



Financing Africa's Cities

The Imperative of Local Investment

Thierry Paulais



THE WORLD BANK

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Contents

<i>Acknowledgments</i>	<i>xvii</i>
<i>About the Author</i>	<i>xix</i>
<i>Abbreviations</i>	<i>xxi</i>
Introduction	1
Notes	6
Bibliography	6
1 Financing Local Investments: A Review of Fundamentals	7
Defining the Concept of Local Investment	7
Different Ways of Financing Local Investment	13
Specific Financing Products and Techniques	19
Climate Change and New Financing Mechanisms	24
The Economy and Financing of Public Sector Local Investment	28
Selecting a Local Investment and a Strategic Framework	33
Governance and the Contractual Approach	36
The Importance of Financial Analysis	42
Some Lessons from the 2008 Financial Crisis	50
Notes	58
Bibliography	58
2 Urbanization and Sectoral Policies in Context	63
Africa(s) on the Move	63
A Perspective on Demographics and Urbanization	68

Still-Underestimated Challenges and Exploitable Opportunities	72
The New Challenge: Climate Change and Its Consequences	80
The Land Access Question	83
Land Development and Housing	88
Estimating the Amount Needed for Local Investment	96
Notes	102
Bibliography	103

3 Decentralization, Basic Services, and Local Governance 109

A Perspective on Decentralization	109
Local Governments' Institutional Landscape	112
An Attempt to Estimate Local Governments' Financial Capacities	117
The Challenge of Managing Basic Services	124
Local-Level Governance and Implementation Capacity	133
Fragile Situations, Fragile Cities	138
Notes	143
Bibliography	144

4 Investment Financing Frameworks and New Funding Mechanisms 149

Local Government Financing Systems	149
Financial Systems and Investment Financing	152
Development Banks and Regional or National Development Finance Institutions	158
Financing Tools and Mechanisms for Local Capital Investments	161
Overview of Public-Private Partnerships on the African Continent	169
Philanthropic Foundations	172
China and Other Emerging Countries	174
Sovereign Wealth Funds and Investment Funds	177
Carbon Finance	179
The Stakes Surrounding Migrant Remittances	182
Microfinance and the Missing Link of Meso-Finance	184
Notes	188
Bibliography	190

5 Outlook for 2030–50: Which Road Map(s)? 197

- Two Imperatives: Changing Scales, Changing Paradigms 197
- Empowering Local Governments 199
- Encouraging Endogenous Financing 201
- Bolstering Investment-Financing Tools 203
- Modernizing Financing Systems 210
- Using Capital Markets 215
- Mobilizing Credit Institutions 220
- Toward a New Generation of Local Investment Funds 222
- Legislative and Regulatory Infrastructure for Subsovereign Debt 228
- Using Land and Land Development to Finance the City:
An Inevitable Evolution 233
- Increasing Resources and Commercial Activity
by Leveraging Housing 240
- A Special Initiative for Fragile Cities 246
- By Way of Conclusion 249
- Notes 252
- Bibliography 255

Appendix: Case Studies: Eight Countries Paired with Their Financing Tools 261

- About This Selection of Cases 261
- 1. Cape Verde and Commercial Banks 263
- 2. The Arab Republic of Egypt, the National Investment Bank,
and Land-Based Financing 269
- 3. Ghana and the District Development Fund 276
- 4. Morocco and the FEC 281
- 5. Nigeria and the Urban Development Bank 288
- 6. Senegal and the ADM 296
- 7. South Africa and DBSA, INCA, and Direct Bond Issues 302
- 8. Tunisia and the CPSCL 311
- Results: An Attempt to Characterize Countries and Their Tools 317

Index 323

Boxes

1.1	The African Development Bank's Overall and Urban Strategies	12
1.2	Partial Guarantees: The Development Credit Authority Example	23
1.3	Adam Smith on Public Investment	30
1.4	Seeking a Virtuous Circle	36
1.5	Six Key Components of Governance	37
1.6	The Millennium Challenge Corporation's Key Indicators	39
1.7	Corruption and Local Governments	40
1.8	City Contracts Support Financial Turnarounds in Tunisian Towns	42
1.9	Factors Affecting a Local Government's Credit Rating	45
1.10	Spotlight on the Credit Rating Agencies	49
1.11	Dexia: A Return to State-Owned Status	53
1.12	Spain's Housing and Development Policy	55
1.13	An Infrastructure Investment Bank for the United States?	57
2.1	Africapolis: Lessons from a Standardized Urbanization Measurement Tool	70
2.2	Different Definitions of Urbanization in Tanzania	71
2.3	Is Urban Poverty Underestimated?	73
2.4	Poverty Reduction Strategy Papers Underrepresent Urban Issues	75
2.5	UN-HABITAT Report on the State of African Cities	76
2.6	A Basic Lesson in Urban Economy from Kinshasa	79
2.7	Floods and Their Relationship to Land Use	82
2.8	What Are "Informal" or "Illegal" Settlements?	84
2.9	Diverse Ways of Acceding to Land in Neo-Customary Systems	85
2.10	An Example of the Way Land Grabbing Occurs	89
2.11	An Analysis of Land Market Failures in Algeria	90
2.12	Lost Opportunities in Tanzania	91
2.13	Housing Policy and the Formal Sector Share of Housing Production in Cameroon	92
2.14	Forty Years of Housing and Land Development Policies in Côte d'Ivoire	93
2.15	The Rental Market in Tanzania	95

2.16	Long-Term Leases and Land Value Capture in Ethiopia	97
2.17	The Africa Infrastructure Country Diagnostic	98
3.1	South Africa's Experience with the Demarcation Act	113
3.2	A Typology of Powers Devolved to Local Governments	115
3.3	A Chronology of Measures That Reduced Municipalities' Roles in Kenya	118
3.4	The Evolution of Local Governments' Basic Services Management	119
3.5	A Typical Institutional Arrangement for the Urban Water Sector	125
3.6	South Africa's Free-Water Policy	126
3.7	Small Private Sector Water Distributors in Maputo	128
3.8	Marginalizing a Municipality: A Water Sector Example	129
3.9	Addis Ababa and Problems with Waste Management	130
3.10	Lomé: A Local Government Loses Control over Its Territory	132
3.11	Chieftdoms and Local Powers in Ghana	135
3.12	Stakeholders' Positions and Actions in Ouagadougou in 2006	137
3.13	Refugees in Urban Areas	139
3.14	It's Not My Problem; You Figure It Out!	141
3.15	Private Sector Initiatives in Somalia's Forgotten Towns	142
4.1	Sharing the Value Added Tax in Morocco	151
4.2	South Africa's Intergovernmental Fiscal System	152
4.3	Donors' Bond Issuance in African Capital Markets	157
4.4	Changes in Universal Banks and Development Banks in North Africa	159
4.5	The Municipal Development Agency: Seeking a Virtuous Circle	165
4.6	The City of Johannesburg's Bond Issues from 2004–10	166
4.7	Lagos State Bond Issues from 2008–10	167
4.8	An Example of Subsovereign Hybrid Financing: Ouagadougou	169
4.9	InfraMed: A Parapublic Investment Fund	179
4.10	Carbon Finance and Solid Waste: Managing Uncertainty	181
4.11	Meso-finance: The Missing Link	187
5.1	Indonesia: Decentralization Support Using an Output-Based Aid Mechanism	201

5.2	A Feasibility Study and Business Plan for a Specialized Municipal Financial Institution	206
5.3	Are Regionally or Continentally Focused SFIs Outdated Concepts?	208
5.4	Modernizing Local Investment Infrastructure: Mexico's Example	212
5.5	State Bond Banks in the United States	218
5.6	Syndication and Market Access: India's Water and Sanitation Pooled Fund	219
5.7	A Specialized Financial Institution Using Commercial Banks in Colombia	221
5.8	State Revolving Funds in the United States	223
5.9	Green Finance: A Comprehensive and Experimental Approach in Amman	225
5.10	Urban Development Investment Corporations in China	228
5.11	Local Development Investment Funds in Vietnam	229
5.12	Colombia's Land Betterment Levy	238
5.13	A Simplified Land Register for Tax Purposes	242
5.14	Support for Builders and Housing: South Africa's NURCHA	244
5.15	Joining Housing-Land Development and Public-Private Partnership in Morocco	245
5.16	JESSICA: Europe's Fund of Funds	248
5.17	Highly Labor-Intensive Work and Implementing Agencies	249

Figures

1.1	Project Ownership: Principal Project Types and Responsibilities	9
2.1	Population Growth in Africa	69
A.1	Countries Positioned According to Market Size and Decentralization Level	318

Maps

1	Africa's Regions as Defined in This Volume	3
2.1	Africa's Cities and Principal Ports	77
2.2	Four Main Types of Climate-Change Risk	81

Tables

2.1	Sub-Saharan Africa's GDP and Population Growth Rates, 1998–2008	66
2.2	Africa's Projected Urban Population Growth, 2010–30	68
2.3	Macroeconomic Approach: Urban Investment Needs	101
2.4	Base-Costs Approach: Urban Investment Needs Based on Service Levels	101
3.1	Local Governments' Institutional Landscape by Major Region	112
3.2	Distribution of Urban Dwellers by Size of City	115
3.3	Share of Local Government Budgets in Relation to the Gross National Budget and GDP, 2010	120
3.4	Top 10 Countries for Local Public Finances, 2010	121
3.5	Estimates of African Local Governments' Borrowing Capacities	123
4.1	Simplified Typology of Specialized Financing Tools for Local Investment	163
4.2	Public-Private Partnerships on the African Continent by Sector, 1990–2009	170
4.3	Public-Private Partnerships on the African Continent by Sector, 1990–2009 (percent)	170
A.1	Cape Verde: Key Indicators	263
A.2	Egypt: Key Indicators	269
A.3	Ghana: Key Indicators	276
A.4	Morocco: Key Indicators	281
A.5	Nigeria: Key Indicators	288
A.6	Senegal: Key Indicators	296
A.7	South Africa: Key Indicators	302
A.8	Tunisia: Key Indicators	311
A.9	Types of Investment Financing Tool by Country	317

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About the Author

Thierry Paulais is an urban planner and an economist. He earned an architecture degree, an advanced degree in urban planning, and a Ph.D. in economics from the University of Paris X. Paulais started his professional career in various civil engineering offices. He later worked as a consultant with firms in France and in more than 20 other countries, where he advised local governments on economic analyses and financing strategies for capital investments. He then joined the Caisse des Dépôts et Consignations (CDC), a French financial institution that uses its deposits to invest in public housing and urban land development, among other activities. At CDC, Paulais headed a team in charge of a credit line and urban project loans for municipalities in financial straits; this urban policy work covered mainland France and its overseas territories. In 2000, he joined the Agence Française de Développement (AFD), France's public development finance institution. There, he created and managed the Urban Development Division, which specializes in municipal finance in North Africa, Sub-Saharan Africa, Southeast Asia, and the Middle East. In 2008, Paulais joined the Cities Alliance secretariat in Washington, D.C., to lead a research and publishing program centered on financing African cities. Paulais then returned to Paris and AFD and was appointed deputy director of the Sub-Saharan Africa Department in 2012. He is an author or co-author of several books on the economics of housing, urban development, and urban investment financing.

Abbreviations

ADL	Local development agency (Senegal)
ADM	Municipal development agency (Senegal)
AFD	Agence Française de Développement
AfDB	African Development Bank
AGETIP	Employment agency for labor-intensive public works (Senegal)
AICD	Africa Infrastructure Country Diagnostic
BDEAC	Central African States Development Bank
BOAD	West African Development Bank
BOT	Build-operate-transfer
BRVM	West African Regional Bourse
BVMAC	Central African Stock Exchange
C2D	Debt Cancellation and Development Contract (France)
CDM	Clean Development Mechanism
CEMAC	Economic and Monetary Community of Central Africa
CFA	West or Central African franc
CFAA	Country Financial Accountability Assessment
CIF	Climate Investment Fund
CO ₂	Carbon dioxide
CPSCF	Loan and Support Fund for Local Authorities (Tunisia)
CTF	Clean Technology Fund
DACF	District Assembly Common Fund
DBSA	Development Bank of Southern Africa
DCA	Development Credit Authority
DDF	District Development Fund
EIB	European Investment Bank
ERDF	European Regional Development Fund

ERPA	Emission Reduction Purchase Agreement
EU	European Union
FDD	Decentralization Endowment Fund (Senegal)
FEC	Municipal Infrastructure Fund (Morocco)
FECL	Local Capital Development Fund (Senegal)
GAVI	Global Alliance for Vaccines and Immunization
GDP	Gross domestic product
GNP	Gross national product
GSE	Government Sponsored Enterprises
HDI	Human Development Index
HFIC	Ho Chi Minh City Finance and Investment State-owned Company
HIPC	Heavily Indebted Poor Countries
HUD	Department of Housing and Urban Development
HIV/AIDS	Human immunodeficiency virus/ acquired immunodeficiency syndrome
IFC	International Finance Corporation
IMF	International Monetary Fund
INCA	Infrastructure Finance Corporation Limited
LAMATA	Lagos Metropolitan Area Transport Authority
LDIF	Local Development Investment Fund
MDG	Millennium Development Goal
MFA	Municipal finance authority
MFI	Microfinance institution
MFMA	Municipal Finance Management Act
NGO	Nongovernmental organization
NUCA	New Urban Communities Authority
NURCHA	National Urban Reconstruction and Housing Agency
OBA	Output-based aid
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PEFA	Public Expenditure Financial Accountability
PPP	Public-private partnership
PRSP	Poverty Reduction Strategy Paper
SADC	Southern African Development Community
SFI	Specialized Financial Institution

SONEDE	National water production and distribution company (Tunisia)
UDBN	Urban Development Bank of Nigeria
UDIC	Urban Development Investment Corporation
UEMOA	West African Economic and Monetary Union
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNHCR	UN High Commission for Refugees
UNESCO	United Nations Educational, Scientific and Cultural Organization
USAID	United States Agency for International Development
USD	United States dollars
VAT	Value added tax

All dollar amounts are U.S. dollars unless otherwise indicated.

Introduction

African countries confront vast economic, social, and environmental challenges. Although urban issues bear upon many of these challenges, they have remained a secondary priority for governments and the international community. Yet the African continent is experiencing the world's highest rate of urban expansion; the next 20 years will see more than 300 million new inhabitants in cities. Accommodating that scale of population increase would be comparable to building—within two decades—new cities large enough to house the entire present population of the United States. Africa's massive urbanization will necessarily increase the importance of urban issues and their financing in public policy.

These additional urban residents will add new demands for capital investment to accumulated infrastructure, facilities, and basic services backlogs—dysfunctions that hamper the productivity of African economies as do energy shortages and poor roads. Urban underinvestment is not a new phenomenon. Since the 1980s, African central governments and the few donors engaged in the urban sector have focused their efforts on decentralization and good governance. Their strategy aimed at a virtuous circle of perennial growth—an outgrowth of increasing, regular, and predictable central government transfers to local governments; development of local tax systems and revenues; improvement of management and managerial skills; and spending of donor funding. However, despite undeniable progress and success stories, and a declared consensus on decentralization's virtues, this eminently laudable approach to urban issues has proven insufficient. For a majority of citizens, infrastructure coverage, basic services, and living conditions have continued to degrade in most cities, to a sometimes tragic degree—especially in Sub-Saharan Africa.

The growing gap between infrastructure and services already built and those needed demands a drastic change in the scale of urban financing. As national and local governments, together with their supporters in the international community, pursue efforts to increase local governments' solvency and investment capacity, they must also rethink their forms and systems of financing urbanization. This book aims to begin that reexamination. It offers a broad methodological perspective and several operational avenues to bolster and modernize the financing that cities urgently require.

The financing of urban investments involves several aspects of local government fiscal matters: public finance, administrative law, taxation, monitoring and controlling of subsovereign debt, urban administration and governance, and so on. It also involves other sectors, such as land management, land development, and housing. These local systems and sectors constitute extremely broad fields of study that cannot be fully addressed in this volume; they will appear here as relevant, particularly when they exercise a direct effect on investment financing.

From many points of view—institutional, economic, sociological, cultural, and geographical—Africa is a highly diverse group of countries; it would be impossible to present exhaustive analyses or propose standardized solutions that would apply everywhere simply because they have succeeded in certain cases. Rather, we will insist that no experience presented in this volume may be transposed to another situation in exactly the same form. We must add that the subject's three constituents—investment, financing, and the city—are eminently cross-cutting themes. How we understand them depends on how we apply tools from different disciplines and different professions, with vantage points from different sectors of intervention, within diversely organized institutions that have different interests. This approach fosters divergences in methodologies and operational approaches, as well as in the definitions of terms. We will try to clarify current notions and provide perspectives on issues that remain controversial.

The conceptual and semantic difficulties begin with defining our geographic scope, because even the term *Africa* carries different meanings. For the United Nations and other institutions, such as the European Union, Organisation for Economic Co-operation and Development (OECD), African Development Bank (AfDB), and United Cities and Local Governments (UCLG), among others, *Africa* means the African continent. For the World Bank and a number of agencies and bilateral donors, such as Agence Française de Développement (AFD), Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), and others, *Africa* corresponds to Sub-Saharan Africa; North Africa belongs to a regional group known as the Middle East and North Africa (MENA) or to the Mediterranean,¹ depending on the given case and the countries included.

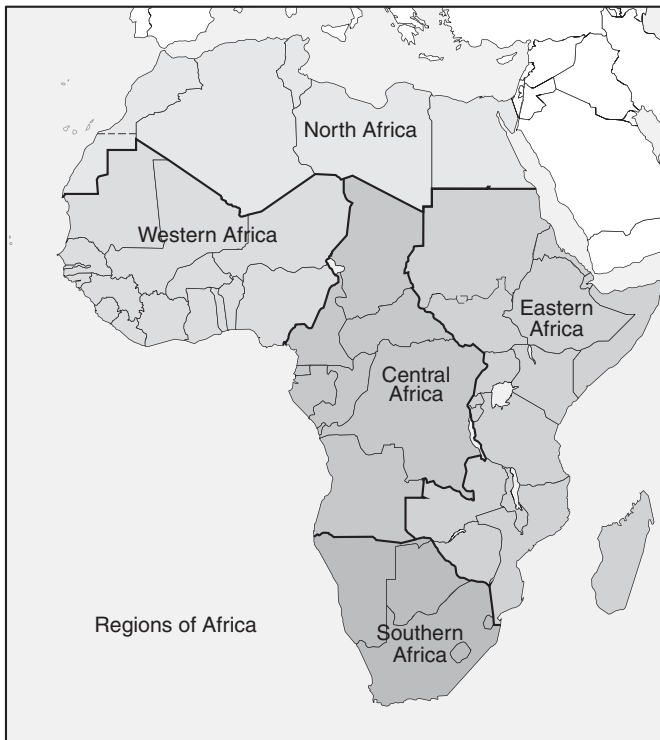
This book defines its geographic scope as two concentric circles within Africa, as described below. It also draws on other regions: the most developed or emerging countries outside the African continent that can furnish examples illuminating, or adaptable to, the African context. The book will refer to the first or second circle according to the subject under review and the data available:

- The first circle is Sub-Saharan Africa. This volume targets the least developed countries; consequently, even though South Africa is located within this circle geographically, it is considered a case apart because of its more advanced economy.

- The second circle includes the African continent (referred to as “the continent” or “Africa”) in its totality; this designation allows us to include the richest lessons from intermediate-revenue countries in the Maghreb (North Africa).

Definitions that refer to large regions of Africa are equally open to confusion. Various sources supply different descriptions for the areas commonly called Western Africa, Eastern Africa, or Central Africa, and so forth. This classification can result in a great deal of confusion, especially if we try to use data from different sources to draw comparisons or show evolutions. This volume will use the definition of regions adopted by the World Bank in *World Development Report 2009: Reshaping Economic Geography* (2009); it appears to be the best adapted to Africa’s geographic and economic realities (see map 1). The countries

Map 1 Africa’s Regions as Defined in This Volume



Source: Author, based on World Bank 2009.

assigned to each region are different than those assigned by the World Bank for administrative purposes, and also different from those assigned by the United Nations Human Settlements Programme (UN-HABITAT).²

This volume is organized into five chapters and an appendix containing eight case studies. Chapter 1 addresses fundamentals—the techniques and principles governing the field of financing local capital investments. We start by defining the term *local investment*. We describe a set of themes and methods central to operational practice—notions such as collective action and collective ownership, urban agglomeration powers, various ways of financing local investments, strategic planning, and financial forecasting. We also review financing techniques and relatively new or recent financing mechanisms, such as those related to climate change issues. We supply a synthesis of public investment economics and summarize debates about the relationship between economic growth and local investment and about the way economic theories legitimize and justify local government borrowing. We review investment analysis, selection, and strategic programming principles; the elements that constitute governance at the local level; and the operational aspects of a contractual approach. Chapter 1 further surveys the various forms of local government financial analyses and compares their relative relevance in each context. We conclude with some lessons from the financial and economic crisis of 2008 that directly relate to local investment issues.

Chapter 2 analyzes urbanization and sectoral policies across the African continent. We look successively at changes in Africa's economies, population sizes, urban growth projections, and the social and economic opportunities and issues raised by urbanization. We examine new human and economic challenges likely to arise from climate change and look at financing for adaptation and mitigation efforts. Chapter 2 also explains the key factors affecting the land question in Africa, which often constitutes the most consistent stumbling block for urban policies. We present an analysis of the land development and housing sectors, with their economic effects and dysfunctions. We further review different methods used to estimate funds needed for infrastructure investments and compare their results. We conclude by proposing estimates of the amount of funding needed, based on regional growth projections and different hypotheses about urbanization and basic services standards.

Chapter 3 is dedicated to Africa's decentralization, basic services provision, and local governance issues. We first situate the decentralization movement within an administrative, political, and budgetary perspective and then analyze the evolution of local governments' institutional landscape. We next estimate local governments' financial capacity and borrowing ability according to certain hypotheses. Chapter 3 also exposes the social and economic issues surrounding the organization, management, and financing of basic services. We examine

urban governance issues and the way they affect local governments' capacity to implement investments. Finally, we address the key concern of *fragile situations* across Africa, and propose a new variant, the *fragile city*.

Chapter 4 examines local governments' investment financing frameworks currently in use in Africa and new, recently emerged sources of financing. We present local government financing systems, financial systems, and municipal investment financing options. We go on to examine the role of banks and regional or national development finance institutions and the way their forms and roles could evolve. We then describe the range of available local financing tools and mechanisms, and we review public-private partnerships and their results from the past few decades—especially in urban environments—proposing a reading of how they may change in the future. We next describe the roles and respective importance of new and increasingly important donors, such as philanthropic foundations, emerging countries (China in particular), sovereign wealth funds, and other investment funds. We analyze how carbon finance and migrant remittances—two relatively new and growing sources of local investment financing—have proven both their importance and potential. We also provide a brief look at microfinance, whose institutions offer management and finance models that might serve as templates for local governments. We discuss an intermediate level of financing known as *meso-finance*; its still-tenuous growth could prove valuable, notably for financing small-scale, private property development and rental housing.

Chapter 5 addresses strategic and operational ideas for infrastructure and local investment financing, anticipating Africa's exceptional urban growth in the coming decades. We focus on Sub-Saharan Africa, beginning with three sections that focus on fundamental issues: "Changing Scales, Changing Paradigms," "Empowering Local Governments," and "Encouraging Endogenous Financing." This chapter crystalizes the analyses of chapters 1 through 4; we estimate investment requirements in relation to local governments' borrowing capacities, draw on lessons from the case studies, and define strategy elements. We then examine ways of bolstering existing financing tools and possible steps toward modernizing financing systems. We describe situations in which financing needs could be met by using capital markets and mobilizing credit institutions; we touch on problems in implementing new financing tools and outline various options, particularly in relation to the size of local investment markets. We propose using the latest generation of local investment funds, drawing on a set of examples from other continents. Chapter 5 also describes the characteristics of a legal and regulatory infrastructure for subsovereign debt. We detail the conditions under which land value capture and land-based development financing techniques could prove effective; recourse to such techniques, we argue, appears inevitable for financing Africa's urban development. We also propose

optimizing measures to leverage the housing sector, as a means to create economic activity and financial resources for local governments. We conclude with a proposal for a special initiative to help cities in fragile situations.

The appendix to this volume features eight concise case studies from Cape Verde, the Arab Republic of Egypt, Ghana, Morocco, Nigeria, Senegal, South Africa, and Tunisia. Rather than exhaustive, single-country studies of decentralization and local finances, these case studies are targeted to specific countries and their tools for financing local investment. The selected cases are arguably the most significant ones in Africa: they demonstrate countries' diversity with respect to investment market size, and they cover all the existing financing tools. The case studies conclude with a concise analysis, summarizing their principal lessons as applied to the analyses and proposals in other parts of this volume.

Africa's cities have the potential to serve as engines of much-needed economic growth, job creation, and social integration, as long as public policy adequately supports and organizes their growth. The 2008 financial crisis showed how closely urban housing, land development, and land management are interlinked with finance and the global economy. The subject of this volume, financing local investment, provides a common thread that allows us to approach and address many complex and vital issues for African societies.

Notes

1. Some countries, such as Mauritania and Djibouti, are grouped with either Sub-Saharan Africa or MENA depending on the institution using this geographic definition.
2. UN-HABITAT's 2008 and 2010 editions of *The State of African Cities* do not even use the same definition.

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Financing Local Investments: A Review of Fundamentals

Defining the Concept of Local Investment

The terms *local investment* and *urban investment* are usually used interchangeably. However, they mean different things, depending on their specific attributes and their user's point of view. *Urban investment* is commonly thought of as “capital investment in an urban setting” and refers to a city's physical or geographic aspects. This interpretation obscures the fact that some important urban infrastructure is located in rural areas—often quite far from the city—such as water catchment and purification stations that supply drinking water exclusively to an urban area. Sometimes, cities and rural areas share infrastructure. For example, a nuclear power plant may serve a large region, although the city or agglomeration for which it was built consumes most of the energy produced. A solid waste landfill (commonly called a “dump”) provides another typical example of a sometimes-shared infrastructure facility located far outside the city, its principal user; in many cases, a specific road must be built to access it.

Furthermore, the meaning of *investments* is often implicitly reduced to subgrade water, electricity, drainage, sewerage, or transportation infrastructure. *Urban investment* then means “subgrade capital infrastructure investments in an urban setting.” This interpretation obscures the fact that, for a city to function, its investments must also include above-grade superstructures, such as schools, dispensaries, and other public buildings and facilities. A city must also invest in land development—residential and commercial areas that, although not generally considered infrastructure in the strictest sense, nonetheless require large investments of capital. Most donors use the term *infrastructure investments*, which causes them to at least partially mask the need for investments in land development and public facilities.

Another meaning given to the term *urban investments* is “capital investments for which the city is responsible,” with the word *city* referring, in most cases, to the idea of an urban local government. This interpretation may be

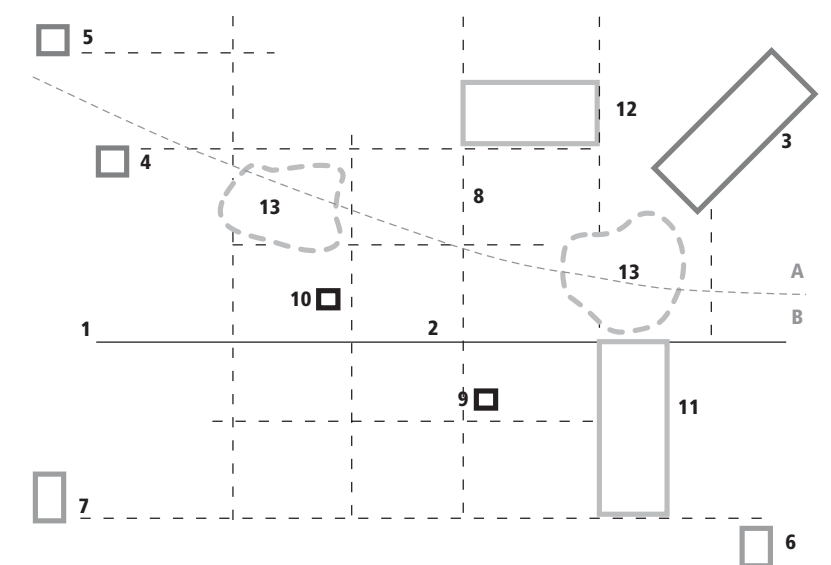
somewhat underused in Africa, where the local government's role remains limited. However, this sense of the term prevails in the most developed countries. It is progressively applied in situations in which the financial sector's level of development and the local governments' capabilities allow what is known as a *municipal credit market* to emerge, with loans and subsovereign borrowing. In this volume, we will most often use the interpretation "capital investments for which the local government is responsible" as the primary sense of *local investment* or *urban investment*. It refers to two other equally important concepts: project ownership and urban agglomeration authorities. A work—the physical investment—is made for a project owner, who orders and owns the work, or a share of it in the case of a collectively owned and managed project. In practice, these ownership functions may be delegated to another entity. In principle, the owner bears the project's financial costs, borrowing funds, if needed, to finance the work. In Africa, the nature of ownership for each type of urban investment varies from country to country, depending on the areas of authority granted to each local government by its institutional framework. In certain cases, a local government's remit is so reduced that thinking of local investment as the local government's responsibility proves meaningless in practice.

In some cases, the use of public-private partnerships to furnish basic services has probably contributed to this reduction of local governments' areas of authority. Centralized national services often arrange and manage service delegation contracts, impinging on local autonomy. A local government without delegating powers or concessional authority has no effective role in such arrangements, even though basic services constitute the best examples of local investments.

The coexistence of various meanings of *local investment* creates a number of misunderstandings and some confusion—particularly errors of omission or double-counting when estimating investment amounts. Figure 1.1 tries to provide a picture of all of the issues surrounding these definitions. It shows a purposely simplified theoretical configuration, using only two regional governments. In real life, stakeholders are increasingly confronted by complex situations that represent genuine governance and public policy implementation challenges at the local level. This ever-increasing complexity around ownership issues has, among other things, surfaced recently in the appearance of new concepts, such as *collective ownership* and *hypercollective action* (Severino and Charnoz 2008).

Collective Action and Ownership

Many economists have expanded on the concept of collective action, following Mancur Olson's foundational work on the production of public goods and game theory (Olson 1965). The term *hypercollective action* may be used in reference to the extreme complexity that characterizes international aid's latest evolution (Severino and Charnoz 2008). The health care sector provides a good

Figure 1.1 Project Ownership: Principal Project Types and Responsibilities

Investment	Index	Central government	Local government ^a	Operator ^b
Large-scale transportation infrastructure				
National road network (outside city)	1	▲		
National road network (crossing city)	2	△	△	
Airport	3	△		△
Fluids production				
Potable water	4			▲
Electricity	5			▲
Sanitation				
Solid waste landfill	6		△	△
Purification station	7		△	△
Smaller-scale infrastructure networks				
Roadways	8		▲	
Electricity, drainage, sewerage, and water distribution			△	△
Public lighting			△	△
Public facilities				
Major facility (for example, hospital)	9	▲		
Commercial facility (for example, market)	10		▲	
Social services facility (for example, school)			▲	
Development				
Industrial and commercial zones	11		△	△
Housing extension	12		▲	
Neighborhood redevelopment	13		▲	

Source: Author.

a. A or B on the diagram: municipality (or equivalent) or agglomeration structure, such as a district or urban community.

b. Operator: state-owned company, office, public-private company, lessee, chamber of commerce, and so forth.

▲ = majority of cases △ = depending on the case or a shared responsibility

illustration: health has become a global public good as massive pandemics—acquired immunodeficiency syndrome (AIDS), bird flu, H1N1 flu—have multiplied and tuberculosis and malaria have persisted. The least developed countries represent the weakest links in the epidemiological chain and require special assistance. The number of public, private, or parapublic agencies and organizations working on pandemic diseases in developing countries suddenly surged in 2000–10. They include the World Health Organization; UNITAID; the Global Alliance for Vaccines and Immunisation (GAVI Alliance); the U.S. President's Emergency Plan for AIDS Relief (PEPFAR); the Global Fund to Fight AIDS, Tuberculosis, and Malaria; the Joint United Nations Programme on HIV/AIDS (UNAIDS); the Bill and Melinda Gates Foundation; and the Pasteur Institute. Some of the new players have considerable financial means or benefit from specific financing mechanisms, such as the international air ticket tax.¹ However, what appears to constitute a high-performance coalition—more actors, more funding, and more innovative solutions—stumbles in practice because of organizational challenges. The health care sector's fragmentation and vertical integration result in mismatches, verging on incoherence; excessive, fragmented—and, at times, conflicting—offers of aid undermine recipients' capacity to absorb it. One of the coming years' prime challenges lies in building a global, coherent, and common policy from this diversity of stakeholders and agendas. Another challenge lies in consolidating governance systems at the local level capable of tackling comprehensive sectoral policies—not only for health care, but also for education, humanitarian assistance, and others (Severino and Charnoz 2008).

The concept of *collective ownership* emerged in Europe in the 1970s with the first urban renewal projects that updated postwar era social housing. Most often, the housing projects had been built using procedures and methods that received special waivers, because new construction was urgently needed and new execution techniques had become available. These shortcuts resulted in a tangle of rules and property systems on areas of land often administrated by several different entities. As a result, works in a single neighborhood of social housing often involve five or six different owners, each owning some constituent element of the urban ensemble. Owners may include the central government for a given type of infrastructure, two or three municipalities for the land, two or three public or private social-welfare donors for large housing projects or cooperatives, and so on. Each of the owners uses different funding sources of various types with different repayment schedules. Not one single thing can be done unless all of the affected owners agree to it. That is how the concept of collective ownership translates concretely; it signifies a type of operation that requires a huge coordination effort—one that entails extremely high transaction costs. This tangle of ownerships has inspired a new category of professionals who specialize in managing collectively owned projects (Géhin and Paulais 2000).

The twinned effects of urban population growth and urban sprawl's consumption of vast tracts of land have led to the appearance of *megacities*, metropolitan areas with populations of 10 million or more, and *urban corridors* where two or more megacities form a continuous chain. Cairo-Alexandria provides one example, as does the 600-kilometer Ibadan-Lagos-Cotonou-Lomé-Accra urban corridor. Urban growth and sprawl also create *urban regions* or *megapolises*, such as Greater Cairo or Gauteng, which includes Johannesburg. For the financing and management of shared investments, this type of urbanization poses familiar yet still-challenging problems; similar giant conurbations have long existed in developed countries. Conurbations that extend over several local territories sometimes boast cooperative governing bodies; however, the latter often lack a clear remit, financial means, legal status, or their own fiscal system.

The issues affecting setting up an urban agglomeration's authorities are not new, and various institutional solutions for them have been tried, as will be shown. But, as in the health care example mentioned earlier, the number of entities active in urban development and management—national offices, project execution offices, philanthropic organizations, national and international nongovernmental organizations, customary authorities, and so on—has grown only recently. Ownership dissolves in a sea of administrative entities superimposed on specific agencies, involving a great many stakeholders and atomized public powers, leading to various questions: Who can legitimately program, plan, coordinate, and make decisions about projects? Who owns and builds the infrastructure, facilities, or services? Who borrows, and who makes payments? This fragmentation of ownership often leads to increased difficulties in financing and implementing projects. Often, local municipal officials and authorities lose their legitimacy. In such conditions, there is a tendency for officials to turn to the central government, which is a threat to local governments' financial autonomy (Paulais 2006).

Collective ownership problems are rather specific to fundamentally cross-cutting and territorial urban issues, compared with other, more vertical sectors, such as water, electricity, transportation, and education. The resulting complexity of supervising urban projects results in longer timescales, higher transaction costs, often slow disbursement schedules, and high political and social risks. This situation probably explains why some donors waited before engaging in actions to support urban governance; at operational and organizational levels, it remains rather difficult for the city to coexist with donors' intervention priorities and sectors (see box 1.1).

Agglomeration Powers and Local Authorities

In general, a central government drives the consolidation of an urban agglomeration's powers into a single local administrative authority. The central government fulfills one of its roles, optimizing urban productivity and rationalizing

BOX 1.1**The African Development Bank's Overall and Urban Strategies**

The African Development Bank's (AfDB) medium-term (2008–12) strategy focused on four sectors: (1) infrastructure; (2) governance; (3) private sector; and (4) higher education.

- (1) *Infrastructure*. AfDB increased loans primarily for the transportation, power, and telecommunications sectors, seeking to ensure that these investments show demonstrable public benefit and help promote economic growth. It continued its focus on access to drinking water and sanitation services, while addressing the needs of Africa's growing peri-urban and urban populations.
- (2) *Governance*. AfDB focused on strengthening transparency and accountability in public resource management, with special attention to fragile states and natural resources management.
- (3) *Private sector*. AfDB focused on improving the investment climate, strengthening financial and banking systems, and supporting businesses.
- (4) *Higher education*. AfDB upgraded and rehabilitated higher-education facilities to improve conditions for scientific and technological innovation. It supported technical and vocational education and training programs to build skills and address chronic high unemployment.

AfDB complemented these four sectors of focus with special assistance for regional integration; fragile states; middle-income countries; agriculture; and cross-cutting themes of gender parity, knowledge management, climate change, and the environment.

In 2011, AfDB published its urban development strategy, after several years of preparation. The strategy is traditionally organized, anchored on three pillars: infrastructure and basic services delivery; governance and decentralization; and private sector development. The urban strategy includes several cross-cutting themes that reflect those promoted in AfDB's overall strategy.

Sources: AfDB 2008, 2011.

administrative systems. The central government can usually count on support from economic actors who happen to have the same interests. By contrast, local governments are often reluctant initially to cede their municipal authority to a larger agglomeration authority, either because they feel an existential threat or because they foresee a potential loss of autonomy and identity. Residents may have mixed feelings about the issue, depending on their socioeconomic status; they usually prefer the status quo, fearing some loss of their direct, democratic control.

The central government or local government officials may assign a number of objectives to the constitution of one or more agglomeration authorities: (1) optimizing services to residents and businesses; (2) coordinating all of each city's institutional actors and civil society stakeholders; (3) controlling spatial expansion; (4) giving the urban agglomeration a clear and strong identity, particularly for external investors; and (5) streamlining financing systems, facilitating borrowing, and redistributing resources equitably between the city centers and peripheries by establishing funding equalization and cross-subsidies.

Urban agglomeration authorities observed around the world show an evolution from division toward unification and from single to shared administrative units. Three forms can be identified: (1) subdivisions by level of jurisdiction, (2) functional divisions, and (3) voluntary cooperatives formed between neighboring urban governments (Bahl 2010). In practice, the most commonly seen form combines all three. For example, one or more parapublic companies complements a subdivision of jurisdiction; a subdivision of jurisdiction combines with a supralocal government, resulting in a two-tiered governance system, with or without shared financing; or a subdivision of jurisdiction combines with a strong central government presence via programs or sectoral entities, interventions by specialized public sector companies, or a financing system dependent on intergovernmental transfers (Bahl 2010).

A simplified typology featuring five main categories of urban agglomeration authorities can be drawn from an analysis of those in developed countries: (1) a merger of smaller local governments into one big government, such as that of the smaller governments that now compose Montreal or Toronto; (2) the creation of a larger local government entity for a metropolitan area, such as the Greater London Authority; (3) the transformation of an existing territorial authority, such as a regional one, into an urban agglomeration authority, such as the autonomous Community of Madrid; (4) the creation of an intergovernmental cooperative entity based on voluntary participation, such as the Urban Community of Lille; and (5) the creation of flexible, à la carte, project- or subject-driven forms of cooperation between local governments and public and private sector stakeholders (Simonneau 2007). The variety of solutions tried in recent decades and in different countries shows no single recipe for success when establishing urban agglomeration authorities. In practice, the solution adopted often results from compromise and pragmatic adjustments to the prevailing institutional and political context of each country and each particular case.

Different Ways of Financing Local Investment

Territorial governments finance urban capital investments in three main ways: with their own financial resources or borrowings, through public-private partnerships, and through land value capture.²

Local Governments' Own Financial Resources

Broadly speaking, local governments' financial resources draw on four sources: (1) intergovernmental transfers, such as grants from a higher-level territorial government or the central government, or from a national value added tax (VAT); (2) their own receipts, such as from business, property and housing taxes, patents, and revenue-generating facilities, and other income-producing sources; (3) external grants or subventions; and (4) borrowing. As a general rule, the central government dedicates its transfer payments and grants to municipal operating expenses. However, in some countries, the central government may designate a large share of central government or regional transfers specifically for municipal capital expenditures. This situation happens in Europe with Ireland and Italy, and may be equated with cases (frequently seen in Africa) in which the central government takes a sovereign loan from a donor and reassigns the funds to a local government in the form of a subvention. In such cases, the majority of funds target a specific investment or investment program, sometimes with an institutional component such as management support, technical assistance, or professional training.

Borrowing

Borrowing should be strictly reserved for capital investments: this rule is sacrosanct in most developed countries and primarily designed to avoid endless loan rollovers, especially with regard to inflated government expenditures prior to elections. However, in practice, some national statutes allow local governments to borrow for any purpose, as in Finland, Hungary, and Poland, for example. Many more nations authorize local governments to make short-term borrowings, for example, to meet cash-flow requirements. In this volume, borrowing is considered reserved exclusively for capital investments.

Borrowing may occur in one of two ways: (1) by taking a loan from a commercial bank or other specialized financial institution in a process known as *financial intermediation*, or (2) by issuing debt obligations (bonds), calling on the public's savings in a process known as *disintermediation* or *direct funding*.

Historically, the municipal credit market was considered specific and unusual. Whatever the system—with or without intermediation—for a long time, competition between potential providers was distorted by tax breaks, central government guarantees, legal protections, and access to subsidized funds. This remains largely the case in many countries. For instance, in the United States, interest income received by holders of municipal bonds is exempt from federal taxes and from many state and local taxes, and several public sector loan funds provide subsidized loans for certain types of infrastructure and services investments. In Europe, most countries have had (or still have) specialized municipal finance institutions that enjoyed a *de facto* monopoly on loans to local governments; these institutions also received highly preferential

terms, preventing competition from all other financing sources. This situation originated in central governments' desire to furnish long-term funds, often with subsidized, below-market interest rates, for local infrastructure investments; it also helped central governments control and supervise local governments' borrowings. The municipal credit market has only recently become completely commonplace in a limited number of countries, where local governments can freely borrow from commercial banks and specialized institutions via loans or from capital markets directly via bonds, either individually or in groups. Local governments can make lenders compete and may choose between direct or intermediated financing according to their best interests and the financing characteristics they require.

No objective reason to favor one system over the other appears evident. Direct financing has been presented as the ultimate stage in the system's evolution (IDB 2002), but this opinion hardly seems well founded. On the contrary, European countries show that bank-loan financing and bond issuance together furnish optimum efficiencies in a nondistorted market; competition drives rates lower, and borrowers can decide which type of financing is best suited for the type of investment planned. From a central government's perspective, both systems share the virtue of collecting and using local savings. In the least developed countries, direct municipal debt financing on capital markets is not widespread. Its viability depends on the existence of adequate legislative and regulatory infrastructure, sufficiently developed capital markets, and technically and financially adept bond issuers. In African countries, these conditions rarely coexist; developing this mode of financing represents a crucial challenge, not least for its potential to collect and transform local savings.³

Donors continue to play a preponderant role in the financing of capital investments on the African continent. In most cases, they provide financing to central governments or to ad hoc financial intermediaries, when present; the funds are then reassigned to local governments as a loan or a grant. In some cases, donors make central government-guaranteed loans directly to local governments. There are a few, very rare examples of what are known as *sub-sovereign* loans, which are loans without a central government guarantee made by donors directly to municipalities or other local governments. But for a few exceptions, commercial banks remain absent from the municipal credit market, and the number of local governments that have issued bonds can be counted on one hand. It should be noted that some countries' statutes prohibit local governments from borrowing. In many cases, the funds that local governments could borrow from a bank or raise on capital markets would have prohibitively expensive characteristics, such as high interest rates, short durations, no grace period, and so forth. In general, access to borrowing remains very limited in Africa, primarily because most local governments are insolvent or have too-weak or too-random repayment capacities. Commercial lenders see no market,

a too-risky market, or a market that costs too much to service. The option of gaining financing through land development remains limited to a few countries. Aspects of some of these points are further developed in chapters 4 and 5.

