (2017) 'Economic Foundations for Sustainable Urbanization' https://goo.gl/HNUu2

iii. The role of DFIs and UN agencies regarding decentralization

DFIs and UN agencies can contribute to the strengthening of decentralization processes. The relevance of their intervention implies a pragmatic approach to this issue. This means that they have to be fully aware of the assets but also of the potential risks of decentralization, and take into account the fact that each country has distinctive characteristics in their decentralization legal and institutional frameworks, based on a case by case analysis.

In order to be efficient, the support to decentralization processes requires in-depth and long-term political dialogue with national and local authorities. To implement this dialogue the main instruments used by DFIs are policy-based loans, accompanied by technical assistance. These loans focus on the different key aspects of decentralization:

- Support to streamline fiscal transfers from governments to local authorities (adequate and sufficient, stable and predictable, based on transparent and objective criteria, etc.)
- Strengthen the legal and regulatory framework concerning local authorities' own revenue (tax rates, revenue collection procedures, etc.)
- Strengthen local authorities' financial management processes, systems and capacities (designing and rolling out of financial information systems, infrastructure and GIS databases, training plans, etc.)
- Improve transparency and accountability on local finance (communication strategy and templates, participatory budgeting, etc.)

IFC-World Bank: Projects in the field

IFC, a member of the World Bank Group, provided a $50 million loan to the City of Buenos Aires aimed to support the development of reliable, safe, and environmentally friendly urban transportation, including the building of new efficient bus lines, introduction of new bicycle lanes and bike-sharing stations that will cut commuter times and reduce carbon emissions in the Argentine capital. In addition to the loan financing, IFC is providing advisory services to Buenos Aires spanning transformational priorities for the city, including transport, energy efficiency in public buildings and assistance in the promotion of green buildings standards with a special focus on Villa 31, a low-income urban settlement in the heart of Buenos Aires.

2. The support to improve cities capacities

Cities have different sizes and capacities as UN-Habitat Global Municipal Database shows (Figure 1). For example, for cities in East Asia and Pacific, where the most dynamic cities of Asia are located, the average budget per capita is over USD 2500, and the allocation of budget to finance capital expenditure is USD 937.

Figure 1. Budget and Capital Expenditure (by Region)

Region	Average budget per capita (USD)	Average capital expenditures per capita (USD)
East Asia and Pacific	$2.521	$937
Europe and Central Asia	$1.718	$254
Latin America and the Caribbean	$1.003	$159
Middle East and North Africa	$489	$385
North America	$3.382	$572
South Asia	$80	$30
Sub-Saharan Africa	$138	$26
All	**$1.610**	**$406**

Source: UN-Habitat, Global Municipal Database 2018.

In smaller cities, in Africa, low-income countries in Latin America, and South Asia, revenues are extremely low, around USD 138 annual per capita in Sub Saharan Africa. More than 70% of cities in the world just don't have the capacity to finance capital expenditure. Most of the revenues are used to cover current expenditures, salaries and maintenance.

These figures clearly underline that despite the recent recognition of their crucial role in development, cities often lack financial resources and human skills to be able to carry out the public policies for which they are responsible for.

In order to address this issue, DFIs and UN Agencies can provide training and capacity building workshops for the staff of these cities, and technical assistance programs for example through city to city technical cooperation, focusing especially on financial management and means to increase revenues:

Training on accounting and budgeting procedures, debt management and financial information systems

Basic financial management is the starting point. In many cities, accounting and budgeting procedures are weak. Many small municipalities across the world just don't apply double entry accounting systems, with revenues and expenditures in two columns. It is thus impossible for them to have a basic record. Training in this area is inexpensive but extremely useful. Even in cities in middle-income countries sometimes basic accounting method is not in place. As for budgeting, few cities have real multi-year budgeting procedures, which are essential for investment planning. It is also crucial for cities to modernize their financial management tools and use proper information systems, with staff properly trained. Basic capacities in terms of debt management of municipal financial staff also have to be strengthened.

Expanding endogenous sources of revenues

The main source of revenues for cities is local assets, which comprise land, properties, local firms forest, etc., that can be used to generate income. But one major issue in many cities is the lack of records, especially land registers or cadasters, that indicate land or properties ownership. These instruments are necessary and have to be created or made more reliable, in order to raise taxes like property taxes and implement land value capture policies, which can increase significantly cities revenues. Cities also have to explore potential areas of revenue generation related to local wealth like betterment levies or local fees.

The modalities of tax and revenue collection can also be improved, for example through one-stop shops or online payment.

Promoting accountability at the municipal level

Accurate fiscal data is also critical in order to strengthen transparency and accountability of mayors and their teams and develop participatory budgeting techniques.

Inter-American Development bank: experience on Subnational governments' revenue-generating capacity

IADB experience reflects the need to continue working to increase subnational revenue generation to cover growing expenditure obligations. Economic policy and country context are important variables that can explain the low mobilization of own-source funds by subnational governments, which often lack the necessary incentives to increase revenues and thus depend to a greater extent on intergovernmental transfers from the central government. There are also weaknesses in local tax administrations' abilities in the areas of tax profiling, assessment, collections, and debt recovery. Actions taken in IADB´s operations that may be considered in other interventions to support the strengthening of subnational revenues include the modernization of registries; the creation of inventories of property tax arrears, as well as improvements in tax systems; integrated financial management, procurement, and human resources systems at the subnational level; and the development of methodologies to measure the fiscal cost of tax benefits granted for municipal taxes accounting for the largest share of subnational governments' ownsource revenues, with a view to building their administration capacities.

II. Bridging the financial gap implies broadening the range of financial instruments

1. Financing facilities for project preparation

In the project financing cycle, the main barrier is between the prioritization of investments and the investments themselves: for many developing cities, the project preparation phase is a blocking factor. Indeed, they lack the technical and financial expertise that is necessary to carry out preliminary studies (vulnerability studies, feasibility studies…). Completing this phase is essential to attract investors with bankable urban infrastructure projects, especially when it comes to projects with climate co-benefits.

DFIs can bridge this gap and fund project preparation through dedicated facilities for cities, generally segmented by geographical region, which will include technical assistance, capacity building, pre-feasibility and feasibility studies. These facilities will target first and foremost low-carbon and resilient urban infrastructure projects.

2. Diversification of funding sources is crucial to increase cities' access to financing for their infrastructure needs

i. The role of DFIs to foster diversification of funding sources

Cities may have access to different debt financing types depending on the nature of their funding needs to be determined by the profile of their capital investments and debt management strategies. It can take the form of on-balance corporate financing raised on the Cities' balance sheet to cover funding gaps on operating balances to finance capital expenditures from multiple investment projects with various sizes including smaller projects that their annual operating revenues are not sufficient to cover. Corporate finance differs from project finance mainly on the entity raising the debt financing and the extent of recourse to the Cities' balance sheet for debt repayment. Under corporate finance, the Cities operating balance is the source of debt repayment, whereas under project finance, which is raised as off-balance sheet by special purpose vehicles established for the development of specific projects, debt repayment relies on the specific project's cash flows which are pledged to the lenders with limited or non-recourse to the Cities' balance sheet.

> "Cities can tap corporate financing from different sources with various maturities, ranging from medium to long-term loans, raised from commercial and DFIs and bonds issued in the capital markets, to short-term credit lines raised from local banks to finance funding gaps arising from capital expenditures and/or refinance existing debt to extend tenors and/or obtain better conditions".

DFIs can support Cities and municipally-owned entities in addressing their funding gaps:

- Directly, granting loans, with or without a sovereign guarantee, or mobilizing multiple sources of lenders through syndication and/or parallel loans. Direct lending without a sovereign guarantee from a DFI sends a positive signal of credibility towards the banking sector and financial markets and generates an incentive effect for risk-taking by private actors.