Public-Private Partnerships

Local capital investments can also be financed by public-private partnerships (PPPs). Partnerships involving concessions, and build-operate-transfer operations and their variants, revolve around revenue-generating infrastructure and facilities, such as telecommunications, electricity, airports, railways, tollways, and so forth. Under a partnership agreement, a private sector operator finances all or part of the investment, earns money from the revenue it generates, and eventually cedes ownership to the local government.

PPPs inspired great expectations at the beginning of the 1990s. After having dedicated many projects to improving public enterprises with little to show for their efforts, donors saw the appearance of the private sector as an opportunity to increase investment in infrastructure and services and a way to introduce the virtues of commercial enterprise management into public agencies. Fifteen or so years later, the results of infrastructure PPPs are mostly disappointing. Beyond the misfortunes of any given project and problems related to exchange-rate fluctuations in foreign currency, this relative disenchantment can be explained by governments, investors, and operators having underestimated the difficulties they would encounter. In sectors such as electricity and drinking water, institutional and rate reforms proved impossible. Business plans' economic viability was compromised; in many cases, private operators pulled out, but the structural problems remain (Harris 2003).

The results are even more disappointing when looking at PPPs in urban areas that involved local governments. There are few urban services for which the private sector can conduct genuinely commercial operations. Very often, regulatory requirements impose *de facto* subsidies on services that can be sold, such as water; rates are a politically sensitive subject. Most often, a private sector operator cannot recover investments in service extensions through user fees alone; public financing remains necessary (Annez 2006).

Furthermore, the 2008 financial crisis also hurt overall PPP results by causing funding to decline drastically. Many projects were frozen, including some in more profitable sectors, such as telecommunications and energy. In sectors closest to local investment, such as water, sanitation, and transportation, project activity declined about 40–50 percent by value and volume (Leigland and Russel 2009). On the African continent, urban sector PPPs remained relatively rare, concentrated in only a few countries. (We explore these points further in chapter 4.) Today, the PPP model has difficulty attracting investors and convincing municipal officials of its utility. A paradox resides in the fact that donors work against the PPP model automatically through their funding offers.

A private sector operator will have access to market-priced financing through these donors' private sector subsidiaries—such as the World Bank's Investment Finance Corporation, or the Agence Française de Développement's (AFD) PROPARGO (Société de Promotion et de Participation pour la Coopération Économique)—whereas a public sector operator will have access to subsidized or even highly subsidized financing, depending on the country or sector. This difference in financing costs alone would suffice to convince local public officials and operators that the public financing solution is best.

However, it does not appear that the PPP concept should be rejected as such. On the contrary, experience shows that introducing private sector methods to the public sector has generally had very positive effects on operators' service levels and management; this observation leads to promoting management mandates. Also, so-called second-generation PPPs emerge, configurations that include different types of partners, particularly local businesses. The conditions for this new model's success reside in the quality of contracts and in the trusting, long-term relationships between residents, local officials, and their private sector partners. Second-generation PPPs appear especially suitable for Sub-Saharan Africa, where municipal authorities often remain relatively weak; the private sector little-developed and mostly informal; and the residents poor, badly represented, and unheeded. These second-generation PPPs prove even more necessary because the relative failures of the past 10 or 15 years have resulted in a decline in service levels for basic services, especially in the urban periphery.

Land Value Capture

Land value capture includes very old mechanisms of municipal financing that probably date back to antiquity. In more recent times, western countries systematically used land sales, leasing, taxation, and land-use fees during the nineteenth century's industrialization period and its accompanying, intense urban growth; these mechanisms were also used during the 20th century for Europe's postwar reconstruction. Today, in Europe and the United States, land value capture mechanisms have been and remain central to municipal financing systems, especially for major investments.

Over the past two decades, the enormous urban growth seen in China was financed, for the most part, using land value capture mechanisms; the share of public financing, historically predominant, gradually declined to a very low level by the end of the 1990s. For example, in the city of Shanghai from 1995 to 2003, public financing represented only 2 percent of total investment costs. The balance was covered by bank loans (21 percent), foreign borrowing (12 percent), and, in particular, two mechanisms based on land sales: collective funds, that is, prepayments by future users (19 percent); and locally collected, self-raised funds from the sale of developed land (46 percent) (Lorrain 2008). Chinese cities created ad hoc companies in charge of land development and

financing. They sold developed lands to operators and users of industrial or commercial zones and economic facilities, such as warehouses, plants, retail stores, and housing developments. The financial gains were reinvested in transportation and communications infrastructure, fluids (drinking water, electricity, drainage, and sewerage), and further land development. In other words, the city finances the city.

These sales and leasing mechanisms, allowing public agencies to finance their operations by capturing value from lands they “create” from raw land, function optimally when central or local governments own or control the land. Land-based financing mechanisms prove particularly well suited to high urban-growth situations where the amount of money required to meet investment needs is so large that the traditional public financing model proves inadequate. Sales and leases generate immediate revenues; consequently, they are particularly well suited to executing large capital investments. As with funds raised through borrowing, the sacrosanct rule remains that the local government’s use of land sales and leasing revenues should be restricted to investing in the asset and not be spent on current expenditures; failure to follow this rule introduces the risk of feeding a financial bubble (see, for example, box 1.11 later in this chapter). As with any other public policy, but even more particularly because of the large amounts of money at stake and the potential revenues, land value capture operations carry their share of risk for corruption, abuses of power, and rent-seeking behavior (Peterson 2009).

Land sales are efficient when economic growth is strong. They cannot continue in the long term, however; the market is not infinitely expandable. Land sales are suitable for launching an investment process, but not for sustaining operating budgets. Sustainable sources of financing must be sought through other land value capture techniques. Land development operations widely use a simple mechanism that features direct contributions from property developers. Developers must build, at their own cost, all or part of the public infrastructure and facilities they have won the right to develop. This same principle operates in a land development or a concession development PPP, in which the property developer is an investor, and not just a contributor. These mechanisms operate through contracts between operators and the municipal authority awarding the land or concession; such contracts remain central to municipal finance systems in many European cities (Pelcran and Bonamy 2007).

Other tools for financing cities via land value capture evolved from the observation that, in many cases, a public agency executing major investments, such as transportation projects, considerably increases adjacent land values—a situation that generates an unearned gain for land owners. The challenge for a local government resides in recouping at least part of the value gained for a return on its investment. One option is for the public agency to purchase land in advance (if not already publically owned) that will benefit from the completed

infrastructure. The agency can then resell the land at market value on project completion, when the works begin operation. Several cities—on different continents—building public transportation systems currently implement this financing method, or one of its many variations (CODATU 2009).

Other options to recover an investment's value include indirect means, such as specific or general taxation. The impact fee used in the United States provides the best example of a specific tax: municipalities levy the tax once on every development project in a given district. Considered a portion of the locality's investment effort, the impact fee tax rate varies depending on a project's nature and purpose, and developers pay the tax in advance. By contrast, general taxation mechanisms seek to maximize regular tax receipts over the long term; examples include tax increment financing and special assessment in the United States and value increment financing and betterment levy in Australia (see another example in chapter 5, box 5.12, in this volume). Introducing a tax on gains in property values provides the local government with a solution that follows the logic of recouping its investment's value; in practice, the variability of the gain and the difficulty estimating it prove to be hurdles (Dye and Merri-man 2006; CODATU 2009). With a few exceptions, African countries do not use these methods of financing investments through land value capture. Ironically, many countries hold appropriate land rights to use these financing means; the central government often owns the land. Considering the current rate of urbanization and the scale of needed investment, local governments certainly have much room to improve in this area.⁴

Specific Financing Products and Techniques

In the following paragraphs, we summarize some of the relevant but possibly unfamiliar techniques and products used in many countries to finance local capital investment.

Specific Funding Mechanisms

Four specific funding mechanisms appear likely to be used frequently, or at least usefully, in most African situations: (1) hybrid loan, (2) revolving fund, (3) output-based aid, and (4) loan buy-down.

The *hybrid loan* results from a subvention within a loan. This is also the definition of a subsidized or *concessional* loan, in which a grant element reduces the loan's interest rate. A specialized financial institution or a local government-targeted financial vehicle may hybridize a loan. Loan hybridization has two objectives: leveraging the subsidy amount and promoting a borrowing culture. For example, a specialized financial institution with access to refinancing via subsidized loans and grants from donors and the central government may

hybridize these two sources, or it may use funds raised on capital markets. The goal is to create the largest amount of funding possible and to adjust its terms—cost, duration, and grace period—to the locality's financial capacity and the nature of the investment.

The *revolving fund*, as its name suggests, uses repayments on previous loans and new funds for its periodic replenishment. This model has been used by states in the United States since the 1980s—for example, via grants to states from the federal Environmental Protection Agency. Each state created a Clean Water State Revolving Fund; the fund hybridizes federal grants with funds raised from the market to create subsidized loans for local governments making a specific type of investment, such as reducing water pollution. Reimbursement of these loans replenishes the fund, as do regularly scheduled federal grants. The revolving fund has been extended to include investments in drinking water, involving the private sector. The states have increased their financing capacity by highly leveraging renewable funds—for example, using the funds to backstop loan guarantee funds as a means of improving financing terms from commercial banks.

Output-based aid, also known as *results-based aid*, is an incentivizing mechanism that operates retroactively on the basis of actual investments. Output-based aid is well suited to basic services projects at the city level. For example, to encourage operators to expand utilities in peripheral areas, the lender—governments—may incentivize operators with subsidies to reimburse investments whose existence the local government can duly verify. This kind of results-based aid may also be used as part of a national program to encourage a group of local governments to implement a particular type of investment (see chapter 5, box 5.1). The reimbursement subsidies may be paid via mechanisms such as revolving funds.

The *buy-down* is a hybrid lending model incorporating output-based aid principles. Lenders may reduce or cancel the interest on a loan, and may convert all or part of the loan into a grant based on the performance actually achieved by a project or a program, with regard to its original, measurable objectives. If the borrower does not achieve the projected results, the loan and its terms remain unmodified. Ideally, lenders implement such a mechanism with loans that have highly concessional (below-market) interest rates and grace periods. The latter allows time for the lenders to evaluate results before the loan enters its capital reimbursement phase. This financial product pairs well with a revolving fund. It offers a subsidy and promotes accountability: what is at stake is less the availability of funding than the amount the recipient will pay for it.

Credit Enhancement Principles

Credit enhancement increases a lender's perceived level of security by reducing a borrower's credit risk, which a financial analyst has determined by assessing a

borrower's credit-worthiness (in this chapter, see the section titled, "Importance of Financial Analysis"). In the United States, external credit enhancement has become a profession of its own, exercised by a type of institution called a *bond insurer*. The credit-enhancement mechanism works as follows: the bond insurer, having a very good credit rating because of its strong capitalization (AAA is the highest rating), offers to guarantee a more lowly rated local government's borrowings. In this way, a B-rated city has access to an A credit rating, resulting in much lower borrowing costs. The savings allows the city to offset the cost of the premium it must pay to the bond insurer for its guarantee. Bond insurers' activity enjoyed a very favorable national regulatory context for many years; however, the 2008 financial crisis severely affected bond insurers (in this chapter, see the section titled "Some Lessons from the 2008 Financial Crisis") without discrediting the principle of credit enhancement.

Donors can provide a type of external credit enhancement that may prove crucial in countries where local government financing remains weak or nonexistent and commercial lenders must be encouraged to enter the market. Used wisely, this credit enhancement probably provides the most effective solution to build well-structured and sustainable subsovereign credit markets. Otherwise, donors who create specialized financial institutions or provide direct guarantees most commonly cause two indirect consequences: they shut out banking market players and stifle the possibility that direct municipal debt-financing activity on local capital markets will emerge.

In principle, credit enhancement implies an irrevocable commitment and unquestionable repayment. This commitment may fall into one of two broad categories: (1) internal, in which the borrowers provide their own guarantee via some form of collateral, or (2) external, in which a third party intervenes with a guarantee. For internal credit enhancement, local governments may pledge their own property as collateral. This mechanism may be used only in countries where land and housing markets are well established; it also presents a number of corruption risks. Alternatively, local governments may pledge guaranteed future income, such as intergovernmental transfer payments. This mechanism may be used only in countries where central government transfers provide cash flows secured by unambiguous legal and regulatory frameworks, and the central government authorizes the practice. Pledging future revenues means that the local government will pay them out in mandatory spending or through direct withholding *intercept* transfers.

In developing countries, guarantee activity is usually the donor's responsibility. In the local government sector, a donor primarily intends its credit backstop to be support for establishing a local market for subsovereign borrowing. In the following two sections, we look more closely at two forms of credit enhancement: (1) collateralization of future revenues through withholdings and (2) external guarantees.

Credit enhancement by intercept agreement Intercepting or withholding guaranteed revenues, such as central government transfer payments, provides a source of credit enhancement that a local government may highly leverage in certain configurations. For example, we may look at a B-rated local government that wants to borrow. Central government transfers provide its primary financial resources; the central government is rated A. Normally, the central government's A-rated transfer payment is immediately downgraded to B as soon as the payment is credited to the local government's account. The direct withholding via an intercept transfer mechanism allows the transfer's A rating to be preserved because it will be used before it is credited to the local government's budget. Thus, with exactly the same payment capacity (the transfer), the locality has a greater borrowing capacity with the intercept mechanism than without it.

However, the intercept mechanism does not always meet this objective and presents a number of disadvantages and negative effects. In many cases, intercepts simply meet a lender's desire to hedge risk; they do nothing for the local government, especially when the lender is a donor or specialized financial institution. The intercept agreement has effects similar to those of a central government-guaranteed loan; it may eventually result in the disempowerment of a local government, divesting it of its resources and ultimately preventing a genuine, subsovereign credit market from maturing.

For these reasons, it may be advisable for central governments and lenders to use the intercept transfer mechanism solely for local governments in default. To empower all parties, the central government may use transfer payment withholdings to penalize a defaulting local government (Painter 2009b).

Credit enhancement by guarantee A total guarantee is the most common form of credit enhancement in the most developed direct municipal credit markets; in the United States, bond insurance companies provide such guarantees (in this chapter, see the section titled "The Municipal Bond Market and the Sinking of the Bond Insurers"). Total guarantees cover both principal and interest, regardless of the cause of a default. In developing countries, only central governments grant total guarantees, for example, for a donor's loan to a specialized financial institution or even for the loans granted directly to local governments (the latter improperly called subsovereign loans, because the sovereign actually guarantees them).

A partial guarantee is an arrangement in which the loan guarantor shares default risk with the lender based on predetermined terms and conditions. The loan guarantor aims to reduce the risk to a level acceptable to the lender, thereby helping the borrower get a more affordable loan. Partial guarantees come in two types: credit guarantees and risk guarantees. A partial credit guarantee will cover a portion of an unreimbursed loan regardless of the cause of the default, and a partial risk guarantee will cover a portion depending on the reason for default, such as political risk.

A partial guarantee has numerous advantages over a central government guarantee. The guarantor and the lender, staking their own capital, will exercise special vigilance when analyzing a borrower's financial situation and when monitoring the borrower's evolving financial situation and its use of the loan. Partial guarantees thereby ensure an empowering process that allows local banking institutions to learn about the specialized municipal credit market. Experience shows that the guarantee's coverage level can be gradually reduced and can eventually disappear (Painter 2009a).

The partial guarantee can be an effective tool for gradually structuring a market for subsovereign debt. Most major donors have created specific entities to guarantee private sector loans. However, transactions involving loans to local governments remain relatively uncommon; the U.S. Agency for International Development (USAID) has pioneered the field, alone so far (see box 1.2). The use of partial guarantees as a means of structuring the local municipal credit market is revisited in chapter 5.

BOX 1.2

Partial Guarantees: The Development Credit Authority Example

The Development Credit Authority (DCA) was created in 1999 by USAID to mobilize local private capital by establishing a risk-sharing mechanism that unlocks companies' private capital for loans to any sector and that facilitates debt financing for urban development, particularly water, sanitation, solid waste, and transportation projects.

The partial guarantee seeks to solve a major problem: risk-averse domestic banks do not understand the municipal credit market. Although domestic banks often have much cash on hand, they grant only short-term loans—unsuitable for urban infrastructure projects—at high interest rates. The partial guarantee compensates for the local lender's lack of experience to some extent, by offering to share the risk of financial loss.

As a general rule, a partial guarantee never covers more than half of a project's cost; covering a larger share would cause significant distortions in the local financial market. It would also contradict the guarantee's objective: inducing the local lender to take risks, and to learn how to analyze these risks, when providing long-term financing for urban investments.

The DCA's experience shows that provision of partial guarantees merits further implementation for projects supporting decentralization and national-scale infrastructure investments. The amount of the guarantee may be adjusted to market size, projected investment amounts, and anticipated loan commitments. By the end of 2009, the DCA had guaranteed a total of \$1.83 billion in loans in all sectors, including approximately \$490 million for urban development and housing.

Source: Painter 2009a.

Cross-subsidization

In general, cross-subsidization occurs when goods and services sold above cost finance goods and services sold below cost. It is difficult to find a rigorous economic definition of the cross-subsidy concept; it has so many different meanings. In deregulated systems, economists and market participants denounce cross-subsidization when financial flows considered external to the market distort competition. Examples would include monopoly situations in which an operator uses cross-subsidization to prevent a potential competitor from entering a market segment, such as an electricity distributor who sells at a loss to consumers by using gains made from sales to manufacturers.

Cross-subsidization is an old concept for urban development and basic services pricing (see box 1.3 later in this chapter). For example, the land development industry has used the concept to produce improved land destined for working-class housing: within the same development operation, developers sell land for luxury housing at a high margin and use the profits to sell working-class housing below cost. This technique may be considered legitimate if it has a redistributive effect without causing market distortions. Economists and market participants generally find it inappropriate to use cross-subsidies between two different types of operations, such as developing both commercial activities and housing, to avoid the risk of creating exclusionary effects.

The pricing of basic services is an area in which cross-subsidization has also been used for some time. For example, water rates based on consumption increments result from this concept. The biggest water consumers—the wealthy—pay above cost for each cubic meter, thereby financing water consumption for the smallest consumers—the poor—who pay below cost or even nothing at all in some countries (see chapter 3, box 3.6, in this volume). Practically all countries cross-subsidize public services; for instance, a stamp's cost remains the same across an entire country.

We note that in many African countries, cross-subsidization sometimes works in reverse: the poor subsidize the rich. It is common in the fluids sector—drinking water, electricity, drainage, and sewerage—because of weaknesses in distribution systems and nonprogressive or even regressive pricing (in chapter 3, see section titled “The Challenge of Managing Basic Services”). Cross-subsidization also occurs when elites can purchase urban land at a low price and build highly profitable property portfolios, reaping capital gains and rents from the property while the poor pay rent and live in insecurity.

Climate Change and New Financing Mechanisms⁵

Responses to climate change fall into two categories: mitigation, as in reducing greenhouse gas emissions, and adaptation, as in adapting to the effects of climate change. The amount of investment required for mitigation and

adaptation efforts is subject to very rough estimates. In terms of mitigation, according to the prudent assumptions of emissions reduction levels and the largest emitters' contributions to mitigation efforts, developing countries need to spend from \$80 billion to \$500 billion annually. Adaptation requirements, depending on the source and calculation method, range from \$10 billion to \$90 billion annually.

In 2010, attendees at the Cancun Climate Summit decided to create a global Green Climate Fund to finance mitigation and adaptation actions. They reported that by 2020, \$100 billion per year would be available to finance the mitigation and adaptation investments needed in developing countries. The money would come from various sources—the public and private sectors as well as bilateral and multilateral donors, including innovative sources. An important part of future multilateral financing for adaptation is expected to pass through the Green Climate Fund. However, in 2011, much uncertainty remained about how and when the money would be raised and about the governance mode that would be adopted.

Although the Green Climate Fund is yet to reach full strength, climate change-related investment financing is based on tools from the Kyoto Protocol. Among these tools, the Clean Development Mechanism (CDM) remains the main source of mitigation funding thus far. The CDM aims to help reduce greenhouse gas emissions by promoting clean-technology investments and reducing fossil fuel dependence. This solution is achieved by an emissions trading system; emitters who fail to reduce their emissions must buy carbon credits generated by those who have made their goals, and the parties trade these credits on carbon markets. Estimates vary for the aggregate amount of funding expected from the CDM, mainly because they are based on assumptions about future carbon prices.⁶ For example, by 2012 and the end of the Kyoto Protocol, the CDM is expected to have directly provided \$15 billion–\$25 billion⁷ (United Nations 2008).

A group of donors recently created the Climate Investment Fund (CIF)—another important future funding source. The CIF is composed of the Clean Technology Fund (CTF) and the Strategic Climate Fund (SCF). The SCF primarily targets mitigation through a forestry program and a renewable energy program, with a small part (\$240 million) reserved for pilot adaptation projects. With more than \$4.3 billion, the CTF will provide concessional financing for investments to lower power- and transportation-related carbon emissions and to increase energy efficiency in construction, manufacturing, and agriculture.

In theory, carbon finance provides additional financing to traditional official development assistance (ODA). However, in practice, CDM subsidies appear to crowd out traditional ODA, substituting for it rather than adding to it. Furthermore, a review of CDM-approved operations shows a strong geographical concentration in a small group of countries—China, India, and Brazil—and sectors; nearly half of CDM financing goes to reducing the chemical industry's

hydrofluorocarbon emissions, particularly in India. This situation reveals methodological problems difficult to avoid at present, for example, only verifiable emissions reductions receive funding. In general, such problems stem from the vertical nature of the financing mechanism as it currently stands.

To address adaptation, the international community expects many results from the gradual operationalization of an Adaptation Fund created in late 2007. This fund is to be financed by a 2 percent tax on CDM transactions. The Adaptation Fund could generate between \$400 million and \$1.5 billion by 2012, depending on carbon prices. To date, existing funds, such as those in the Global Environment Facility, are equipped to finance only intangible actions, such as studies, training, planning, action plans, research and development, pilot initiatives, and so forth. These actions notably include National Adaptation Plans that set up investment programs for urgent actions.

The Adaptation Fund's operating procedures have yet to be determined. The international community expects the private sector to be involved in adaptation measures—directly or indirectly—because many economic activities' profitability or continuation is liable to be affected. However, the private sector's share of these investments remains difficult to estimate. In any case, investment needs are counted in billions of dollars per year, whereas adaptation funds are counted in the hundreds of millions of dollars per year at best.

Because cities consume much energy, urban activities represent the leading source of carbon dioxide (CO₂) emissions. Thus, cities should receive a large share of mitigation funding. In addition, cities are affected by climate change, and they will need to make investments in all domains related to adaptation, such as protection against sea level rise.

In addition to a lack of financing, local governments face a problem with available financing's characteristics and even its accessibility. Theoretically, a market mechanism like the CDM lends itself well to local urban financing for investments owned by a local government or one of its divisions, such as a local utility, or by a private sector partner, in the case of a service concession. Urban projects receiving such financing primarily include solid waste management, and secondarily include public street lighting and transportation.⁸ Carbon finance provides additional funding that could prove decisive for including an investment in a city's program that it might otherwise exclude.

From the local governments' perspective, a certain number of constraints and limitations stymie effective recourse to the CDM. Uncertainties currently surrounding the carbon market's continuity beyond 2012 are unlikely to make investors comfortable, even though some funds have committed to purchase contracts beyond that date. The mechanism is also complicated to use, requiring know-how beyond that of most people. In addition, the CDM requires sophisticated project assessments that can prove extremely costly compared with the resources obtained. Other disadvantages to this source of funds include

its degree of uncertainty given market volatility, the time required for project registration, and the time needed to establish the amount of money the project will earn in reality. Thus, it is critical that stakeholders not draw up a financing plan based on overly optimistic assumptions.

Finally, even if carbon finance provides revenues *a posteriori*, it has difficulty addressing the issue of initial financing. Some funds may make advances of up to 20 or 25 percent of the purchase contract, but this situation requires a guarantee. Theoretically, a lender can collateralize the future income stream from an Emissions Reduction Purchase Agreement (ERPA) to back start-up financing, but this type of arrangement obviously involves additional costs and increases an operation's complexity.

The indirect effect of these constraints and uncertainties is to make carbon finance a tool better suited to large-scale projects, in which project assessment costs can be amortized. It is also better suited to sectors in which a simple and reasonably accurate measurement method exists and in which funding would have been available anyway. An example is the proposed controlled landfill for the Municipality of Greater Amman, which simultaneously obtained a loan from the World Bank and an ERPA.⁹ We know that the profitability of these projects will be improved by the revenues *a posteriori*, but in varying proportions¹⁰ that are also difficult to predetermine precisely. A city seeking to finance several projects must wade through the same assessment and registration procedure for each project, with the same uncertainties every time.

When the uncertainties about the future of carbon finance are lifted, the international community will have to review the mechanisms that currently govern its implementation. Therefore, we suggest that carbon finance should move toward comprehensive approaches at the scale of an urban area, financing operations programs according to overall performance. To this end, donors, nongovernmental organizations, and others are currently developing methodologies to strengthen systems for measuring emissions reductions in the waste, energy, and transportation sectors (see chapter 5, box 5.9, in this volume). Furthermore, it is likely that donors could create significant incentives if they set up simple and inexpensive prefinancing mechanisms based on their commitment to buy future purchase contract revenues, perhaps incorporating a guarantee to cover possible variations within an agreed range.

A tool such as CTF, having a precise instrumental aim—to reduce global greenhouse gas emissions—and being able to allocate huge sums of financing with their attendant disbursement challenges, takes a wholesaler's approach. It targets sovereign borrowers and large national and regional infrastructure investments, especially electricity production. The sovereign borrowers could certainly on-lend CTF financing to their local governments, but the fund's threshold amount for an investment makes this prospect unlikely. For example, if the CTF plans eventually to finance investments in public transportation for

a local authority, the investments would have to have the central government's approval, come under its guarantee, and come under a national program for a number of sites. For now, it appears that urban local governments will remain absent from the CTF's operational strategies.

The Economy and Financing of Public Sector Local Investment

The Resources-and-Uses and Supply-and-Demand Approaches

The question of local government investment is often approached from one of two perspectives: (1) resources and uses of funds or (2) supply and demand. The former approach—the government's receipts and borrowings and their resulting financing capacity—may also be thought of as the supply. The latter approach—capacity planning, investment programming, project contracting, and effective implementation of physical investments—may be thought of as the demand.

These two approaches reflect the views of two distinct professions and cultures. One side features financial experts, decentralization institutionalists, and public finance specialists who focus mostly on resources; they think that the investment issue is solved once cities have access to adequate financing for their investments. The other side features municipal technicians—professionals working in urban development and fluids (water and electricity) production and distribution who focus on demand; they think that once the city has the capacity to plan, implement, and manage investments, then financing should rise to meet needs.

Many national- and local-level strategy disappointments and failures probably arise from this dichotomy in approaching and understanding the subject. At the national level, it is counterproductive for the government or financial systems to mobilize funding resources (supply) in excess of their market (demand): cities must be able to actually implement the investment and repay it. At the local level, sanctions occur immediately: a city that borrows too much or too soon relative to its needs, thereby exceeding its ability to repay and implement an investment, pays interest on an ill-advised debt and thus impairs its ability to make future investments. From another viewpoint, it is counterproductive for a city to set investment goals based only on purely technical and quantitative needs. Often, the end result is that cities make no investment because the identified needs are disproportionate to truly achievable funding resources.

In the most advanced countries, local governments reconcile these two views at the local level with the resources-and-uses approach. This approach assumes that the community has, or can mandate, sufficiently large and competent professional teams capable of comparing supply versus demand views and

synthesizing these views into a resources-and-uses approach. It also assumes that local authorities are capable of making well-informed tradeoffs. Local governments more rarely meet these conditions in the least developed countries than in the advanced countries.

The resources-and-uses and supply-and-demand approaches also prove critical at the national level for sectoral studies, market analyses, and feasibility studies. These studies and analyses should govern the creation of specialized financial operators or generally determine public local investment financing policy. (We return to these aspects in chapter 5.) To further understand this subject, we note that donors also share this dichotomy; some departments may implement strategies and operations focused on supply, whereas others may focus on demand in an uncoordinated or even contradictory way.

Given developing countries' huge investment needs, no one pretends that funding supply problems do not exist. However, in many cases it is clear that funding supply is not the only concern. Many countries have substantial funding capacity—oil-producing countries, in particular—yet have urban problems no less severe than elsewhere. In other countries, local governments receive resources for capital investment that, although not significant, they fail to spend effectively. Finally, the poorest countries—where needs are most acute—sometimes cannot completely use all granted aid because of weak local implementation ability. These findings refer to *absorption capacity*, or the local government's ability to implement investments effectively with the financing it has or could have, using its available human resources within its economic and institutional context. Absorption capacity is not expandable; when it is weak, the question of increasing funding, let alone loans, becomes pointless.

Public Investment in Economic Theory

Local capital investment implementation and financing have long been topics of interest.¹¹ Since the founding of modern economics by Adam Smith (see box 1.3), infrastructure and public facilities as an engine of economic growth has been a major theme to varying degrees, depending on the school of thought. After Adam Smith's initial treatment, public investment and infrastructure subsequently experienced mixed fortunes in various schools of thought. Although hardly present in classical economic theory, in Keynesian theory public investment and infrastructure have a cyclical effect on the economy with their direct and indirect "multiplier" effects, but then they disappear again with their marginal role in neoclassical economics.

In the 1980s, the endogenous growth theory (Romer 1986; Lucas 1988) returned public investment to the heart of the growth process. The movement of goods and information at national and local levels—as at the enterprise level—serves as the main source of production process improvements. In 1990, Robert Barro (1990) presented an endogenous growth model in which public investment

BOX 1.3**Adam Smith on Public Investment**

In *The Wealth of Nations*, Book V, Chapter 1, Adam Smith (1904 [1776]) sets out most of the concepts that shape today's public investment policies.

On Large Public Works Being the Central Government's Responsibility

"The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expence to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain. The performance of this duty requires, too, very different degrees of expence in the different periods of society" (Smith 1904 [1776], Vol. 1, 69).

On Local Investments Being Better Done by Local Governments

"Were the streets of London to be lighted and paved at the expence of the treasury, is there any probability that they would be so well lighted and paved as they are at present, or even at so small an expence? The expence, besides, instead of being raised by a local tax upon the inhabitants of each particular street, parish, or district in London, would, in this case, be defrayed out of the general revenue of the state, and would consequently be raised by a tax upon all the inhabitants of the kingdom, of whom the greater part derive no sort of benefit from the lighting and paving of the streets of London" (Smith 1904 [1776], Vol. 1, 88).

On Recovering Costs from Users

"It does not seem necessary that the expence of those public works should be defrayed from that public revenue, as it is commonly called, of which the collection and application are in most countries assigned to the executive power. The greater part of such public works may easily be so managed as to afford a particular revenue sufficient for defraying their own expence, without bringing any burden upon the general revenue of the society" (Smith 1904 [1776], Vol. 1, 72).

On Financing Maintenance

"When the carriages which pass over a highway or a bridge, and the lighters which sail upon a navigable canal, pay toll in proportion to their weight or their tonnage, they pay for the maintenance of those public works exactly in proportion to the wear and tear which they occasion of them. It seems scarce possible to invent a more equitable way of maintaining such works" (Smith 1904 [1776], Vol. 1, 74).

On the Sources-and-Uses-of-Funds Approach

"When high roads, bridges, canals, etc. are in this manner made and supported by the commerce which is carried on by means of them, they can be made only where that

continued on page 31

Box 1.3 (continued)

commerce requires them, and consequently where it is proper to make them. Their expences too, their grandeur and magnificence, must be suited to what that commerce can afford to pay" (Smith 1904 [1776], Vol. 1, 76).

On Cross-Subsidization

"When the toll upon carriages of luxury, upon coaches, post-chaises, etc. is made somewhat higher in proportion to their weight, than upon carriages of necessary use, such as carts, waggons, etc. the indolence and vanity of the rich is made to contribute in a very easy manner to the relief of the poor, by rendering cheaper the transportation of heavy goods to all the different parts of the country" (Smith 1904 [1776], Vol. 1, 75).

Source: Smith 1904 [1776].

plays a key role. His theory has been validated by empirical research (Ashauer 1989; Munnell 1990) that finds correlations between public capital, production, private investment, and employment. Similarly, the school of economic geography gives infrastructure, in its broadest sense,¹² a central place in economic growth. Infrastructure is a factor in improving communications and trade, as well as in lowering production costs for companies (Hoorens and Chevallier 2006). Although the neoclassicists do not view public investments as a growth engine, and believe them to be detrimental to the private sector, economic geography's models highlight the positive relationship between public investment and the private sector; the former improves the latter's working conditions.¹³

Many academic works completed in recent decades empirically validate economic geography's models, particularly in Europe and its implementation of European structural funds (OECD 2006). The emergence of phenomena such as growth and technology hubs, border zones, and regional specialization has generated much analysis of the complementarities between public investment and the private sector and of public investment's effect on local-level development.

The most enlightening insights about the synergies between public investment and the private sector come from quantitative and qualitative research surveys of business owners about their reasons for localizing or offshoring their activities (OECD 2006). Decision makers in large metropolises know the factors contributing to the cities' attractiveness. Companies decide where to locate based on national factors, such as labor costs, legislation, taxation, and business climate, and local factors, such as skilled-labor supply, education and training infrastructure, telecommunications infrastructure quality, personal and property security, land availability, housing supply, environmental quality, and corruption levels. Economists and business owners now see local-level

infrastructure as a critical factor in the private sector's endogenous development and business decisions to localize. This factor, together with the fact that the bulk of public investment is local investment in developed countries, places local governments—whatever their institutional form—at the heart of growth issues.

These transformations are at work and fully visible in emerging countries on the African continent, perhaps in major cities in North Africa most particularly. These major cities compete with Asian cities to capture European industrial capital investments; a number of other African cities are likely to join them soon. Economists and analysts often raise the question of Africa's economic development in these terms: How can Africa's respectable economic growth rate of 4–5 percent annually be increased to meet the 7 percent growth rate required by its population growth and infrastructure investment backlog? (See, for example, Severino and Ray 2010.) The recent economic theories briefly discussed previously, and the experiences of emerging and European countries, suggest that the level—local—of local investment may provide part of the answer.

Borrowing's Legitimacy, Virtue, and Economic Justification

Where is the legitimacy of borrowing for public spending? This question has been hotly debated in economics, from the Ricardian equivalence principle of the early nineteenth century¹⁴ to recent developments in generational accounting (Kotlikoff 1992) and post-Keynesian models of the effectiveness of fiscal policy. The question still sparks many theoretical works.

The specificities of cities in developing countries—rapid population growth and a need for investment in basic services—theoretically justify the principle of borrowing. It makes sense to stagger loan repayments over time for an investment that—over time—will benefit an increasing number of residents. Financing capital expenditures through current savings is equivalent to making the current population pay for an investment that will benefit a larger future population. This expenditure is supposed to occur in cities whose financial capacity is increased by broadening the tax base (Aronson and Schwartz 2004). Conversely, most cities on the African continent have difficulty accessing credit, which severely handicaps their performance. They cannot make critical investments, and their productivity—relative to their increasing population—gradually deteriorates. Despite an increase in the tax base, poor service or the lack of it hampers the performance outcomes of local taxes. When resources stagnate, dysfunctions increase, thereby setting off a downward spiral of underdevelopment.

For all of these reasons, we could argue that a city remains condemned to continued deterioration when it experiences sustained population growth and cannot borrow. The limit for this reasoning lies in the level of debt: borrowing is constrained by the ability to repay. Theoretically, an urban government's receipts should increase in tandem with its population growth and gains in

economic productivity. However, this is not the most frequent case because of a combination of factors, such as underemployment, administrative failures, and underinvestment.

In some cases, economists and donors perceive borrowing as having the power to improve a local government's management. They think that the need to repay loans automatically leads local officials to become better managers. This issue is also the subject of debate (Paulais and Stein-Sochas 2007) and is often discussed in light of different moral or religious considerations that accompany the concept of debt. From a factual standpoint, it is certain that a city seeking access to borrowing is led to optimize its ability to provide savings. The city must also show credit institutions and rating agencies evidence of its financial management ability. However, doing so does not ensure that the limits of reasonable debt will not then be exceeded, especially because lenders and borrowers must always pose questions about the investment's quality at the same time as questions about the loan.

Selecting a Local Investment and a Strategic Framework

Borrowing to Do What?

"Borrowing means anticipating receipts": the profession's old adage retains all of its relevance today. Borrowing requires a local government to have the ability to plan for the future: if the government cannot plan, the locality is at risk. This situation immediately raises questions about the nature of an investment and its appropriateness for the government's real debt-servicing capacity. A loan forms an integral part of a financing plan that presents debt-carrying costs and incurred operating costs compared with direct or indirect receipts to cover these costs (Paulais and Stein-Sochas 2007). Three things must take precedence over all other considerations: the quality of the investment, its feasibility relative to local economic circumstances, and its appropriateness for the locality's needs and possibilities. In particular, local governments that lack the internal expertise needed to perform strategic planning and feasibility studies for each investment must always call on professional advice.

Further questions about the nature of the investment should ask what type of investment should take priority. We can roughly consider three categories of investment: (1) investments expected to generate receipts for a city, for example, a commercial area or industrial development zone; (2) investments that generate no direct receipts but that are indispensable for a city's productivity, such as roads, transportation, drainage, electricity, and essential facilities; and (3) investments that generate no receipts for the city, that are not directly related to its productivity, and that have high operating costs, for example, prestigious or nonessential facilities. The nature of the investment is a critical question for

cities with limited financial resources and borrowing capacity. Local governments should prefer the first category—investments that generate receipts. These investments have a limited if not neutral effect on budgets in cases where the investment generates revenue equal to annual loan installments. The investments also increase the city's wealth and economic productivity. The second category—indispensable investments—is fundamental, because without such investments, the city—as an economic machine—will see its performance deteriorate, together with the level of its tax receipts. However, in this regard, all investments are not created equal, and so city managers must set priorities for essential expenditures. And last but not least, the third category of investments—luxuries—should be excluded in all but exceptional cases.

Two considerations must guide the setting of priorities within these categories: the investment's economic profitability and its projected effect on the municipal budget. One of the parameters affecting investment prioritization is determining how much an investment will affect a local government's operating budget through recurring costs for maintenance and operations. An investment that does not bring in additional receipts but that has significant recurring expenses diminishes the locality's savings and therefore its future borrowing capacity.

Investment Planning

Investment decisions and questions about the choice of investments remain among the most difficult issues faced by local decision makers. By definition, an investment is a long-term commitment with serious consequences, and it must be chosen in a context of uncertainty. Numerous uncertainties arise from a variety of factors, including (1) the level of a city's future receipts, particularly in situations in which intergovernmental transfers are not guaranteed over the medium or long term, and (2) the effective cost of the investment, that is, its financial return for revenue-generating facilities or the profitability for facilities without direct revenue generation that are expected to increase a city's productivity. Furthermore, in situations in which funds are scarce or lacking, a city's decision makers must prioritize investments by asking the following questions: Why finance one investment over another? How can we determine and prioritize necessary investments, all desired by residents or economic actors? What criteria should we use? Based on what strategy?

Strategic investment planning should develop in tandem with projected financial analysis (see the following section), which allows projections for receipts and theoretical borrowing capacities to be determined as needed. On this basis, the investment plan establishes sensible priorities. It makes choices explicit while leaving decision makers some discretion to arbitrate between investment choices—but to do so rationally, on the basis of preliminary studies and economic profitability analyses. Economic analysis is of greater or lesser interest depending on the types of investment it covers. However, determining the internal rate of

return (IRR) or economic rate of return (ERR) proves an unequalled tool for making rational investment decisions. Both IRR and ERR calculations can be used to optimize public capital expenditures and are especially relevant when comparing multiple versions of the same investment, for example, two sketches for a connecting road. In this volume, we do not intend to present techniques for calculating profitability; the reader may refer to a large number of books and manuals showing these techniques that have been published in recent decades.

The Overall Strategic Framework

An investment plan cannot be deemed strategic unless it specifies actions according to a comprehensive approach based on a “City Development Strategy” (or similar designation)—at least for major cities and agglomerations. For all cities, including small ones, an investment plan should be part of an urban space planning document, such as a development plan or structural diagram. Lacking such a strategic framework document, the city has no more than a list of investment ideas unconnected to a comprehensive, future, physical, economic, and social vision of the city. An urban development strategy, structural diagrams, financial analysis, forecasts, and investment plans are closely interrelated documents. They must be designed as a comprehensive whole that is continuously adjustable. They define a strategic framework that potential lenders and credit rating agencies will see as an undeniable asset when performing a risk analysis and credit scoring.

Indeed, a local government capable of projecting itself into the medium-term future in a proactive and pragmatic fashion, able to translate its vision into concrete terms through an investment strategy and financial framework based on financial projections, proves its unarguable mastery of management. A local government able to prove such mastery will be considered a good risk, and may borrow on better terms. Creating a strategic framework is the first step toward a virtuous circle (see box 1.4) in which the locality will gradually increase its productivity and attractiveness through investments financed at the best price, thus increasing its resources and borrowing capacity, and then repeating the process.

Completing each element of a comprehensive strategic framework involves various skills; it demands considerable resources and time commitments. Bringing the various elements into perspective is a complex task. In fact, few local governments—even those in developed countries—have all the needed skills and desirable experience required to implement such an approach under satisfactory conditions. Using external advisers is common, if only for part of the task, and also appears desirable for cities with high economic potential that wish to benefit from the experiences and examples of other cities—including foreign cities. Multilateral and bilateral donor mechanisms to support local governments in Africa make sense in these situations, provided the donors have sufficient human and financial resources.

BOX 1.4**Seeking a Virtuous Circle**

Many donors' municipal development or decentralization projects try to make management of local governments enter a virtuous circle. Such projects aim to strengthen absorption capacity in general, and ownership abilities specifically, for example, by strengthening institutions, supplying professional training, and supporting local businesses. These projects include measures and incentive systems designed to gradually improve managerial ability and governance quality, thereby ultimately increasing a local government's ability to generate its own resources internally.

Some of these projects rely on the use of lending and borrowing to teach certain virtues. Within a donor's overall grant to strengthen project management and governance, donors instill a small dose of lending in urban governments that have the repayment ability. An initial operation may involve a revenue-generating investment; receipts will replenish the city's budget and raise its credit capacity so that it can borrow more and invest more. Donors may also introduce a number of incentives to encourage good administrative management at this stage—for example, city contracts, performance contracts, and output-based aid.

Urban governments gradually see improvements in their ability to implement and manage projects and to repay loans. The share of lending within a grant may also increase gradually. A virtuous circle can be considered triggered when this process of progression goes into effect and national officials politically support it, making it part of their decentralization support strategy. Depending on the size of the local investment market and characteristics of the financial sector, a self-sustaining municipal credit market becomes possible.

Success in such efforts demands time and consistency. We note that this process resembles the process that prevailed in a number of European countries. Local governments in Europe have long received financing with favorable terms from monopolistic credit institutions and institutional or specific support programs, for example, in the fields of financial and technical engineering.

Source: Author.

Governance and the Contractual Approach**Governance and Local Governance**

The notion of *governance* arose in India 400 years ago (Kaufmann and Kraay 2007). Despite the concept's longevity, no consensus has been found for the word's meaning. In some cases, it is used interchangeably with other concepts, such as *institutions* or *institutional quality*, but substantially different meanings occur, depending on political and institutional cultures. A World Bank strategy paper on governance and corruption defined governance as "the manner in

which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services” (World Bank 2007, 3). The notion of *good governance*, its definition, and its relation to economic efficiency and development have inspired much writing on the subject.

Local governance is the same concept applied to the local (as opposed to central) government level. The term *local government* refers to a specific institution or entity created to provide a number of services in a geographically defined territory. Local governance is a broader concept that can be defined as the definition and implementation of collective action at the local level (Shah 2006). Good local governance is not limited to the provision of local services; it includes items such as residents’ security, protection, and freedom; local democracy and citizen representation; and administrative effectiveness and accountability (see box 1.5).

BOX 1.5

Six Key Components of Governance

The World Bank Institute (2009) defines governance as the traditions and institutions through which authority is exercised in a country. These include the process by which governments are selected, monitored, and replaced; the government’s ability to formulate and implement sound policies; and citizens’ and central governments’ respect for institutions that govern economic and social interactions. Governance is divided into six key components:

- *Democracy and freedom.* The degree to which a country’s citizens can participate in choosing their government and enjoy freedom of expression, of association, and of the press.
- *Political stability and absence of violence or terrorism.* The probability that a government will be destabilized by unconstitutional or violent means, including terrorism.
- *Government effectiveness.* The quality of public services, the civil service’s capacity and independence from political pressures, and the quality of policy formulation.
- *Regulatory quality.* The ability of government to provide policies, laws, and sound regulation that encourage and promote private sector growth.
- *Rule of law.* The amount of confidence that citizens and noncitizens have in society’s rules, including the quality of enforcement for contracts, property rights, the police, and courts, as well as the likelihood of crimes and violence.
- *Corruption control.* The degree to which public power is used for private purposes, including petty or large-scale corruption, and the degree to which the elites and private interests “capture” central government.

Source: World Bank Institute 2009.

A full discussion of governance and local governance exceeds the scope of this volume. However, there is a direct link between local governance and a city's administrative quality and economic efficiency, and therefore a direct link between local governance and a local government's ability to finance local investments. Nothing makes the relationship between local governance and access to funding clearer than a review of the parameters used by credit rating agencies to analyze urban governments' creditworthiness (see box 1.9 later in this chapter). In addition to purely financial ratios, credit rating criteria broadly overlap governance considerations, linking access to capital to governance. Thus, a local government's governance matters not only to donors and aid agencies, but also—via the credit rating agencies—to capital markets, investment banks, and operators who may enter into a public-private partnership.

A city seen to have poor governance sharply cuts off its access to external investment-financing funds. This exclusion from the market risks becoming even worse if the city's perceived poor governance becomes embedded within a similar poor perception of the central government's governance. In the 1990s, multilateral donors, thinking about aid effectiveness, devised mechanisms to allocate international funding. As a result, donors' selection of governments that will receive aid is based on each country's governance performance; each country's performance rating involves a multiplier called the *governance factor*. Many aid agencies and multilateral donors have gradually applied these selectivity principles; for example, the Millennium Challenge Corporation's Challenge Account, established by the United States in 2002, works almost exclusively on this principle (see box 1.6).

Donors using selectivity principles based on economic and institutional performances reject potential aid candidates who earn a bad governance factor. Their systematic rejection has proven quite effective—so effective that, in retrospect, it has become clear that a side effect has been the disqualification of fragile states. These states have been described as real “aid orphans” (Raffinot and Rosellini 2007). In summary, access to financing closely correlates with the governance performance of central and local governments alike. In one sense, local governments should understand that access to financing is not a right in this new configuration; it is earned through substantive work on all components of local governance, notably management and the fight against corruption (see box 1.7). In this context, financial evaluation systems of local governments take on a special importance.

The Contractual Approach

In developed countries, public decision making's fragmentation and its resulting ownership and governance difficulties have led to new ways of managing aid allocations, based on the notion of contracting. Two forms of

BOX 1.6**The Millennium Challenge Corporation's Key Indicators**

The Millennium Challenge Corporation (MCC) uses policy indicators in three categories to establish its governance performance ratings: the extent to which government governs justly, invests in its citizens, and encourages economic freedom. MCC promotes key indicators established by independent third-party institutions using objective, publicly available data and a rigorous analytical method. MCC looks for indicators that cover the largest number of countries, allowing comparability between countries and consistency from year to year. The 2009 indicators and the institutions that established them are listed below.

Governing justly

Civil liberties	Freedom House
Political rights	Freedom House
Democracy and freedoms	World Bank Institute
Government effectiveness	World Bank Institute
Rule of law	World Bank Institute
Corruption control	World Bank Institute

Investing in citizens

Immunization rates	World Health Organization
Public expenditure on health	World Health Organization
Girls' primary education completion rate	United Nations Educational, Scientific, and Cultural Organization (UNESCO)
Public expenditure on primary education	UNESCO and national sources
Natural resources management	Center for International Earth Science Information Network and Yale Center for Environmental Law and Policy

Encouraging economic freedom

Starting a business	Industrial Finance Corporation of India
Land rights and access to land	International Fund for Agricultural Development and International Finance Corporation
Trade policy	Heritage Foundation
Regulatory quality	World Bank Institute
Inflation	International Monetary Fund World Economic Outlook database (IMF WEO)
Fiscal policy	IMF, IMF WEO

Source: Millennium Challenge Corporation 2008.

BOX 1.7**Corruption and Local Governments**

The concept of corruption has many definitions. In general, one may define corruption as an abuse of power for personal gain. This abuse of power includes illegal payments for a normally free service or the use of public powers for unlawful purposes. It may include acts of omission or commission and can involve legal or illegal activities. It may involve actions internal to an organization, such as embezzlement, or external actions, such as extortion. Although certain types of social benefits may sometimes result, corruption generally leads to injustice and inequality.

Whatever its definition, when corruption reaches a central government, it is fatal. Systematic corruption generates economic costs by distorting incentives, political costs by undermining institutions, and social costs by redistributing wealth and power to those who have not earned either. When corruption undermines property rights, the rule of law, and investment incentives, it compromises economic and political development.

Corruption is a universal problem, but local officials seem particularly susceptible to it. Often, the public accuses them not only of mismanagement, but also the misuse of public funds for personal interests. Corruption's forms prove as varied as the activities of municipal authorities.

Source: Klitgaard, MacLean-Abaroa, and Parris 2000.

contracting emerged at about the same time: the *performance-based contract* and the *central-local government contract*.

The first form, performance-based contracts, emerged in Anglo-American countries in the wake of their public-services privatization movements. These contracts reflect a need to regulate relationships between delegated project owners and their private sector partners. The contracts cover areas such as basic utilities and social services. They generally set time-bound quantitative objectives for the level and quality of services and administration. They also set operating and capital expenditure budget ranges for each stakeholder. Borrowed from the private sector, these performance-based techniques emerged in the realm of public service delivery, and the changes they wrought led to a new concept—*new public management*. It has spread extensively since the end of the 1990s (Pollitt and Bouckaert 2000).

The second form, central-local government contracts, arose in many variations in several continental European countries simultaneously. This contracting method emerged to try to regulate central and local governments' financial and organizational relationship during a decentralization process, as the European

Community took shape. An example of this approach is France's State-Regions Planning Contract. Countries affected by the postreconstruction urban social-housing crisis have used the contractual approach at the municipal level. This crisis is particularly acute in France and has led the central government to create a set of provisions gradually grouped together into the city's policy; one of its central elements is the city contract.

In general, we could define contracting as a multiple-stage operational approach. The stages include (1) negotiating a consensus, (2) presenting the consensus in some contractual form, and (3) creating a means to monitor implementations and adjustments and possibly to conduct an assessment. Unlike a PPP's performance-based contract, a central-local government contract has an equivocal legal status because it involves no obligation to build or create anything. Rather, it sets a framework for resolving conflicts and making progress through discussion and compromise.

The relative flexibility of the central-local government contracts facilitated the progressive involvement of members of civil society as stakeholders. Their participation proves crucial in arrangements that aim to improve governance, especially urban governance for city contracts. Despite the relative flexibility of city contracts, they may present some constraints, notably via their financing arrangements. For example, in France, local officials must sign a city contract to obtain preferential types of financing, such as extended loan terms, subsidized interest rates, and extended grace periods granted under France's urban policy (Géhin and Paulais 2000).

These contractual approaches have evolved quite a bit since their initial implementation. For example, we can now distinguish three main types of contracts that may be negotiated: (1) a framework agreement for a regional land development strategy; (2) a framework agreement to localize general public policy; and (3) a framework agreement among a region's project or program stakeholders, operators, and financiers (Simonneau 2007).

In developing countries, performance-based contracts have seen some distribution alongside the spread of PPPs. Donors have exported central-local government contracts, and more specifically city contracts, to African countries, including Cameroon, Senegal, and Tunisia. International donors see these contracts as effective tools to guide urban projects and programs (Farvacque-Vitkovic et al. 2006). Programs that support decentralization currently use the contractual approach extensively; in such programs, we also note some convergence between the performance-based contracts and city contract forms. With their systems of key indicators and incentives, these contracts have proved to be powerful tools to implement and support public policy, thereby allowing central governments to regulate the decentralization process, improve urban governance, and increase public investment efficiencies (see box 1.8).

BOX 1.8**City Contracts Support Financial Turnarounds in Tunisian Towns**

At the beginning of the 21st century, the finances of some Tunisian towns known as *communes* (similar to municipalities) grew worrisome. This financial weakness called into question the communes' ability to make payments on loans from Tunisia's loan and support fund for local government, the Caisse de Prêts et de Soutien des Collectivités Locales (CPSCL). This situation resulted from a highly supervised lending policy unconnected to a town's real repayment ability, but deteriorating spending and tax collection management also contributed to the situation. As part of a municipal development program funded by the World Bank and AFD, the Tunisian government introduced a financial recovery package for troubled towns. The communes were classified into three categories: vulnerable, weak, or healthy. Special provisions accrued to each category, particularly in terms of borrowing. Tunisia implemented a series of technical and training support measures along with managerial measures, including administrative budget control for vulnerable communes, and a monitoring system based on reliable indicators was also set up. At the same time, contractual incentives were introduced; once a commune improved its management indicators and performance during the contract term, it could move into a higher category and receive a number of financial benefits as a result.

These are the latest generation of quite sophisticated tripartite city contracts, between the central government, the local government, and the CPSCL. The latter has the distinction of being at once the lending institution, the supporting institution, and the distribution vehicle for a portion of the central government's municipal subsidies. In addition, Tunisia's Institut National de Formation (National Training Institute) for municipal employees also facilitates connecting this system to its key indicators with a targeted institutional support program. In sum, the municipal development program and its city contracts provide comprehensive support for decentralization and urban governance.

Sources: AFD 2001; World Bank 2002; see Tunisia case study in the appendix.

The Importance of Financial Analysis**Retrospective and Prospective Financial Analyses**

In general, financial analysis of a local government begins with a retrospective review of financial statements for the previous—usually five—fiscal years. The concept of self-financing is central to financial analysis. Represented by a positive balance of receipts versus operating expenditures, self-financing serves as an indicator of good fiscal management to the outside world, and it determines a local government's ability to obtain a loan. The retrospective nature of the analysis is fundamental; it highlights changes and trends over time that must be

analyzed. In cases in which a local government already carries debt, the debt's characteristics provide another essential element in understanding the community's financial situation. Conventionally, the local government's financial situation is summed up by a battery of indicators and ratios (see box 1.9 later in this chapter), which are both necessary for good financial supervision and helpful in discussions with national government overseers and potential lenders.

Prospective financial analysis—equally centered on the concept of self-financing—projects a financial strategy into the future; it incorporates assumptions about the external environment and forecasts the changes in a local government's accounts that may result from structural trends (Klopfer 2001). Stakeholders use prospective financial analysis as a tool to determine short-term capital investment capacities. They also use it to determine whether the planned investment financing is reasonably feasible.

Prospective financial analysis is a fundamentally approximate exercise; the analysis must be updated annually. For local officials, it provides a management tool that helps them see into the future. Prospective financial analysis has two other qualities: (1) it is an educational tool for the public and for private sector businesses, and (2) it serves as a tool for discussion with potential lenders and is more convincing than retrospective analyses. Prospective financial analysis proves essential to establishing a financial strategy, thereby functioning as a management dashboard for forward planning.

The Importance of Systems to Assess Local Governments' Finances

A credit rating system for subsovereign borrowers is a prerequisite to developing a capital market. The ability to properly assess risks associated with a debt largely depends on market transaction volumes and the credit analyst's detached perspective. In a new market, the relationship between credit ratings and interest rates may not be clear or even fixed if the number of bond issues proves too small to set pricing signals. Bond markets remain nascent in many developing countries, often because the institutional environment does not support them. Legal and regulatory frameworks that would give investors confidence are often lacking, while laws regulating repayment of municipal debt may be nonexistent or too vague to constitute a security. Other impediments to the development of municipal bond markets include a lack of reliable information about local government funding, weaknesses in auditing and supervising local governments, a lack of visibility on intergovernmental transfers, and uncertainty about these transfers.

In general, all credit rating agencies stress that their sovereign and subsovereign ratings' credibility largely depends on the political and institutional environment. Theoretically, a local government may receive a satisfactory rating based on its economic, financial, and taxation performances. However, investors will remain reluctant to invest if uncertainty remains about national-level institutions' permanence and quality (Fitch Ratings 2008).

Credit rating agencies' methodologies also draw on qualitative factors, and ultimately leave much room for subjective judgments. These factors work alongside quantitative financial-ratios analysis. However, rating agencies, investors, or lenders can only reasonably apply their qualitative judgments within a framework that allows for market comparisons and benchmarking. This means that it may be difficult and time-consuming to build an environment in which credit ratings take on their full meaning and in which they spur a vibrant market for subsovereign debt (Liu and Song Tan 2009).

Credit Ratings by Agencies

One may define subsovereign credit ratings as opinions expressed by a credit rating agency about the ability of rated local governments to honor their debt commitments as payments become due. Credit ratings reflect and quantify the risks associated with a borrower not complying with its financial obligations. They embody the credit rating analysts' assessments in a rating that uses a single scale for all industry sectors and countries. The credit rating becomes a passport to capital markets. Obtaining a rating presents different challenges for the local government and the credit rating agency: the locality that wants to be rated commits to a process of financial transparency, and the credit rating agency commits its reputation and responsibility (Fitch Ratings 2008). From the local government's perspective, the rating's interest resides in a combination of three objectives: (1) improving budgetary and financial management; (2) meeting transparency requirements and communicating with several publics—citizens, taxpayers, businesses, government services, and other localities; and (3) acceding to better financing terms, whether for issuing bonds or simply for borrowing from a financial institution.

As we mentioned previously, subsovereign ratings are based on qualitative and quantitative criteria (see box 1.9). Qualitative criteria include the local government's institutional framework, its relationship with its central government and other communities, its executive strategy, and its internal and external audit and control procedures. These criteria carry the most weight in credit scoring because they constitute the backbone for other elements. Quantitative criteria assess a local government's fiscal performance and its socioeconomic profile, that is, the factors that influence receipts and expenditures, including the locality's wealth, demographics, and employment levels. The receipts criterion measures the urban government's real fiscal flexibility and ability to control expenditures, thereby preventing increases. These criteria's roles and relevance vary from country to country, remaining closely linked to local legal and economic contexts (Fitch Ratings 2006, 2008).

The rating process takes place in two phases. The first phase results in an assessment (not a full rating) of the local government's creditworthiness that the local government can publicize if so desired. The second phase—required for bond

Factors Affecting a Local Government's Credit Rating

Management capabilities prove a critical component of subsovereign credit analysis, even more so now than in the past because of decentralization's breakthroughs and local governments' empowerment (at least in some countries). Credit rating agencies limit their reviews to an assessment of a local government's aims and the means it can marshal to achieve them. Credit rating agencies measure three types of management factors: the rated entity's financial sophistication, the quality and monitoring of its accounting and financial statements, and its management's ability to accurately forecast budget results. Credit rating agencies have used these factors to establish a list of good and bad governance and management practices that influence an analyst's assessment of a local government's creditworthiness.

Good practices that positively influence a rating include the following:

- Multiyear prospective financial statements
- Publication and monitoring of monthly or quarterly financial statements
- Allocation of windfalls to capital expenditures
- Depreciation of fixed assets over their effective life
- Matching of debt to the financed asset's lifetime
- Regular and public review of the local government's ability to repay its debt
- Incorporation of management costs into investment projects
- Clearing of program authorizations and the work that remains to be done
- Policies for cash, working capital, and reserves

Bad practices that adversely influence a rating include the following:

- Single-entry bookkeeping and unfamiliarity with financial statements
- Identification of significant weakness by an inspection entity such as an inspector general or regional chamber of accounts
- Overreliance on exceptional, nonrecurring revenues, for example, asset sales
- Budget deficit exceeds the legal limit at period-end budget closing, such as carrying forward of expenses
- Lack of multiyear capital expenditures
- Excessive borrowing by related entities without future repayment ability
- Unacceptably long terms for debt repayment
- Unfunded pension obligations
- Significant increase in short-term debt, rising faster than annual expenditures
- Debt restructuring that introduces loan deferrals unjustified by capital expenditures
- Taking up of structured debt products that are too complex in relation to the local government's financial management ability or that put the community in a speculative position

Source: Fitch Ratings 2008.

issuance—includes further analysis and discussions between the credit rating agency and the local officials, leading to the publication of the subsovereign's actual bond rating. Local governments unable or uninterested in issuing a bond are usually exempt from the second phase. Furthermore, we note that other methods of analysis may offer attractive alternatives, especially in countries where benchmarking of local-government credit ratings proves difficult, or more simply in localities with few means. Alternative analyses may also prove interesting for already-rated local governments that want to expand their analysis to include other considerations better treated with alternative methods. The following section outlines some of these methods' contents and compares them with credit ratings.

Alternative Methods of Analysis¹⁵

An increasing number of city assessment methods demonstrates urban observers' keen interest in measurement systems. The emergence of new fields of inquiry, such as the type of measurement or the use of environmental criteria, has further enriched conventional approaches. We will now compare three predominantly financial methods: a self-assessment developed by the Institute of Delegated Management (IGD 2008), local government credit scoring as practiced by major agencies, and the Public Expenditure and Financial Accountability (PEFA) program developed by a group of donors at the beginning of the 21st century. Originally intended to assess national finances, PEFA is now directed toward subsovereigns. Its first municipal assessment covered the city of Dakar, Senegal, in 2009.

Different Objectives

Credit rating probably covers the most topics with the most focused objective: its primary goal is to measure the risk of a local government defaulting on its debt payments, whether a loan, bond, or other debt instrument. Self-assessment resembles the credit rating approach; it presents a local government's financial position from several angles so that officials can obtain a document that opens conversation with a funding agency. Both methods put together their reviews with an eye to operational financing; both perform risk analysis.

PEFA has a somewhat different primary objective: to evaluate a publicly owned organization's budgetary performance and accounting system. Because PEFA was originally designed to assess national finances, it centers on the budget cycle—the basis for central government action. It draws on a series of high-level indicators, which are classified as such because they synthesize several basic concerns to make an overall assessment. For example, PEFA indicates the budget's high-level credibility based on a subindicator, the completion rate. These synthetic indicators reflect various aspects of the budget process, including political aspects—democratic practice—as much as purely financial aspects—budget credibility. Rather than focusing on immediate, operational

funding, PEFA provides a snapshot of a given situation and behaviors. By highlighting the weaknesses of a local government's budget and financial system, PEFA calls for the government's managers to rectify the shortcomings. In doing so, it serves as a tool to easily define an action plan. PEFA has a secondary objective: to encourage improvement. It is a long-term method; donors recommend that local governments take their PEFA measurements every three years.

Collaborative and Solo Approaches

The methods' procedures also differ. The credit rating is an indicator that only an independent organization, external to the local government, can establish. Yet, in the vast majority of cases, the credit rating agency conducts the rating review in collaboration with the local government. This situation is not unusual, because the locality often requests a rating so that it can issue a bond. However, only the rating agency's internal committee can decide on the final rating, which it does in a collegial way, according to its procedural guidelines.

PEFA uses a similar approach. External consultants working with countries' central governments have conducted many national PEFAs, as was the case for the city of Dakar. It is a significant commitment for urban governments to adopt the PEFA method, because they will need to repeat the process every three to four years. The PEFA secretariat exercises some supervision, assessing the quality of each entity's results and posting the results online.

As its name implies, self-assessment is performed by the local government itself. Largely based on financial data, the self-assessment method resembles retrospective and prospective financial analysis. It works well for countries where the local government's accountant belongs to a civil service network; the data are considered objective and therefore reliable. However, this method cannot escape having a touch of self-leniency. Its main value lies in having a local government prepare financial statements the same way as a large company, using a standardized and specifically local government-focused conceptual framework; the method is accompanied by a proven pedagogical guide.¹⁶

The Details of PEFA's Method

We outline the PEFA method's main features because the method is less well known than that of the credit rating agencies or financial analysis (which resembles the self-assessment method). The PEFA performance evaluation of public financial management determines 28 high-level indicators to describe management quality on three levels: (1) budget credibility; (2) the budgeting system's coverage and transparency; and (3) the budget cycle's effectiveness—its relationship to public policy, predictability, budget execution monitoring, accounting system, financial reporting, surveillance, and external audits.

The indicators directly cover the main types of financial management tasks from an administrative and political efficiency perspective, rather than in terms

of a local government's financial situation. Of course, all of the indicators relate to financial results either implicitly or indirectly, that is, some do so in a semi-direct way, such as the indicator for tax collection effectiveness. PEFA indicators have been calibrated to express management quality; the assumption is that any improvement in the PEFA rating reflects an improvement in financial management.

The Current Limits of PEFA's Use for Local Governments

The PEFA framework was designed for use by central governments, and thus, it does not reflect various, more diverse local government concerns. The calibration of its quantitative indicators is poorly suited to some local government accounting systems, especially French-speaking African municipalities—for example, in the way that it separates the ordering party and the payer in a cash-flow indicator, or the way that it delegates services entrusted to national tax authorities in the taxpayer identification indicator. Another important distinction between central governments and urban administrations lies in the latter's direct responsibility for its residents' well-being and their expectations for daily services, such as water, waste management, sanitation, security, firefighting, and roadways. And assessing financial management performance alone, without any data about the tangible results of this performance, appears to be frustrating or incomprehensible for citizens.

Comparing Areas Covered by an Assessment

Credit rating is the most comprehensive method, covering all areas of a local government's financial environment: (1) its political and administrative organization; (2) its institutional and economic environment, sometimes detailing employment, unemployment, and other issues; and (3) its finances, with particular attention to savings, debt, and subsidiary risk. The self-assessment method is somewhat confined to financial aspects but largely covers future prospects. PEFA's method does not address the financial data per se, but rather assesses their significance at a higher level, seeking answers to four critical questions: (1) Is the community's method of tracking subsidiaries a source of risk? (2) Does budget credibility show an absence of or an incompetency in forecasting? (3) Are there any extra-budgetary expenses beyond democratic control? and (4) How is the deliberative assembly monitored and inspected?

Relative Effectiveness and Interest of Each Method

Credit rating is the only method with a sufficient history for us to compare the results of its methodology with its objective to measure default risk. The 2008 financial crisis has reduced confidence in the credit rating agencies' credibility (see box 1.10). However, their dubious activities were unrelated to analyzing local governments, and their failures in other areas must be put into perspective.

Spotlight on the Credit Rating Agencies

As the 2008 financial crisis ensued, the International Monetary Fund pointed out—albeit indirectly—the credit rating agencies’ responsibility in the matter, noting that “investors were . . . relying too heavily on ratings agencies for assessing the risks to which they were exposed.” Many other voices have since risen to criticize the rating agencies, sometimes in much less diplomatic terms. The many complaints and accusations directed at the credit rating agencies fall into three main types: (1) the three major agencies constitute an oligopoly protected by the central government and let their standards slip; (2) the agencies used defective risk analysis techniques despite many warnings from researchers and professionals; and (3) the agencies operate at the heart of a system riddled with conflicts of interest, in collusion with bankers, mortgage brokers, bond issuers, and other financial players. We discuss these criticisms below.

We start by asking what it means to call the three major credit rating agencies—Fitch, Moody’s, and Standard & Poor’s, which are all private companies—*agencies*. In the collective unconscious, they are practically semiofficial agencies, the exclusive beneficiaries of legislation that, since the Great Depression, makes their services mandatory for institutional investors. Ratings are supposed to protect investors. Since 1975, the U.S. Securities and Exchange Commission rules make competition with the rating agencies for similar services to institutional investors almost impossible. It appears, then, that the credit rating agencies, not only freed from competition but also thriving and pursuing rent-seeking in protected markets, gradually fell into carelessness, guesswork, and venality.

The rating agencies gradually abandoned traditional analysis techniques for measuring a borrower’s solvency and collateral values, and instead systematically and exclusively relied on mathematical models and statistical approaches to risk analysis. However, mathematicians from many organizations and levels criticized the rating agencies’ complete confidence in statistical tools and historical data. Some rating agency managers and analysts also voiced serious concerns about the methodological changes, arguing for maintaining a parallel, basic credit analysis—actions that apparently cost some of them their careers at the agencies. The fact that using statistical models is fast and economical compared with conventional analysis underpins the first accusation mentioned previously—that the agencies sank into profit-maximizing laziness.

The credit rating agencies operate at the center of conflicts of interest because they are paid by the entities they rate rather than by investors, as was their original practice. This payment for ratings has been the agencies’ practice since the early 1970s and has likely played a significant role in the magnitude of the credit enhancement crisis. The credit rating agencies are doubly implicated. A law requiring *investment grade* rated bonds creates a viable and profitable activity for credit enhancers—the bond insurers, also known as *monolines*, so the credit rating agencies’ rating makes the bond insurers’ activity possible. At the same time, the money paid by the bond insurers for their rating makes the credit rating business highly profitable for the rating agencies. For a credit rating agency, downgrading a bond insurer, thereby making it impossible for the latter to conduct business, is akin to killing off one of the agency’s best clients—a difficult decision to make.

Sources: IMF 2008; Schich 2008; Katz, Salinas, and Stephanou 2009; White 2009.

In fact, if the ultimate goal is bond issuance, a credit rating by an agency is still required.

Self-evaluation is more a question of using a local government's resources efficiently, rather than generating highly useful results. The self-evaluation process results in a document that expresses a local government's financial quality and its prospects. This factor may be key in promoting a discussion process with the central government or with public or private sector funding institutions.

PEFA aims for effectiveness by driving a dynamic within a local government: its indicators are calibrated to reflect the assumption that any improvement in management quality will be reflected in a higher PEFA rating. By identifying faulty indicators, a PEFA rating gives local managers a list of actions to implement to improve management. In summary, all three methods have different, largely complementary objectives. Local governments can use each rating approach according to their needs and means.

We find it unfortunate, however, that none of these methods truly consider—either qualitatively or quantitatively—the local government's scope of jurisdiction or its management effectiveness for administrative, basic, and social services. Furthermore, the question of urban agglomeration authorities and their management remains underaddressed, despite the fact that these are increasingly important issues. All three methods underanalyze articulations between local governments and supralocal organizations, such as agglomeration communities and intercity unions.

Some Lessons from the 2008 Financial Crisis¹⁷

The 2008 financial crisis affected all urban local governments worldwide to varying degrees, depending on their location and their central government's stimulus plan. Housing and urban development have been strongly affected in many countries, including the most developed; in the United States, the crisis began in housing. Investment financing systems have also been deeply affected by the financial crisis; entire sectors of activity have been devastated. In this section, we highlight the consequences of the crisis and draw lessons directly related to this volume's subject—local investment financing systems and housing policies.

The Municipal Bond Market and the Sinking of the Bond Insurers

In the United States, bonds furnish almost the only means of financing local governments. The usually thriving tax-advantaged municipal bond market—representing \$2.5 trillion in outstanding issues and new annual issues of nearly \$200 billion—severely contracted in the 2008 financial crisis. Local governments with average or low credit ratings found it very difficult to raise money. They had to cut back their investment programs to make up for higher bond

interest rates. They had to abandon projects, even those usually easy to finance via revenue bonds because the projects generate their own income.

The increase in financing costs struck local governments even harder because it followed prosperous times when municipalities could easily raise money from bonds having historically low yields. Three years after the financial crisis, local governments with low or average credit ratings remain excluded de facto from borrowing. They no longer benefit from credit enhancement services that guarantee their debt, because credit enhancement companies, known as bond insurers, are also failing. These bond insurers, along with the credit rating agencies, appear to be responsible for a great deal of the credit crisis debacle. The *credit enhancer* is a type of financial company that provides a guarantee to securities purchasers. Until 1985, their activity in the United States was limited to municipal bonds. The credit enhancement company—rated AAA, the highest possible rating—provides its guarantee for a bond issued by a lower-rated local government. This guarantee allows the lower-rated local government to raise funds in capital markets for a better interest rate than would have been obtained without the guarantee. Credit enhancement companies are known as bond insurers, monoline insurance companies, or simply monolines, although they are not insurance companies, strictly speaking.

Bond insurers owed their prosperity, founded on a low-risk activity, to U.S. federal legislation. The U.S. Congress, wanting to protect the assets of key institutional investors such as banks and fiduciaries, created laws ruling that pension funds may invest only in investment-grade securities rated equal to or greater than BBB. Lower-rated U.S. municipalities therefore constitute an almost captive market for the bond insurers; the insurers enhance the lower-rated local government borrower to investment grade, thereby opening access to more abundant and less costly funding sources. The borrower's savings on financing costs more than offset the cost of a bond insurer's guarantee.

However, to increase and diversify their business, some bond insurers began enhancing structured debt products backed by assets as part of a process known as debt securitization. First, they guaranteed U.S. mortgage-backed securities and then followed with other increasingly complex products as securitization techniques grew more sophisticated.

The bond insurers played an important role in the development and distribution of these financial products to investors in the United States and other countries—products that were later declared “toxic” (Schich 2008). As the U.S. housing market bubble burst, the deterioration of these products' value caused a tsunami of bad debt to sink the bond insurers. Indeed, the high rating the credit rating agencies had assigned to the bond insurers was justified, in principle, by the latter having sufficient capital to meet their commitments. When it became clear that the bond insurers did not have sufficient capital, the rating agencies had to resolve to downgrade most of them, accelerating the rout. Of a dozen

active monolines in the United States, only three maintained an AA rating; one of the largest, Ambac Financial Group, Inc., was downgraded from AAA to C, or *junk*, while others lost their rating entirely, condemning them to oblivion. The economic rationale for the credit enhancement business, its usefulness, and its future are now much debated in the United States (Rose 2009).

Specialized Financial Institutions on Life Support

In countries where local governments borrow more from commercial banks or specialty municipal lenders than from bond markets, the credit contraction proved sharper, primarily because of the poor condition of the largest banks. Interest rates increased for this reason. Consequently, in Europe, very old and established specialty lenders, such as Kommunkreditt in Norway or Kommunkredit in Austria (CEMR 2009), found it difficult to obtain finance capital. Ultimately, the Austrian government took over Kommunkredit.

The most notorious incident involved Dexia, a world-leading French-Belgian municipal finance bank. It was caught in the credit crunch and was handicapped by the losses of its American subsidiary, Financial Security Assurance, a municipal bond insurer that Dexia had acquired in 2000. In addition, Dexia garnered sharp criticism in countries where its shareholders—including Belgian towns—were furious about its losses. It was also attacked for selling structured products that proved to be time bombs for the local governments that purchased them. Dexia, criticized by its shareholders and technically in bankruptcy, survived only through a rescue plan jointly proffered by France and Belgium.

This event took on a special, symbolic meaning because Dexia was the latest manifestation of a privatization process that the French government had initiated 20 years earlier (see box 1.11). It is certain that Dexia's (supposedly provisional) return to parapublic status will likely discourage some specialized financial institutions in Africa from pursuing the privatization movements that donors so strongly recommended prior to 2008.

Public Policy's Role in Housing

The mechanisms—in particular, securitization—through which the housing sector in the United States damaged the global financial system are well documented. However, the role of public housing policy appears relatively underestimated—a vital point in understanding the process and its origins. Historically, the U.S. Department of Housing and Urban Development (HUD) relies on two giant mortgage lenders: the Federal National Mortgage Association, known as *Fannie Mae*, and the Federal Home Mortgage Corporation, or *Freddie Mac*, both government-sponsored enterprises (GSE). The Federal Housing Authority (FHA) provides mortgage insurance for poorer people, requiring very small or no cash down payments to close a loan. In the mid-1990s, as government policy favored housing construction and access to homeownership for low-income

BOX 1.11**Dexia: A Return to State-Owned Status**

In September 2008, the French and Belgian governments' recapitalization of Dexia undid 20 years of the bank's progress in positioning itself as one of the world's leading bond issuers and financiers of local governments.

Dexia's forerunner, the Caisse d'Aide à l'Équipement des Collectivités Locales (CAECL), was created in France in 1996. It was the only financial institution authorized to lend to local communities and operated under close government supervision. CAECL funded its activities via capital markets, either by using its own name or by providing its guarantee to bonds issued by groups of local governments.

Municipal banking in France experienced an upheaval beginning in 1982, with the central government's decentralization laws. These were followed by easier access to bank credit in 1984. As local governments became autonomous, they obtained comprehensive rather than project-based financing, and their investment needs multiplied as their responsibilities increased. Easy access to bank credit allowed them to borrow from all kinds of credit institutions that competed for their business. At the same time, the financial products available to them diversified.

In 1987, CAECL was rebranded Crédit Local de France (CLF) and began a privatization process that culminated in the central government selling its remaining shares in 1995. During the 1990s, CLF remained a dominant player in the market for public sector local investment, achieving a 40–50 percent market share. Its longtime position in the local government market honed its proven expertise in municipal-risk analysis and enhanced its detailed knowledge of the French market; CLF had to innovate constantly to maintain its edge.

CLF was the only specialist in a market characterized by a predominance of very long-term lending. Because CLF was not a deposit-taking bank, it had to fully fund itself via capital markets, notably international markets. This constraint led CLF to seek alliances with other financial institutions. In 1996, its merger with Belgium's Crédit Communal de Belgique, followed by its rebranding as Dexia Bank and then Dexia Group, propelled a rapid international expansion, into Europe primarily and then to other continents and gradually into emerging markets. Dexia became the world leader in the subsovereign credit market. In 2000, Dexia acquired Financial Security Assurance (FSA), a major credit enhancement company for municipalities in the United States.

In 2008, as with most other municipal bond insurers, the so-called subprime crisis hit FSA hard, jeopardizing Dexia. The bank was already in trouble because the interbank lending market had refused it further credit and the financial markets crisis found it holding a €1.7 billion bond portfolio. The French and Belgian governments stepped in to bail out Dexia because of the amount of local government savings for which it was responsible. The two governments provided a capital injection and sovereign guarantees for its liabilities to credit institutions and other counterparties. Dexia sold off FSA under unfavorable conditions, and the bank's new supervisors refocused its activities in Europe.

Sources: Paulais and Stein-Sochas 2007; Schpilberg-Katz 2008; Paulais 2009.

people, HUD directed Fannie Mae and Freddie Mac to grant mortgages to low-income people without going through the FHA and gradually increased their loan disbursement objectives. To achieve these government-mandated objectives, Fannie Mae and Freddie Mac put ambitious and evocatively named programs in place—American Dream Commitment and Catch the Dream, respectively—conceived to help the poorest households acquire a home. Eventually, commercial banks entered the market and subcontracted mortgage sales to independent agents, some of whom were unscrupulous (Kelly 2009). New mortgage products provided the basis for the GSE programs: low- or no-down-payment loans; 30-year mortgages; low initial interest rates (known as 2/28, 3/27, and so on); or even interest-only negative amortization loans, with monthly payments of less than the full interest due and the deferred interest to be added to principal at the end of the loan's term.

The mortgage credit system's architecture rested on a borrower's ability to refinance his or her mortgage. One method entailed cashing out an existing mortgage with a higher-value loan after a few years. Another relied on home equity lines of credit, in which an increase in home value (over the value of the initial loan) served as collateral for another loan to pay off interest due on the first loan. These two mechanisms acted as rechargeable mortgages that worked well as long as home prices increased, even as they helped feed rising prices and a housing bubble. Tax-deductible mortgage interest and other advantages for cash-out loans spurred borrowers to refinance systematically and on a grand scale. It became prevalent for borrowers to buy larger houses than needed and to use home equity lines of credit with tax-deductible interest to pay for consumer goods and everyday needs (Wallison 2009).

When the real estate market bubble burst and prices began to decline, the situation took down solvent and qualified borrowers—who appeared to be the primary victims ultimately—along with poorer households, artificially solvent borrowers, and speculators riding the bull market. Even after having made regular initial payments and taking out mortgages suited to their financial situation, solvent borrowers could find themselves in a negative equity situation: just as with the other borrowers, the value of their mortgage exceeded the value of their house. In September 2009, nearly 12 million households were thus *underwater* on their loans, owing more than their houses were worth (Moody's 2009). In most states today, because of tax laws and other laws, owners in a negative equity situation can best retrench by ceasing mortgage payments (Wallison 2009). The bank forecloses and takes over the house, feeding the snowball of ever-lower house prices. Some owners not in a negative equity situation choose to keep their houses while waiting for a hypothetical or gradual price increase. During this time they lose their ability to move—apparently worsening the employment situation in some parts of the country where there is a correlation between homeownership and unemployment rates.

Key Lessons and Situation Analysis

We first note that in the 2008 financial crisis, we see a shining example of the close relationship between local government finance and public housing and land development policies. In the United States and other countries, such as Spain (see box 1.12), the bursting of the housing bubble doubly affected local public finances: first, through a drop in receipts—declining up to 45 percent in the United States—and second, through increased social welfare expenditures because of the collapse of employment in the construction and other sectors.

The facts related previously allow us to highlight some fundamental truths about public policies. First, no miracle financial product, such as an unregulated, rechargeable mortgage, can make up for a borrower's insolvency. A policy of homeownership for everyone cannot work in the long term unless it is accompanied by social programs that shore up borrowers with personal assis-

BOX 1.12

Spain's Housing and Development Policy

Spain has experienced one of the deepest recessions in Europe. Its economic expansion of 1997–2006 ended abruptly with the bursting of the housing bubble that had raised all indexes. The mechanisms behind Spain's bubble depended, in part, on those operating in the United States, and on the specifics of Spain's socioeconomic and institutional circumstances, as well as its housing policy. The expansionary period began with strong demand for housing because of population growth and decreasing average household sizes. At the time, the demand was directed solely toward home purchases because of historical arrangements that penalized renting. Tax policy strictly favored homeownership while the legal framework discouraged construction of private rental properties. This situation obligated young households and the poorest people to purchase housing at all costs. In 10 years, the number of dwellings per person doubled in Spain: with 568 dwellings per 1,000 inhabitants, Spain now has the highest rate in Europe (Vorms 2009). Banks met this growth with increasingly attractive financial products for homebuyers exposed to ever-increasing prices. In addition, 40- or 50-year mortgage loans with low or even optional down payments encouraged the construction of second homes, as well as speculative investments in general. At the end of the expansionary cycle, property prices had increased more than 17 percent per year.

The bursting of the housing bubble precipitated bankruptcies for many property developers and builders, which aggravated the effects of the worldwide recession in Spain. It also plunged local governments into serious difficulty, given their dependence on receipts from construction activities, permits, and increases in land values.

Sources: Aspachs-Bracons and Rabanal 2009; Vorms 2009.

tance. Shifting such a policy's financing to the private or parapublic financial sector, at no cost to the central government, is by no means sustainable.

Second, housing policies based exclusively on homeownership for all are incomplete, by definition. Property ownership as development's ultimate goal and privileged path is a concept that stems more from cultural—or even ideological—thinking (Cannato 2010) than from economic rationality. Countries where the percentage of homeowners is low, such as Germany, the Netherlands, Sweden, and Switzerland, rank among the richest in the world, with some of the lowest levels of poverty and exclusion. In cities in developing countries, rental housing—which may be privately owned—that is regulated and secured for the renter and owner alike can accommodate the poor and recent migrants. It can also ensure some market flexibility and collect local savings. A well-regulated private rental sector can play an important part in a balanced housing policy, and so deserves donors' active support.

With regard to financing systems for local capital investments, such as the U.S. municipal bond market or specialized financial institutions, factors external to local investment financing caused the problems. These systems' viability is not in question, although some of their constituent practices—such as structured debt products—may well be.

The financial crisis shattered paradigms that had governed the financial sector for several decades: market professionals and donors commonly said that modernization required exclusive use of private sector financing and structured products. This discourse is no longer credible. In this regard, donors' legitimacy as advisers has been dented (Severino 2009).

However, it would be incorrect to think that all of the techniques underpinning the paradigms have become obsolete and useless. On the contrary, they remain at the heart of various financing solutions designed to stimulate mechanisms that will produce sustainable cities. For example, the bond insurers' collapse may condemn their profession—especially the way they exercised it—but credit enhancement as a whole and in various forms remains necessary and useful, for example, through guarantees or intercept agreements.

Given the increasing needs, and alongside private investment's difficult recovery and the stagnation or even decline in international aid, financing local investment in developing countries will depend—postcrisis more than ever—on mobilizing all resources and all available techniques. Worldwide, we see a kind of convergence of policies and strategies toward solutions that reflect some pragmatism. Often based on proven concepts, these solutions proffer a renewed spirit (see box 1.13) that seeks to fully exploit decades of technical achievements while learning from the 2008 financial crisis. We return to these issues later in this volume, especially in chapter 5.

BOX 1.13**An Infrastructure Investment Bank for the United States?**

Should a new bank be created to finance infrastructure programs in the United States? Felix Rohatyn, an investment banker, argues that it should be, according to a widely shared agreement about the alarming state of U.S. infrastructure. The broken levees that were supposed to protect New Orleans during Hurricane Katrina and the collapse of a highway bridge in Minneapolis highlight only the most tragic consequences of widespread underinvestment. American infrastructure investment has fallen below the level required for maintenance and renewal and well below the level required to meet future needs, such as for urban transportation, high-speed rail, and preventive measures to mitigate the effects of natural disasters.

Capital expenditure levels are not the only problem; the national infrastructure financing system, inherited from the early 20th century, is obsolete. Federal agencies administer thematic programs for airports, water, roads, and so forth through calls for projects that are answered by states and cities. The system does not promote a search for alternatives, such as adjusting airport runway pricing to demand volume rather than simply expanding an airport. Nor does it promote creative financing, such as establishing a fee for driving cars in city centers during rush hour. The system does promote new investment at the expense of maintenance and renewal, but does not compare projects' relative effectiveness, for example, preserving wetlands versus building new levees.

The federal government would capitalize the proposed national infrastructure bank with \$60 billion to \$70 billion, and the bank would then finance itself via capital markets. The infrastructure bank would examine each project's feasibility and interest by analyzing proposals' intrinsic profitability, comparing various solutions' cost-benefit assessments, and evaluating each project's effect. The bank would evaluate the proposed financial package, such as whether it uses a local government's capital, borrowing ability, or user fees, and would determine the bank's financial contribution. Funding could come in the form best suited for the project: a grant, loan, partial guarantee, interest rate subsidy to lower the rate on the bond issued to finance a project, credit enhancement, and so on.

The proposed infrastructure bank could issue its own bonds or create a secondary market for loans to attract private capital on terms better than local governments' can obtain with their isolated and often poorly designed public-private partnerships. Because a federal government guarantee would not backstop the proposed bank, it would have to build credibility for itself through a strong and transparent investment portfolio. However, its public purpose would justify tax exemptions for its bonds, just as municipal bonds remain tax free.