- Indirectly through credit lines or Partial Credit Guarantees (PCGs) as credit enhancements whether to Local financial institutions and Municipal development funds - generally public owned - that constitute in many countries essential intermediaries and relays between governments and local authorities and are useful to reach smaller cities on long maturities, or to commercial banks. These latter generally view cities and local governments with reluctance, because of their needs in terms of financing, especially the maturity of the loans, which are different from their usual clients, and of the political dimension of that can also often be a source of mistrust or excessive caution. PCGs and TA are therefore very useful in order to encourage the structuring of a local borrowing market, with higher loan amounts, longer maturities and reduced borrowing rates, and thus broaden and diversify the financing sources for cities. PCGs can also be used for the issuance of bonds by cities in the capital markets, targeting green bonds in priority, to reduce the risk for investors and encourage them to take an interest in cities.

ii. The requirements that cities need to comply with to have access to financing

> "Cities need to demonstrate a commitment to transparency, prudent financial policies, and financial management capacity to meet operating and capital expenditures required for the adequate provision of municipal public services, while maintaining sustainable debt service profiles. This includes adequate financial management policies and practices, financial performance, timely execution of budgets and planned investments, ability to increase revenues with timely collection of receivables, and investments to expand operating balance to support capital expenditures and debt service".

Cities also need to prioritize investments through an efficient investment decision-making process by using a strategic long-term vision and the definition of medium-term goals to optimize available resources and identify funding gaps to be filled by private service providers.

Global Rating Agencies (i.e. Standard and Poor's, Moody's and Fitch Ratings) have rating methodologies used for local and regional governments which define key rating drivers that start with assessing the Cities' institutional framework followed by the analysis of key rating factors that determine the Cities' credit profile. They take into consideration legal and statutory regulations, control and oversight by upper tiers of government, operational and financial autonomy, rigidity of expenditures, demand for capital investment, and access to third-party funding in addition to central government transfers. They also consider the adherence to sound institutional processes and policies, transparency and prudential regulations in data adequacy and disclosure.

Source: Zaid Ali Taher Assaf pour l'Agence Française de Développement

For example, S&P starts assessing the Cities' institutional framework and regulatory environment where Cities operate, focusing on the predictability, revenue and expenditure balance, and transparency and accountability. It then assesses seven key rating factors: (i) economy, measuring factors that affect revenue generation capacity, spending needs, and debt service ability; (ii) financial management, measuring aspects that affect the willingness and ability to service debt (political and managerial strength, long-term capital and financial planning, revenue and expenditure management, debt and liquidity management, and impact of related entities); (iii) budgetary flexibility, measuring the willingness and ability to raise revenues, political aspects and economic limits that could curb the use of the flexibility and revenues from asset sales, and to cut expenditures (expenditure flexibility) as needed to maintain debt service ability; (iv) budgetary performance, measuring the level and volatility of cash flows from operations and investment activities available to service debt and the efficiency of financial policy (operating balance and balance after capital accounts ratios); (v) liquidity, measuring how internal sources of liquidity, (cash reserves and cash flow generation), and external sources (bank lines and market access) may affect debt service capacity; (vi) debt burden, measuring how the level, structure, and size of debt may affect debt service capacity, including access to liquidity, revenue and expenditure predictability, and budgetary flexibility; and (vii) contingent liabilities, measuring the extent the risk of occurrence and relative size may impair debt service capacity net of contingency reserves.

iii. The means to improve cities' creditworthiness

> "Cities have various options to enhance their creditworthiness and become bankable that range from technical advisory support through Municipal Financial Management Assessment (FMA) and creditworthiness evaluation, issuance of independent credit rating, institutional capacity, PEFA subnational evaluations, and action plans to improve debt profiles to reduce the risk of default".

Cities have various options to enhance their creditworthiness and become bankable that range from technical advisory support through Municipal Financial Management Assessment (FMA) and creditworthiness evaluation, issuance of independent credit rating, institutional capacity, PEFA subnational evaluations, and action plans to improve debt profiles to reduce the risk of default.