Source: Rohatyn 2009.

Notes

1. The international air ticket tax was created in 2006 in six countries originally. The majority of the funds raised are allocated to UNITAID, a United Nations agency specializing in AIDS-related health care programs. Between 2006 and 2009, it received \$650 million via the tax, representing 70 percent of its budget for the same period (Leading Group 2009).
2. In every case, the individual or private sector user can be called upon to pay for the investment once it is operational, or even in advance via land-based financing mechanisms.
3. These points are further explored in chapter 4.
4. We return to these subjects in chapters 2 and 5.
5. This section is partially based on Paulais and Pigeay (2009).
6. Some experts also believe that the estimates are overstated, partly because they include trading volumes of carbon markets, where the same credit is sold twice on average and therefore also counted twice.
7. These are estimates, to be compared with actual amounts.
8. At present, public transport projects are difficult to fund with carbon finance mechanisms because of methodological issues related to the measurement of emissions reductions, as mentioned previously.
9. The World Bank loan is for \$18 million to the municipality, with a central government guarantee. The ERPA of the Carbon Fund for Europe amounts to 900,000 tons CO₂-equivalent from the beginning of 2010 through the end of 2014. Captured methane will be used for electricity generation.
10. For example, in capturing methane from landfills, many parameters come into play, such as the volume of waste, its composition, and the climate. There is a threshold below which projects do not provide a sufficient return to be eligible for carbon finance. For large projects, the additional revenues can account for 15–50 percent of the investment, as well as up to 75–80 percent in cases where revenues can be earned from electricity generation, if we assume that the power can be sold at high prices.
11. For example, in the year 110 A.D., Pliny the Younger (1963 [110]) wrote about local investment with regard to the building of aqueducts to serve the cities of the Roman province of Bithynia (now Turkey) where he was governor.
12. In that school, infrastructure includes education and teaching infrastructure (Martin and Rogers 1995).
13. See, in particular, *World Development Report 2009: Reshaping Economic Geography* (World Bank 2009).
14. “Borrowing and taxes are two methods of financing public expenditure” (Ricardo 1999 [1817]).
15. This section is based on Chomentowski (2009).
16. For further information, see Institute of Delegated Management, <http://www.fondation-igd.org>.
17. This section is based on Paulais (2009).

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Urbanization and Sectoral Policies in Context

Africa(s) on the Move

The image of a *changing Africa* describes a continent, and especially the Sub-Saharan African region, often characterized by powerful social and economic dynamics. Africa's many variations show high contrasts; perceptions and presentations of the continent vary radically, reflecting stakeholders' different sensibilities and interests. Thus, Africa may appear simultaneously as a "new El Dorado for investors" or as a continent "preyed upon by famine, epidemics, and wars," without either assertion being completely untrue (OECD-AfDB 2007; Hugon 2008; Pourtier 2008).

As a whole, the African continent has reported very positive economic results in recent years, until the 2008 international financial crisis. Beginning in the mid-1990s, many African countries' gross domestic product (GDP) growth rates consistently exceeded 5 percent annually—higher than most industrial countries. In 2007, Africa's average GDP growth rate stood at about 6.5 percent (OECD-AfDB 2009). Sustained growth during a 10-year period resulted from at least three concomitant factors: (1) central governments generally improved their macroeconomic policies and public finances; (2) donor countries provided debt relief under the Heavily Indebted Poor Countries (HIPC) initiative; and (3) strong international demand for raw materials (ores, minerals, and oil) rose so much that oil-exporting countries contributed more than 57 percent of all GDP growth across the continent (OECD-AfDB 2009). Commodities revenues led to the creation of sovereign wealth funds, first in Botswana and Nigeria, and more recently in Algeria, Libya, São Tomé and Príncipe, and Sudan. African sovereign wealth funds, having garnered more than \$120 billion by the time the 2008 financial crisis struck, account for about 2 percent of all capital held by such funds worldwide (AfDB 2009).

Correspondingly, the African financial sector began to attract international investors with its likely high rates of return. Financial system reforms allowed

strong African financial services companies to emerge; for example, some Nigerian banks were able to raise funds in international capital markets through bond issues. Overall, a series of reforms greatly improved Africa's business climate (ECA 2007). In recent years, many African governments, alongside some donors, have been seriously involved in strengthening Africa's financial markets. They have streamlined securities and commodities exchanges, built more robust news and price quotation systems, and professionalized asset management companies, creating deeper, more liquid markets that attract investors. Donors who wanted to make local-currency loans to African firms raised funds from African capital markets (see chapter 4, box 4.3, in this volume). These initiatives should be very promising for African economies, to the extent that functioning financial markets collect and redeploy local savings into investments that the African continent needs.

However, Africa's economic and financial performances remain subject to external shocks, and they are unevenly distributed among African nations. The 2008 global financial and economic crisis caught up with African countries, like all others. It most affected Algeria, the Arab Republic of Egypt, Kenya, Morocco, Nigeria, and South Africa, which together account for two-thirds of Africa's GDP. In the poorest African countries, the 2008 economic crisis superimposed new challenges on those created by food shortages earlier in the year, and higher food commodity prices ensued (Devarajan 2009).

Although the 2008 crisis severely affected some countries, Sub-Saharan African countries' economies have generally shown great resilience. Prudent macroeconomic policies and targeted donor aid allowed African economies to recover from the crisis relatively quickly compared to other countries. Africa's private sector activity continued to grow, drawing on domestic and foreign investment. Investment returns from some sectors, such as telecommunications, count among the highest in the world (McKinsey Global Institute 2010).

The emergence of an African middle class shows¹ one of the obvious and promising manifestations of African economies' progress. The African Development Bank distinguishes three middle-class subgroups on the continent: an upper-middle subgroup, a middle subgroup, and a lower-middle subgroup, known as the *floating class*, which is actually near the poverty line. Exogenous shocks could cause the floating class to fall below the poverty line. While the entire middle class represents about 40 percent of Africa's total population, this floating subcategory makes up nearly 60 percent of Africa's middle-class population (AfDB 2011). The middle class has generally arisen with the concept of *inclusive* growth, stronger institutions, and local democracy (Birdsall 2010). It is also generally related to consumption patterns informed by priorities such as children's education (Banerjee and Duflo 2008). The African middle class is primarily urban, and in many ways, how it grows will determine how African cities and their financing will evolve, particularly for land development and housing.

Between 1995 and 2005, Sub-Saharan Africa's poverty rate declined 1 percent per year (World Bank 2011a). Countries have implemented structural reforms that have generally improved the business climate. These findings suggest that Africa "could be on the verge of an economic takeoff, the same as China thirty years ago and India twenty years ago" (World Bank 2011a, 3). However, these economic performances remain unevenly distributed among countries; they should be measured by the yardstick of structural constraints. Any slowdown in economic growth has severe consequences for countries whose population growth is high (see table 2.1). Some observers argue that to fully integrate with international trade systems, Sub-Saharan Africa needs an 8 percent annual economic growth rate until its demographic transition (Severino and Ray 2010). When Africa's average GDP growth rate was 6 percent, an 8 percent rate appeared achievable with higher levels of infrastructure and facilities investment and productivity. Postcrisis, it seems difficult to achieve for many countries. An annual growth rate below 3 percent, which would be considered an excellent result in the most developed economies, means that some African countries will show a lower GDP per capita in real terms (see table 2.1).

A slowdown in economic growth thus risks turning into a major social crisis by shifting tens of millions of households below the absolute poverty line—a line that often marks the beginning of malnutrition (Devarajan and Shetty 2010). Malnutrition proves an even more significant threat because food production remains a small part of agricultural activity (Losch 2008). The 2008 food riots that occurred in several countries on the African continent following the rise in price of basic foodstuff, and the tensions that persist around agricultural commodities prices, highlight most African countries' dependence on global food markets: more than 80 percent of the continent's food is imported (World Bank 2007a). This is a consequence of decades of governments almost universally neglecting to promote food self-sufficiency policies. Various factors underlie inattention to the issue, including historically low ocean-transport costs and agricultural subsidies in rich countries (Losch 2008).

On paper, Africa has a very large reserve of arable land, but farmers often exploit farmland beyond its regeneration capacity, damaging hundreds of millions of hectares. The physical evidence of farmland degradation varies among regions and among equatorial, tropical, Sahelian, and other zones. Water resources prove one of the most distinguishing factors. In general, Sub-Saharan Africa's considerable water resources remain underused because of deficits in facilities and infrastructure. However, North Africa and the Sahel already experience water stress; predictions about climate change's consequences forecast a decline in rainfall in these regions (World Bank 2007b).

The African continent also remains afflicted by conflicts that burden entire regions, post-conflict countries, and those struggling to emerge from crises, known as *failed* or *fragile states* and *fragile situations*. Despite progress in the

Table 2.1 Sub-Saharan Africa's GDP and Population Growth Rates, 1998–2008*percent*

Countries with less than 4% growth			Countries with greater than 4% growth			Oil-exporting countries		
Country	GDP growth rate	Population growth rate	Country	GDP growth rate	Population growth rate	Country	GDP growth rate	Population growth rate
South Africa	3.7	1.6	Mozambique	7.8	2.6	Equatorial Guinea	23.1	2.8
Kenya	3.6	2.6	Rwanda	7.6	4.2	Angola	10.7	2.8
Malawi	3.6	3.0	Sierra Leone	7.6	2.9	Chad	8.3	3.2
Guinea	3.4	2.0	Uganda	7.0	3.2	Sudan	6.7	2.2
Lesotho	3.4	1.2	Cape Verde	6.7	1.7	Nigeria	5.3	2.4
Swaziland	3.3	1.3	Ethiopia	6.7	2.6	Mauritania	4.4	2.6
Seychelles	2.7	1.1	Tanzania	6.1	2.7	Cameroon	3.8	2.3
Burundi	2.5	2.3	Mali	5.7	2.2	Congo, Rep.	3.6	2.1
Congo, Dem. Rep.	2.3	2.8	Botswana	5.5	1.5	Gabon	0.9	2.1
Comoros	1.9	2.2	Burkina Faso	5.5	3.2			
Togo	1.6	2.8	Ghana	5.4	2.3			
Central African Republic	1.4	1.9	Gambia	5.1	3.2			
Côte d'Ivoire	0.7	2.3	Namibia	4.7	2.0			
Eritrea	−0.8	3.6	Senegal	4.5	2.6			
Guinea-Bissau	−0.8	2.3	Benin	4.4	3.2			
Zimbabwe	−3.6	0.3	São Tomé and Príncipe	4.3	1.7			
			Mauritius	4.3	0.9			
			Niger	4.4	3.5			
			Zambia	4.2	2.4			
			Madagascar	4.1	2.9			
(30% of total population)			(39% of total population)			(31% of total population)		
Average	1.8	2.1	Average	5.6	2.6	Average	7.4	2.5

Sources: Adapted from Okonjo-Iweala 2009 using World Bank World Development Indicators.

past decade, Sub-Saharan Africa includes 16 of the 18 countries in the world where more than 50 percent of the population lives in extreme poverty (OECD-AfDB 2007).

African countries—especially in Sub-Saharan Africa—show very slow progress for their populations' health; average life expectancy in Sub-Saharan Africa is still only 46 years compared to 65 years worldwide, while the infant mortality rate is 9 percent, compared to less than 1 percent in Europe. Major pandemics—human immunodeficiency virus/acquired immune deficiency syndrome (HIV/AIDS), tuberculosis, and malaria—affect the continent: according to the World Health Organization, 25 million Africans carry HIV. Opportunistic diseases related to HIV/AIDS have reached nearly 10 percent of the population since the beginning of the 21st century, tuberculosis especially. The economic consequences prove numerous and varied and directly affect economic growth in all cases. According to the International Labour Organization, because more than 20 percent of South Africa's population carries HIV, the country will lose 1 percent of GDP growth per year simply because of a related decline in its labor force.

However, Africa's key characteristic is its youth: 65 percent of Sub-Saharan Africa's population is under the age of 25, compared to 30 percent in Europe. Theoretically, this relatively young population represents a unique potential for growth. In fact, this population is beginning to be a huge burden for countries in all domains, particularly education. Qualified training and education levels remain among the lowest in the world: only 5 percent of eligible youth achieve higher education. Working-age cohorts continuously enter fragile urban economies. With few construction, manufacturing, or services companies to absorb them, this influx poses extremely hard-to-manage problems (Ould Aoudia 2006). In major North African cities, youth unemployment exceeds 30 percent. In North Africa, and even more in Sub-Saharan Africa, the informal sector acts as a shock absorber, allowing city dwellers to make a living or at least scrape by (Losch 2007; OECD-AfDB 2009).

All African economies' performance is seriously affected by weaknesses in government, particularly the high levels of corruption, as measured by accepted indicators,² even though a number of countries report good results or palpable progress. Governance deficiencies manifest in the more prosaic "quiet corruption" that affects all levels of society and public services, for example, teacher absenteeism in schools, doctor absenteeism in medical clinics, drug thefts for resale on the private market, and so forth. This quiet corruption has long-term repercussions; beyond its effects on economic performance, it affects populations' education and health (World Bank 2010a).

Sub-Saharan Africa also suffers from a serious infrastructure deficit that hampers its economies' productivity and affects all sectors. Deficient electricity production probably takes first place among the factors hindering development, even in emerging countries such as South Africa. Sub-Saharan Africa's average

per capita electricity consumption is one-tenth that of developed countries. The transport sector also shows serious shortcomings in its seaports and airports, as do terrestrial communications services and fluids utilities (water, electricity, drainage, and sewerage). Lack of hub-and-spoke integration and poor rail, air, and road coverage weigh heavily on productivity in all sectors of the economy. This fragmentation also hampers trade among and within regions (World Bank 2010b; see box 2.5 later in this chapter).

A Perspective on Demographics and Urbanization

United Nations' population projections show that by 2030, the African continent will boast an overall population of 1.5 billion, with more than 1.3 billion people in the Sub-Saharan African region. Urbanization will deeply change demographics between 2010 and 2030: an urbanization percentage of about 30 percent at the beginning of the 1990s will increase to 50 percent in 2030 (UN-HABITAT 2008). These overall numbers hide large regional differences. Eastern Africa, currently the least urbanized region in the world, is rapidly urbanizing. North and Southern Africa are the most urbanized regions on the continent, but their rate of urbanization has begun to slow. In general, cities' growth is increasingly endogenous and relatively less migration driven.

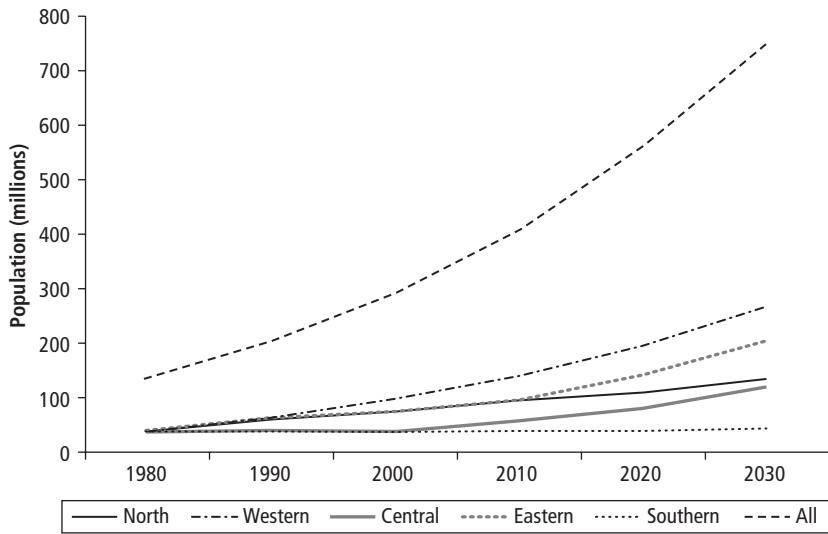
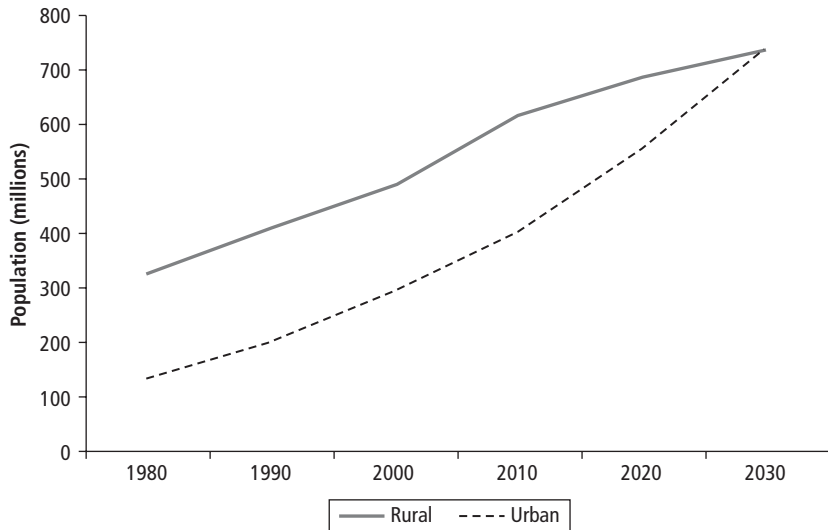
In 2010, Africa's urban population was estimated at 372 million inhabitants and forecasted to reach 754 million inhabitants by 2030, including 382 million new urban dwellers within two decades (UN-HABITAT 2008; see table 2.2). These estimates' accuracy should probably be put into perspective; the projections use empirical models with synthetic indexes for fertility and life-expectancy trends, and the definition of what constitutes a city is imprecise and variable (see boxes 2.1 and 2.2). Even current urban population numbers are

Table 2.2 Africa's Projected Urban Population Growth, 2010–30

Region	2010 (inhabitants, thousands)	2030 (inhabitants, thousands)	Growth rate (%)	New urban dwellers (inhabitants, thousands)
North Africa	87,509	128,308	1.9	40,800
Western Africa	108,750	261,425	4.5	152,675
Central Africa	49,434	118,515	4.5	69,081
Eastern Africa	88,005	202,882	4.3	114,877
Southern Africa	38,055	42,473	0.6	4,418
All regions	371,753	753,603	3.6	381,850

Sources: UN-HABITAT 2008; World Bank 2009b; Godin 2010.

Note: Regions follow World Bank (2009b) and Godin (2010).

Figure 2.1 Population Growth in Africa**a. Urban population growth in Africa****b. Urban and rural population growth in Africa**

Sources: Godin 2010; UN-HABITAT 2008; World Bank 2009b.

Note: Regions follow World Bank *World Development Report 2009*.

BOX 2.1**Africapolis: Lessons from a Standardized Urbanization Measurement Tool**

Two studies about Africa's urbanization, one conducted in 2008 and the other in 2010, have established a database of 2,582 urban agglomerations with 10,000 or more inhabitants in the Central, Eastern, and Western regions. A third study for Southern Africa will be available in late 2011. The studies' statistical and morphological identification of urban agglomerations uses remote sensors crossed with statistics from population censuses. The sensors determine construction continuity: an urban agglomeration is defined as "a group of buildings with a distance between them of 200 meters or less," as recommended by the United Nations in 1984. The minimum urban population threshold is 10,000 inhabitants.

In the 35 countries surveyed, the 2010 urban population was 117 million. The number of urban agglomerations has increased tenfold since 1950; 30 have more than 1 million inhabitants. Africa has the world's highest potential for urbanization; six countries (Burkina Faso, Chad, Eritrea, Mali, Niger, and Rwanda) have urbanization rates below 25 percent, and three fall below 15 percent (Burundi, Ethiopia, and Uganda). Appreciating urbanization's potential requires looking at all different sizes of cities.

Where and how does urban growth occur? No one disputes the population explosion in the great capital megacities of Khartoum, Kinshasa, Lagos, and Luanda, nor the recent growth of medium-size towns. The primacy of megacities that continue to grow and expand geographically occurs at the expense of second-tier cities, accentuating a longstanding dichotomy between a group of globalized capitals and second- and third-tier cities. However, with few exceptions, the growth of megacities has slowed sharply; they now grow naturally as rural-urban migration slows and population growth increases rapidly, 2–3 percent annually from 2000 to 2010.

Previous research revealed less about trends for cities with more than 10,000 inhabitants that show dense seedbeds of urban agglomerations growing in the orbit of megacities, along roadways, and especially in rural areas; often, their urban quality is not recognized politically or statistically. This urbanization process is especially typical of the Central African Republic, Ethiopia, and countries in Western Africa.

In Eastern and Central Africa—the last parts of the world to urbanize—urban dynamics undergo changes in speed and form; they propel higher urbanization rates and transform conventional views about Africa's urbanization process. Indeed, the most recent changes occur in densely populated areas, following a very active *in situ* urbanization movement. Some of these new centers of urbanization take the form of large conurbations linking megacities or second-tier cities, such as those in Cameroon, the Democratic Republic of Congo, and Kenya.

Source: Harre 2010.

BOX 2.2**Different Definitions of Urbanization in Tanzania**

In Tanzania, estimates of the extent of urbanization use three approaches. The first, a political-administrative approach adopted by the Tanzanian prime minister's office, finds its legal basis in the Local Government (District Authorities) Act of 1982. The act authorizes the prime minister to establish appropriate urban authorities, which are divided into three levels—cities, municipalities, and town councils. The second, a physical human settlements approach used by the Ministry of Lands, Housing and Human Settlements Development, features a classification based on population size and services levels. It contains four levels of urbanization: cities, municipalities, towns, and townships. The third, a statistical approach adopted by the National Statistics Office, rests on a small spatial unit—the enumeration area—that defines an “urban space” as one with 300–500 individuals, possessing their own market and providing their own social services.

Tanzania's urbanization rate ranges from 16.8 percent (using the political-administrative approach) to 22.8 percent (using the statistical approach) and 23.5 percent (using the human settlements approach). Nonetheless, these three measures still underestimate the true count. If we apply the occupancy-density-based approach of the Organisation for Economic Co-operation and Development (OECD), with the term *urban* defined as more than 150 people per square kilometer, Tanzania's urbanization rate rises to 33.5 percent.

Currently, the political-administrative approach prevails. One consequence is that many areas defined as *rural* do not receive intergovernmental transfers, even though they are already urban in practice. Peripheral areas generate business activities that help cities' economic development and must face large investment needs for basic services. Intergovernmental fiscal frameworks should be adjusted so these rural-urban areas can receive the same central government subsidies as local urban governments that fall under current administrative definitions.

Sources: World Bank 2009a, 2010d.

imprecise, and future projections for 20 years out are even more so. Nonetheless, the magnitudes remain indisputable.

Some subregional groups may experience significant migration because of structural economic and cultural trends or because of expected climate change effects. In North Africa, populations have concentrated in coastal areas for several decades. The traditionally compact North African city now spreads into extended conurbations like an oil spill along the coast. Elsewhere, migration between densely and sparsely populated areas will probably occur, following rapid and diverse changes to economies and territories. Population pressure creates competition for limited, available arable land in the Sahel; competition

for land also arises in coastal areas along the Gulf of Guinea and in the Great Lakes region. Climatic changes could exacerbate these latent tensions, eventually leading to political instability and massive displacements of populations toward cities in other regions (World Bank 2007b).

Still-Underestimated Challenges and Exploitable Opportunities

Sub-Saharan Africa has the highest urban growth rate in the world. In 20 years, its cities' current populations will double. Yet African governments and the international community do not appear to fully grasp the scale of the urban phenomenon, the economic and social challenges it poses, or the scope of opportunities it offers.

Underestimating the Challenges

Underestimating urbanization's challenges is an old story. In the early 1970s, the thinking in development economics was openly hostile to the city; a theory of *urban bias* stigmatized public policies that were assumed to focus on urban issues at the expense of rural areas and agricultural production—the latter considered a useful sector.³ Research showed a correlation between the acceleration of rural migration and the creation of urban jobs (Todaro 1969). Various studies, stripped of meaning by too many simplifications, finally gave rise to a Manichean axiom: the city acts as a parasite on the countryside, urbanization plays a negative role in the development process, and any investment in urban areas ultimately worsens poor countries' economic and social conditions (Lipton 1977).

Donors only gradually grew interested in urban capital-investment policies. The first generation of projects centered on urban infrastructure. Following economists' work on relationships between growth and redistribution (Chenery et al. 1974), the World Bank developed a *basic needs strategy*. It began financing urban development projects, referencing the basic needs strategy, because cities were seen as a major political risk.⁴ However, the World Bank's voluntarism proved relatively short lived; its commitment to urban issues lessened in the 1990s with the structural adjustment era.

At the end of the structural adjustment period, the international community placed its emphasis on poverty alleviation. The United Nations Millennium Development Goals (MDGs), set up in 2000 to measure progress in achieving concrete results, are essentially tailored to sectors—water, health, education, and so on—and thus not conducive to the cross-cutting approach that urban interventions require. Only one MDG specifically concerns urban issues.⁵

Because extreme poverty in Africa is most prevalent in the countryside, policies to alleviate it have focused on rural areas. Concomitantly, poverty in urban areas has increased (Ravallion, Chen, and Sangraula 2007). In addition, methods used to estimate urban poverty, especially extreme poverty in African cities, likely underestimate it (see box 2.3).

In summary, urban Sub-Saharan Africa has been neglected for two to three decades (Elong Mbassi 2005). At the same time, it has suffered from a genuine conceptual crisis. Previously, donors had been able to formulate a comprehensive vision for African cities⁶ and had mobilized to develop them with strategies, methods, and integrated financing tools (Annez, Huet, and Peterson 2008). However, starting with the structural adjustment period and until recently, the international community seems to have gradually abandoned the ambition to understand Africa's urbanization in all its dimensions. Cities have rarely been a continentwide priority for the international community. The city has suffered from being a complicated subject for donors and aid agencies; it has an unappealing, lackluster image and also fails to fit into only one sector within aid

BOX 2.3

Is Urban Poverty Underestimated?

If the poverty line is defined as living on the equivalent of \$1.00 to \$1.25 per person per day, the extent of urban poverty is often underestimated. Indeed, this threshold does not take into account the fact that the urban poor often pay rents that can reach 20–30 percent of their income and that they also must buy water—sometimes at astronomical prices—and must pay to use latrines and public transportation. When it was created, the poverty line was almost entirely based on the cost of food; the threshold would need to be raised to cover the cost of minimal housing and drinking water, especially in large cities.

Poverty lines based on the actual cost of food and nonfood items, adjusted by district or neighborhood, would give a more accurate view of reality. In cities such as Cairo, Lusaka, and Nairobi, a large percentage of the population lives on more than \$1.00 per day. However, people remain malnourished and live in insecure accommodations in the heart of unsanitary settlements without drainage or sanitation. Infant and maternal mortality rates in these settlements often remain extremely high; for example, in Ethiopia, the mortality rate for slum-dwelling children under age five is almost double that of children living in other districts in the same metropolis. Access to health care is generally better in cities than in rural areas, but the poorest city dwellers often have no access for lack of money. Life expectancy in the slums is significantly lower than elsewhere in the city and lower than the national average in some cases.

Sources: Satterthwaite 2004; Gendreau 2008.

organizations that generally remain precisely structured around sectors such as water, transportation, education, and so on.

African governments that bring urban issues to the forefront remain rare, as notably seen in an analysis of Poverty Reduction Strategy Papers (PRSPs) (see box 2.4). Countries had to develop these strategic documents as a necessary condition for receiving debt relief under the HIPC initiative.⁷ Few PRSPs have ranked cities within their priorities. It is significant that very few local governments have benefited from the HIPC initiative's effects. Of the 30 African countries qualified for the HIPC debt-relief initiative, Cameroon is one of the few that sent HIPC appropriations directly to its cities; Douala and Yaoundé benefited from structuring investments financed by France's Debt Cancellation and Development Contract (C2D), agreed within a debt-relief framework.⁸

Many local African governments still appear largely left on their own, without guidance, support, or recognition. Some have adopted an urban strategy, but few seem truly engaged in programs to support urban development. Many reasons underlie this apparent disinterest and detachment; they fall into distinct but interlocking domains—policy, governance, special interests, and logical apparatus—further discussed in chapter 3 of this volume.

Paradoxically, the ability to adapt and survive shown by residents of cities and largely abandoned settlements may work against them. Their adaptability and resilience reinforces the idea that cities and citizens can fend for themselves through their talent for self-organization and informal work; this perception legitimizes donors and governments concentrating their spending on other sectors of the economy and society. Donors and governments alike lack a strategic vision for urban administration and financing. They also underestimate the stakes. Thus, recent decades of underinvestment relative to the stakes have led to huge stocks of poor housing, underserved neighborhoods, and—more generally—the dysfunctions afflicting most cities on the African continent (see box 2.5).

Fortunately, there has been a renewal in donors' ability to formulate strategic plans, at least among those actually committed to supporting local governments and urban management. On the African continent, a growing number of central governments in the least developed countries should follow the example of emerging countries that eventually implemented urban policies.

Opportunities to Exploit: Improve African Cities' Productivity

The international community perceives African urbanization less negatively now than previously. Everyone understands that urban growth is structural: no policy can effectively oppose it, so helping it is better than fighting it. And eventually everyone remembers that cities contribute to economic and cultural development, in accordance with what has happened on other continents. Causal relationships between urban growth and economic growth prove difficult to

BOX 2.4**Poverty Reduction Strategy Papers Underrepresent Urban Issues**

Since the late 1990s, most African countries have developed PRSPs with support from the International Monetary Fund (IMF) and the World Bank. A PRSP aims to establish a national strategy for development and poverty reduction in alignment with the MDGs. Achieving the MDGs should lead to a significant improvement in access to basic services.

To date, 30 African countries have prepared PRSPs. Our review of these documents shows that although most countries take stock of urbanization, few make urban development a national priority, focusing instead on economic development and productive sectors. Most African countries' PRSPs are structured around the following themes: governance (90 percent), economic growth (95 percent), and infrastructure in the largest sense of the word (60 percent). All give a key place to human development; they blend Human Development Index (HDI) requirements with the MDGs, as in providing access to services such as drinking water, education, health care, and so on.

When it comes to urban administration and municipal capacity building, cross-cutting urban issues break off piecemeal into unitary themes such as infrastructure, human development, or even governance. Ultimately, we find it hard to estimate the real importance given to cities, especially because the PRSPs generally make no distinction between rural and urban basic infrastructure and because they rarely present budget projections for needed actions. Among the sectors that partially come under the urban heading, we see a prevalence of housing projects, followed by water and sanitation projects, land access, and—finally—local governance.

Only three African countries—Djibouti, Guinea, and Senegal—have urban strategies with relatively well-defined budgets, allocating one-quarter to one-third of projected expenditures to urban issues. No country places urban development at the heart of its strategy for poverty reduction. In most cases, because rural areas have higher poverty rates, agriculture and food security issues prevail over urban issues. Four countries—Ethiopia, Lesotho, Madagascar, and Zambia—place rural concerns at the center of their national strategies.

Overall, PRSPs give priority to productive infrastructure, such as interregional transportation routes and power generation and distribution, and to social services, such as health care and education. This priority probably favors national sectoral policies to the detriment of local-level and local government actions that remain underrepresented.

Source: Author.

BOX 2.5**UN-HABITAT Report on the State of African Cities**

In *The State of African Cities 2008*, the United Nations Human Settlements Programme (UN-HABITAT) aims to describe African cities and the continent's urban transition. The report reviews four geographic areas—North Africa, Western and Central Africa, Eastern Africa, and Southern Africa—providing details about six topics: the size and characteristics of urban populations, cities' economic role, urban poverty and housing conditions, environmental management challenges, urban governance systems, and emerging urban areas.

Chapters on these topics provide some national perspectives, bringing differences into relief. Even though cities generate about 55 percent of GDP, 43 percent of city dwellers live below the poverty line (\$1 per day), which has increasing and costly environmental impacts. Only North African countries see significant reductions in urban poverty, because of their development programs for informal settlement areas, land-tenancy regularization, and relocations. By contrast, in Western and Central Africa, urbanization occurs without planning, development, or social policies, and economic opportunities are also lacking. Cairo, Kinshasa, and Lagos will be Africa's three largest megacities by 2025 with populations of more than 15 million; they provide typical examples of these deficiencies. In Eastern Africa, the urbanization percentage is much lower than elsewhere (20 percent), but urban populations are expected to increase 2.5 times by 2030. Urban poverty and the proliferation of slums, sometimes home to more than half of the residents, as in Addis Ababa, Dar es Salaam, and Kigali, result less from urban expansion than from institutional failures that perpetuate socioeconomic inequities. Therefore, urban policies must take into account synergies between rural and urban areas and must also reform land tenure systems.

The report also highlights regional configurations emerging in the orbit of large cities: urban corridors such as Grand Ibadan–Lagos–Accra and Kenitra–Casablanca–El Jadida, and metropolitan areas such as Egypt's northern delta, Gauteng, and Nairobi (see map 2.1). The report fully describes a dozen of these configurations, emphasizing their role in structuring national and subregional economies. The authors recommend adopting supralocal economic growth models that would complement city-level urban policies. They also recommend other major investments in housing, basic services, and improved living standards for cities with fewer than 500,000 inhabitants; these smaller cities currently absorb two-thirds of urban population growth and often expand in the same underequipped conditions as the megacities.

Sources: UN-HABITAT 2008, 2010.

establish scientifically, but statistics show close correlations. The more a country grows, the greater the share of GDP produced in cities, rising from 55 percent in the least developed countries to 75 percent in the intermediate-revenue countries and 85 percent in rich countries. In intermediate-revenue countries, the per capita value added produced in megacities is several times higher than the

Map 2.1 Africa's Cities and Principal Ports

Source: World Bank, based on 2007 UN population data.

national averages. Many studies have found a relationship between a country's level of urbanization and its economic growth or its income per capita (Fay and Opal 2000; Annez and Buckley 2009; World Bank 2009b). This is equally true for Sub-Saharan African countries (Kessides 2006). Most authors agree that economic globalization should increase urban areas' comparative advantages with regard to economic output.

The city is an integral part of industrialization and the growth of commerce, construction, and service industries. That is where trade takes place, and with it, market, finance, and credit activities. The city is a special place for transmission

of information and knowledge; for teaching and research; and for the arts, politics, and cultural activities. These dimensions prove crucial for Africa's urban growth dynamic.

People do not always migrate exclusively for economic reasons: young people go to the city to escape the gerontocracy of rural societies, to launch themselves into the future, and to access modernity. The ongoing internationalization of economic and cultural life probably increases the city's attractiveness. A question remains about whether growth promotes urbanization or the city generates growth (Freire and Polèse 2003). In Sub-Saharan Africa, population growth clearly generates urban growth; the nature and extent of urbanization's economic benefits in recent decades remain subject to discussion. The city's primary virtue as an economic entity arises from gains in industrial productivity, a phenomenon recognized since the time of Adam Smith.⁹ But in African cities, modern manufacturing remains underdeveloped and has even declined since the 1990s; deindustrialization occurred during the structural adjustments and selling-off of state-owned industries (Fox and Sekkel Gaal 2008). Factories and workshops have also been lost to competition from imported goods manufactured in Asia. The share of manufactured products in total goods exported from Sub-Saharan Africa remains the lowest in the world (World Bank 2011a).

The informal sector's explosive growth has acted as a buffer, providing jobs and business activity, but it remains an especially fragile sector of low productivity and very low revenues. The arrival of low-priced Asian-manufactured goods has undermined whole areas of informal and formal sector handcrafted and small-scale manufacturing—for textiles, clothing, and everyday objects. Africa's informal sector provides mostly subsistence work with low multiplier effects. Without a formal manufacturing sector, it is difficult to create the virtuous circle of demand and agricultural-market modernization that is supposed to start the urbanization process (World Bank 2010c). Even the most urbanized countries often lack the conditions needed to structure the manufacturing sector.

All kinds of shortcomings handicap African cities' economies. Insufficient infrastructure, public health services, and environmental impact management combine with institutional weaknesses and deficient taxation, land administration, legislation, and governance; corruption and violence complete the tally. These urban dysfunctions result in significant losses of economic productivity that are difficult to quantify because data are lacking. In fact, the higher the level of urbanization, the greater the negative impacts of functional and institutional dysfunctions on economies (Freire and Polèse 2003). These dysfunctions cause direct losses, for example, in hours lost in travel and in capital destroyed by floods. They also have opportunity costs because investors lack secured land tenure, and all formal and informal firms lose productivity. These dysfunctions also cause indirect losses through environmental costs, ill effects on health from failed drainage and sanitation systems, inability to invest local savings, losses of

human capital, and so on. All these economic losses limit African cities' investment capacity. Eventually, losses and failures become self-sustaining in systems where each is both the cause and the consequence of the other; these systems constitute genuine underdevelopment traps (see box 2.6).

Ultimately, the old debates about whether African governments should or should not promote urbanization now seem very outdated. Today's cities are an irreversible fact; the doubling of their population in the next 20 years is inevitable. Questions about the share of economic growth resulting from urbanization will continue to generate debate and academic works. From policy makers'

BOX 2.6

A Basic Lesson in Urban Economy from Kinshasa

In the heart of Mont Ngafula, it took years to build a gas station. A few months later, the new owner installed a large lamppost on the site. Since the station has its own generator and does not depend on the city for its electricity, the light always works. In no time, many bars, an Internet café, and a telephone shop gathered around the light; buses and taxis began to make the site their local terminal, leading more people to the bars. Business picked up at the nearby hotel; it had been in decline for years. Through the magic of a single lamppost, a simple street corner, almost deserted in the dark, became a meeting hotspot where all kinds of activities take place until midnight. This is how Kinshasans build their city. Space belongs to whoever claims it and uses it. This process of appropriation is the foundation of the megacity's unbridled expansion (De Boeck 2006).

This story, told by an anthropologist, provides an exemplary illustration of the relationship between utilities and the local economy: in a city without much electricity and street lighting, one point of light immediately inspires a series of economic activities. Beyond any other commentaries about the private sector's role in this case or the extraordinary dynamism of people who seize the first opportunity, this story highlights the economic consequences of poor governance's disastrous failures. No electricity means no machines or computers and, in turn, disabled industries, handicapped commerce, and deficient services. In Kinshasa, an urban agglomeration of more than 8 million inhabitants, hundreds of thousands of potential jobs are probably lost. Beyond the lost jobs, this situation also means no sales tax receipts and no business taxes, and therefore no revenues to finance future capital investments. If we consider that a local government's primary role is to provide a framework so residents can maximize income and well-being and so production systems can maximize productivity, the above story reflects the structural difficulties that too many African cities still face.

Source: Author.

and administrators' points of view, the problem is different: they aim to exploit the economic growth opportunities brought on by urbanization—to optimize its ability to transform societies and economies. We must make Africa's cities more productive and efficient, referring back to traditional sectoral-strategy approaches, to the tiny investment economy, and to governance and urban administration.

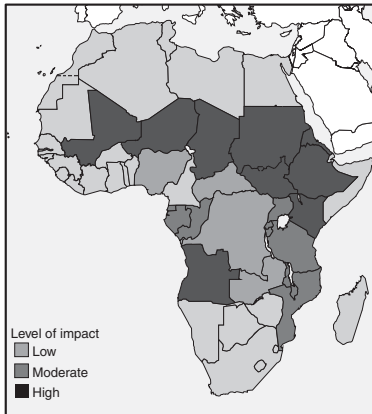
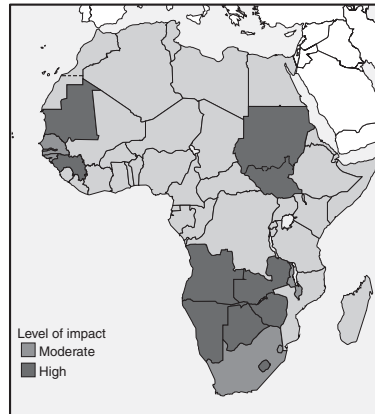
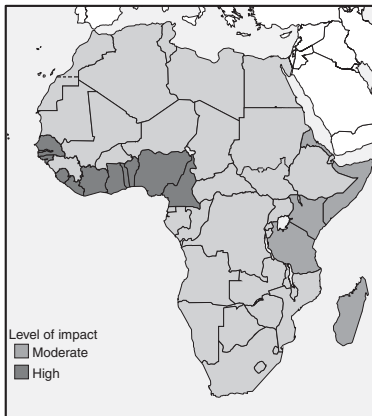
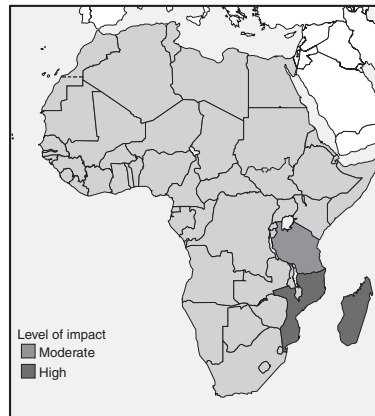
The New Challenge: Climate Change and Its Consequences

In Africa, exposure to climatic changes varies by region. Four major types of risk loom: floods, droughts, sea-level rise, and cyclones (see map 2.2). These phenomena's impacts will affect many cities directly or indirectly, particularly through agricultural production and potentially through migrations.

Flooding and Sea-Level Rise

Africa's most populous cities are found in coastal areas. In Western Africa, 40 percent of the population lives on the coast. In Senegal, for example, two-thirds of the population and 90 percent of industry are located in Greater Dakar; the city rises only a few meters above sea level. Many other cities in Sub-Saharan Africa may be affected by sea-level rise, such as Banjul, Cotonou, Lomé, and Port Harcourt. In North Africa, several cities are also directly threatened. For example, a sea-level rise of 0.5 meter would affect more than 2 million people in Alexandria, resulting in lost land, property, and infrastructure worth about \$35 billion, not including the value of lost heritage (Toulmin 2009).

Heavy rainfall, whether related to cyclones or not, has already had great impacts on large areas; cyclonic events regularly affect countries in Eastern Africa, such as Madagascar and Mozambique, causing significant injuries to humans, damaged property, and lost production. In some cases, heavy rains affect the region; in 2002, thousands of people fled their homes in Burundi, Kenya, Rwanda, Tanzania, and Uganda (Satterthwaite 2007, 2008). In Western Africa, heavy rains in 2009 and 2010 affected more than 1.5 million people. Flooding caused extensive damage, long disrupting economic activities, transportation, communication, and drinking water supply. In Benin—one of the most affected countries—direct damage was estimated at \$160 million and lost production at \$100 million, and the expected impact on gross national product was a 0.8 percent decrease (World Bank–UNDP 2010). We underscore the fact that flooding in urban areas, regardless of the weather event that causes it, is rarely simply because of infrastructure inadequacies; in most cases, flooding is a consequence of urbanization patterns and therefore stems from urban administration (see box 2.7).

Map 2.2 Four Main Types of Climate-Change Risk**a. Floods****b. Droughts****c. Sea level rise****d. Cyclones**

Source: World Bank 2008a.

Droughts, Agricultural Production, and Migrations

Cyclical droughts are not new to many parts of Africa, but they are expected to become more frequent and severe. In the same proportions, agricultural production will be affected in rain-fed and irrigated areas alike in Southern Africa, such as Botswana and Namibia.

The immediate consequences of drought on cities will be seen in rising food prices and the corresponding risk of social tensions. In some cases, there may be

BOX 2.7**Floods and Their Relationship to Land Use**

When thinking about protecting coastal cities from floods, localities first look to investments that protect against rising waters—especially high tides—and to drainage systems and pumping stations. However, in most cases, flooding closely correlates with how local governments manage urbanization and land use. Two recent examples show the relationship.

In Algiers, a flood in Bab el-Oued caused 800 deaths in 2001. Downstream, the flood was caused by a malfunctioning drainage channel that did not drain. Instead, it pushed water upstream because of a rise in sea level caused by a high tide combined with strong winds. Upstream, intense rains created an unprecedented volume of water that needed to be discharged. The flooding was caused by poorly maintained drainage systems and, most important, by impervious surfaces in the city's heights that had been created by urbanization and uncontrolled deforestation.

In Lomé, recurrent floods have affected the city center for many years. The city was built on a lagoon, partly at sea level; rainwater must be removed by lift stations, making it vital to protect the sea wall and keep drainage ditches operational. However, uncontrolled urban expansion in Lomé's heights has created impervious surfaces. The resulting stormwater runoff exceeds the lagoon's capacity to act as a retention basin and the lift stations' capacity to discharge the excess water.

Source: Paulais and Pigey 2009.

conflicts between urban residents and farmers—both sometimes depend on the same surface water or groundwater resources (Satterthwaite 2007). If drought is severe, the hardest hit rural residents will migrate to cities. These additional migrants will burden employment, land markets, and basic services provision, creating additional needs for capital investments.

Adaptation and Mitigation Investment Financing

A number of African cities directly affected by climate change will have to adopt adaptation strategies. These strategies should target urban management plans, land use, and development patterns. To design these strategies, local governments can benefit from a number of funds created specifically for adaptation purposes.¹⁰ Adaptation plans should also materialize in capital investment plans. Estimates for the overall costs of adaptation infrastructure—protection, drainage, and fortification—in urban Sub-Saharan Africa have yet to be calculated. In the present situation, and until the Adaptation Fund reaches full capitalization and provides additional funding, local governments finance specific adaptation infrastructure with the same budgets and the same financial instruments as

other investments. To the extent that infrastructure may condition the pursuit or profitability of many economic activities, the international community expects that the private sector will probably finance some adaptation measures. Rules and ad hoc mechanisms for such funding have yet to be established in accordance with national contexts.

Relatively less uncertainty surrounds mitigation financing. Because Sub-Saharan Africa accounts for only about 3.5 to 4 percent of global carbon dioxide emissions, the efforts it must make, and its share of financing opportunities, are commensurately minor (Collier, Conway, and Venables 2008). As mentioned in chapter 1 of this volume, carbon finance mechanisms concern mainly a small group of countries and certain types of activity; the mechanisms are not particularly adapted to local governments or small-scale projects in urban areas. However, the situation could improve because changes to methodologies now under way should allow regional-scale performance to be taken into account. In the present situation, as mentioned in chapter 1, opportunities for additional funding already exist, for example, via the Clean Technology Fund for projects in sectors such as transportation and waste. Given the relatively high carbon-production thresholds required for an Emissions Reduction Purchase Agreement (ERPA) and the relatively high project assessment costs, *a priori* only major cities will qualify for an ERPA. However, consolidation of mitigation projects becomes possible at the national level if an operator acts as a project wholesaler and assembler.

In general, we believe that there are opportunities for proactive cities and operators that make the intellectual investment needed to position themselves in innovative fields—climate change adaptation and mitigation. The expected gains are twofold: first, additional funding for a number of projects and second, acquisition of methods and skills that will benefit a city's administration in general, and the image it projects to investors in particular.

The Land Access Question

The question of land access remains at the root of most of the obstacles and difficulties that affect the administration of cities in Sub-Saharan Africa. It is a paradoxical situation, because in most countries, public authorities have a monopoly on land production, but this so-called state model¹¹ breaks down in most cases and applies only to a fraction of urban lands. Its failure has relegated all other modes of land occupation to informal, spontaneous, or illegal status (depending on the terminology commonly used), thereby fostering a dual conception of land occupation that opposes modern state law—generally considered the goal—in favor of informal or illegal land tenure systems.

The worrying physical, economic, fiscal, and financial situations of most African cities certainly stem from the land imbroglios that reign in some countries, after decades of national governments' manifest incapacity to regularly and appropriately produce improved land. A short overview of the situation and characterization of the stakes involved in land access, a subject of debate and extensive literature, follow

The Many Facets of Urban Land Production

While the state model's objectives and terms have changed little, major developments and innovations have occurred in the broad category of so-called informal, customary, or traditional land systems, where landownership is not guaranteed by a title deed issued by the government, giving rise to a wide variety of systems and land practices. Rooted in local contexts, these systems secure equally variable rights. As defined by UN-HABITAT, illegal neighborhoods (slums) house more than 70 percent of the urban population in many African countries (UN-HABITAT 2008). Case studies show very well that land

BOX 2.8

What Are "Informal" or "Illegal" Settlements?

The generic terms *informal settlements* and *illegal settlements* cover distinct physical realities. Configurations may vary city by city, but we distinguish six major categories:

1. Slums are often situated on public land, particularly in the inner city and outskirts. They are especially common for urban residents in Eastern Africa, much less so in Southern Africa. Slums are also where most rentals are located, especially in older slums.
2. Settlements are in interstices within city centers. This type of occupation is very vulnerable to eviction during urban redevelopment.
3. Unauthorized subdivisions are created by developers who subdivide occupied spaces and resell them as lots, often on private land. Such subdivisions are illegal because they do not comply with town planning regulations and are subdivided without permission from officials.
4. Poorly built housing is in areas with unsuitable terrain. These places are also urban renewal targets.
5. Residential suburbs are often occupied by the middle classes who build primary residences there. This category overlaps with residential property developers' subdivisions.
6. New peripheral areas are those that have recently absorbed one or more villages that are administered under customary laws.

Sources: Tribillon 2004; Cotula 2007; Durand-Lasserve and Selod 2007; UN-HABITAT 2008.

tenure systems are local (Tribillon 2004), rooted in country-specific or even city-specific political, historical, and cultural contexts (see box 2.8).

Thus, land situations—landownership and tenure systems and modes of administration—and land rights differ depending on the type of inhabited urban area. The areas differ by the land's status—whether it is state owned, privately owned, collectively owned, or owned under customary rights. They also vary by their occupants' social status and income (Tribillon 2004) and especially by the process of creating home sites and neighborhoods. Among these different land situations, *neo-customary* systems cover 50–90 percent of city dwellers (Durand-Lasserve 2005) living in many of the older informal neighborhoods and most of the cities' current territorial expansions. Neo-customary systems prevail in the peripheries' urbanization on land that often officially retains a rural classification, except in South Africa. Studies show that rural land laws exhibit very similar trends (Cotula 2007). Initially controlled by customary authorities, rural systems mix customary practices—especially land management by community representatives—with formal and informal practices specific to modern land markets (see box 2.9).

Recognition of illegal and neo-customary systems varies by country. In general, until the 1970s, governments fought occupations not coming under

BOX 2.9

Diverse Ways of Acceding to Land in Neo-Customary Systems

Neo-customary arrangements for land access vary but share common features. Three principal routes allow access to land under customary-rights status: (1) obtaining a parcel as a member of the group owning the customary land rights; (2) buying a customary-rights parcel on the land market; and (3) buying a customary-rights parcel guaranteed by the state. In many cases, the transactions occur between individuals, whether they are customary rights holders or occupants selling their interests.

With few exceptions, land under customary-rights status has long been sold and is no longer given to newcomers. Neo-customary systems have very actively participated in expanding the market for land, often contributing to steep price increases in suburban areas. The market for land under customary-rights status increasingly depends on middlemen, property agents, and land-purchasing companies.

At the request of new-owner nonprofit groups who want to regularize land tenure and ownership, rights transfers and sales procedures have been progressively formalized through written transactions and witnesses and by use of lawyers to draft sales agreements together with use of surveyors and urban planners.

Sources: Tribillon 2004; Rakodi 2007; Payne, Durand-Lasserve, and Rakodi 2008.

customary rights with evictions, preferring to have commercial establishments—factories, shopping centers, and property developers' residential developments—on coveted land in city centers. The status of customary systems is more complex. They were officially abolished in some countries, such as during land nationalizations in Cameroon in 1974 and in Mauritania in 1983 (Choplin 2006). By contrast, much of the original urban area historically comes under customary law in Benin, Ghana, and Rwanda. In Ghana, where 80 percent of land is under customary authority and administered by chieftains (see also chapter 3, box 3.11 in this volume), or Nigeria, traditional authorities soon engaged in land allocation and management (Farvacque and McAuslan 1992). In these cases, customary rights and national laws coexist, without the former necessarily being legalized.

Research in nine African countries shows a trend toward combining neo-customary and national systems (Durand-Lasserve 2005). This merging occurs mainly through increased official recognition of customary rights and adoption of new land codes (in Ghana, South Africa, and Uganda), simplification of registration procedures, and ratification of anti-eviction measures and collective land rights. To meet the demand for urban land in Botswana, the central government placed land contiguous with urban boundaries under land boards' administration—one board per tribe. The land boards subdivide their land and allocate lots for an indefinite period, issuing customary rights certificates (Rakodi 2007). In Cotonou, Benin, customary-rights holders initiate the bulk of urban and peri-urban land production; they sell parcels divided into individual lots, registering and authenticating each transaction. Before the new owners build on the land, the city's planning department produces a land readjustment plan that complies with existing land use plans, granting new, smaller lots to the owners along with occupancy permits (Durand-Lasserve and Selod 2007). In addition, observers note that participants in customary systems integrate some formal practices, such as complying with town planning regulations, authenticating transactions, and recording transactions in local property registers. On the scale of a large urban center, concomitant land systems may create complex situations with variations of neo-customary and illegal forms of land uses; commercial ways of accessing or acquiring land, rights, and relationships to the state model; and so forth. As we mentioned in chapter 1, this complexity may have significant repercussions on governance and urban development project-ownership arrangements.

A Continuum of Individual and Collective Urban Rights

These various land situations correspond to very unequal levels of tenancy. An increasing number of empirical studies indicate the circumstances in which legal or illegal land tenancy is—or is not—related to insecurity (Durand-Lasserve

and Selod 2007; Payne, Durand-Lasserve, and Rakodi 2008); the relationship's formalization provides a basis for thinking about land policies. Evidence shows that many—but not all—illegal settlements offer relatively secure tenancy. This situation is particularly true when they fall under customary law recognized by institutions or even included in government procedures. It is also the case when social networks set up and control settlements across an entire site or neighborhood, as occurs in South Africa.

For many illegal settlements built on public land, the risk of eviction lessens through de facto recognition of occupancy. Other illegal settlements, even when they have developed outside official procedures, are not considered illegal by governments, which recognize sales contracts or issue certificates of temporary occupancy during administrative formalization operations (Durand-Lasserve and Selod 2007). Various land situations provide multiple but nonetheless effective levels of tenancy. As a result, regularization programs have often had a relatively small effect on residents' security of tenure (see, for example, Cairo, Cotonou, Dar es Salaam, and Johannesburg in Payne, Durand-Lasserve, and Rakodi 2008).

Some observers focus on the collective dimension of land rights; they understand *land capacity* as the result of strategically constructed and tactically managed social relations with the central government, which becomes a player like any other. Land capacity varies greatly from one social group to another and not just because of income differences. In particular, variations in land capacity stem from groups' unequal ability to create institutions that improve land situations and neighborhoods' infrastructure and services, institutions that unlock value from land by collectively improving it, building on it, and putting it up for sale (Tribillon 2004). Although nonexistent in the state model, legalized forms of collective rights are nonetheless beginning to serve as tools for land reform, as an alternative to individual rights; legalizing collective rights is the first step toward regularizing informal and illegal neighborhoods (Durand-Lasserve and Selod 2007).

In summary, we see that illegal and neo-customary land situations largely derive from synergies between central government institutions, the private commercial sector, and groups forming urban communities. Land rights and related levels of tenancy have been formalized in the concept of a *continuum of land rights*. This continuum runs between two extremes: people without rights, such as squatters and tenants at risk of eviction, and people with rights who have a title deed or a long-term contract recorded in a public land register. Between these two extremes, the range of situations can be very large. For example, the categories of tenancy in effect in South Africa range from formal, intermediate, waiting, and informal ownership to the mere occupation of land, rental with a lease, or rental without a lease (Payne, Durand-Lasserve, and Rakodi 2008).

The Limits of the State Model

The state model remains dominant, but most experts and other observers question its current implementation rules and its relationship to other rights. In fact, it seems that all the systems currently in use have shown their limits. Governments have not had the technical or financial means to exercise their role as producers of urban land, to meet individual or collective needs for regularization of *de facto* urban expansions, or to subdivide new extensions of public land. Of course, this observation should be qualified according to each case and system; for example, the use of long-term leases in Ethiopia constitutes such a case (see box 2.16 later in this chapter). Generally, we can say that inadequate land administration causes the problems that currently affect the urban fabric of city centers and peripheries.

The state model has also shown its limits in relation to regularization programs for illegal settlements and the land titling that donors have supported since the 1980s. Cumbersome, centralized, slow procedures and the cost of requirements and unrealistic construction demands have led to these programs' relative failure; most remain at the stage of pilot projects (Durand-Lasserve and Selod 2007; Comby 2008; UN-HABITAT 2008; Payne, Durand-Lasserve and Rakodi 2008).

Basically, the state model draws criticism for its inherent inadequacy for African land situations. It was designed for raw land and has been applied in political situations to evict resident communities and impose colonial administrations' models of urban boundary definitions (Comby 2008). Except in rare cases, as in cities located in desert areas, the state model system conflicts with existing customary systems. Each country has had its own approach to expanding public land: nationalization, localized seizures, extension of urban boundaries, and prohibition or simple passivity toward customary rights.

The problem remains and grows larger, aggravated by the scope of cities' growth. No real land rights exist that would allow the central or local governments to ensure satisfactory conditions for their mission to produce urban land. And rural land rights do not necessarily adapt to situations in which agricultural land governed by customary rights becomes urban through its use (Tribillon 2004).

Finally, for most observers, the prevalence of illegal and neo-customary situations results from *laissez-faire*, the state apparatus—compromising principles, and individual and collective special interests: land grabbing by elites, nepotism, and cronyism often prove to be the real drivers of land administration (see box 2.10).

Land Development and Housing

The Production of Urban Land and Development

The production of improved urban land is a long and often complex activity that calls on several types of skills—legal, technical, and financial. In some of the

BOX 2.10**An Example of the Way Land Grabbing Occurs**

The city of Nairobi has about 200 slums, including two of the largest in Africa, Kibera and Mathare; they shelter hundreds of thousands of residents. The landownership patterns that prevail in these slums are linked to their history, the land's legal status, and tenancy seniority.

Land grabbing occurs through people in institutional positions of power or close to the government. Land grabbing happens when those charged with planning and development change the legal status of land, allowing privatization and modified land use. In some cases, land grabbing causes illegal-occupant evictions and occurs at the expense of affordable housing. The urban planning process instigates these actions to take control of land, and the people in charge of planning and implementing development are involved. It is not so much the land use plan as the private interests of the powerful that ultimately determine land use; this practice seems to be the rule rather than the exception.

With the expansion of land grabbing in slums, the landlord or *slumlord* has become increasingly important, whether he or she actually holds a title deed or simply benefits from political protection. These highly protected entrepreneurs have invested in rental housing in the slums; under these conditions, the slums provide some of the best returns on investment in the world—100 percent in Kibera and 70 percent in Mathare. Political protection proves particularly important because the buildings are illegal; a high level of protection allows for eviction of competitors occupying the spaces and, subsequently, the creation of valuable property portfolios.

The slumlords have outsourced their property administration duties and rent collection to thugs who have gradually organized into militias, empowering themselves, taking advantage of recent political events, and constituting gangs acting on their own behalf. The violence ravaging the slums then increases a notch.

Sources: Syagga, Mittullah, and Karirah-Gitau 2002; Médard 2006.

most developed countries, urban land development involves two distinct operators: a *land operator* and a public or parapublic land corporation or developer. The land operator acquires raw land; packages it into parcels; purges others' land rights; and ensures environmental remediation, for example, in brownfield sites. Public institutions, having the luxury of time, may perform these land development activities over a 10- or 20-year period, sometimes with the aim of controlling land prices. Semipublic land operators may also develop land in public-private partnerships (PPPs), or land operators may come from the private sector. The land corporation or developer—public or private—performs the second activity: improving raw land to make it usable and then marketing it to individuals, other property developers, builders, and others.

High urban growth makes urban land production crucial. Therefore, Africa should be seeing intense land development activity, yet this is not the case. If we look back to the 1970s and 1980s, land development corporations were created in some countries to ensure modern or prestigious urban developments and to build residential developments in suburbs. During the same period, donors—primarily the World Bank—were engaged in the land development sector with *sites and services* operations. These gave rise to specialized execution agencies that were basically land developers.

In Africa, land developers currently work mainly in South Africa and in North African countries where they have achieved various successes (see box 2.11). In Sub-Saharan Africa, the number of transactions and land operators remains limited. Some countries, following the example of Côte d'Ivoire, have long-standing development experience, but successes remain rare and production levels far below what is needed (see box 2.14 later in this chapter). Many

BOX 2.11

An Analysis of Land Market Failures in Algeria

In Algeria, the *land problem* is usually blamed for the housing market's failures. The land problem stems from various shortages and inadequacies: (1) a shortage of land for sale, (2) a shortage of public facilities and basic services, and (3) administrative failures in the field of urban planning regulations.

The shortage of land available for development stems from a combination of several factors, including the public sector's near-monopoly on land resources, a lack of advertising about sales, and the high cost of private property. Cash-ready buyers put pressure on the few available building lots, increasing land values. This dynamic would be beneficial if it financed the production of a greater number of new building lots. It actually subverts broad development when it finances only rent-seeking. Central government services set land prices according to a market value that is practically impossible to ascertain without public land auctions, given the opacity of the private land market. Land sales receipts should be spent on improving raw land where demand is highest, rather than disappearing into public coffers. However, no conduit exists to funnel improved-land sales receipts into financing of new development of raw land.

Without a structured land market, the land operator's job is impossible—failures mean not acquiring raw land, no packaging or improving it, and no selling building lots or reinvesting the proceeds in further development. Structuring the market would involve establishing an operational procedure for urbanism that would distinguish raw, improvable land not yet buildable from already improved and buildable land. It would also involve creating a local land corporation to improve land for building. Such land corporations have been created, but have turned into property developers who compete to win buildable land from the public domain.

Source: Comby and Horenfeld 2002.

countries have one or more land developers, but their production remains limited and often inappropriate (see, for example, box 2.13 later in this chapter). Land market failures hinder the production of improved land.

In other countries, we see local officials abdicating their responsibilities, especially when it comes to developing urban expansions. For their part, donors abandoned land development activities during the structural adjustment period. Consequently, for the past decade or two, a self-organized process has developed with varying degrees of success on city outskirts without any administration or planning, laying waste to large spaces. The process normally consumes large amounts of land and almost never includes installation of adequate utilities and infrastructure. A lack of consolidated data makes it impossible to rigorously evaluate this phenomenon across the continent. However, all recent urban studies and planning documents, together with field surveys of basic services and remote sensing analyses, confirm the extent of the phenomenon in most large cities and towns.

Land development shortcomings and failures have particularly affected post-conflict and fragile states, as well as many other countries where the same resignation arises in the face of challenges posed by development and funding shortages and ill-adapted legal systems. The consequences of 20 years of neglect and laxity weigh heavily on the situation; generally, the city outskirts have deplorable service levels (see chapter 3, box 3.14, in this volume). Most urban extensions prove hard to manage: local governments have difficulty collecting taxes or fees within them, and the local government has undersold the land, whose developed value is lost to the locality. Only the costs remain, and the future burden of upgrading these areas to ensure a minimum of services (see box 2.12).

BOX 2.12

Lost Opportunities in Tanzania

Tanzanian local governments have no incentive to regulate and control urban development. For many years, land was considered worthless. Even today, urban parcels are sometimes given away, free of charge. In such a system, local governments have no financial incentive to develop and sell their land. Since the 1970s, more than 80 percent of Tanzania's urban development has occurred outside the formal system.

Policy makers do not clearly establish the link between the lack of land available for development and the proliferation of informal areas. Having no incentives for formal development means that informal areas will continue to expand, accumulated facilities and services backlogs will remain a burden, and the ability to attract capital investments that require tenure security will prove limited.

Source: World Bank 2009a.

Housing

Housing and its financing constitute entire subjects beyond the scope of this volume. We discuss them here inasmuch as they relate to the issue of local investment, its financing, and—more generally—management of urban economies.

Although African nations possess housing policies of some description, effective working ones exist only in South Africa and some North African countries (see chapter 5, box 5.15, in this volume). A number of Sub-Saharan African countries may report that they have formal housing policies and strategies, and sometimes operators and financing instruments; in practice, their systems remain incapable of producing significant amounts of housing. In recent decades, formal housing rarely exceeds 10–15 percent of Sub-Saharan African cities' total housing production (Horenfeld 2006, 2007; boxes 2.13 and 2.14).

BOX 2.13

Housing Policy and the Formal Sector Share of Housing Production in Cameroon

Since Cameroon's independence in 1960, its housing policy has been based primarily on a system of direct central government intervention through three organizations: (1) the Mission d'Aménagement et d'Équipements des Terrains Urbains et Ruraux (Mission to Plan and Improve Urban and Rural Land, or MAETUR); (2) the Société Immobilière du Cameroun (Cameroon Real Estate Corporation, or SIC); and (3) the Crédit Foncier du Cameroun (Cameroon Land Credit Bank, or CFC). However, this system has met only a limited share of the demand; despite the government's measures, it has produced less than 1 percent of all parcels—a supply that is further limited to the upper-middle classes, especially civil servants.

Residents' self-construction and self-marketing efforts created parcels without central government or decentralized local government intervention. Land access has been organized in mainly informal or quasi-regulatory ways; customary authorities have developed the urban extensions, and de facto and legal landowners have increased the density of urban areas through the private rental market, the largest share of housing in Douala and Yaoundé today.

During the past two decades, structured private property developers have appeared, initially in response to incentives provided by the central government, such as a property development decree and tax incentives for structural projects. Yet these developers' interventions remain modest and lack visibility. In 2006, Cameroon's external debt was cancelled, and in 2009, the country set growth objectives, increasing the urgency of developing a housing policy once again. Therefore, Cameroon's central government committed to defining a new regulatory framework to stimulate coordinated, private production of parcels and housing.

Source: Groupe Huit 2009.

Forty Years of Housing and Land Development Policies in Côte d'Ivoire

After independence, the Ivorian government set a central objective: access to housing for all, the guarantor of social order. From 1960 to 1980, 70,000 housing units were built in urban and rural areas with central government support, for purchase or rental by civil servants. A set of specialized companies produced this housing, including the Société Ivoirienne de Construction et de Gestion Immobilière (Ivorian Construction and Property Administration Company, or SICOGL), and the units constituted a property portfolio ranging from luxury villas to affordable housing available for rent, lease purchase, or outright purchase. Another company, Société de Gestion Financière de l'Habitat (Housing Financial Management Company, or SOGEFIHA), managed the government-provided funding for housing construction and the government's affordable housing programs for low-income urban households. The Société d'Équipement des Terrains Urbains (Urban Land and Facilities Company, or SETU) acted as the land operator and developer. The Fonds de Soutien à l'Habitat (Housing Support Fund, or FSH) was the main government financing vehicle.

The economic crisis of the 1980s hastened the end of this system; it suffered from management problems and unprofitability. As part of a structural adjustment loan from the World Bank, Côte d'Ivoire committed to comprehensive housing policy reform, withdrawing from the housing sector and setting up provisions for the private sector to step in. The central government closed down its construction companies and ceded rental units to their occupants. A new institutional framework enabled government support for affordable and social housing construction and created two financing instruments. The Compte de Mobilisation pour l'Habitat (Housing Mobilization Fund, or CDMH) served as a relay to extend commercial bank loans for 10 or 20 years, and the Compte des Terrains Urbains (Urban Land Account, or CTU) financed raw land improvements through gains on sales of improved land to property developers. Ten years after these reforms took effect, housing production levels proved much lower than what was needed.

In 1997, a World Bank technical assistance project studied a new reform. The new policy had three objectives: (1) promote development of a market for land, particularly for low-income households; (2) encourage private investment in the housing sector by setting up a specific financial system; and (3) strengthen the institutional capacity of public and private sector operators involved in developing and managing urban land and housing. Policy implementation was to depend on three new instruments: (1) the Agence de Gestion Foncière (Land Management Agency, or AGEF) to improve raw land and resell it to private property developers; (2) the Société de Refinancement Hypothécaire (Mortgage Refinancing Company, or SRH); and (3) the Caisse de Garantie Mutuelle pour l'Habitat (Housing Mutual Guarantee Fund, or CGMH) to improve low-income households' access to mortgages. Implementation was delayed because of the complexity of the policy's institutional aspects, especially for legislation preparation and adoption and for the time required to create special instruments. Ultimately, the policy never completely went into force because of the political upheavals that affected Côte d'Ivoire at the turn of the 21st century.

Sources: Author; Paulais 1995; World Bank 1997, 2001.

These shortfalls occur for several reasons: (1) housing occurs downstream from land development and cannot develop normally because of insufficient improved-land production; (2) construction costs for the modern sector are high compared to those of the informal sector; and (3) most frequently, housing sales and marketing activities remain underdeveloped.

Formal sector property developers' production, which integrates construction costs and the cost of improved, titled land, remains confined to the narrow middle- and upper-class housing segments. The nature of small-business financing compounds this situation, because it features generally expensive, short-term products (see chapter 3 in this volume). Consequently, marketing and selling housing depends on refinancing loans or asking buyers for large advance payments, thereby increasing sales costs. Moreover, the lack of suitable loan products naturally affects potential purchasers.

Ultimately, modern housing production generally excludes the middle classes through a twinned eviction effect: insufficient supply and inadequate financing. Therefore, these households are pushed toward informal sector production. Middle-class housing constitutes a growing potential market in virtually all economies, but the production apparatus cannot meet the demand, resulting in strong pressures on the market that eventually affect lower-income groups. Housing failures often stem from policies that claim to want to "promote housing for the greatest number." Policies and implementations often wrongly merge the concept of social housing with housing for the middle-class and civil servants. And policies and implementations seldom pragmatically address social housing in its proper sense, meaning housing for the first two or three deciles in the income distribution.

We note that housing policies in Sub-Saharan Africa—national and donor-promoted ones alike—give no attention whatsoever to rentals. The scheme underlying all policies is "home ownership for all." An ownership society seems to be everyone's unquestioned goal, a universal model. Clearly, owning property is a dream rooted in most peoples' unconscious, wherever they live, and such a program easily wins general acceptance. Authors such as de Soto (1989) have even made individual homeownership the cornerstone of economic development processes.

This opinion could certainly benefit from some nuance, as may be highlighted by situations in some European countries (see chapter 1 in this volume). In Sub-Saharan Africa, realism should lead governments and donors to consider alternatives to home-ownership-for-all strategies; in most large cities, rentals make up most of the housing stock. Accurate and comparable statistics for many countries are difficult to find, but available figures—especially those derived from household surveys conducted for urban projects—report a high percentage of tenant households in large cities and towns. South Africa is

an exception; renters account for at least 75 percent of households elsewhere in Africa¹² (UN-HABITAT 2003a, 2003b, 2010; Huchzermeyer 2010).

Since the 1970s, because of the failures of the major public sector land corporations and operators that some countries had created (see, for example, box 2.14), the formal and informal private sector has built and controls most rental housing stock for the poorest through upper-middle-class residents. In some African cities—Nairobi, in particular—rental property developers in the private sector are now able to produce collective housing at several levels, following models similar to Cairo's, for example (Huchzermeyer 2007). Local authorities rarely recognize or support the rental sector.¹³ In most cases, rental properties develop in an unregulated fashion with regard to construction, facilities, and tenants' rights, while escaping specific taxes, often making rentals a highly profitable activity (see boxes 2.10 and 2.15).

In these contexts where rentals dominate, even effective housing policies focused on homeownership will inevitably have a limited effect on the market. Certainly one of the most important issues for Sub-Saharan African cities in the decades to come lies in supporting and managing the rental phenomenon, given its importance. We will return to this subject in chapter 5 of this volume.

A Review of the Particularly Serious Economic Consequences

Dysfunctional urban land corporations and production channels certainly remain among the biggest curbs to growth for local and national economies,

BOX 2.15

The Rental Market in Tanzania

In Tanzania, the formal and informal rental market is divided into several segments. Tanzanians employed in the formal sector may rent rooms from \$50 per month or a small apartment for \$300 per month. Upper-class Tanzanians and expatriates pay between \$1,000 and \$5,000 per month, depending on location and amenities.

Paying a year's rent in advance is common. The rental market is a lucrative business. Investors generally buy several units or apartment buildings at a cost of between \$200,000 and \$300,000. They rent units for \$1,500–\$5,000 per month, gaining a net return on investment within three to five years. Rentals in the informal sector and for lower-income brackets often have even higher returns. In a typical scenario, the property owner's family occupies one part of a housing unit and rents out the other to another party. In low-income neighborhoods, three or four families commonly live under one roof.

Source: World Bank 2010d.

hindering activity at several levels: economic operators cannot access secure, developed land for construction, manufacturing, commerce, and services; households remain without residential housing; and public and private sector investors, whether local or external (for example, migrants or foreign asset managers), cannot expand the rental housing supply.

Housing sector dysfunctions result in various kinds of economic losses in closely interrelated industries. The building industry suffers, its growth hindered, particularly for modern sector housing. Normally, housing construction is a major provider of jobs for unskilled laborers and traditionally a key to fighting unemployment in less industrial economies. Housing also normally serves as a prime vector for collecting lower-class and middle-class savings, with owners investing most—if not all—of their savings in their homes.

These economic losses are compounded by potential losses from deficient infrastructure and chaotic areas of urban expansion. The losses also combine with local budget shortfalls arising from lost land and property taxes and lost land value capture—revenues that could be used to finance future capital investments (see box 2.16). Urbanization develops through private initiatives in the informal sector, without local governments being able to realize any economic return.

Estimating the Amount Needed for Local Investment

Capital investment needs are difficult to grasp, even more so when it comes to distinguishing national ones from those that relate more directly to cities and local governments. Capital investment policies are programmed by sector of activity—transportation, agriculture, industry, health, and so on—and public budgets generally do not distinguish between national and urban investments. In this section, we point out various ways to proceed, show some recent estimates for African infrastructure as a whole, and provide an estimate targeted more specifically to local capital investments.

Estimates Using Ratios at the Macroeconomic Level

The so-called top-down macroeconomic approach uses GDP to determine the amount a country or region needs to invest in capital expenditures. The World Bank estimated that the amount of investment needed for public infrastructure in all developing countries was \$600 billion per year for 25 years (World Bank 2005). The assessment distinguishes between intermediate- and low-income countries; the former need to spend 5.5 percent of annual GDP, about \$460 billion annually, and the latter need to spend more to catch up on their backlogs: 7 percent of annual GDP, about \$1.1 trillion per year. According to this

BOX 2.16**Long-Term Leases and Land Value Capture in Ethiopia**

According to Ethiopia's constitution, land is government property. In theory, households should pay an annual rent to their local government for an occupancy permit. In 1993, the central government introduced a long-term urban land lease specifically for use in cities; it guarantees full tenancy rights for a fixed term, for example, 25 years in the Amahara region. One of this reform's aims was to give municipalities an additional, autonomous revenue source; regional governments regulate other municipal revenues.

Local governments allocate urban land leases through three different mechanisms: administrative prices set by the municipality, prices negotiated with the purchaser, and transfers through auctions. Purchasers must pay part of the lease amount upon acquisition and may elect to make payments with interest over time. The leases' effect on Ethiopian municipalities' revenues has proved to be limited. First, the central government granted only the largest cities the right to lease urban land. Second, urban residents did not find attractive what they perceived as a temporary landownership status, even though the lease provides full tenancy rights during its term. Conversely, an occupancy permit may become permanent; an article in the Ethiopian civil code makes lawful occupation of property immutable for permit holders who have paid taxes for more than 15 years. Permit holders may also acquire the property for free because the local government actually manages to collect only half of all annual rents due.

Most municipalities have allocated urban land leases based on administrative prices they set, except for a few large cities such as Mekele or the capital, Addis Ababa, which mostly use auctions. Administrative prices are low and do not reflect land values observed in the secondary (resale) market. Local governments could increase their property tax receipts by 20 to 60 times if they allocated land at market prices. Privileged individuals obtain leases through local administrations, capturing rents and making substantial profits on the secondary market. The dynamism of the secondary market shows the size of the municipalities' receipts collection shortfall.

Overall, urban land leases represent only a fraction of land tenancy modes, even in cities where they have been practiced for a long time. Meanwhile, urban expansion—driven by population growth and urban sprawl—pressures these leases' legal framework; observers note that there is no legal means to transfer rural tenancy rights into urban ones.

Sources: Peterson 2009; World Bank 2007a, 2011b.

top-down estimate, an estimate for urban investment needs can be determined by applying another ratio. It has been established (UCLG 2007) that about one-third of developing countries' total infrastructure investment needs concern urban areas; this average ratio should be adjusted to the relative size of each country's urban population (see table 2.3 later in this chapter).

Estimates Using Sectoral Analysis

The recently released Africa Infrastructure Country Diagnostic (AICD) made a decisive step forward in understanding Africa's capital investment needs. A multidonor initiative, it focuses on Sub-Saharan Africa and has collected data and analyses to estimate needs by sector for a 24-country sample. In addition to offering several key findings (see box 2.17), the AICD study produced an estimate of \$93 billion per year for overall investment needs, one-third of which is for maintenance, leaving a net investment need of \$60 billion annually. Infrastructure needs vary greatly by type of country, for example, fragile states versus oil-producing countries.

BOX 2.17

The Africa Infrastructure Country Diagnostic

According to the Africa Infrastructure Country Diagnostic study, its 24 sample countries spend the equivalent of 6–12 percent of their GDP on infrastructure, with a range from 1.0 to 4.5 times between the lowest percentage (Côte d'Ivoire at 3.8 percent) and the highest (Cape Verde at 18 percent). These percentages may seem relatively high compared to those of developed countries (about 5 percent in the OECD countries). However, they remain low when broken down into absolute value or per capita terms because of the weakness of developing economies: most of the countries surveyed spend less than \$600 million per year on public infrastructure, or less than \$50 per capita. The ratios are even lower for landlocked countries in the sample (Chad, Malawi, Niger, Rwanda, and Uganda); their investment per capita is less than \$30. South Africa spends about 10 times more on public infrastructure—\$500 per capita per year.

The level of investment is very modest when broken down to the cost of needed infrastructure: \$100 million in capital expenditures would generate 100 megawatts of electricity, build 300 kilometers of paved roads, or connect 100,000 households to drinking water and sanitation services. Furthermore, inadequate maintenance generates considerable need for repairing existing infrastructure, particularly roads—about 25 percent of the amount needed for new urban investments and 35 percent of the amount needed for new rural investments. If countries have high-performing road funds, it makes a big difference compared with countries that do not have road funds or have funds that do not perform well. Low-income countries in the sample spend more than 80 percent of their capital expenditures on energy and transportation because donors favor the transportation sector.

In addition, we note that debt cancellation for 33 HIPC countries led to a significant increase in the poorest countries' investment budgets; intermediate-income and oil-exporting countries show visible declines in their investment levels over the same period. The AICD study also provides information about these public investment implementations, including three important findings. First, public service corporations and

continued on page 99

Box 2.17 (continued)

utility companies that sell basic services—water, electricity, telecommunications, and so on—implement some of these investments: an average of 70 percent of all investments, or 60 percent in non-oil-producing countries. However, most of the funding intended for investment actually covers maintenance expenditures. Central governments remain responsible for most large investments, with external funding support, especially in the least developed countries and for water and transportation. Second, administrations and public or private service and utility companies spend only part of their allocated budgets—66 percent on average, ranging from 28 percent in Benin to 89 percent in Madagascar. Their poor spending performance derives from planning and implementation errors, cumbersome procedures, and so forth. Simply improving their ability to execute projects would increase investment levels significantly. Third, despite these mixed results, the data show improvements in economic indicators. On the one hand, GDP growth and public budget increases in the first half of the 2000s had positive effects on investment levels in low-income countries; those countries' investment levels increased 1 percent as a percentage of GDP, that is, \$40 million over five years. On the other hand, intermediate-income countries, such as Nigeria, reduced their capital expenditures to spend more on maintenance and operating costs.

Source: World Bank 2010b.

The AICD study divides infrastructure into three categories. The first comprises productive infrastructure at the national level, for example, energy generation and transmission, telecommunication networks, highways, railways, airports, and ports. The second category covers public utilities and services in urban areas, for example, roads, electricity, water, and telecommunications, and the third category comprises public utilities and services in rural areas, for example, roads, water, electricity, drainage, and irrigation. The AICD study estimates that the first category represents 34 percent of total needs, the second 32 percent, and the third 34 percent. Ultimately, the investment needs for infrastructure in urban Sub-Saharan Africa amount to just over \$20 billion (34 percent of \$60 billion) per year.

Estimating Local Investment Needs Using Base Costs¹⁴

The *base-costs* approach looks at urban investment on the basis of three types of needs: (1) upgrading infrastructure and facilities in already urbanized and occupied neighborhoods; (2) opening new areas to urban expansion to accommodate some growth; and (3) modernizing facilities and economic development. The base-costs method makes detailed estimates for typical development operations and then extrapolates the estimates to overall population levels broken down by city size and region. This method presents some problems

and risks, producing inaccuracies inherent in expanding a sample's results to a countrywide or regional scale.

All the relevant urban projects—from the earliest urban projects financed by donors in the 1970s to the municipal development programs of the 1990s—have kept data on urbanization and facilities costs relatively current. However, urban sprawl's growing importance and cities' accumulated, ever-larger backlogs in basic utilities make it challenging to estimate urban extension costs. African cities' high consumption of space per person strongly affects development costs; for the same level of infrastructure and facilities per capita, costs vary by as much as threefold depending on occupation densities (World Bank 2010b). Some urban extensions, particularly those in medium-size towns, are so sparsely populated that infrastructure and facilities costs become prohibitive. Yet it is precisely these small and medium-size towns that anticipate the most urban growth in the next 20 years.

However, in this volume, we thought it useful to use the base-costs approach to estimate investment requirements. Indeed, it is ultimately the method best able to quantify development costs for urban extension areas; they constitute a large share of local investments, and their ownership is almost always local.

Our base-costs estimate excludes the cost of land and superstructure facilities but includes basic infrastructure costs—roads, drainage, water, electricity, sanitation, and solid waste facilities. It also includes costs for off-site installations, studies, and supervision. We consider three different levels of services and various characteristics of saleable products, the land, and lots. We based these options on several recent operations conducted in various African countries; they reflect the economic realities of local markets. These factors led us to adjust our assumptions for each major region. Finally, we added the cost of refurbishing shantytowns and underserved neighborhoods to the urban extension costs, using values determined by UN-HABITAT in 2008.

In all, according to these assumptions, Sub-Saharan Africa's funding requirements established by the base-costs method range from \$12.5 billion to \$35.0 billion per year, depending on the urban extension areas' equipment levels and population densities (see table 2.4).

A Summary of Results for Each Approach

Applying the macroeconomic approach to individual countries, using a rate of 5 percent to 7 percent of GDP depending on the country's development level, produced a minimum estimate for needed public investments across Africa of about \$100 billion per year. Applying the ratio of one-third of the total for urban areas, cities' annual investment needs amount to \$30 billion per year for the continent overall, of which \$20 billion is for Sub-Saharan Africa (see table 2.3). For Sub-Saharan countries, excluding South Africa, the average amount of investment per capita is on the order of \$15 per year. The mechanical nature

Table 2.3 Macroeconomic Approach: Urban Investment Needs

Region	Urban investment level per year (US\$, billions)	Per capita (US\$)	Overall GDP (US\$, billions)	Urban financing level (% GDP)
North Africa	10.58	62.99	582	1.82
Western Africa	5.50	18.09	284	1.94
Central Africa	2.81	7.55	150	1.88
Eastern Africa	5.50	13.57	235	2.15
Southern Africa	5.61	101.12	309	1.82
All regions	30.00	28.67	1,560	1.92

Sources: Godin 2010; IMF 2009.

Note: GDP = gross domestic product.

Table 2.4 Base-Costs Approach: Urban Investment Needs Based on Service Levels
US\$, billions

Region	Service level	Extension development	Rehabilitation development	Total	Total/per year
North Africa	1	13.59	6.80	20.39	1.02
	2	46.63	6.80	53.44	2.67
	3	57.43	6.80	64.24	3.21
Western Africa	1	63.12	46.65	109.78	5.48
	2	220.13	46.65	266.78	13.33
	3	269.99	46.65	316.64	15.83
Central Africa	1	28.56	19.17	47.73	2.38
	2	99.66	19.17	118.78	5.93
	3	122.16	19.17	141.33	7.06
Eastern Africa	1	27.65	37.71	65.36	3.26
	2	103.40	37.71	141.12	7.05
	3	129.04	37.71	166.75	8.33
Southern Africa	1	1.47	5.68	7.15	0.35
	2	5.05	5.68	10.73	0.53
	3	6.21	5.68	11.90	0.59
All regions	1	134.40	116.03	250.44	12.52
	2	474.83	116.03	590.87	29.54
	3	584.84	116.03	700.88	35.04

Source: Godin 2010.

of the method obviously leads to focusing investment efforts on Africa's richest regions.

The base-costs approach gives the results summarized in table 2.4.

AICD's sector-analysis approach estimates the need for infrastructure investment in urban Sub-Saharan Africa at \$20 billion per year, as mentioned previously.

These three estimation methods ultimately define a fairly consistent set of numbers while showing regional disparities; they result in a range of urban investment needs from \$15 billion to \$30 billion per year for Sub-Saharan Africa alone.

This range may be considered large, but we need to consider two types of approximations or bias: these estimates do not cover exactly the same types of investments and do not count certain types of them. The sectoral approach focuses on major infrastructure, while the base-costs approach stresses land development and services. Each attempts to account for issues beyond its central subject, such as urban extension developments that include off-site infrastructure costs, so there is some degree of double-counting. However, some local investments are not counted, especially all superstructure facilities and industrial and commercial zones. Inclusion of these missing elements suggests that even if we allow for a low equipment standard, the amount of investment needed is at the top of the range, about \$25 billion per year.

Whatever the amount needed, we must bear in mind that the notion of local investment must be viewed through the lens of local governments' areas of authority. To a large extent, the nature of ownership—between local and central governments—will ultimately determine how capital investments can be financed.

Notes

1. The African middle class is defined in relative terms, that is, households located between the second and eighth deciles on the income scale, or in absolute terms, that is, households with 2009 annual income and purchasing power parity greater than \$3,900 (AfDB 2011).
2. See Transparency International's Corruption Perceptions Index, http://www.transparency.org/policy_research/surveys_indices/cpi.
3. Surprisingly, this assumption echoes economics' first premises, as postulated by François Quesnay and the Physiocrats; two centuries ago, they had considered agriculture the only productive sector, seeing industry, commerce, and services as sterile activities.
4. "The frustrations that fester among the urban poor are readily exploited by political extremists. If cities do not begin to deal more constructively with poverty, poverty may begin to deal more destructively with cities" (McNamara 1975, 20).
5. Subobjective 11 is "to have significantly improved the living conditions of at least 100 million slum dwellers." This objective is paradoxical because even if it is achieved, given the expected increase in slums worldwide, it would result in a deterioration of the situation in real terms because of the sheer number of slum dwellers.
6. See, for example, Farvacque-Vitkovic and Godin 1997.
7. The International Monetary Fund and the World Bank launched the HPIC initiative in 1996; in 2005, it was complemented by a multilateral debt-relief initiative that included the African Development Fund.