FMA and creditworthiness assessment (diagnostic stage): Advisory support can start with an FMA to analyze a City's financial management practices, its strengths and weaknesses in relation to peers and international good practices and include obtaining an international credit rating to have an independent view on its creditworthiness, how it stands relative to the central government rating and what constrains it. An FMA includes reviewing financial projections to assess the City's financial capacity to meet its obligations from on-going investments and debt service payments though (i) an evaluation of existing financial statements and other relevant information to enable prospective sources of financing to evaluate the City's financial standing; (ii) a financial model that allows for the modeling of new commercial and development financing required by existing and foreseen capital expenditures; (iii) evaluation of the City's financial condition to determine its capacity to finance foreseen investments given its current and projected financial condition and fiscal implications; and (iv) recommendations of actions to strengthen the City's financial condition and debt capacity. It may also include a funding sources assessment to explore areas to generate higher revenues from current and foreseen provision of public services and new taxes.

Based on the initial FMA and credit rating assessment, a financial sustainability road-map can be designed with actions to address identified weaknesses and strengthen a City's financial management practices, financial performance, revenue generation and debt management, including areas for revenue generation from current and foreseen provision of public services, sustainable management of its operating expenditures, and debt reduction scenarios to improve the City's capacity to meet its infrastructure investments requirements and maintain prudent financial policies and sustainable debt profiles. Actions may also include the prioritization of high-impact infrastructure initiatives to optimize the use of available resources and identifying funding gaps that can be met by private service providers by supporting investment decision-making by using a strategic long-term vision and the definition of medium-term goals. The credit rating can be helpful for potential bond issuance, to diversify the City's funding sources.

Public Expenditure and Financial Accountability (PEFA) assessment methodology of the Public Finance Management (PFM) systems can be used for Cities. Supplementary guidance for subnational governments was released in December 2016.

Since the update of the methodology in 2016, PEFA identifies seven pillars of performance for PFM systems that are essential to achieving these objectives. The pillars are as follows:

Figure 2. The Seven Pillars of PFM Performance

Source: https://pefa.org/content/pefa-framework

Within these pillars, PEFA defines 31 specific indicators disaggregated into 94 dimensions that focus on key measurable aspects of the PFM system.

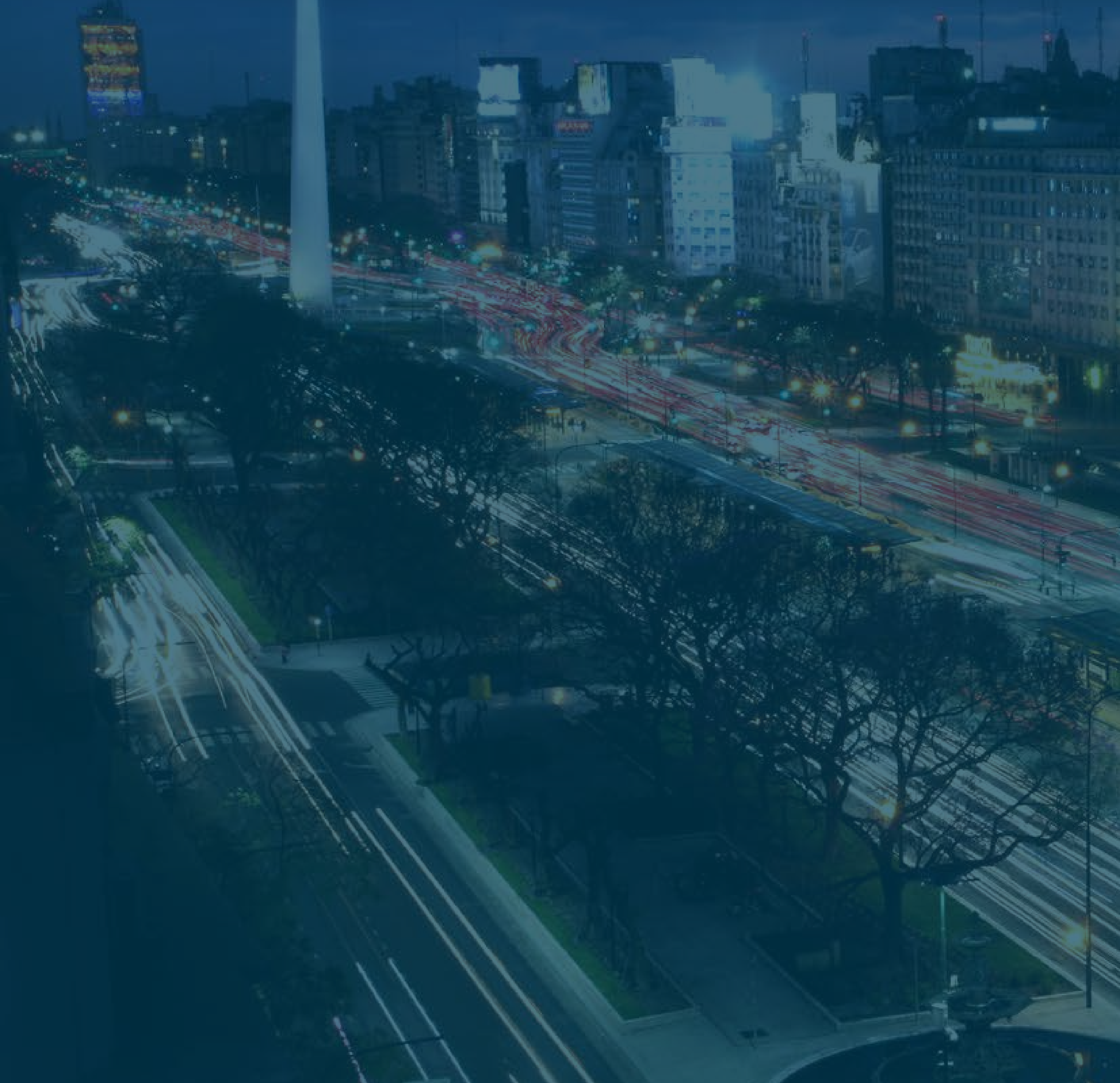
Since 2006, some 240 PEFA assessments reports have been prepared at the subnational level, which has assessed 203 different local governments in 41 different countries.