8. The C2D is a French bilateral addition to the HIPC initiative.
9. For example, in *The Wealth of Nations*, Book III, Ch.1, Adam Smith notes, “We must not, however, upon this account, imagine that the gain of the town is the loss of the country. The gains of both are mutual and reciprocal, and the division of labour is in this, as in all other cases, advantageous to all the different persons employed in the various occupations into which it is subdivided” (Smith 1904 [1776]).
10. See chapter 1, the section titled “Climate Change and New Financing Mechanisms.”
11. Landownership is guaranteed by the central government. It appropriates all urban land rights and transfers the property by issuing a land title deed after identifying the land, marking its borders, and registering the parcel in public property tax rolls (cadastre) (Comby 2008; Tribillon 2004). New urban spaces arising from a land development plan follow an identical process after the subdivision and allocation of individual lots.
12. In Port Harcourt, Nigeria, 86 percent and in Nairobi, Kenya, 84 percent of households are rentals, for example (Huchzermeyer 2010).
13. Among the notable exceptions, we mention South Africa, where rental housing has a small share for historical reasons, but now the government actively supports and structures “social housing institutions” (Hervé 2009).
14. This section comes from Godin (2010).

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Decentralization, Basic Services, and Local Governance

A Perspective on Decentralization

The international community has promoted decentralization in developing countries for nearly 50 years (UN 1965). A range of situations prevails after decades of decentralization, varying from one country to another. In this regard, it may be more appropriate to speak of decentralizations in the plural (Le Bris and Paulais 2007). Some African countries have merely outlined reforms, other countries have adopted reforms but with differing objectives, and still others see reforms going nowhere or in reverse.

A Concept That Can Take on Many Meanings

Decentralization is a term with many meanings, depending on the viewpoint—institutional, administrative, political, or fiscal. The term is also used to describe a condition and a process. Decentralization in the institutional and administrative sense commonly refers to three distinct stages (Gauthier and Vaillancourt 2002): (1) deconcentration, in which the central government assigns some of its powers to agents who perform their duties in a territorial division under central government authority; (2) delegation, in which the central government delegates responsibility for specific domains to more or less autonomous entities, which generally remain accountable to a higher level of government; and (3) devolution, in which the central government transfers specific powers to local governments, which are granted decision-making autonomy. In fact, these three stages often coexist in an antagonistic or complementary fashion (Shah 2006; Dafflon and Madiès 2008).

Decentralization in the political sense forms part of the concept of devolution. It assumes that public officials elected by their constituents perform duties at the territorial level, answering for their actions to elected assemblies. To some extent, political decentralization overlaps the *democracy in proximity* concept, and is often seen as an opportunity to ground African countries in legitimate

governance (Elong Mbassi 2007). Decentralization in the fiscal sense also forms part of the devolution concept (Petersen and Freire 2004). It assumes a clear distribution of financial relationships between upper and central levels of government and the lower territorial level; the latter has the power to use funds and make spending decisions (Smoke 2008). To some extent, fiscal decentralization overlaps the concept of financial independence, often perceived as the most authentic expression of the decentralization process (UCLG 2010).

Decentralization often appears as a process, starting with a deconcentration stage, followed by political decentralization, and ending with financial decentralization as its “highest” stage (Fritzen and Lim 2006). This final stage presumably offers the highest economic efficiency, as empirical studies for the European Union’s regional policies sought to demonstrate, for example (OECD 2006; Ahmad, Brosio, and Tanzi 2008).

To a certain extent, the African continent remains subject to a movement toward standardizing institutional and administrative forms. With rare exceptions, decentralization finds consensus, especially as a means to improve basic services access (Ahmad et al. 2005). However, decentralization comes in different forms, particularly political and fiscal; it remains partial and incomplete. This is especially true when local governments have their decision-making powers truncated and are ultimately disempowered in the eyes of their constituents (Devarajan, Khemani, and Shah 2007).

Changes on the Continent

In 2002, a review based on 30 Sub-Saharan African countries revealed decentralization’s progress from political, administrative, and fiscal points of view. Although political decentralization had advanced in more than half of the countries surveyed, administrative decentralization was marking time, and fiscal decentralization was described as weak. According to consolidated indicators for all three dimensions, the English-speaking countries of Ghana, Nigeria, South Africa, and Uganda ranked among the most advanced countries. The French- and Portuguese-speaking countries were generally rated as slower (Ndegwa 2002).

Of course, a range as broad as Sub-Saharan Africa masks large differences among institutional, legal, and local governmental systems; it also masks contextual differences, such as a country’s size and share of population. However, the question of decentralization has generally been posed more in terms of freedom than in terms of local areas of authority and resources. Furthermore, central governments sometimes use the decentralization concept rhetorically, even as local elites may see decentralization as a way to leverage their systems of capture and influence.

Across Africa, power transfers from central to local governments remain relatively ineffective. Central governments control land in large measure; they refuse to give up power over something so politically and economically important. In

addition, public procurement processes remain highly centralized, and basic services management often occurs without local government involvement.

The weakness of local government finances provides evidence of decentralization's fragile condition. The degree of decentralization is commonly measured by assessing local governments' share of total revenue. The concept of *level of fiscal decentralization* compares the actual level of local revenue with what public revenues should be, according to an empirical model (Bahl and Smoke 2003). According to this model, many Sub-Saharan African countries present a mediocre level of fiscal decentralization. Economic policy guidelines may be the reason for low local resources (Bahl and Smoke 2003).

In all events, strengthening local governments' financial autonomy appears as a prerequisite for the credibility of the decentralization process as a whole (Yatta 2009). Given the difficulty of improving yields from local government resources, central government transfers remain critical budget elements. Once transfers reach a certain level, a substitution effect gradually accelerates, thereby increasing local dependence on the central government for revenues and services. Taxation efficiency and local government empowerment—the heart of the decentralization concept—are reduced.

The question of whether decentralization is actually progressing on the continent is a subject of debate. A number of examples in this volume suggest that it is, in fact, often retreating. At least two factors appear to contribute to this regression, in addition to some countries' crucial but lacking political will. The first factor arises from the side effects of basic services reforms. In the name of financial and technical streamlining, these reforms too often exclude local governments from administering basic services. Local governments often have no real responsibility for land management and no power over public utilities and pricing. Hence, they lose all leverage over city administration and therefore much of their legitimacy with respect to their citizens. Consequently, they lose opportunities to increase local revenues.

The second factor arises from measures that resulted from the Paris Declaration of 2005 in favor of aid effectiveness. The idea was that more aid for central government budgets would increase aid effectiveness. Such budget assistance inherently favors vertical sectors, such as health and education, and national implementations (through line ministries) at the expense of territorial approaches. Paris Declaration guidelines also promote international aid to strengthen intergovernmental transfer policies, from national budgets to local budgets. This strategy aims to strengthen decentralization, but most often eventually reinforces local governments' dependence on their central government.

Ultimately, these measures risk being implemented at the expense of local economic efficiency. Decentralization in the fullest sense of the term implies empowering local governments, particularly in financing and policy implementation across their territories.

Local Governments' Institutional Landscape¹

Creating New Administrative Entities from Settlements

In the past 20 years, Africa has experienced a strong movement to legally classify settlements, creating new entities—towns, villages, municipalities, *communes* (cities), and so forth. The number of local governments and the territorial organization of various countries remained relatively stable until the emergence of decentralization and full settlement classification movements in the 1990s. These movements occurred in the wake of structural adjustment policies and democratization in most countries. The movements' most visible manifestation was an increased number of local governments, mainly in small settlements; large cities generally already enjoyed decades of municipal or similar status.

The emergence of new, decentralized levels of government, including regional and interlocality levels, remained tentative in most regions. However, local government frameworks primarily depended on the municipal model; deconcentrated services were also strengthened in prefectures or governorates known as *commands*. (Note that most African countries are unitary, not federal, nations.²)

The number of local governments counted in 2010 remained quite modest. An estimated 25,000 local governments were spread over the continent's 53 countries, predominately in Western and North Africa. Each of these two regions had about 10,000 local governments, including 2,000–3,000 mostly French-speaking towns and communes (table 3.1).³ So-called base localities, that is, urban and rural townships and villages, represented 80 percent of local governments, with 20,000 entities; about 8,000 of these entities, or 40 percent, were classified as urban as opposed to rural towns, or had another legal identity and completely autonomous financial status.⁴ However, of these 8,000 base localities, only one-third (3,000–4,000) had a population greater than 10,000 inhabitants.⁵

In French-speaking countries, rural localities and simple administrative groupings have attained the status of commune with a distinct legal status and financial autonomy. The old distinction between fully functional local governments and

Table 3.1 Local Governments' Institutional Landscape by Major Region

Region	Local governments	All towns, villages, and communes	Excluding rural towns, villages, and communes
North	9,357	8,932	2,601
Western	7,679	6,386	1,858
Central	2,300	1,745	760
Eastern	4,585	4,128	2,709
Southern	827	701	425
All	24,748	21,892	8,351

Source: Sinet 2010.

other governments has gradually disappeared in favor of a single status that puts all communes on an equal footing, regardless of size. This movement has affected most French-speaking countries, including those experiencing challenging political situations; in postconflict countries such as Côte d'Ivoire and the Democratic Republic of Congo, communes are set up as transitional actors, in contrast to central government institutions with dubious legitimacy.

In English-speaking countries, decentralization usually occurred later and in reaction to previous territorial delineations based—in some cases—on the principle of racial segregation.⁶ South Africa was probably the first English-speaking country to engage in the decentralization process, which aimed for better resource allocation (especially financial) between local governments. This goal was set out in the country's Soweto Agreement; the postapartheid constitution; and the Local Transition, Facilitation, and Demarcation Acts in 1993. Uganda waited until 1995 to include the principle of decentralization in its new constitution, and two years later, in 1997, it adopted the Local Government Act. In 1998, Tanzania adopted a Policy Paper on Local Government, opting for a voluntary devolution (Kundishora 2009; see box 3.1). Overall, the number of rural localities in English-speaking

BOX 3.1

South Africa's Experience with the Demarcation Act

Only a few countries on the African continent have sought to limit the number of local governments and maintain *noncommunalized* or state-owned portions of their territories. This is the case in the Maghreb countries of North Africa, where territories' access to municipal status is more selective; the territories must meet efficiency and sustainability considerations for existing structures. The most emblematic experience comes from South Africa; after apartheid, it reduced the number of towns and redrew their boundaries, aiming to erase the social and economic inequalities inherited from previous times and to improve cities' productivity and administration.

The Municipal Demarcation Act of 1998 led to the creation of metro areas—Cape Town, Durban, East Rand, Port Elizabeth, Pretoria, and Johannesburg—thereby reducing the number of municipalities from 843 to 284. The act also ranked them into three categories:

- Category A featured 6 metropolitan municipalities that received an exclusive executive and legislative authority over their jurisdictions.
- Category B featured 232 first-level municipalities sharing their authority with category C municipalities in the same jurisdiction.
- Category C featured 41 district municipalities with authority in one jurisdiction that comprises several municipalities.

Source: See case studies in the appendix to this volume.

countries is large, as in Kenya, and follows the principle of distinguishing status according to size, as in city, municipality, county, and town. These localities are generally grouped under the generic name of *district*, whereas French-speaking countries are more likely to have a single status for all communes.

In English-speaking countries, the system of territorial organization differs from that of French-speaking countries in four notable ways: (1) for pragmatic reasons, deconcentrated central government representation overlaps with that of decentralized local governments, giving rise to composite or consolidated entities for territory-bound public action; (2) an overlap also ensues for deconcentrated and decentralized powers, with public and private sector staff members performing the same role within a local government, thereby complicating matters; (3) a “stacking” of levels of government and decision making occurs in metropolitan areas; and (4) the important and competitive role played by traditional authorities in elective decentralization—for example, chieftaincies and Native Authorities—results in many local government entities in rural areas.

Cities with more than 10,000 inhabitants account for more than 85 percent of Africa's urban population, or 35 percent of all Africans. Cities with more than 1 million inhabitants constitute 42 percent of the urban population, or 16 percent of all Africans.⁷ These numbers confirm that decentralization in Africa remains first and foremost an urban issue. In 2010, a high concentration of urban populations occurred in a few municipal entities—fewer than 4,000 cities across the continent. Smaller localities occupy the landscape primarily through their relatively high number—about 5,000 entities. As a result, the average city in Africa had 50,000 inhabitants in 2010, 10 times the size of an average European city.⁸ Noncommunalized residents, under the purview (administration) of villages or rural communities or directly answerable to central or provincial authorities, remain the majority—60 percent of Africa's total population.

According to the United Nations' urbanization forecasts, following the 1990–2000s population explosions—concentrated in large metropolitan areas—urban growth across Africa will take place mainly in cities with fewer than 1 million inhabitants, those known today as *second-tier cities*. These cities account for about 35 percent of Africa's urban population at present; their share would therefore increase. The cities currently are relatively poorly served by financing systems, which privilege either very large cities that concentrate most of a country's economic and fiscal potential, or small local governments that primarily receive central government transfers (see table 3.2).

The Question of Local Governments' Areas of Authority and Powers

In many countries, laws relating to the transfer of powers still await implementing decrees; these countries lack a simple solution for creating power transfers and simultaneously providing related financial and human resources (Yatta 2009; see box 3.2). Thus, decentralization often wears an unfinished air; with few exceptions,

Table 3.2 Distribution of Urban Dwellers by Size of City

	Number of urban dwellers	Percentage of all urban dwellers
> 5 million inhabitants	70,814,000	18
2–5 million inhabitants	57,593,000	14
1–2 million inhabitants	38,082,000	10
500,000–1 million inhabitants	36,371,000	9
250,000–500,000 inhabitants	26,988,000	7
100,000–250,000 inhabitants	45,397,000	11
50,000–100,000 inhabitants	30,618,000	8
10,000–50,000 inhabitants	50,983,000	13
<10,000 inhabitants	42,672,000	11
Total	399,518,000	100

Source: Sinet 2010 based on country and regional census databases.

BOX 3.2

A Typology of Powers Devolved to Local Governments

An analysis of 26 countries classifies the powers devolved to local governments into three groups:

- Group 1 has basic responsibilities, such as street maintenance, cultural and sports activities, street lighting, and garbage collection. These responsibilities are rarely shared with central or regional governments.⁹
- Group 2 has the same responsibilities as group 1, plus preschool and primary schooling and basic health services (for example, in Guinea, Namibia, and Zambia). In some countries, these powers are granted only to larger local governments. In some cases, local responsibility extends only to infrastructure construction and maintenance; in others, it includes services provision and related support-staff salaries, but rarely salaries for teachers or health care workers. Other countries, such as South Africa and Tunisia, add economic development promotion, employment, policing, security, and secondary education powers.
- Group 3 has the same responsibilities as groups 1 and 2, plus higher education, professional and technical training, housing and shelters, and water and energy production (for example, in Malawi and Mozambique).

Devolution of powers to other local government levels, if applicable, generally results in a decrease in the local government's role, especially for urban infrastructure, as in Côte d'Ivoire. Such devolutions show a preference for government levels that mix deconcentration and decentralization, as seen in English-speaking countries and the Maghreb.

Source: Vaillancourt and Yatta 2010.

most local governments account for only 3–7 percent of central government expenditures. This situation often limits them to administrative and maintenance tasks for property holdings that central governments have vested in them. For historical reasons, local governments in French-speaking countries rarely have direct responsibility for major basic services, such as water or electricity.

Most local governments in Africa have a low level of power, as summed up by a commonly heard saying: “the local government manages local affairs” (PDM 2008). Local governments’ interventions are implicitly governed by the principle of *subsidiarity*: public action should be conducted by the entity closest to the constituents or users. In practice, local government capacities limit applications of this principle to areas such as vital statistics, social action for the poorest, health and hygiene, and light maintenance of buildings. In many countries, even urban planning does not fall under the city’s responsibility, remaining in the realm of the central government or ad hoc organizations under its control, with the common exception of dividing land into plots and marking borders.

However, decentralization movements have generally raised questions about local governments’ role in public actions. The usual response has defined blocks of powers to be transferred in their totality, such as education or health, to avoid overlapping multiple jurisdictions in the same region. Relevant sectoral policies, such as education policy, have remained with the central government, as has teacher and health care worker remuneration in most cases.

This principle of transferring blocks of powers has often foundered on the difficulties posed by decentralizing national sectoral budgets. Apportionment, indexing, and transfer procedures—crucial for allocating responsibilities between local governments—remain poorly resolved, even if some cases, such as Uganda, prove exemplary (Kundishora 2009). Such transfers’ adequacy in relation to the International Monetary Fund’s (IMF) instruction to central governments also proves questionable; overall, structural adjustment policies have not favored sustainable financing mechanisms for power transfers.

We may identify three main arrangements for transfers: endowments, national tax transfers, and delegated funds. Endowments, such as Senegal’s decentralization fund, provide very small amounts of funds relative to purposes of the transfers listed by national regulations. The funds, apportioned among local governments (and usually weighted by population size, to prevent too much going to large cities), come in fixed amounts regardless of the scope of responsibilities or assets transferred.

National tax transfers—often value added taxes (VATs) where applicable—also operate relatively independently of the degree of power transfer achieved. In some countries, the percentage of tax is determined by the initial national regulations, such as in Morocco (see chapter 4, box 4.1).¹⁰ Other countries expect to review tax percentages periodically, such as Tanzania and

Uganda. Overall, this mode of financing favors local governments more than do endowments.

In principle, delegated funds best reflect the actual status and effectiveness of power transfers. These funds are managed by the relevant line ministry and, theoretically, can be calibrated to local governments' multiyear investment programs, as in Côte d'Ivoire. However, it appears that their inflexibility lessens their effectiveness.

As for social sectors, it seems that the time has passed for decentralization to serve as an adjustment variable in public finances, such as when powers were transferred to local governments without a transfer of resources. Donor-provided budget support has been accompanied by incentives for effective decentralization, although in many cases, it seems that donors self-impose some caution in using incentives for fear of seeing deterioration in crucial services, such as health care or education (Diarra 2003).

In some countries, beyond official displays in favor of decentralization, we can actually see local governments' role regressing to a certain degree (see box 3.3). We can also see local governments' marginalization, particularly when line ministries create specialized agencies and specific fiscal channels.

This trend toward disempowering local governments is evident throughout Africa in some sectors, particularly water and electricity supply. For some local governments in English-speaking countries, such as South Africa, these sectors were crucial to their fiscal structures.¹¹

The increasingly technical nature of these sectors, and the hope of encouraging private foreign investment to meet growing investment needs, have led donors and central governments to consolidate water and electricity production operations and to encourage local governments to outsource distribution through concessions, leases, delegated management contracts, and other contracts (see box 3.4). In many cases, local governments have been left out of these sectoral reforms, even for utilities in which they play a prominent role (see next section regarding the challenge of managing basic services). Finally, the undermining of local governments' devolved powers appears to be a major factor behind Africa's weak municipal finance market, especially in Sub-Saharan Africa.

An Attempt to Estimate Local Governments' Financial Capacities¹³

Any estimate of African local governments' financial capacities is necessarily very rough because reliable and consistent data remain scarce. In the case of our estimates, we acknowledge that values over several years and comparisons between countries or cities may prove highly debatable. Rapid changes

BOX 3.3**A Chronology of Measures That Reduced Municipalities' Roles in Kenya**

After independence in 1963, Kenya began its decentralization. However, following the adoption of the Transfer of Power Act in 1969, the central government took back responsibility for primary education, health, and road maintenance and also decided to keep some municipal governments' revenue base for its own use. Since then, municipalities have been consistently undermined. National ministries have become the leading service providers, acting through deconcentrated provincial administrations. The chronology of actions that have weakened local governments follows:

- 1969: Transfer of Power Act returned municipalities' core powers to the central government.
- 1974: Graduated Personal Tax was abolished, removing municipalities' primary source of receipts.
- 1983: District Development Committees were created, chaired by the Provincial Administration to coordinate development planning.
- 1980–90: Political expediency continued to break up municipalities' powers through reduced resources, creating nonviable entities.
- 1990s: Ministry of Local Government controlled municipalities through the Public Service Commission, which had delegated powers of appointment, promotion, and reassignment of staff members, thereby weakening municipalities' autonomy.
- 2000: Ministry of Local Government began to interfere in the administration of municipalities through the Treasury's delegated authority to approve local budgets, supervise the use of decentralized funds, and approve new markets through new rules. These measures centralized municipalities' financial management.
- 2003: Parliament approved the Constituency Development Fund Act, which set up a "community" project-financing facility at the constituency level, competing with municipalities and weakening town councils, the primary means of delivering local public services.
- 2007: Amendment to the Constituency Development Fund Act authorized the hiring of 210 program managers at the constituency level. This amendment initiated a local bureaucracy in competition with the municipality, instead of streamlining the Constituency Development Fund management within a municipal framework.
- 2007: Twenty new administrative districts were created; this action demonstrated the central government's clear desire to affirm its role by strengthening the power of provincial governments.
- Post-2007: Municipal reforms continue recentralizing fundamental powers.

Source: World Bank 2008.

BOX 3.4**The Evolution of Local Governments' Basic Services Management**

Although water and electricity distribution is covered in theory by specific budgets, and although these budget balances remain precarious in many cases, utilities provide local governments with working capital that they would not receive otherwise. Across Africa, trends favor (1) recentralizing drinking water and electricity production and (2) privatizing distribution or outsourcing its management. Compelling reasons justify these changes, such as streamlining production, improving performance, and meeting the utilities' need for capital and investments.

Recent examples of distribution recentralization include (1) progressive privatization of municipal utilities in Rabat-Salé, Tangiers, and Tetouan, Morocco; (2) delegated management for water in Libreville and other principle cities in Gabon, in Niamey and 52 other local governments in Niger, and in Dakar along with 45 other local governments in Senegal; and (3) the transformation of Nairobi City Water and Sewage Company (Naiwasco)¹² in Kenya and Johannesburg Water in South Africa from city water authorities into privately owned companies.

Source: Sinet 2010.

in the institutional landscape and demographics of local governments are two other challenging parameters. We gathered or extrapolated data from different sources¹⁴ of various types. It should be made clear that the estimates presented in this section aim solely to support analyses by giving orders of magnitude unavailable elsewhere.

An Estimate of Local Budgets' Share of Gross Domestic Product

The quantitative method of evaluating decentralization levels consists of relating local government-managed budgets (expenditures and receipts) to their country's gross domestic product (GDP) and gross national budget.¹⁵ These two indicators are used to approximate local governments' contribution to the national economy and the central government's level of fiscal decentralization. This method works with whatever local-level financing system is used, whether a system heavily dominated by the central government's redistribution of resources or a system based on local taxes. These indicators, although insufficient to judge the degree of powers enjoyed by a country's local governments, reflect the importance given to the latter in the national economy.

The total resources of local governments in all 53 African countries were generally estimated to be \$51 billion in 2010 or about \$52 per capita per year

(see table 3.3). This amount represents 3.3 percent of the continent's combined GDP and 11.7 percent of African countries' public finances. As mentioned previously, this is a macroeconomic approach, based on recent IMF data for 2010. The data show a clear improvement over 2009, a year notably marked by recession in all regions except Eastern Africa.

At the continental level, North Africa and Southern Africa concentrate high levels of local public finances and show marked differences in economic performance. Some regional averages cover large differences between countries. Thus, only 10 countries account for 90 percent of local public finances in Africa. Of these 10 countries, Algeria and South Africa account for more than half of the total (see table 3.4).

Africa's most populous countries do not necessarily account for the larger volumes of local public finances: highly populated Democratic Republic of Congo, Ethiopia, Kenya, Tanzania, and Uganda are also characterized by a relatively moderate rate of urbanization. Therefore, local government finances concentrate in a few cities, including capitals.

The two key indicators used to measure decentralization's progress (municipal budgets divided by GDP and municipal budgets divided by national budget) gave the following results. Southern African countries lead in terms of local budget share as an indicator of decentralization's progress, accounting for 43 percent of all of Africa's local public finances and representing 7 percent of GDP and 25 percent of national budgets. This performance is close to that recorded in Organisation for Economic Co-operation and Development (OECD) countries and essentially results from a well-designed system of inter-governmental financial regulation.

Table 3.3 Share of Local Government Budgets in Relation to the Gross National Budget and GDP, 2010

Region	Local government receipts (US\$, billions)	Receipts per capita (US\$)	Region's % of receipts	% of GDP	% of central government finances
North Africa	20,586	127	40	3.6	10.2
Western Africa	3,061	10	6	1.1	6.2
Central Africa	3,424	27	7	2.2	5.8
Eastern Africa	2,342	7	5	1.0	5.7
Southern Africa	21,973	389	42	7.0	24.6
Total or average	51,386	52	100	3.3	11.7

Source: Sinet 2010.

Note: Data on GDP and national budgets for each country from 2007 to 2010 were obtained from the IMF Government Finance Statistics database (<http://www.imfststatistics.org>). Data on local budgets' share were obtained either directly from countries by publications ministries or specialized agencies in Burkina Faso, Cameroon, Côte d'Ivoire, Mauritania, Morocco, Senegal, South Africa, Tanzania, and Tunisia, or by extrapolation and comparison. Total 2010 population figures were sourced from United Nations Human Settlements Programme (UN-HABITAT).

Table 3.4 Top 10 Countries for Local Public Finances, 2010

Country	Total population (thousands)	Urban population (thousands)	Urban population (% of total)	GDP (US\$, 1 billion)	National budget, excluding grants (US\$, billions)	Local budget (% of national budget)	Local budget (% of GDP)	Local government receipts (US\$, billions)	Local government receipts per capita (US\$)
Algeria	35,423	23,556	66.5	154.8	61,318	13	5.1	7,971	225
South Africa	49,278	30,405	61.7	286.4	77,030	25	6.9	19,057	387
Egypt, Arab Rep.	79,537	34,042	42.8	208.5	56,701	10	2.7	5,670	71
Libya	6,530	5,087	77.9	74.7	45,928	7	4.3	3,215	492
Morocco	32,381	18,360	56.7	98.3	26,936	11	3.0	2,963	92
Angola	18,493	10,818	58.5	87.7	40,964	7	3.3	2,868	155
Nigeria	158,313	78,840	49.8	185.8	29,734	8	1.3	2,379	15
Tunisia	10,664	7,177	67.3	42.0	10,172	8	1.8	767	72
Sudan	41,230	18,636	45.2	65.0	12,993	5	1.0	650	16
Botswana	1,953	1,193	61.1	11.5	4,227	15	5.5	632	325
All of above	433,802	228,114	52.6	1,214.7	366,003	13	3.8	46,172	106
All African countries	1,030,173	415,199	40.3	1,562.0	439,000	8	3.3	51,386	52

Sources: GDP and national budgets IMF 2009; UN-HABITAT 2010.

Note: GDP = gross domestic product.

Countries in North Africa, historically little decentralized, effectively show ratios significantly lower than Southern Africa's, with local public budgets representing 3.6 percent of GDP and about 10 percent of national public budgets. These countries' local governments receive a significant percentage of financial transfers from their central governments, mainly for investment financing.

For the past 20 years, Western and Eastern African countries show almost the same percentages: local public budgets represent 5 percent of national public budgets and 1 percent of GDP. However, these percentages represent growth in absolute terms because of the regions' sustained economic performance, at least until 2008; per capita revenue remains stable, about \$10 per year, because of population growth. It seems that the leeway for spending generated by central governments through heavily indebted poor country (HIPC) debt relief has had relatively little positive effect on their local governments' budgets, the latter rarely having been among the highest priorities (see chapter 2, box 2.4).

Central African countries present a better situation in terms of local public budget sizes, but most of this performance is concentrated in Angola. However, their local budgets' share of GDP and national budgets is no more satisfactory than in Western Africa, although Central Africa's lower population density results in a higher per capita ratio.

Three primary factors determine each country's results. First, sound public finances largely depend on the level of economic development, even if the correlation is not always a straight line, as seen in some oil-exporting countries.

Second, the share of local public budgets in the national budget correlates to the urbanization rate. Urbanization's features also play a certain role: for example, a network of small towns comprising many small local governments with low fiscal capacities will probably be less significant than a network of large cities and towns.

Third, the nature of policies affecting central to local government transfers also affects outcomes. Often constrained local tax-receipt yields make inter-governmental transfers the main source of funding for local public budgets. Their apportionment mode varies and often includes—particularly in North and Southern Africa—an equalization objective, which makes transfers a fundamental public policy tool.

The dominance of these three factors shows that decentralization has not had a major effect on the relative weight of local finances. In fact, in many cases, budgets for the transfer of powers have been only partially transferred. The political processes of decentralization did not necessarily immediately result in significant local budget increases.

An Estimate of Local Governments' Borrowing Capacity

Local governments' financial capacity—their ability to generate savings to finance investments—can be estimated reasonably as fluctuating between 10–20 percent of their resources, depending on revenue size. On this basis,

local governments' savings can be roughly estimated at \$8.7 billion in 2010. This amount is very unevenly distributed among regions: approximately \$3 billion in North Africa; \$4.4 billion in Southern Africa; \$440 million in Western Africa; \$500 million in Central Africa; and \$280 million in Eastern Africa. Excluding Southern and North Africa, the amount totals \$1.2 billion. If we assume that half of these savings would be dedicated to loan repayments, then probable loans for local investments over the next 10 years would come to about \$35 billion, using a 10-year loan term and 5 percent interest, without grace periods.

Local-government borrowing capacity is logically concentrated in the North and Southern Africa regions, with \$12 billion and \$17 billion respectively (see table 3.5). If we use the same assumptions, Sub-Saharan Africa's theoretical borrowing capacity over 10 years (for Western, Central, and Eastern African local governments) is about \$4.8 billion, or \$480 million per year; the 10-year breakdown shows \$1.72 billion for the Western region, \$1.98 billion for the Central region, and \$1.11 billion for the Eastern region.

If we assume that this amount could be topped-up by a share of the savings allocated to capital expenditures, then the total investment capacity of local governments in the three regions—Eastern, Western, and Central Africa—would be \$480 million in borrowing plus \$600 million in savings (50 percent of \$1.2 billion), for a rough total of \$1 billion per year, or \$10 billion over 10 years.

As mentioned in the introduction to this section, we intend to give only orders of magnitude with these estimates. Sub-Saharan African local governments' real potential for investment should be measured against other

Table 3.5 Estimates of African Local Governments' Borrowing Capacities

Region	North Africa	Western Africa	Central Africa	Eastern Africa	Southern Africa	All
Population (thousands)	161,924	297,002	124,682	350,887	56,520	991,015
2010 Annual savings (US\$, billions)	3.09	0.44	0.50	0.28	4.37	8.68
Maximum debt service (% of receipts)	15–20	10–15	10–15	10–15	15–20	
Annuity (% of savings)	50	50	50	50	50	
Loan terms (assumptions)	5% over 10 years	5% over 10 years	5% over 10 years	5% over 10 years	5% over 10 years	
Annual debt service (US\$, billions)	1.54	0.22	0.25	0.14	2.18	4.33
Borrowing capacity over 10 years (US\$, billions)	12.16	1.72	1.98	1.11	17.19	34.16

Source: Author, based on Sinet 2010.

considerations—limited, nonexistent, or impossible access to borrowing; often-limited absorption; and implementation capacities—in cities in fragile states in particular and in most small and medium-size towns in general.

The Challenge of Managing Basic Services

It is often said that basic services, especially water, sewerage, drainage, electricity, and solid waste disposal¹⁶ represent local investment par excellence. Indeed, utilities service quality appears as a key parameter of urban administration quality, the basis for citizen judgments of their local officials. However, the largest investments in these sectors generally extend beyond the local level. This holds true especially for water and electricity production and distribution, which are often handled at a regional or national scale; it is sometimes true for waste treatment facilities that may be located subregionally.

In *Africa's Infrastructure: A Time for Transformation*, the World Bank (2010a) provides the most comprehensive review to date of these sectors' technical and economic aspects. It stresses that urban basic services provision in the formal sector has stagnated since the mid-2000s. Sub-Saharan African governments spend about 0.7 percent of their GDP on water and electricity subsidies, benefiting a fraction of the population. The vast majority of countries find it impossible to extend these subsidies to a broader population base. Improving service and supporting cities' population growth and spatial expansion requires other solutions. These must be second-best solutions that use moderate standards, less expensive than so-called modern systems, but still provide acceptable service levels, unlike levels that currently prevail in poorer neighborhoods and urban peripheries. We will not repeat the World Bank's sectoral analyses and guidelines here; the reader is welcome to refer to the original work.¹⁷

We will examine certain aspects of the changes that have occurred in the past 10 years to cities' provision and management of basic services; we also highlight the likely consequences of these changes on local governments' future capacity to finance local investment. As we mentioned earlier in this chapter (see box 3.4), there is a tendency of central governments in Africa to recentralize many basic services by creating agencies or national public utility corporations (see box 3.5). In the 1990s, development professionals sought to promote the private sector's entry into water and electricity production and distribution on the continent, as elsewhere. Despite some exceptions, and faced with the ineffectiveness of many public-service corporations and the challenge of reforming them, local governments saw private sector operators—most often foreign companies—as the safest way to achieve their goals in service levels and utilities connections, as well as a means to relieve pressure on public finances by outsourcing expenses.

BOX 3.5**A Typical Institutional Arrangement for the Urban Water Sector**

In Niger, the urban water sector's institutional reform took shape in 2000, with the liquidation of the Société Nationale des Eaux (National Water Company, or SNE), a public-service corporation that had a monopoly on water production and sales in urban centers. The company was split into two: the Société de Patrimoine des Eaux du Niger (Niger Water Asset Company, or SPEN) and the Société d'Exploitation des Eaux du Niger (Niger Water Operating Company, or SEEN). SPEN, a state-owned-assets corporation for infrastructure, has a concession contract with the central government. SEEN, a private sector water-distribution utility, has an affermage contract with the central government and with SPEN. Its hybrid leasing-affermage models requires SEEN to contribute to the capital investment.

From 2001 to 2008, SEEN paid in about 10 percent of the total investment costs; it does not contribute to financing of water treatment facilities or electromechanical equipment, but it does cofinance the distribution network's repairs and new connections, including water meters.

Niger's central government defines water management policy, develops legislative and regulatory frameworks, and establishes pricing policy. In addition, it set up a multisectoral regulatory authority in 2005, responsible for overseeing water, energy, transportation, and telecommunications utilities. The authority polices regulatory and legal compliance, protecting consumers' and operators' interests. It also promotes its utilities' effective development and arbitrates any conflicts.

Source: Dupont 2010.

Following the failures or mixed results of the first generation of basic services public-private partnerships (PPPs), especially in emerging countries, a second generation of partnerships began to emerge in the 2000s. These more recent partnerships display moderate ambitions for participation by the private sector, which would assume limited or no risk. The newer contracts no longer depend on service concessions. Rather, they use affermage contracts or delegated-management mandates. In this context, the central government supposedly takes responsibility for sectoral policies and rates through regulatory systems.

However, the regulatory process does not stop at a face-off between a central government and a services operator; in varying degrees, it involves other actors—local governments, civil society, and companies and local microbusinesses that operate utilities (Blanc, Cavé, and Chaponnière 2009). Indeed, one of the most significant phenomena to emerge from the changes of the past 10 years

is the appearance of national private sector operators, as a result of the withdrawal of major international operators, leaving room for local entrepreneurs.

Water supply is certainly the most socially, politically, and culturally sensitive utility. The water sector is also where we probably find the greatest diversity of operating and financing modes between countries. Water pricing policies still cause much debate, particularly about totally or partially free water and cross-subsidies between consumer groups (see box 3.6).

Among basic services, water utilities have also probably seen the most extensive technological changes in distribution and services provision. In many Sub-Saharan African cities, public-service corporations' shortcomings, failures, and financing difficulties have led to adopting new, alternative technologies over the conventional, consolidated, closed-loop network and extensions model,

BOX 3.6

South Africa's Free Water Policy

After the fall of the apartheid regime in South Africa, the new authorities faced a hard choice in pricing water services. As a form of social resistance, most ghetto residents had ceased paying for water, making it politically challenging to apply new terms of use. The authorities responded by setting a policy for partially free water, first in Durban, and then in most municipalities countrywide: the first quota of consumption, up to six cubic meters per household, was provided at no cost.

However, this eminently public-spirited measure could not be applied fairly. In fact, 30 percent of the poorest South Africans do not receive free water, for two reasons: (1) more than 5 million have no access to clean water at all, getting their water from unsafe sources, and (2) some rural municipalities cannot afford the measure. South Africa's Municipal Water Services Authorities have two sources of funding: consumer billing and grants from the central government. In principle, grants offset the policy of providing the first six cubic meters, but in practice, the policy hinders the grant-dependent water authorities' investment capacity, because the grants are restricted to covering operating costs. Therefore, less well-capitalized water authorities, particularly in small towns, struggle to finance public utility extensions to the urban periphery, exactly where the poorest residents live.

This pricing policy is also blamed for negative effects on consumer behavior, because the notion of free water causes people to lose sight of drinking water's value, resulting in waste at public water distribution points. South Africa's free water policy may also curb consumer motivation to report or repair leaks, and may lie behind acts of water equipment vandalism.

Sources: Vircoulon 2003; Blanc and Ghesquières 2006.

particularly in urban areas. Gradually, new types of hybrid water-supply systems have developed; these systems may be one manifestation of a broader phenomenon that observers describe as the *ruralization* of African cities (Chaléard and Dubresson 1999). Previously limited to small towns and villages, many privately run, rural-style water utilities have appeared in the urban peripheries, featuring boreholes with submersible pumps and storage tanks with small adjoining standpipes or above-ground flexible plastic pipes.

The achievements of small, alternative water utilities vary across cities and countries. These utilities obviously meet a basic need and have emerged gradually as a solution for distributing water in neighborhoods deemed unprofitable by conventional utilities and left underserved by their local governments. However, these alternative utilities pose a number of problems. The water's sanitary quality is monitored with varying thoroughness, and resource management issues are ignored in most cases. It is relatively easy and inexpensive to drill a borehole, making water production a good investment. Therefore, there are many boreholes, hundreds in some cities. These wells draw water from the same aquifer, with no oversight or even knowledge about what might constitute overpumping. In some coastal cities, saltwater intrusions and aquifer salinization already occur. In other cities with relatively shallow groundwater, faulty sanitation facilities increasingly pollute water sources, creating major health risks (see box 3.7).

In many cases, residents pay small private operators a much higher price for water—up to five or seven times more¹⁸ than residents served by the conventional public utility. Another pitfall lies in the frequent disconnect between these private sector services and local authorities (see box 3.8); in the long run, this disconnect may harm local democracy, because it marginalizes the local government's role. Institutionalizing this disconnect renders cross-subsidization by districts and consumption levels impracticable, even more so when revenues from other services are used. To some extent, accepting this disconnect confirms neighborhoods' marginalization and the local government's abandonment of its search for long-term financing. Finally, a question remains about future integration of these alternative utilities in a somewhat more urban pattern, allowing proper water resource management, fair pricing, and sustainable—or at least regular—financing mechanisms.

Similar issues arise for other basic services. Wastewater and sewage, normally treated alongside drinking water, have always suffered from a chronic lack of funding. Now they are almost always neglected, despite the environmental risks mentioned previously. Some donor-funded wastewater projects target industrial zones, business parks, or densely populated areas, by installing aerated lagoons, for example. In most residential areas, little is done except for a few, scattered programs by aid agencies and nongovernmental organizations (NGOs) that promote individual or public latrines.

BOX 3.7**Small Private Sector Water Distributors in Maputo**

In Maputo, Mozambique, the conventional, public potable-water utility serves only a small portion of residents. Many people, especially those living on the city's outskirts, have no choice but to buy water from informal sector providers. Autonomous water-supply systems operated by small private operators emerged in the 1990s, and have now become key players in Maputo's water sector. These small private operators drill their own wells and work independently of the official water utility. They use completely private financing for their capital investments, receiving no monies from international aid projects or the public sector. They also operate without formal authorizations.

Maputo's conventional public water utility offered poor coverage of the city, so the small operators' arrival in the market proved successful. The success of the small operators rests on a combination of several factors: very strong demand for services because of supply deficits, an entrepreneurial private sector, abundant and easily accessible groundwater, and a supportive institutional and legal environment. Through their responsiveness and speed to support urban development, small private operators have gradually emerged as the only operators capable of responding to the city's growth. Donors have begun to support their initiatives, trying to bring them into the formal sector; donors offer better financing conditions and access, and they integrate these small, private water installations into master plans.

One of the keys to the success of this experience lies in the selection process for small private operators: it limits political interference. Competition among the operators serves to moderate rates; consumers can easily compare rates and switch suppliers. However, we may observe that the Maputo operators' business model rests on abundant groundwater that costs little to pump. Notably, this alternative water-supply system has no oversight to regulate water quality, which remains hard to assess.

Source: Blanc, Cavé, and Chaponnière 2009.

Electricity distribution experiences follow similar patterns to those of water supply; in neighborhoods abandoned by conventional public power utilities, small private operators emerge with alternatives, including batteries. Alternative electricity distributors' direct effects on residents are less critical than with alternative water and sanitation utilities; they cause fewer health-related problems and less direct environmental damage. However, electricity availability can strongly affect economic activity—including in the informal sector—and therefore employment. From a technical point of view, electricity distribution may readily follow a sufficiently high creditworthy demand, if providers can ensure sufficient volume.

The solid waste management sector also saw the emergence of many small private operators. The solid waste stream usually includes three distinct stages:

BOX 3.8**Marginalizing a Municipality: A Water Sector Example**

The Société de Patrimoine des Eaux du Niger (Niger Water Asset Company, or SPEN), the public-assets corporation entrusted with water supply investments in Niger (see box 3.5), introduced 338 new drinking-water standpipes in Niamey in 2001–10. SPEN owns these fountains, but their operation has been delegated to a private sector company, under the leadership of the Société d'Exploitation des Eaux du Niger (Niger Water Operating Company, or SEEN), the operating company. Financing and installing all new fountains comes under SPEN's remit, in consultation with SEEN.

The standpipe operators sign a management contract with SEEN. In principle, they can manage only one standpipe, must live in the neighborhood, must meet hygiene regulations, and must apply regulated rates. In practice, these principles are rarely observed: many operate several standpipes and charge much higher rates, up to twice as much as the set prices, and hygiene is largely ignored. Most of the standpipe operators pay no municipal taxes, which theoretically are due for each pipe's operation. Given these conditions, managing one or more standpipes turns out to be a very profitable business.

Municipalities and the Niamey Urban Community have effectively divested themselves from engagement with the issue, yet it remains central to their areas of responsibility—urban development and expansion on the periphery. The urban authorities collect practically no receipts, are excluded from decision making and oversight, and have no responsibility for providing an essential service; therefore, they have little legitimacy in the eyes of their citizens.

Source: Dupont 2010.

(1) trash collection from households or from businesses and large producers, (2) trash transport between the city and the treatment center, and (3) trash treatment or storage centers and their operations. In many African cities, the entire waste management sector has been involved in PPPs. In many cities of all sizes, micro-operators collect trash because the local government's system fails to do so; these micro-operators are paid directly by the households they serve. In most cases, the operators transport trash to more or less developed waste-transfer stations. From there, other private operators or municipal workers must truck the trash to a landfill.

Investment in waste management infrastructure covers the final stage—landfills and access roads. Financing for such investments is relatively available, at least for the largest and most creditworthy cities. In some circumstances, and at a certain level of waste, a carbon financing facility may provide additional funding (see box 3.9 and chapter 1 in this volume).

BOX 3.9**Addis Ababa and Problems with Waste Management**

The Ethiopian capital of Addis Ababa, with a population of about 4 million in 2007, produces about 1,200 tons of trash per day. Only 70 percent of it is actually collected. The landfill is located in an area that has been overtaken by urbanization and is now densely populated.

After 40 years of operation, the landfill is saturated with trash that has never been sorted or compacted. Because the trash has not been compacted or covered with a layer of soil, recyclers lay claim to the garbage, as do domestic pets and pests. Uncontrolled fires constantly release toxic fumes from the landfill. Untreated leachates percolate into the river bordering the site; no one monitors the type of waste—toxic or otherwise—that enters the landfill.

First-stage collection is the responsibility of district councils known as *subcities*. These subcities ensure trash collection in accessible neighborhoods, that is, in wealthy residential or commercial areas that produce about 30 percent of the collected trash. The subcities delegate the remaining trash collection to microcompanies, which take the trash to dumpsters at waste transfer stations.

Municipal trash pick-up in accessible neighborhoods costs residents nothing, whereas the micro-operators charge residents in inaccessible neighborhoods according to the volume of trash collected. The cost is about \$55 per ton, which equals a levy of about 2.4 percent on these residents' average household income. This constitutes another example in which the rich are entitled to free services whereas the poor must pay. The subcities are responsible for removing the dumpsters from the transfer stations and transporting trash to the landfill. For this service, the city government gives them an annual operating subsidy, which is insufficient to ensure the renewal of the truck and dumpster fleets.

Municipal operation of the entire waste stream would represent a total of just over 1 percent of the city government's budgeted expenditures. This percentage is unusually low compared with the continent's average, which ranges from 20 to 30 percent for an often-inferior collection level. For example, Kenya's largest cities collect no more than 30 percent of the trash produced. This paradoxical result derives from the fact that Addis Ababa has a large number of municipal responsibilities compared with most African cities, as well as a relatively large budget. Above all, the city's waste management service is inexpensive for four reasons: (1) most first-stage collection is financed by households; (2) transport costs are minimized because the landfill is nearby; (3) the landfill's operating costs are minimal because trash is not compacted, treated, or monitored; and (4) the landfill carries no depreciation costs. In recent years, the municipality has been forced to make emergency repairs to extend the landfill's useful life, but these (significant) costs were written into the capital expenditures rather than the expenses section of the budget.

continued on page 131

Box 3.9 (continued)

The landfill's health risks, saturation, and management shortcomings are critical and will require more intervention. Its closing and decommissioning in accordance with environmental standards will generate substantial costs. Opening a new, sanitary landfill will prove crucial in the short term and requires significant investment. The new landfill will necessarily be expensive to operate, as are all facilities that meet basic environmental standards. It will be located about 20–30 kilometers farther away from the city, completely changing transport conditions. The latter's costs will multiply, whether operated by a public service corporation or a PPP. Under these conditions, the municipality's operating budget for waste management will increase dramatically.

Addis Ababa could benefit from donors' aid to the central government, if the latter were to on-lend funds in the form of subsidies, but the city will probably self-finance part of its investments. This factor, and the prospect of significant operating cost increases, might encourage the municipality to seek additional funding from carbon finance facilities (see chapter 1), and to establish an ad hoc waste disposal tax to at least partially fund services on a sustainable basis.

Source: AFD 2007.

The first stage of waste disposal—household trash collection—is self-financed when micro-operators perform the service and charge residents. The second stage, transporting trash to the landfill, requires capital investment for rolling stock (trucks) and operating expenses (fuel and drivers); the former is generally ineligible for donor funding. When local governments contract out trash transport to the private sector to avoid equipment expenses, the related operating costs prove extremely expensive. Thus, it is hard for many local governments to sustainably finance solid waste transport. Traditionally, disposal services were funded through specific receipts, such as property taxes or municipal garbage fees. Collecting these types of taxes and fees becomes more challenging in cities where microcompanies operate. Residents, who generally pay a small operator for trash removal, do not understand why they should pay for transport from transfer stations to landfills. These dysfunctions in trash disposal lie behind the mountains of garbage seen in some cities, garbage heaped several stories high with all of its usual unsanitary effects.

Available data are insufficient to determine the scope of local governments' growing problems with basic service provision to urban extensions. However, we do know that these problems affect a very large number of cities, ranging from large cities of several million inhabitants to small subcities—and not only cities in fragile states. The situation seems hopeless for some cities, where municipal authorities have gradually abandoned or lost all or part of their

authority over large areas of their territory. These local governments provide residents with almost no visible public services that would justify the residents paying a tax or local fee. Thus, cities see their revenue per capita stagnate or decline as the urban population increases (see box 3.10).

This situation is likely a major reason that indicators of essential service access show stagnation, especially in the least developed countries. Current and complete data are lacking, but various analyses estimate, for example, that there has been no significant progress in providing access to drinking water in Sub-Saharan Africa since 2000 (UNCTAD 2010), and poverty (which is also defined in relation to access to basic services) has increased in urban areas (Chen and Ravallion 2009; Ferré and Ferreira 2010).

It should be emphasized that these findings relate to land development issues. Indeed, implementing and financing the extension of basic services means improving land with infrastructure and facilities. This is known as raw land development, an activity once considered a priority obligation of local

BOX 3.10

Lomé: A Local Government Loses Control over Its Territory

Like many other cities in Africa, Lomé, the capital of Togo, has long lacked the resources, expertise, and independence to perform its administrative responsibilities: guide urban growth, make needed investments, and mobilize financing. Togo's decentralization reforms have lagged compared with other countries, because of its history and challenges as a fragile state. As a result, backlogs in all areas under urban administration have accumulated in recent decades.

The way that Lomé defines administrative areas has worsened the situation. Most urban growth has occurred—and still occurs—in outlying areas beyond the municipality's borders. These peripheral districts are supposed to be administered by a prefecture. However, because most of the prefecture's territory is rural, authorities are located far away. The municipality has no real authority to intervene in these districts.

Lomé gives the impression of being a city where the municipal authorities have lost control and supervision over urbanization. The city has no reliable statistical data, recent urban planning documents, or even a land-use inventory. The municipality has virtually no latitude to increase its receipts. It does not even appear able to track its own finance department's tax collection performance. The situation worsens in proportion to the city's growth. Reviving fiscal budgets would require restoring the municipality's capacity to produce effective services. Territorial reform constitutes the first crucial step in putting the city back on a path toward progress. In 2008, a pool of donors and lenders made territorial reform part of their urban development projects.

Source: AFD 2006b.

governments; even the concept seems to have disappeared in some countries. Given the extent of needs, it is certainly not possible to imagine equipping urban extensions along the conventional model of centralized, closed-loop public utilities with high standards of service. However, it is necessary to turn to modern technical solutions that ensure a minimum standard while guaranteeing water quality, managing water resources, and ensuring waterworks sustainability. It is also vital to integrate these solutions into a coherent whole technically, as well as for rates and cross-subsidized financing. We return to these points in chapter 5.

Local-Level Governance and Implementation Capacity

One factor that greatly impedes the quality of urban development and basic services is how often local governments perform poorly in implementation. Two broad categories of problems contribute to this weakness: first, a local government's *absorption capacity*, and second, local governance issues and related phenomena, such as resistance to change, stakeholder interactions, and special interests.

Absorption Capacity

Absorption capacity refers to local governments' potential for effective implementations. In some cases, implementation potential remains inferior to the funds that are available or that could be marshaled. In other words, money is sometimes available for investments, but cities cannot spend it, and therefore cannot carry out a designated project. Some capital cities in oil-producing countries provide striking examples. Generally, in such situations, the flow of funds eventually freezes and goes into other sectors, no matter the size or nature of the needs. Several factors often contribute to a local government's low absorption capacity, including skills shortcomings, a lack of ad hoc operators, a poorly structured local economy, and ownership dysfunctions.

Inadequate skills and expertise at the local government level are common on the African continent. Qualified personnel with requisite skill levels are in short supply in regional or local governments; few countries have a subnational civil service. When a lower-level civil service does exist, low wage scales limit hiring opportunities. In the absence of a permanent local civil service, personnel are often hired for an electoral term or for qualifications other than technical ones. In countries with good education systems and a pool of graduates, the graduates find the low pay of local governments unattractive; the most competent see local government jobs as stepping-stones to private sector jobs.

Therefore, subnational civil service training rises as a major issue across the continent. Some of the most advanced countries have their own regional

administrative training systems. Donors and aid agencies offer programs for this purpose (see chapter 5). Training is inseparable from remuneration and status levels, which often require national reforms that prove hard to complete for political and public finance reasons.

The absence of ad hoc operators is also a very common impediment for regional governments. Performing operations in particular areas requires specialized organizations with the requisite institutional and professional skills, as well as technical and financial resources. Land production and development are typical activities that require experienced operators.

Weaknesses in the local economic fabric prove another limiting factor. Qualified firms that could implement infrastructure or construction investments are not always available in sufficient numbers. Firms that are available often specialize in large markets for large installations and are not necessarily the proper size for investments in urban areas. Specialized, medium-size firms suited to the most frequent types of urban public works are rare, particularly in Sub-Saharan Africa. Similarly, projects commonly suffer from weak local firms, particularly engineering design and technical inspection offices. Without a network of skilled companies with implementation capacities, projects and programs with guaranteed financing experience significant delays or are eventually abandoned.

In the preceding chapters of this volume, we have already evoked the institutional and governance complexities that limit implementation capacities. These complexities stem from collective project management and ownership issues, institutional overlaps, administrative fragmentation, and divided agglomeration authorities (see box 3.11). Such governance and institutional issues are not specific to Africa, but they probably cause more problems on the continent than elsewhere because they combine with the other challenges—especially the lack of skilled civil servants, operators, engineers, and other professionals. Ironically, international aid organizations sometimes aggravate these problems.

Donors involved in the urban sector have tended to create implementing agencies to increase effectiveness. The agencies have a secondary effect of bypassing local-level ownership. Originally, donors set up implementing agencies to build centers of excellence and to enable faster project implementation; they often used extraordinary procedures outside of normal channels. Eventually, local government authorities divested themselves of their powers as owners; this benefited the implementing agencies, which then acted as delegated owners. The agencies may also weaken municipal teams by recruiting the best people and offering higher wages.

Major foundations, NGOs, and bilateral aid agencies, in turn, have tended to focus on interventions directed at neighborhood and community groups. They want clearly identifiable projects to show their sponsors, donors, or voters. This sometimes results in an abundance of projects promoting different approaches and technical solutions, without local officials being able to supervise anything or, at times, even remain informed. The proliferation of stand-alone solutions

BOX 3.11**Chieftdoms and Local Powers in Ghana**

Administrative life in Ghana is organized into 170 districts that were established after independence. Traditional tribal leaders have shown an amazing ability to adapt to these new administrative divisions. Decentralization, introduced in the late 1990s, aimed as much to organize regions into democratic institutions as to contain the role and influence of tribal leaders. Ghana's tribal chieftains have always sought to negotiate compromises needed to survive when faced with governments' long reluctance to restore the leaders' former privileges. Today's chieftains aim to be influential players in local politics; they use whatever means they have to assert their authority and remind all that they are the lords of the land and symbols of group unity.

Two administrative systems, one representative and the other customary, compete for power, particularly for control over land and resources. On the one side, district councils have budgets financed by their own, internally generated resources and those returned from the central government. In practice, the district councils provide few services and depend greatly on the central government. On the other side, tribal leaders are sensitive to development issues and some have proper training on the subject. They monitor project implementations, create ad hoc NGOs, and solicit donors. The chieftains have become the gatekeepers of local development initiatives. They often have close relationships with civil society nonprofit organizations.

Tribal leaders prove as effective institutions of mediation and social cohesion. Some chieftains do more than mediate: they initiate development. However, such personalities' presence in politics adds a level of complexity to the institutional framework.

Source: Jacquemot 2007.

results in high transaction costs for municipal teams that try to organize coherent approaches.

Overall, we see that some regional governments' weak absorption capacity often stems from factors beyond their jurisdiction, especially structural deficits in national or regional budgets. These factors may cause the helplessness that sometimes overwhelms local administrators who are willing to act but lack the means to do so.

Local Governance and Resistance to Change

We discussed the concepts of governance and local governance in chapter 1. Administrative effectiveness, accountability, transparency, and citizen support for strategies ultimately strengthens local autonomy and economic performance (Meisel and Ould Aoudia 2008). Conversely, autocratic municipal governments, opaque and arbitrary decision-making processes, and authoritarian administrations—unwilling to be held accountable to taxpayers and other constituencies—eventually weaken the local economy and completely lose their legitimacy.

However, electoral competition without conditions certainly does not suffice in itself to trigger economic development. Indeed, local elections may prompt politicians to lose interest in providing public goods, preferring instead patronage for certain parties likely to influence voters. These practices ultimately reduce local economic performance, mainly because of underinvestment and investments with low profitability or losses. These phenomena are compounded by the fact that the local levels of government—especially public works, land planning, and housing—are particularly conducive to corruption (see chapter 1, box 1.7). Local governments' relative weakness regarding corruption has been used to relativize decentralization's benefits (Prud'homme 2003). In fact, by increasing levels of government and authorities—appointed, elected, tribal, and others—decentralization promotes the spread of corruption.

Experiences of successful containment of corruption by cities on other continents show that the best results come from increasing citizen and other constituent involvement; strengthening accountability mechanisms for politicians and administrations also helps (Klitgaard, MacLean-Abaroa, and Parris 2000; Glaeser 2011). Ultimately, governance seems the local government's best tool to improve the local economy's performance and ensure its long-term institutional and financial autonomy.

However, governance's dysfunctions are frequently well known and defy successful reforms, because resistance to change is strong. Countries where economic and political elites are closely related through personal relationships prove more prone to this classic phenomenon of collective action; nepotism and privileged networks inevitably develop through a process of accumulated relations—crony capitalism (Meisel 2004). In Africa, such networks are especially visible at the local government level in land-grabbing activities (see chapter 2, box 2.10).

In practice, it is hard to get around systems organized by supportive individuals within small, determined groups. Indeed, the amount of resources the group controls—assets, cash flow, national or even international business connections, more or less hidden networks, and others—allows it to oppose any type of reform, or to divert reform from its original objective so that the group benefits (Sindzingre 2006). The inability of some national and local governments to implement land-policy reforms provides a clear illustration of these phenomena. Public interest would require a reform that all stakeholders know would influence development, but this reform cannot succeed. It fails to change because of the elites' powers to resist and circumvent reform and because of a classic collective action problem: although all desire to change the situation, the individual cost—to owners, tenants, public officials, and others—acts as a disincentive. Thus, slums have persisted for decades in large African cities, surviving many successive projects designed to eliminate, regularize, restructure, or integrate them.

In a similar vein, we may see objective alliances form between different stakeholders in major African cities and towns for urban development projects.

Over time, each party finds an activity that corresponds to its own interests and seeks to perform it in relative autonomy: the elites accumulate capital, donors fund projects, NGOs manage local government projects, tribal leaders consolidate their power, and so forth. The parties agree not to break the balance that allows them to locate their individual interests (see box 3.12). This is another collective action situation in which reform becomes very difficult, because even

BOX 3.12

Stakeholders' Positions and Actions in Ouagadougou in 2006

In Burkina Faso, national utilities are responsible for water and electricity supply countrywide. However, they remain tentative about intervening in the spontaneous, informal neighborhoods on the outskirts of the capital, Ouagadougou. In principle, the land tenancy situation is regulated by two national government services deemed appropriate: land registry and public lands. These services always remain one or two peripheral rings' worth of settlements behind reality. On the one hand, the duties of these land offices include evicting residents who have settled illegally and spontaneously. On the other hand, the land offices also regularize such residents, negotiating local customary powers. Land development in the physical sense is ensured in a somewhat coordinated way through funding from donors. Donors find these outskirt neighborhoods fertile ground for the essential services supply projects they need to achieve their international-community-assigned objectives, that is, the United Nations Millennium Development Goals.

Meanwhile, in the heart of the city, sovereign bonds finance a several-dozen-hectare urban renewal project driven directly by the presidency. A little farther away, an administrative and business district, known as Ouaga 2000, has arisen. Another central government initiative, Ouaga 2000 relied heavily on private financing, which raised questions about the source of the funds. The Ouaga 2000 district was built with high land consumption, facilities standards, and production costs.

What are the municipality's areas of authority? It is responsible for waste collection, transport, and disposal; road and public spaces maintenance; and small social or economic facilities—all areas in which expenditures are high and revenues nonexistent. The municipality carries out its responsibilities quite well, given its meager budget. However, its investment capacities are reduced, as is its real autonomy.

Ultimately, we may read the division of labor in the capital as follows: the central government system *raises money* from capital markets to create prestigious urban areas founded on high-end speculative development. The donors *give grants* to finance poverty alleviation and utilities extension to provide essential services to disadvantaged neighborhoods. The municipality *tries to manage* political relationships between various social groups, so-called civil society and the customary powers. It also runs the city's everyday affairs, but not within the enclaves reserved for the apparatus of the state.

Source: Le Bris and Paulais 2007.

rational actors who should work in favor of reform eventually find an interest in maintaining the status quo.

Fragile Situations, Fragile Cities

Fragile Situations and Local Governance

The term *fragile situation* is gradually replacing *fragile state* to describe territories facing severe challenges, particularly ongoing conflicts or their outcomes: governance shortcomings, administrative weaknesses, violence, and so forth. The new term proves more appropriate for regions that are not separate nations, or for cases in which a central government has collapsed. Despite variations in terminology,¹⁹ there is consensus on what constitutes a fragile situation. The principal multilateral donors—World Bank, African Development Bank, and Asian Development Bank—use a classification system, the Country Policy and Institutional Assessment, to establish a benchmark list of fragile situations. Because the list is reviewed annually and fragility is a changeable status, there is no permanent ranking. However, if we were to smooth the rankings over several years to avoid excessive volatility, we would find the following orders of magnitude: on average, there are about 30 to 35 fragile situations in the world, of which approximately 60 percent are in Africa; and about 40–50 percent of Sub-Saharan African countries qualify as fragile situations (EU 2009). The countries that are richest in natural resources are often affected by internal armed conflicts and large-scale corruption. In addition, a number of countries not classified as fragile have recently suffered or currently suffer from political instability, especially in the wake of coups and disputed elections that result in violence.

These countries' cities most often suffer from the same problems: poor governance, limited management skills, violence, and corruption. Under these conditions, the cities' economic productivity remains very low, although their populations often increase at a higher rate than that of nonfragile cities. Conflicts give rise to displacement, so refugees are now increasingly urban (see box 3.13).

“Downward Spirals” and the Trapped-City Syndrome

Rather than progressing to the virtuous circle described in chapter 1 (see box 1.3) that development policies seek to instill in local governments, these governments may fall into a downward spiral having the opposite effects. The economist Irving Fisher (Fisher 1993) describes this mechanism in the aftermath of the 1929 stock market crash. In his analysis, debt deflation worsened the Great Depression as indebted individuals were driven to sell their financial assets to pay their debts. Such forced sales drove down asset prices, which increased the real value of debt, which in turn required further asset sales by debtors, resulting in further price declines, in a continuing downward spiral.

BOX 3.13**Refugees in Urban Areas**

Urban population growth may be fueled by a flow of refugees, people fleeing conflicts or displaced by natural disasters or famine. According to the United Nations High Commissioner for Refugees (UNHCR), half of the 10.5 million refugees worldwide lived in urban areas in 2009. Refugees and displaced people find their way to cities for the same reasons that rural migrants do: they hope to find better opportunities for employment or survival; they have family or community networks in the city; and they seek the protection of urban anonymity. However, as recently arrived outsiders often lacking legal status, they are more vulnerable to exploitation, poor housing conditions, and harassment.

According to the UNHCR, in 2009, the major African host countries for refugees and displaced persons included Kenya (358,928), Chad (338,495), Uganda (127,345), and Tanzania (118,731). The refugees came mainly from the following countries: Somalia (678,309), Sudan (368,195), Eritrea (209,168), the Democratic Republic of Congo (185,809), the Central African Republic (159,554), Angola (141,021), and Rwanda (129,109).

Sudan's capital, Khartoum, has accommodated 1.5 million displaced persons. Depending on the statistical source, Nairobi, Kenya, has between 46,000 and 100,000 refugees from eight countries: Somalia, Ethiopia, the Democratic Republic of Congo, Sudan, Uganda, Rwanda, Eritrea, and Burundi. The capital city of the Arab Republic of Egypt, Cairo, hosts a million refugees from Sudan, as well as refugees from Somalia, Eritrea, Ethiopia, and Iraq, just as does Alexandria, Egypt's second-largest city.

Urban refugees often face special challenges and unjust situations: abuses by police, various extortion schemes, joblessness, lack of basic services, barriers to children's schooling, and general discrimination and xenophobia.

Sources: UNHCR 2009; Pavanello, Elhawary, and Pantuliano 2010; Puerto-Gomez and Christensen 2010; World Bank 2010b.

Cities in fragile states are liable to fall into this type of downward spiral. Shortcomings and failures in infrastructure and utilities drive down urban structures' productivity and economies of scale. Inadequate or nonexistent public transportation, unpredictable traffic congestion and travel times, electrical surges and power cuts, intermittent water supply, flooding, and stagnant effluent all reduce business profitability. Unsanitary neighborhoods increase health care costs and absenteeism; poor educational performance and even the rise of illiteracy and antisocial behavior can be blamed on these neighborhoods' isolation. Negative environmental effects—air pollution, concentrations of untreated sewage, and solid waste—increase in tandem with these phenomena and also result in economic costs.

At a certain point, these cumulative negative effects and urban management failures risk tipping a city's economy into a relentless deterioration. In such circumstances, all indicators fall and control levers no longer work. Revenues stagnate; they cost more to collect precisely when the funding to do so cannot be increased. Infrastructure maintenance is increasingly neglected. Public land policy is stymied while elites improve upon their speculative activities; land development projects are abandoned and poor housing stock increases. The formal sector's share of economic activity decreases as the informal sector's share rises. Therefore, tax yields fall on business income, property, and occupancy. Basic services budgets must be revised downward and new investments become increasingly doubtful. The city's attractiveness gradually decreases. Outside firms choose to locate elsewhere, in cities where their capital and business investments will be more profitable and secure. The city's image grows tarnished. Conditions for obtaining financing from other sources deteriorate, and further cuts to municipal services must be made. A tip into these downward spirals can be triggered quite suddenly after a somewhat long period of slow deterioration. It becomes hard to escape without outside help.

However, the external funding available to these cities is also smaller: small transfer payments reflect a weak central government, parsimoniously supported by development aid. As we mentioned in chapter 1, donors' financial instruments, selectivity, and quest for aid effectiveness eventually exclude fragile states from much aid. This case is especially true for countries without natural resources that fall into genuine funding traps (Raffinot and Rosellini 2007). The foreign aid situation is equally critical for cities. In some cases, the urban environment counts as a priority in support programs for fragile states,²⁰ but only rarely. Deficiencies in urban administration and governance, together with the corruption that generally accompanies them, take on prohibitive proportions in the eyes of many donors, lenders, development-aid agencies, and major foundations—all of whom need to present satisfactory results in their key performance indicators.

Ultimately, these cities face hopeless situations. They are stuck in twin traps—poverty and funding. For this reason, we call them “trapped cities.” Their residents are the direct victims; left to themselves (see box 3.14), they frequently live in survival mode, their fate often unknown.

Toward a Concept of *Fragile Cities*

The European Union distinguishes itself somewhat from other multilateral donors by using the term *fragile situations* to describe situations in which the social contract is broken because “the State is unwilling or incapable of meeting its obligations regarding service delivery, management of resources, rule of law, security and safety of the populace and protection and promotion of citizens' rights and freedoms” (EU 2009, 17). This description perfectly fits cities in fragile states or situations; we may simply replace the words “central government” with

BOX 3.14**It's Not My Problem; You Figure It Out!**

In a now-famous speech, longtime president and dictator Mobutu Sese Seko ordered Zairians to cope. In 1997, Laurent Kabila, the then-new president of the Democratic Republic of Congo (previously Zaire), expressed much the same thing, telling citizens that their government could not do much for them. After more than 30 years of dictatorship, followed by a transition period aggravated by a still-unfinished civil war, the Democratic Republic of Congo's urban residents have long known to expect nothing from their municipal governments.

The capital city of Kinshasa, with 8 million inhabitants, is the second-largest Sub-Saharan African city after Lagos, Nigeria. Urban growth has developed in a chaotic way, sometimes by densification of postcolonial working-class neighborhoods, but especially through urban sprawl on the periphery; settlements have expanded to unsuitable land prone to devastating landslides. This unbridled growth—Kinshasa's urban area has grown sixfold in the past 40 years—has spread without any utilities connections or access to basic services. The number of infrastructure facilities has not increased since the 1980s, although the urban population has tripled. Whole sections of the city remain without any utilities supply—water, electricity, or sewerage. Only about 35 percent of residents have access to electricity, and about the same percentage can access safe drinking water—half of the 1980s rate.

The dilapidated state of economically productive infrastructure strongly hinders the city's productivity and, consequently, formal sector jobs and cash-income opportunities. Kinshasa may be the world's leader in informal sector employment—a sector that is also hampered by vehicle operations costs, transport challenges, and the lack of electricity. Many Kinshasans eat only once a day; 25 percent eats only once every two days. Chronic malnutrition affects half of the children living in the most disadvantaged neighborhoods. Some parents choose to send only one child to school each year, with all of their children receiving some education in rotation. Access to health care is very limited, while unsanitary conditions in underserved neighborhoods increase residents' chances of becoming sick. Caring for the sick and even burying the dead also prove challenging for cash-strapped residents in the poorest neighborhoods. Insecurity, violence, and extortion are part of everyday life.

Sources: Grootaers 1998; Nlandu 2002; Tollens 2004; Trefon 2004; Groupe Huit and Baissac 2010.

“municipality” or “local government” as appropriate. Most of these *fragile cities* are larger in population than countries or regions officially ranked fragile. Kinshasa, with its 8.0 million inhabitants, is much larger than Sierra Leone (6.0 million), Togo (5.8 million), the Central African Republic (4.0 million), and others.

In these circumstances, the question may be raised: should we work with a new concept—that of *fragile cities*? Doing so could allow cities in fragile

situations to benefit from the international community's specific assistance programs, as do countries or regions in fragile situations. Fiduciary risk is not automatically higher in cities than in fragile states. In addition, some experiences show that private sector industry, construction, commerce, and services—primarily located in cities—can be driving forces in a country's recovery process (Porter Peschka 2010) and in a local government's process, as well (see box 3.15). We return to these points in chapter 5.

BOX 3.15

Private Sector Initiatives in Somalia's Forgotten Towns

In 1991, the fall of the Barre regime in Somalia had several consequences. On the one hand, the fall of the regime made the state apparatus and its attributes—its monopoly on legitimate force, national territorial control, and economic activities regulation—disappear. On the other hand, it caused the country to fragment into three entities, following clan-determined fault lines: Somalia, Somaliland, and Puntland. In recent years, insecurity in the countryside and successive droughts have caused a major exodus to the cities: by 2009, the cities of Mogadishu (Somalia) and Hargeisa (Somaliland) each had about 2 million inhabitants, and Bosaso (Puntland) had about 1 million.

Where observers would expect to see complete disorder, the level of security currently prevailing in Somali's cities is higher than before the government's collapse. A self-governing administration, led by religious leaders, clan leaders, and their militias, has restored relative safety.

The private sector has stepped in to ensure public services. Fierce competition between private operators has resulted in one of the best telecommunications networks in Sub-Saharan Africa: all major cities have telephone and fax lines, plus Internet access. Private primary education shows fairly satisfactory results, although with a lamentably low level of schooling for girls. Health care services function quite well in most major cities, at relatively affordable prices. The percentage of residents with access to electricity is also quite good; private power utilities charge according to the number of light bulbs per household. Electricity is available in smaller towns that had none prior to 1991. Private utilities' urban water production and distribution have had mixed results. Historically, Somalia has been one of the lowest-rated countries for water access; now most cities are well supplied, but distribution remains partial, although affordable.

When in power, the central government was so predatory that it crippled the country's growth. Since the government's disappearance, development indicators have rebounded, reaching levels that surpass those of some postconflict African countries that have received substantial aid from the international community. More than half of the key development indicators—such as life expectancy, infant mortality, and maternal mortality—are higher and extreme poverty is lower in Somalia than in Sierra Leone; the latter receives five times as much aid for a smaller population.

Sources: UNDP 2001; Nenova and Harford 2004; Bakonyi and Abdullahi 2006; Leeson 2008; Véron 2009.

Notes

1. This section based on Sinet 2010.
2. There are five federal countries: Comoros, Ethiopia, Nigeria, Sudan, and Tanzania (a two-party confederation). We also note the existence of two countries with extensive provincial governments: the Democratic Republic of Congo and South Africa.
3. These data were reconstructed from information posted by the ministries in charge of local governments or by associations of municipalities and local officials in each country. No other specific statistics for local governments across the African continent or its subregions were identified, nor were any historical views of changes in the number of local governments in all countries.
4. Totals excluded villages that are in the process of classification, as follows: 8,273 in the Central African Republic, 8,549 in Côte d'Ivoire, 44,402 in Kenya, and 10,075 in Tanzania.
5. This total results from comparing the number of municipalities with the number of towns (3,144) with more than 10,000 inhabitants counted elsewhere on the continent.
6. In Zimbabwe, see *Urban Councils* (white towns), *African Councils* (black towns), and *Rural Councils* (areas administered by white farmers). In Kenya, see *Municipal and Town Councils* (where whites lived), *County Councils* (where white farmers lived), and *African Districts Councils* (where blacks lived), and other localities.
7. The reconciliation between towns and cities is random: the definition of urban varies from country to country, and may be based on threshold population, administrative status, and possible variations in definitions from census to census.
8. The original 15 countries of the European Union (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom) have a total population of 400 million people in 73,000 towns; the average number of inhabitants per locality is 5,200 people with sizable deviations from 1,600 inhabitants per town in France to 47,200 in Ireland to 5,000 in Germany.
9. However, street lighting and garbage collection services often receive exceptional financial support from the central government, at least in larger cities where local finances cannot cover the costs, such as in Dakar or Douala.
10. In Morocco, 30 percent of VAT receipts go to municipalities.
11. A significant portion (up to 60 percent) of South African local governments' receipts come from electricity surcharges.
12. The assets remain 100 percent the property of the City of Nairobi.
13. This section is based on Sinet 2010.
14. Sources include the IMF's Government Finance Statistics database (<http://www.imfstatistics.org>) for a breakdown of public finances between central and local governments. However, these statistics prove very uneven across countries, especially in Africa. Two French-language monitors, the Observatoire de la décentralisation à l'échelle du continent (Decentralization Across the Continent Monitor) (PDM 2007) and the Observatoire de finances locales (Local Finance Monitor) cover the French-speaking countries of West Africa as part of a West African Economic and Monetary Union program looking at common procedures in public finance. For other countries, data are taken from publications or official databases, such as annual publica-

- tions of the Treasury in South Africa or the Ministry of Interior in Morocco, or specific studies conducted in some local governments for projects funded by donors, or even extrapolated from generally accepted ratios such as the share of local finances in relation to central budgets or the gross domestic product.
15. These indicators are used by the Organisation for Economic Co-operation and Development to compare decentralization trends in developed countries.
 16. Public transportation and telecommunications are usually included in the definition of basic services, together with water, drainage, sewerage, electricity, and solid waste disposal. "Essential services" as defined by United Nations agencies also includes basic health care, primary education, and public safety.
 17. This book is also published in French by Pearson (Paris): *Infrastructures africaines: Une transformation imperative*.
 18. Prices are those observed in Nairobi (Bousquet 2006).
 19. The designations *failed states* and *postconflict countries* have also been used. The World Bank also uses the term *low-income countries under stress* (LICUS).
 20. For example, in 2008, the World Bank allocated LICUS (low-income countries under stress) grants to an emergency program in Lomé.

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Investment Financing Frameworks and New Funding Mechanisms

Local Government Financing Systems¹

Local government financing systems follow a vast and complex typology; the main parameters include a locality's national economic situation and national political, legal, and administrative traditions. The type of financing system depends on important contributing factors, including whether the local government holds responsibility for city water or electricity utilities; the degree of balance found in the country's urban systems, at least relative to the locality's share of national population; the size of a city; and disparities between the largest and smallest cities, or the richest and poorest, and so forth.

Customarily, in developed countries, these financing systems—or at least some of their instruments—change periodically, usually every 5 to 10 years. In Africa, pressure from local authorities generally proves insufficient to justify a real influence on the choice of fiscal positions; local finances have not yet reached a substantial enough level to influence fiscal choices and usually serve only as an adjustment variable when balancing public budgets. However, the situation is changing, particularly in some English-speaking countries such as South Africa, Tanzania, and Uganda, as governments seek to optimize resource sharing and public expenditures between historically more intertwined central and local governments. Central government transfers and shared national tax receipts prove crucial in this framework.

Despite their differences, all municipal financing systems rest on central government transfers and shared local and related tax receipts and fees. The balance between locally collected resources and shared taxation shapes the financing system typical of each African country. In the name of decentralization, the French-speaking countries have generally favored separating national and local taxation. They combine this structure with strong central government monitoring and oversight of local tax base assessments, rate setting, collection, and the *single coffer* principle,² which allows all local tax resources, regardless of their source, to be used for any and all local expenditures. Exceptions and

implementation delays still occur within this preference for taxation specialization by decision-making level. For example, Côte d'Ivoire does not recognize local-level taxation as such; its central government and cities still share receipts, and a fee known as the *communes' extra penny*³ still prevails in Cameroon. These exceptions or delays result, in part, because central governments encounter both very weak potential tax capacity and difficulties in managing local taxation; in most cases, this difficulty has led central governments to maintain a mix of resources—taxation, transfers, and fees. They have also attempted to develop more effective informal-sector tax schemes, such as synthetic taxes, occupation taxes, and so on (Chambas and Duret 2000).

In English-speaking countries, financing systems were built around property taxes and sophisticated transfer schemes: the latter represent more than 70 percent of local government revenues in Uganda, for instance. Such systems have important specific features, such as the crucial role that water and electricity surcharges play in financing South African cities; they provide about 60 percent of all municipal resources. As in French-speaking countries, no common denominator emerges from a diverse range of situations. Central government transfers provide a decisive share of local government finances in Ghana, Kenya, and Uganda. South Africa, Zambia, and Zimbabwe draw on sizable local taxation and utilities taxes (Steffensen and Trollegaard 2000). A complex tax-sharing scheme involving three major levels of government—federal, state, and local—distinguishes Nigeria's situation (Akindele, Olaopa, and Obiyan 2002; Egwaikhide and Okafor 2010).

In general, rapid and variably controlled urbanization has resulted in a relatively poor performance for property- or income-tax-based financing systems, as seen in Uganda's Graduated Tax. Such schemes often prove difficult to set up and collect on (Steffensen and Trollegaard 2000). Most often, resources have not increased proportionately with localities' expanded jurisdictions. In most cases, local governments must resign themselves to tailoring service levels to available resources. Local taxation generally consists of taxes on land and indexed activities, such as licenses or business taxes (including informal sector businesses), and local governments often share receipts from indexed activities with their central government. Sometimes local taxation includes occupancy taxes; in French-speaking countries, local governments have justified adding occupancy taxes recently because property taxes proved inadequate, given many countries' weak property rights.⁴ Local governments have difficulties setting up land or property taxes because of problems in determining cadastral rental values or the size of the potential tax base and in dealing with illegal settlements. Local taxation suffers from significant difficulties in identifying taxpayers and assessing and collecting taxes. Various examinations of local taxation efficacy show that yields remain based primarily on occupied spaces and economic activities (see box 4.1).

BOX 4.1**Sharing the Value Added Tax in Morocco**

The share of value added taxes (VATs) in Moroccan urban resources illustrates the significant weakness of local direct taxation through municipal, urban, and occupancy taxes and licenses. Until 1995, VAT receipts were allocated only to local governments having an operating budget deficit. Thus, 70 percent of VAT went to operations and only 30 percent to capital investment budgets. This procedure only encouraged municipalities to run deficits to receive a larger share of VAT transfers.

In 1996, the Moroccan government introduced a new regime for sharing VAT receipts, giving 30 percent of its VAT income to local governments. Of that 30 percent, the central government allocates 70 percent to local governments' general operating expenses; 15 percent to expenses such as education or health care costs that have been transferred from the central government to local governments; 10 percent goes to intercity projects, and 5 percent is reserved for exceptional local government expenditures.

This significant transfer of VAT receipts provides vital sustenance to Moroccan towns, representing 40–50 percent of their resources on average. However, distribution remains a concern, because selection criteria have not yet been optimized relative to the potential tax base.

Source: DGCL 2008.

As a result, household contribution to city finances most often remains residual. Local taxes also prove rather situational, principally applying to relatively large cities that have a minimum potential tax base, which is often land related, as in historical city centers and business districts. Medium-size cities continue relying on local use taxes, primarily occupancy of public markets and bus stations.

The poor performance of local taxation has led many countries to turn to shared taxation. This method allows local communities to take advantage of national tax yields, providing an essential complement to local receipts. Shared taxation may take many forms: (1) sharing national taxes, such as stamp or transfer duties, with the plan that part of these receipts should naturally be returned to cities (central governments generally allocate them to cities according to where the taxes were raised and collected); (2) sharing all national tax receipts—income, business, value added, and others—by means such as an extra penny for cities (in Cameroon, such a surcharge represents 10 percent of all nationally collected taxes); (3) sharing local taxation without any additional national receipts, as in Côte d'Ivoire where, until recently, some local tax receipts were pooled among all municipalities; and (4) sharing an endowment fund that

allows the central government to make equalization payments among cities. Endowment-fund types of systems have many applications in both English- and French-speaking countries in North and Sub-Saharan Africa.⁵ They allow the central government to regulate local financing systems, acting on the size of transfers, the degree of equalization among local governments (especially urban versus rural ones), and the equilibrium between expenditures on operations versus capital investments through earmarked transfers.

Having long based their policies on a vision of financially autonomous local governments supported by well-planned taxation, most central governments now appear ready to prioritize some regulation through transfer payments (see box 4.2). However, public financing constraints actually provide little room to maneuver, and deficiencies in the statistical apparatus for local public finances often hamper the allocation of transfers.

Financial Systems and Investment Financing

Financial Systems: Inefficient and Dominated by the Banking Sector

The concept of *financial system* integrates financial intermediaries, their products, the markets where they operate, and the institutions that ensure the

BOX 4.2

South Africa's Intergovernmental Fiscal System

The constitution of South Africa provides for a more equitable sharing of national income between the central and local governments. Designed to redress past inequalities, national income sharing among South Africa's three levels of government drives the new system. In 1998, new boundaries for municipalities were adopted through the Demarcation Act.

Every year, South Africa's Intergovernmental Fiscal Relations Act (1997) turns to a law on revenue sharing, the Division of Revenue Act, to determine the percentage of income accrued at each level, based on the central government's budget priorities. Thus, the provinces receive a share roughly equivalent to that of the central government, about 40–55 percent. However, municipalities must collect 90 percent of their revenues themselves—hence, the importance of equalization payments introduced through the Demarcation Act.

This intergovernmental fiscal system applies to about half of all transfers by value; the other half is allocated to finance municipal infrastructure investments. The central government ensures distribution to avoid the risk of provinces making patronage-driven allocations.

Source: Department of National Treasury 2009.

system's proper functioning. When a financial system operates correctly, it provides essential functions to the economy, such as facilitating trade and services, collecting savings, transforming and allocating savings, producing information, and managing risks (Kasekende 2010). For several decades, analyses of financial systems have rested on a set of criteria: accessibility, depth, efficiency, profitability, stability, institutional quality, and international openness (Aljounaidi et al. 2007). Although a financial system as a whole includes various institutions such as pension funds and insurance companies, in most countries, banks remain the most important financial intermediaries.

Observers agree that African financial systems remain ineffective despite a number of reforms made over the past 15 years or so. Africa's financial systems remain small in terms of absolute value, relative to economic activity and—except for those of Mauritius and South Africa—relative to other financial systems in the world. In addition, they prove the least accessible: on average, less than 20 percent of African households have access to retail banking services (Beck and Demirgüç-Kunt 2009). Furthermore, African banks are overly liquid. They are also very expensive; they earn high margins by paying investors poorly and ultimately provide the world's best returns (Beck, Fuchs, and Uy 2009). African banks delay taking action and show extreme caution in granting new financing. They tend to invest their own funds in short-term government bonds or to increase their reserves with central banks, loaning out only a small fraction of their assets (Honohan and Beck 2007; IMF 2010). Because of the relatively high interest rates offered by government bonds, the banks certainly have no incentive to take risks or to lend to private sector companies. A lack of products and little diversity among clients also characterize financial systems in many countries. Ultimately, companies and entire economic sectors—especially agriculture, housing, and municipal capital investment—remain victims of banks' inertia, risk aversion, and preference for a few familiar market segments (Aljounaidi et al. 2007).

African financial systems offer mostly short- or medium-term maturities for either savings or loans. This product offering particularly harms the property development and housing sectors, where longer maturities remain most needed. Land operators and property developers working in Africa finance their activities mostly with short-term loans that they renew, and they also use purchasers' down payments. Repeated loan renewals prove costly and inherently require that developers operate in the luxury and high-end market segments.

However, observers see encouraging trends. The African banking sector seems to have entered a phase of rapid change. In 2005, banking reforms in Nigeria led to fewer institutions; they now swarm into neighboring countries. Egyptian, Moroccan, South African, Tunisian, and other countries' banks pursue expansion policies. This change is already reflected in a movement to professionalize the industry and diversify product and business lines. Eventually,

these trends will lead banks to enter sectors such as housing, where the potential demand is enormous. The share of bank loans in municipal infrastructure financing is growing. Obviously, averages hide large disparities among countries, and it appears that banks' growing loan portfolios remain very concentrated in a few highly profitable sectors, such as telecommunications, geared to a few successful borrowers and operators (Irving and Manroth 2009). However, one trend suggests that if African banks had suitable public policy and institutional frameworks, they could play an increasingly important role in financing local capital investment.

Financial Markets in Africa

Forty African countries have securities, commodities, or currency exchanges,⁶ and the number of countries without access to a financial market is decreasing. Among recently created or planned financial exchanges, we note the regionally focused Ethiopia Commodity Exchange (ECX) and the Angola Stock Exchange. In less than a decade, the number of African financial markets has quintupled in the wake of financial reforms; their creation is often related to privatization programs (Moss 2007).

Financial markets have many positive economic effects: mobilization of domestic savings, reduction of investment risks, availability of alternative sources of funding, and information on prices and investment returns (Yartey and Adjasi 2007; Senbet and Otchere 2010). Financial markets help Africa better integrate with global capital markets. This integration is boosted, in turn, by African markets' good financial performance (Senbet and Otchere 2010). However, except for the Arab Republic of Egypt, South Africa, and—to a lesser extent—Nigeria, African financial markets suffer from their small size, lack of liquidity, and too-weak regulatory institutions; some exchanges hardly function. South Africa makes up 90 percent of the total capitalization of Sub-Saharan Africa (Yartey and Adjasi 2007; Senbet and Otchere 2010).

Foreign firms account for a large share of many African financial markets; subsidiaries of multinationals dominate and have easier access to capital by calling on their parent companies (Moss 2007). Creating a less expensive mid-cap market with easier listing procedures for local companies would increase transaction volumes (Honohan and Beck 2007). Regional consolidation of capital markets is generally considered a solution for African markets' liquidity, size, and fragmentation problems (see, for example, Adelegan 2008; Adelan and Radzewicz-Bak 2009). Consolidation may result from the merger of the national financial markets into a single institution or from cross-listings or agreements between two or more countries. Western Africa provides an example of merging, with its creation of a regional financial exchange, the Bourse Régionale des Valeurs Mobilières d'Afrique de l'Ouest (West African Regional Bourse, or BRVM), based in Abidjan. The exchange began operations in 1998, five years after the Council of Ministers of the West African Economic

and Monetary Union (comprising Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal, and Togo) decided to acquire a regional financial market. The political crisis in Côte d'Ivoire has had strong repercussions on the entire regional market; the BRVM appears less developed than other African financial markets (Adelagan 2008).