This instrument is both essential in the analysis and assessment of fiduciary risk, and very useful to foster the dialogue with national and / or local authorities in the articulation of decentralization support programs. Its framework of analysis is complementary to that of the rating agencies and the own financial analysis of the DFIs Ensures on the robustness or fragility of budget and financial processes.

The strengths and weaknesses highlighted in the PEFA studies help identify the in-depth work needed to improve the situation and develop a reform action plan with the provision of technical assistance.

RECOMMENDATIONS

The Way Ahead: Strengthening Subnational Finance



Responding effectively to the challenge of improving subnational funding requires both a proactive and a pragmatic approach.

The need for financing urban infrastructure requires strong action to quickly release large amounts of financing. It is therefore imperative to strengthen and diversify funding channels : increase and improve the predictability of fiscal transfers from central governments ; strengthen the autonomy of creation, modulation and recovery of own-source revenues, especially local taxes; facilitate direct financing by DFIs and intermediated financing via public or commercial banks; give access to disintermediated financing through the issuance of bonds. In this perspective, DFIs must innovate and widen the range of tools that they can propose, making sure to adapt to the legal and institutional realities of each country.

But the success of this strengthening of subnational finance in the long term implies a more in-depth dialogue and increased mutual trust between national and local governments. This is indeed fundamental to enable LGs to benefit from an institutional and financial framework that fully empowers them on clear competences, and allows them to take effective action with sufficient resources, and give them access to the possibility of borrowing, so as not to put the burden of investments only on current users and taxpayers. This dialogue and mutual trust will also enable national governments to rely on LGs with strong management capacities, that are able to finance, build and operate public infrastructure expected by the populations, and which can play a role of growth drivers and catalysts of local economic and social development. A good illustration of this crucial need for increased cooperation between national and local governments is the capacity to hold the Nationally Determined Contributions (NDC) commitments taken under the Paris agreements. Only joint action of national and local governments will make these commitments reachable. DFIs and UN Agencies must become more effective actors in the support they can bring to this decentralization dialogue in many countries, increasing their mutual cooperation with more co-financed programs or technical assistance combination that will impact the leverage effect and the coherence of their joint actions in favor of the strengthening of local governments' role and capacities.

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