In 2006, Gabon created a financial market for Central Africa, the Bourse Régionale des Valeurs Mobilières d'Afrique Centrale (Central African Stock Exchange, or BVMAC) and gave it a regional focus on the countries of the Communauté Économique et Monétaire de l'Afrique Centrale (Economic and Monetary Community of Central Africa, or CEMAC), which includes Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon. Cameroon withdrew from that project to open the Douala Stock Exchange in 2005. A recent project now proposes a new grouping within a single regional market. The BVMAC's activity levels currently seem very low.

Countries in Southern and Eastern Africa seem to have taken a different approach, using agreements and partnerships. In 2000, the stock exchanges of the Southern African Development Community (SADC) aligned their listing procedures with the Johannesburg Stock Exchange. The Johannesburg Stock Exchange also signed agreements outside Southern Africa, with Egypt, Ghana, Kenya, Nigeria, and Uganda. The Nairobi Stock Exchange also made its own agreements with Ghana and Nigeria (Yartey and Adjasi 2007). Kenya, Tanzania, and Uganda have established the East African Member States Securities Regulatory Authorities, which promotes regional integration by aligning national regulations (Yartey and Adjasi 2007). Agreements signed between the exchanges allow company listings on one or more exchanges outside their original market. Botswana, Namibia, and South Africa signed the first cross-border listing agreements in 1992. Abidjan's BRVM has listed a few companies from exchanges in Nigeria and Ghana, and vice versa. Another partnership agreement allows Moroccan companies to list on Cairo's stock exchange. Agreements among exchanges in Kenya, Tanzania, and Uganda and among exchanges in the BRVM, Ghana, and Nigeria allow triple listings (Adelegan 2008). The need to harmonize accounting standards and information among exchanges can make the regional integration process long and arduous, and currency convertibility serves as another limiting factor (Moss 2007; Adelagan 2008).

Domestic Bond Markets

In Africa, bond issuance on domestic markets comes primarily from central governments and secondarily from parapublic and private sector companies. In recent years, an increasing number of private companies have been involved in local capital investments for water and electricity utilities and telecommunications. Specialized financial institutions that intermediate for local governments have also emerged, such as the Municipal Infrastructure Fund (Fonds d'Équipement Communal, or FEC) in Morocco. However, the number of local

governments that have directly issued bonds remains low (see boxes 4.6 and 4.7 later in this chapter). It is unclear whether this means of financing will increase significantly on the continent for reasons further developed in chapter 5 of this volume (see section titled “Using Capital Markets”).

In some countries, internal debt markets are just beginning to develop; they are almost nonexistent in Cameroon, Guinea Bissau, Mali, and Niger. However, internal debt growth remains strong across Africa, showing an 11 percent increase as a percentage of gross domestic product (GDP) from 1989 to 1999, and 22 percent from 2001 to 2008. Nonetheless, this percentage remains below that of emerging countries’ 40 percent increase as a percentage of GDP over the same period. Absorption capacity and financial sector size prove major constraints for most Sub-Saharan African countries (Adelegan and Radzewicz-Bak 2009).

The situation is different in North Africa, where the market for debt in local currencies is well developed. North African countries benefit from market liquidity, which reduces exchange rate risk, curbs dependence on external financing, and provides savings over the high cost of using international capital markets. The yield curve of local currency bonds is well established; their longest duration is 15 years (Dell 2009). Subsovereign bond issuance is not uncommon, especially in Egypt and Morocco.

Many countries in Sub-Saharan Africa have access to foreign financing at rates significantly lower than market and for very long durations. These two criteria—rate and duration—often determine the choice of using internal versus external borrowing. Generally, currency exchange risk is too low to erase the benefits of external borrowing rates and durations over those of domestic borrowing. External loans are more frequently used for project financing. In general, African governments prefer to raise money from internal markets to finance their expenditures. Overall, they favor short-term bonds to receive the lowest possible rates. As a result, very short-term (three-month) bonds dominate the internal debt market: on average, governments must refinance half of their debt four times per year (Christensen 2004).

Commercial banks serve as the main purchasers of debt on the internal market, where they find high levels of remuneration and safety. In general, this situation does not encourage them to loan to sectors where they must analyze and take on risks. As mentioned previously, this situation in itself reflects the relative weakness of financial markets in Sub-Saharan Africa (Honohan and Beck 2007; IMF 2010). However, recent developments are worth noting. First, the growth of pension funds in Botswana, Kenya, Malawi, Mauritius, Namibia, South Africa, and elsewhere, along with insurance and mutual fund assets, have had a stimulating effect because of their long-term investment strategies (Lukonga 2010). In recent years, Kenya, Nigeria, Tanzania, and Zambia have also taken the legal and regulatory steps needed to support these types of financial institutions. Second, it appears that domestic savings—the greatest constraint on bond market growth (Adelegan and Radzewicz-Bak 2009)—are palpably growing in

Sub-Saharan Africa. Third, as mentioned previously, the emergence of local private operators in water, electricity, and telecommunications services has created a market for corporate bonds—a market apparently set to grow. Finally, as the middle and upper classes emerge in urban areas, so do individual retail shareholders; they are interested in long-term investments to supplement future retirement income (Demey 2010).

Moreover, international donors such as the World Bank and the Agence Française de Développement (AFD), together with their private sector subsidiaries, the International Finance Corporation (IFC) and the Société de Promotion et de Participation pour la Coopération Économique (PROPARCO), have started raising funds on African capital markets to expand their local-currency loan portfolios. These bond issues have met with some success that must be attributed to their issuers' excellent credit, but they prove that African savings are genuinely available for investment. However, bond issuance by international donors on African markets runs the risk of drawing away needed resources from local companies—and, potentially, from local governments (see box 4.3).

BOX 4.3

Donors' Bond Issuance in African Capital Markets

To increase their lending capacity for subsovereign entities, donors raise capital in local currencies. For example, in 2006, IFC and, in 2008, AFD (France's bilateral development bank) issued bonds in West African CFA francs (XOF) on Abidjan's regional financial exchange, BRVM; these went for loans to members of the West African Economic and Monetary Union. IFC raised the equivalent of \$44.6 million in 5-year securities, financing industrial and tourism infrastructure in Côte d'Ivoire and Senegal. AFD raised the equivalent of €35.5 million through 8-year bonds placed with institutional and individual investors; the funds were allocated to AFD's private sector subsidiary, PROPARCO, to generate CFA franc loans and to AFD's nonsovereign operations, benefiting public and private enterprises and local governments.

The World Bank seeks to expand this type of borrowing; in 2007, it created a special program, the Global Emerging Markets Local Currency Bond Program (Gemloc), which aims to raise the equivalent of \$5 billion. The Gemloc program aims to improve local capital markets by promoting reforms, creating an innovative index, and providing advisory services, thus improving the markets' attractiveness to long-term investors. In its initial configuration, the Gemloc program covers three intermediate-income countries: Egypt, Morocco, and South Africa; its effect on Sub-Saharan Africa remains limited.

The success of these two bond issues in Africa proves domestic savings availability and investment capacity at the local level. However, repeated bond issuance by these two AAA-rated institutions risks siphoning capital away from African markets, depriving the local private sector of resources it needs.

Sources: World Bank 2007; Geiss and Mvogo 2008.

In another vein, some initiatives have arisen to encourage local currency investments with exchange-rate risk hedges. For instance, in 2008, the Currency Exchange Fund (TCX) was created by the Dutch development bank, FMO, and several other donors that are now shareholders in the fund. It aims to encourage U.S. dollar- or euro-based investors in emerging markets to provide long-term, local currency financing; to this end, the fund offers hedges for exchange-rate risks based on currency swaps.

A Perspective on the Local Capital Investment Situation

The developments mentioned previously remain tenuous, but they do suggest that financial systems in Sub-Saharan Africa could make room for more local currency financing in the future, as already occurs in North Africa. Depending on the country, such financing may accompany the rise of bond markets or follow a change in banking behavior. In this connection, note that no empirical study proves the superiority of one means of financing over the other; performance depends more on the financial system's degree of development than on its composition (Beck 2010). Ultimately, it makes little difference whether savings are collected and conveyed through the banking system or through bonds and the capital markets. In this regard, establishing capital markets in economies where they do not exist or in small economies where demand is low would not be the most rational option (Lin, Sun, and Jiang 2009). In such cases, the priority might be to establish an enabling legal, fiscal, and institutional environment for banks to provide efficient financial services. In all events, donors' assistance and their support for structural reforms will probably be necessary in many countries. Financing local capital investment with local savings is an issue that goes beyond the simple question of financing volumes to questions of economic, political, and social benefits. Developing endogenous modes of financing appears as a major issue for the coming decades. We will return to these points in chapter 5 of this volume.

Development Banks and Regional or National Development Finance Institutions

Alongside the African Development Bank (AfDB), a traditional multilateral donor (see chapter 1, box 1.1), Africa has many development banks and development finance institutions;⁷ they were originally designed to address market inefficiencies and provide long-term project financing. Some date back to the colonial period, and others were created after countries' independence and in the early decades of foreign aid policies.

An Overview of Existing Institutions

By the late 1980s, most of these development banks and finance institutions appeared to have rather failed in their missions or suffered from governance problems. Overall, they had low loan repayment rates and high operating costs. Many obviously suffered from central government interference with their management. The structural adjustment period saw donors trying to close down these institutions; however, many proved resilient and survived. In North Africa, they have evolved in different ways in various countries, depending on central government strategies or new banking laws (see box 4.4). More than 60 still operate in Sub-Saharan Africa (Honohan and Beck 2007). Within their grouping, we can distinguish regionally versus nationally focused institutions.

BOX 4.4

Changes in Universal Banks and Development Banks in North Africa

Morocco had two types of financial institutions: *specialized financial institutions* regulated by specific laws and lending only to specific sectors, and *universal* (commercial and investment) banks created since 1993. Since 2006, when new banking regulations introduced tighter prudential rules, some financial institutions have faced management challenges; the Banque Nationale pour le Développement Économique (National Bank for Economic Development, or BNDE) and the Caisse Nationale de Crédit Agricole (National Farm Bank) had to begin restructuring. The Caisse de Dépôt et de Gestion (CDG), a state-owned financial institution, had acquired BNDE in 2003; it eventually became a commercial bank.

In 1958, Tunisia established the Société Tunisienne de Banque (Tunisian Banking Company, or STB) as a public sector commercial bank specializing in tourism, trade, manufacturing, and property development. It subsequently acquired two competitors to form a larger and stronger entity working with subsidiary banks in many sectors of the economy. A state-owned bank, STB implements the government's development assistance policies. The Banque Nationale Agricole (National Farm Bank) was established in 1959 to support agricultural activity; it was subsequently renamed the Banque Nationale de Tunisie (National Bank of Tunisia) and expanded its activities in almost all sectors of the economy. It is now wholly state owned, and its development activities are limited to the agricultural sector through its subsidiaries.

In Egypt, the National Development Bank became a commercial bank in 1980, the National Bank for Development (NBD). It retains an orientation toward development to some degree, particularly through innovative microcredit mechanisms launched since 1987.

Source: Garson 2006.

In the Franc Zone⁸ in the 1990s, market liberalization reforms led many development banks to close or change into universal banks. Two regional banks, the Banque Ouest Africaine de Développement (West African Development Bank, or BOAD) and the Banque de Développement des États de l'Afrique Centrale (Central African States Development Bank, or BDEAC), reinforced their original development assistance vocation.⁹ Established in 1973, BOAD contributes to national and regional projects by providing credit lines to national governments or to participating development and commercial banks. It also provides medium- and long-term loans and venture capital to companies, and it finances projects in various sectors such as infrastructure, agriculture, energy, and telecommunications. BOAD's principal shareholders comprise the eight member countries of the West African Economic and Monetary Union (Union Économique et Monétaire Ouest Africaine, or UEMOA). Its resources come from financial markets and from lines of credit granted by international donors at concessional rates in the name of development assistance.¹⁰ In the UEMOA area, some financial institutions specialize in social economy organizations, such as the Regional Solidarity Bank (Banque Régionale de Solidarité, or BRS).

Created in 1975, BDEAC was restructured in 2003 after experiencing financial problems. It aims to become the leading CEMAC institution for long-term financing. The six CEMAC member countries hold up to 51 percent of BDEAC's equity; BEAC, AfDB, and France constitute its other principal shareholders. BDEAC also funds itself through international donors. The East African Development Bank (EADB) was created in 1967 in cooperation with Kenya, Tanzania, and Uganda; 10 years later, the introduction of the East African Community (EAC) validated the EADB's regional mission. Following the 2008 accession of Burundi and Rwanda to the EAC, Rwanda took an equity stake in the EADB.¹¹ The four EAC countries hold 75 percent of EADB's capital; commercial banks, AfDB, and FMO hold most of the remaining equity. The EADB funds itself on national capital markets and through donors. It operates in traditional development-banking sectors while seeking to expand its scope—to housing finance, for example.

In recent decades, many development banks and national development finance institutions in Sub-Saharan Africa have had problems positioning themselves in their markets. They have also had critical governance problems. For example, in the early 2000s, Nigeria's major development banks¹² presented truly negative results: smaller loan portfolios, too-thin loan margins, high currency-exchange-risk exposures, weak project analysis cultures, and a disastrous lack of profitability. Some banks could not refinance themselves and used their contributed capital to fund the few loans they made; annual operating costs ran far above annual lending levels. Such results were not limited to isolated cases; they also applied to many Sub-Saharan African countries (Honohan and Beck 2007).

The development banks and finance institutions that survived the structural adjustment period and banking sector restructuring now form an amorphous

group that includes some barely active, illiquid institutions with tiny loan portfolios. This group often includes specialized financial institutions, such as the National Bank of Agricultural Development in Mali (Banque Nationale de Développement Agricole, or BNDA), founded in 1981; it has begun to expand its activities beyond the rural sector. The housing sector counts a number of specialized development banks, such as those of Burkina Faso, Gabon, Mali, and Senegal. In practice, most of these housing-oriented banks appear to limit themselves to providing short-term financing (Garson 2006). We review banks and institutions that specialize in financing local governments and investments separately, later in this chapter.

The Outlook

The future of national development banks and finance institutions now appears uncertain. Many are designed for markets far too small to be profitable. In principle, institutions with a regional focus benefit from a larger market. They also have an advantage in being relatively immune to pressures from central governments; such interference underpinned the governance failures of some national financial institutions. Private sector equity participation has often been invoked to avoid such problems in the future. In some cases, a bank opening its equity to the private sector has resulted in a privatization, as in the case of the Urban Development Bank of Nigeria (UDBN).¹³ It also often results in a shift toward retail and commercial banking, as with the Austral Bank in Mozambique, DFCU Group in Uganda, and the Development Bank of Kenya (Garson 2006; Honohan and Beck 2007).

Since the 2008 financial and economic crisis, it has become clear that systematic use of the private sector does not suffice to meet the needs of all levels of the local capital investment market. This insufficiency is true for the entire continent, and even more so for Sub-Saharan Africa, where, as we have seen, the financial sector remains absent or defective in entire sectors of the economy. This inadequacy shows a need for financial institutions that could fill gaps in the market by creating long-term financing products to position themselves among capital markets, donors, and the private sector. If development banks and finance institutions were to modernize and professionalize their long-term financing activity, they could figure prominently in this new and necessary financial services architecture. We return to these points in chapter 5 of this volume.

Financing Tools and Mechanisms for Local Capital Investments

A number of countries have developed specific financing tools for local governments' investments. These tools come in two categories: *specialized financial*

institutions (SFIs) and *local investment funds*. The former's main if not sole purpose is lending; the latter serve as conduits for channeling resources from central governments and donors to local governments. In countries with investment funds and in those without specific tools, whatever local government borrowing is possible is usually highly regulated and requires a trusteeship agreement from a finance ministry or a cabinet decision. In other cases, some African local governments have been able to finance themselves by issuing bonds directly or by borrowing without intermediation.

Specific Financing Tools: Specialized Financial Institutions and Local Investment Funds

SFIs appear primarily in emerging countries: South Africa and other SADC member countries use the Development Bank of Southern Africa (DBSA) and South Africa's Infrastructure Finance Corporation Limited (INCA); Nigeria has its UDBN; Tunisia employs its Caisse de Prêts et de Soutien des Collectivités Locales (Loan and Support Fund for Local Authorities, or CPSCCL); and Morocco uses its FEC. These countries and tools have significantly different approaches, starting with their legal status—state-owned or private sector (see case studies in the appendix to this volume). However, the SFI model has a common origin and characteristics.

Local investment funds are found primarily in the least developed countries of Sub-Saharan Africa. In creating these funds, central governments were often motivated by a desire to channel foreign aid to local governments; some funds were also designed to partially function as credit institutions. Senegal has two, the Agence de Développement Municipal (Municipal Development Agency, or ADM) and the Agence de Développement Local (Local Development Agency, or ADL); Ghana is creating a District Development Facility (DDF); Cameroon has the Fonds Spécial d'Équipement et d'Intervention Intercommunale (FEI-COM), Mali has the Agence Nationale d'Investissement des Collectivités Territoriales (ANICT), and Burkina Faso has the Fonds de Prêts aux Collectivités Locales (FPCL). Political uncertainty affects these funds' viability; often, they must coexist with other subvention distribution systems that finance or interior ministries manage directly (see table 4.1).

Other countries have no specific instrument for financing local investments. Donor interventions generally take the form of project financing for urban, municipal, or sectoral development projects. We note the example of Cape Verde, where a donor provides lines of credit to commercial banks that use them to make loans to local governments for productive investments (see case studies in the appendix to this volume).

In intermediate-income African countries, SFIs now constitute the dominant model. They have mostly a parapublic status (INCA and UDBN are currently the two private sector exceptions) and combine credit activities with one

Table 4.1 Simplified Typology of Specialized Financing Tools for Local Investment

Characteristics	Country	Financial institution	Source of funding
State-owned or private sector SFI Active municipal credit mechanisms	South Africa* (and other SADC countries)	DBSA	Capital markets
		INCA	Donor loans
			Own resources
		CPSCL	Donor loans through central government
	Morocco*		Capital markets
			Own resources
		FEC	Commercial banks
			Capital markets
	Nigeria*		Own resources
		UDBN	Donor loans through central government
Investment fund Limited or nonexistent municipal credit mechanism	Senegal*	ADM	Donors through central government (retrocession)
		ADL (created 2010)	Central government resources
	Côte d'Ivoire		Own resources
		FPCL (no longer operating)	Donors through central government
			Central government resources
		FEICOM	Withholdings from municipal resources (CAC) (mutual fund)
	Cameroon		Donors through central government
		CFC (no longer operating)	Credit line from Crédit Foncier du Cameroun
			Donors through central government
		LGLA	Central government revenues
	Kenya		Own resources
		DDF (created 2010)	Donors through central government
			Central government revenues
			Own resources
	Ghana*		Donors through central government
			Central government revenues
			Own resources
			Withholdings from land sales revenues and from a tax on electricity (mutual fund)
	Niger	CPCT (no longer operating)	
	Mali	ANICT (2000)	Donors through central government
	Burkina Faso	FEICOM	Donors through central government
		FPCL	Central government resources

Sources: Paulais and Stein-Sochas 2007; Sinet 2010.

Note: ADL = Agence de Développement Local; ADM = Agence de Développement Municipal; ANICT = Agence Nationale d'Investissement des Collectivités Territoriales; CAC = centimes additionnels communaux; CFC = Crédit Foncier du Cameroun; CPCT = Caisse de Prêts aux Collectivités Territoriales; CPSCL = Caisse de Prêts et de Soutien des Collectivités Locales; DDF = District Development Facility; DBSA = Development Bank of Southern Africa; FEC = Fonds d'Équipement Communal; FEICOM = Fonds Spécial d'Équipement et d'Intervention Intercommunale; FPCL = Fonds de Prêts aux Collectivités Locales; INCA Infrastructure Finance Corporation Limited; LGLA = Local Government Loans Authority; SADC = Southern African Development Community; SFI = specialized financial institution; UDBN = Urban Development Bank of Nigeria.

* See appendix for case studies on these countries and Cape Verde and the Arab Republic of Egypt.

or more complementary roles, which may include implementing central government endowments and supporting local government technical assistance missions, particularly for investment planning and sometimes for institutional reinforcement.

Donors have actively promoted this SFI model at various times; for example, the U.S. Agency for International Development (USAID) supported Morocco's FEC and Tunisia's CPSCS in the 1980s. In Senegal, the Agence de Développement Municipale (Municipal Development Agency) was created under the auspices of the World Bank in the late 1990s; it may be regarded as an attempt to transplant a North African model by adapting it to the circumstances of a least developed country (see box 4.5 and case studies in the appendix to this volume).

In varying proportions, these SFIs confront a range of difficulties, mostly due to narrowness of the municipal credit markets. This limitation often stems more from brakes put on the decentralization process than from cities' lack of creditworthiness. For the SFIs, the market's narrowness leads to stagnation and eventually an inability to evolve and modernize. Private sector SFIs may also face competition once they have demonstrated that a market exists; they may also have problems refinancing themselves. Parapublic SFIs may also be subjected to their overseers' interference and remain unable to operate with sufficient autonomy. This restriction may hamper their management, hinder performance, and curb modernization efforts; it also often prevents them from diversifying their funding resources.

Obviously, local investment funds cannot escape their overseers' interference and its consequences either. In general, these funds' high dependence on external finance weakens them. Low activity levels significantly reduce their room to maneuver, especially for training and professionalizing their staff. These investment funds draw mostly on a local development approach that refuses to distinguish between urban and rural localities in the name of a certain notion of decentralization. In many cases, this approach renders these funds useless to local urban governments and destroys their credibility in the eyes of local officials, primarily because the funds lack the skills and resources to meet cities' specific needs.

The above remarks are made in general and apply to varying degrees—or not at all, depending on each case. Further analysis requires situating municipal financing tools within their national context, as seen in the eight case studies and a characterization of countries and their tools. Questions about financing tools for SFIs are central to the local investment problem: How should they evolve? Should they be created where they do not exist? In what form and on what scale? And under which conditions? We examine these questions further in chapter 5 of this volume.

BOX 4.5**The Municipal Development Agency:
Seeking a Virtuous Circle**

In 1997, Senegal created the Agence de Développement Municipal (Municipal Development Agency, or ADM) in Dakar, based on five guiding principles:

1. Develop a comprehensive mechanism for financing municipal investments, using self-financing, subventions, and borrowing based on realistic assessments of central government and city financing capacities.
2. Apply this system to all cities in Senegal on a relatively direct basis, and ground the new arrangements in the 1996 decentralization statutes.
3. Submit this financing mechanism to a predefined multiyear investment program prepared in consultation with the central government (as with city contracts and Priority Investment Programs).
4. Determine cities' financial contribution based on their ability to pay through self-financing and loan repayments (including variations in loan profiles).
5. Assist local governments in their capital investment identification, preparation, and implementation.

These provisions resulted from analyses of a number of failures and successes in municipal financing devices. They defined a comprehensive approach to local investment and management issues. They also transplanted technical and institutional tools such as the city contract, which had proved effective elsewhere, into North Africa.

The combined provisions outlined a comprehensive vision of urbanization based on the idea of helping municipalities enter a virtuous circle of development by targeting investments and improving administrative quality; these steps would increase economic productivity and revenues—and thus municipalities' borrowing capacity—which, in turn, would allow them to borrow, invest, and improve even more in a repeatable process. The World Bank, AFD, and other donors supported this approach and financed it as one of several municipal development projects; Senegal's ADM was the linchpin.

A dozen years later, the transplant clearly did not appear fully successful. ADM appears more as a project implementing agency than a vital national institution. Even the donors seem less committed to it. In 2010, the Senegalese government created a new Agence de Développement Local (Local Development Agency, or ADL), a type of investment fund without lending powers. Senegal seems to be moving toward a binary solution where donors and a specialized financial institution would ensure any lending separately from the ADL, perhaps through the Caisse des Dépôts et Consignations du Sénégal (Deposit and Consignment Office) also recently created.

Sources: Lemelle 2006; Nodalis 2010; Sinet 2010. See also case studies in the appendix to this volume.

Municipal Bond Issuance

A limited number of African cities can access financing through capital markets without intermediation by issuing bonds. In recent years,¹⁴ we note that Johannesburg (see box 4.6), Lagos (see box 4.7), and Douala¹⁵ have issued bonds. Others will probably follow. It seems that some countries, such as Morocco, plan to make the necessary legal and institutional adjustments to allow their largest cities to issue bonds, at least on an experimental basis and under central government supervision. Other local investment participants—private sector utility and services companies—may use direct funding from local capital markets. In Kenya, where the central government offers tax incentives for bond issuers and investors, KenGen, an electricity generation

BOX 4.6

The City of Johannesburg's Bond Issues from 2004–10

Since 2004, the City of Johannesburg (population 3.3 million) has successfully launched six bond issues for a total of R 5.8 billion (\$762 million). Beginning in 2006, these bond issues occurred within a framework known as the Domestic Medium-Term Note Programme. For capital investments that mainly target disadvantaged areas on the city's outskirts, this program allowed the municipality to issue bonds worth up to R 6 billion by 2010 without providing additional documentation beyond that needed for the initial credit rating. This funding diversification complements financing obtained from commercial banks and the Development Bank of Southern Africa (DBSA). In 2004, the International Finance Corporation and DBSA guaranteed an equal share of some bond issues, allowing the municipality to extend maturities to 12 years and improve its credit risk.

The City of Johannesburg is rated AA by Fitch Ratings (2007) for long-term credit and F1 for short-term credit, the highest short-term rating possible. Among the municipality's indicators of financial health, Fitch Ratings gave major consideration to its cash flow (savings net of debt service), which was estimated at 14 percent of receipts in 2006, compared to 8 percent in 2003. This improvement resulted mainly from improved local tax mobilization, driven in turn by the city's more than 6 percent annual GDP growth.

The City of Johannesburg has established a sinking fund, furnished with dedicated resources, to ensure its bond interest payments. However, it is the only South African municipality to have directly used capital markets, overcoming important constraints: an R 500 million minimum threshold for each bond's value, proven financial health through a good credit rating, and a transparent fiduciary environment.

Source: Fitch Ratings 2007.

company, and Safaricom, a telecommunications company, have issued widely subscribed bonds (Irving 2010).

Opinions are divided on the future of municipalities' direct bond issuance on the African continent. Skeptical observers present two arguments against a future for this type of financing, at least in the medium term. First, in the current state of affairs and legislation, only a handful of cities in only a few countries may issue municipal bonds. The cities must be credit rated and have sufficient borrowing capacity to issue bonds of high enough value; below certain thresholds, bond issuance fees become prohibitive. Second, solvent and well-rated cities can find funding at better rates and durations from three other sources: national SFIs;¹⁶ donors now entering the subsovereign debt market (see

BOX 4.7

Lagos State Bond Issues from 2008–10

In 2008, Lagos State, in southeast Nigeria (population 18 million), committed to a ₦275 billion (\$1.850 billion) bond issuance program in tranches of ₦50 billion (\$385 million); three were issued between late 2008 and April 2010. The goal is to raise sufficient funds to meet the requirements of a \$150 billion proactive infrastructure program by 2020: roads, public transportation, urban development programs for free economic zones and residential areas, water and electricity utilities repair and extensions, social services facilities, and so forth. Most of these investments involve public-private partnerships. One-quarter of the funds raised are expected to cover debt service.

The three bond issues were oversubscribed—the latest one by 249 percent (issued in early 2010). Only institutional investors and qualified buyers could purchase the bonds, principally because of the bonds' especially favorable conditions compared to sovereign debt: income tax exemptions and fixed interest rates of 13.0–14.5 percent over five to seven years. Lagos State has set up a debt service reserve fund underwritten by dedicated local resources. Lagos State was rated AA (national) by Fitch Ratings, Global Credit Rating in South Africa, and Augusto and Company in Nigeria.

Lagos State, created in 1967, is the only one of Nigeria's 36 states to have issued bonds. It boasts a better financial position than other states, generating nearly 75 percent of its revenue internally through taxation and from user fees, particularly for public transportation. Other Nigerian states depend much more on federal government revenue sharing—particularly oil revenues.

However, observers fear a too-rapid rise in the state's debt levels if tax receipts fail to increase sufficiently. In 2010, the Lagos State budget was ₦249 billion (\$1.7 billion), leaving little extra margin for the ₦17 billion needed for debt service.

Sources: Fitch Ratings 2008; Sinet 2010. See also the Nigeria case study in the appendix to this volume.

the following section); and even commercial banks, once they realize that a domestic municipal credit market exists, as has happened in other, more mature markets.

In these circumstances, the future of municipal bond financing may lie in intermediation more than direct issuance. African SFIs, such as CPSCL and FEC, already fund themselves in domestic markets, with mixed results.¹⁷ However, we imagine this practice is liable to develop further. If SFIs were to consolidate the funding needs of a greater number of local governments, including second-tier cities, their bonds could reach a size sufficient to make an issuance program financially sound. A financial intermediary working for a group of localities could accommodate the capital markets' relatively short durations more easily than a single locality by managing a successive refinancing strategy.

For these reasons, and because it has the necessary skills, a financial intermediary is apt to benefit from credit enhancements, such as partial guarantees from donors. It is also likely to produce hybrid financing by mixing different funding resources with those drawn from capital markets. We return to these subjects in chapter 5 of this volume.

Direct Local Government Borrowing

Very few local governments on the African continent have direct access to loans. As we have noted, commercial banks are overly liquid but not very dynamic; at present, they have neither the appetite nor the skills needed to enter the municipal credit market. The few direct municipal loans on record come from donors that can make subsovereign loans in Africa; at present, these donors include only the IFC–World Bank's Subnational Finance Program and France's bilateral development finance institution, AFD. To date, they have made loans to cities in the least developed countries, including Dakar and Ouagadougou, in modest amounts with highly concessional terms; AFD intends for these loans to have an exemplary effect (see box 4.8).

The situation will likely change over the short to medium term. Large local governments—in emerging countries, North Africa, and big oil-producing countries (Nigeria) with their enormous capital needs for transportation and other investments—offer attractive financing opportunities for donors and for nonconcessional products as well. It is likely that the number of donors that might make subsovereign loans—at least with guarantees—would increase significantly if they adjusted their bylaws.

These perspectives raise some questions. Donors' activities carry their own contradictions, whether funding sovereign or nonsovereign entities. In the local government sector alone, it is clear and fairly well documented that donor financing, even with few or no concessions, has a crowding-out effect on private sector financial service companies and deters borrowers from using local financial markets. We return to this issue in chapter 5 of this volume.

BOX 4.8**An Example of Subsovereign Hybrid Financing: Ouagadougou**

The capital of Burkina Faso, Ouagadougou, has more than 1.2 million residents. In 2006, it saw an exemplary hybrid subsovereign financing operation, involving a municipally owned, revenue-generating commercial facilities project. Investment centered on rebuilding the city's central market; it had hosted 2,900 merchants before being destroyed in a fire. Additional works centered on reinforcing a network of secondary markets, including some in outlying areas that were underequipped and unsanitary.

The project's technical, economic, and financial feasibility studies were carried out at the same time as a prospective analysis of the municipality's financial accounts. Loan simulations using various borrowing amounts determined how much of the municipality's net savings could be used without overburdening its investment capacity. The optimum amount thus determined led to an adjustment of the project's characteristics; the breakeven point for operations was optimized on the basis of a target cost and the markets' projected receipts, allowing for the facility's pricing constraints.

Following these simulations and projections, it emerged that a grant was needed to complete the capital investments without burdening the municipality's repayment capacity. Thus, the financing became *hybrid*, combining a €2 million loan with a €3.15 million grant. The variable-rate loan was very concessional, based on Euribor less 186 basis points, a 20-year term, and a 5-year payment deferral; this grace period means that capital repayments would not start until the works were completed and the first receipts collected.

The loan repayment amounts were based on 10 percent of recent annual gross savings. The grant's share of the financing prioritizes six markets on the city's outskirts, where receipts are very low. The grant also covers a series of institutional aids, including actions to strengthen the markets' management authority, RAGEM (Régie Autonome de Gestion des Équipements Marchands). Management quality remains crucial for the financing operation, because profits earned by the Authority endow an investment fund and pay the city a fee essentially equivalent to the loan payments. As part of the financing arrangement, the donor asked the municipality to open a special account with Burkina Faso's treasury and make the loan's debt service an obligatory expenditure.

Source: AFD 2006.

Overview of Public-Private Partnerships on the African Continent

The World Bank maintains a database¹⁸ of public-private partnerships (PPPs) in developing countries; it served as the basis for our following observations.

First, from 1990 to 2009, the African continent received only 10 percent of developing country PPP investments; by sector, this amount breaks down to

15 percent for telecommunications, 6 percent for energy, 6 percent for transportation, and 4 percent for water and sanitation. Second, over the same time period, spending on African PPPs reached \$152 billion; a high share—70 percent—went to the telecommunications sector. Table 4.2 presents details of capital expenditures for the four sectors that the database follows, broken down by North Africa and Sub-Saharan Africa.

PPPs concentrated in four countries: Algeria, Morocco, Nigeria, and South Africa received two-thirds of capital investments even though these four countries represent only 27 percent of Africa's population. Energy projects concentrated in North African countries, especially Algeria and Egypt. Investments in telecommunications (69 percent) and transportation (72 percent) dominated in Sub-Saharan Africa (see table 4.3).

PPPs in Urban Areas

The database does not allow for a precise breakdown among local, regional, and national operations. In the electricity sector, most projects were for transportation or power generation and might be completely or—most often—partially directed at urban areas; electricity distribution—largely urban—accounted for only 10 percent of such projects. However, comprehensive projects that do not clearly separate power generation from distribution include a share of distribution; such energy projects represent about 20 percent of the total.

Table 4.2 Public-Private Partnerships on the African Continent by Sector 1990–2009

Region or continent	Energy	Telecommunications	Transportation	Water and sanitation	Total
North Africa (\$, billions)	17,638	33,083	4,521	2,082	57,324
Sub-Saharan Africa (\$, billions)	9,656	73,306	11,812	266	95,040
Africa (all; \$, billions)	27,294	106,389	16,333	2,348	152,364
Share (percent)	18	70	11	2	100

Source: World Bank Private Participation in Infrastructure (PPI) Project Database 2010.

Table 4.3 Public-Private Partnerships on the African Continent by Sector, 1990–2009
percent

Region or continent	Energy	Telecommunications	Transportation	Water and sanitation	Total
North Africa	65	31	28	89	38
Sub-Saharan Africa	35	69	72	11	62
Africa (all)	100	100	100	100	100

Source: Adapted from the World Bank PPI Project Database 2010.

In the water and sanitation sector, of 40 projects identified by the database, only 29 appear to relate to urban areas. In the water sector, these mostly urban PPPs were created in 18 countries.¹⁹ Other PPPs included electricity, water, and sanitation distribution. In Morocco, PPPs in Casablanca, Rabat, Tangier, and Tetouan generated \$5.1 billion in capital investment. National companies in Algeria, Gabon, Guinea-Bissau, and Mali also set up PPP contracts.

However, most of these PPPs were management contracts without private sector investment, as in 26 of the 40 projects mentioned here. Many multinationals have withdrawn from the PPP market, considering it insufficiently profitable. Meanwhile, we saw a rise in national and regional private operators (see chapter 3, section titled “The Challenge of Managing Basic Services,” in this volume).

Private sector involvement in telecommunications has grown explosively in the past 10 years, as mobile telephony has expanded throughout Africa. These mainly national contracts extend telecommunications networks countrywide or specifically within capitals and major cities. Private companies operate under concessions or build-operate-transfer (BOT) contracts, building the networks or commercially exploiting them.

In the transportation sector, the majority of PPPs cover major infrastructure—ports and airports in particular—to reduce isolation and improve economic development. These facilities have national or regional effects and also often affect the cities they serve. Urban roadway PPPs remain rare on the African continent. One example is a toll expressway in Senegal between Diamniadio and Dakar, set up as a concession with a private company, which will finance part of the investment and operate the expressway. Complementing this private sector investor’s and the Senegalese government’s investments, loans from the World Bank, AfDB, and AFD will finance more than 40 percent of the \$500 million project.

PPPs under Local Government Ownership

With the information available, it is hard to accurately count the number of projects under local governments’ ownership, but they are clearly rare. In 2009, only a dozen could be counted in the water and sanitation sectors, primarily in Morocco and South Africa. Among other things, this low number reflects decentralization’s relatively slow progress. In many countries, utilities, especially water and electricity, do not come under municipalities’ remit. Furthermore, municipalities rarely have the legal authority or the technical skills needed to enter into such contracts, even for sectors under their jurisdiction. However, gaps are evident in the database for urban services—particularly waste disposal, which comes under local powers in many cases; many waste sector PPPs escape the census.²⁰

What Are the Prospects for PPPs in Urban Areas in Africa?

Some observers think that PPPs were set up in developing countries too early, preceding the central government-level reforms needed to ensure their success (Harris 2003). This is probably true for African countries; these countries' urban sector PPPs have proven the most disappointing relative to expectations. Today, as genuine concessions and BOT contracts tend to lose out to management contracts, PPPs' interest for African local governments may lie less in expected financing terms than in skills enhancement (Marin 2009). Negotiating a contract requires knowledge and experience in procurement and monitoring operations; a PPP provides an opportunity for a local government to acquire these skills and knowledge. In addition, management contracts may offer tremendous training opportunities to local government staff, if they are designed for this purpose; qualified private sector personnel ensure a continuing education process, rather than a single consultancy session.

Local-government-owned urban sector PPPs appear worthy of continued, active support but in a renewed form. Urban PPPs could finance a share of capital investments, but they could especially improve services management and build local management and contracting capacities. This is particularly true in the field of basic services, as we mentioned in chapter 3 of this volume.

Philanthropic Foundations

Since the late 1990s, philanthropic foundations' donations for international aid have risen sharply, reaching about \$5 billion per year; about three-quarters comes from U.S. foundations, far more than from European and Asian ones (Kharas 2007; Sulla 2007). In 10 years, donations from U.S. foundations almost tripled, reaching \$44.4 billion in 2007. In 2009, the 1,384 largest U.S. foundations gave \$22 billion; \$5 billion went to foreign aid. Although donations to international causes accounted for only 11 percent of total giving in 1998, by 2008 they accounted for 24 percent (Foundation Center 2009). This amount includes donations to organizations located in the United States that carry out international actions. Foundations' increasing interest in international activities arose just as U.S. private sector foreign aid contributions reached \$37 billion in 2008 (Center for Global Prosperity 2010)—exceeding that year's official development assistance (ODA) from the United States of \$27 billion (OECD 2010).

In general, foundations have no formal place in the architecture of international aid organizations; because each foundation presents its results in a different way, the amount of funding involved is difficult to estimate. Foundations often make their donations work through nongovernmental organizations (NGOs). However, this avenue masks which countries or beneficiaries really receive the resources.

Foundations in the United States are relatively new players in the field of international aid, because—until recently—they donated to causes within the United States following a social redistribution rationale. In recent decades, major new foundations have greatly changed this situation, with international donations increasing at a rate faster than domestic ones. The Bill and Melinda Gates Foundation (Gates Foundation), now the world's largest, made grants worth \$3 billion in 2009; it allocated 80 percent to developing countries, concentrating a high percentage—60 percent—on the health sector.

When foundations work directly with foreign organizations, they tend to favor direct intervention in emerging countries such as Brazil, India, and Mexico. When foundations work in the least developed countries, they often use intermediary organizations based in developed countries (Zimet 2006); 40 percent of U.S. foundations' direct international donations pass through Europe. Foundations in the United States seek out international institutions' expertise and security, providing a large share of grants—about 22 percent, which is more than Africa receives directly—to Switzerland-based organizations such as the International Committee of the Red Cross; the Global Fund to Fight AIDS, Tuberculosis and Malaria; and several United Nations agencies such as the World Health Organization and the United Nations Refugee Agency. Through their global programs, these institutions reallocate a portion of the funds to the least developed countries. Donations passed through Europe and these institutions primarily target the health sector, while those arriving in Sub-Saharan Africa through other channels principally target education, agriculture, and rural development.

The urban and housing sectors represent a marginal part of foundations' activities; local governments rarely benefit from direct grants, except for Cape Town and Johannesburg in South Africa and a few towns in the Philippines (Foundation Center 2009). In most cases, NGOs and international fiduciaries implement such funding targeting the urban environment or housing. For example, in 2007, the Gates Foundation funded a project to improve water and sanitation access in Sub-Saharan Africa through an \$11.3 million grant to an NGO—Water and Sanitation for the Urban Poor; the project aimed to strengthen local operator and government capacity. In 1995, the Open Society Institute (now the Open Society Foundations) drew on a grant from the Soros Economic Development Fund to create the National Urban Reconstruction and Housing Agency (NURCHA), a finance company in South Africa, endowing it with a \$50 million fund to guarantee mortgage loans for affordable housing (see chapter 5, box 5.14, in this volume).

The major foundations increasingly act in partnership with international organizations and fiduciary funds. The Gates Foundation has contributed to the World Bank's Water and Sanitation Program for pilot projects to build latrines in urban areas of India, Indonesia, and Tanzania. In 2009, the Gates Foundation

donated \$15 million to a Cities Alliance program to support nationwide slum upgrading efforts in five countries, including three in Sub-Saharan Africa—Burkina Faso, Ghana, and Uganda (Cities Alliance 2010).

We should emphasize how much the new foundations' approach differs from that of traditional charitable organizations. The new generation of philanthropists, having made fortunes in technology or finance, has helped diversify the use of funds toward income-generating activities as well as nonprofit ones. Some foundations partially assume the role of investor, being able to take risks and opening the way for the private sector by showing that investing in certain sectors—such as microfinance—can be profitable. These new philanthropists have economic development goals, not just social visions.

Recently created, more forward-looking foundations evolve toward philanthropic banking, offering a wide range of financial services using loans and grants. They participate in innovative, sometimes sophisticated financial engineering initiatives. For example, the Gates Foundation is a member of the Global Alliance for Vaccines and Immunisation (GAVI), a public-private partnership that includes the United Nations, the World Bank, and vaccine producers. A GAVI entity, the International Finance Facility for Immunisation (IFFIm), raises funds in capital markets by issuing bonds. These bonds are secured by long-term financial pledges from donor countries and thus have a AAA credit rating. The IFFIm transfers the funds raised to beneficiary countries in the form of subventions; the countries must cofinance their programs (GAVI 2009).

GAVI has proved to be a remarkable innovation in the international aid landscape: a PPP with eclectic partners, leveraging pledges to raise its funds from capital markets. This model could be useful for local government and urban development initiatives (Paulais and Pigey 2009). In general, African local governments should make it a goal to put their administrative and financial affairs in order to capture a share of the resources available from these foundations—resources that escape localities almost entirely as matters currently stand. We return to this point in chapter 5 of this volume.

China and Other Emerging Countries

China at Present

In recent years, China's presence in Africa has intensified, with a marked increase in Chinese imports. Chinese companies have also increased their share of contracts to exploit natural resources and build infrastructure. Whereas Chinese foreign aid to Sub-Saharan Africa focused on five countries in 2001, it covered about 40 countries by 2010. China became Africa's second-largest trading partner after the United States, as its trade with Africa increased sevenfold between 2000 and 2007 (Chaponnière 2008). Chinese imports have a significant

effect on the economic growth of some countries, such as Benin, Burkina Faso, and Togo; in turn, they export more than half of their cotton production to China (CEDEAO and CSAO/OCDE 2006).

China's involvement with foreign aid to Africa began in the 1960s. At that time, China's ODA amounted to about \$100 million per year; it increased steadily to reach \$5.1 billion in 2009.²¹ From 2001 to 2010, China committed about \$20 billion to infrastructure in Sub-Saharan Africa (Foster et al. 2011). The Chinese government plans to create a national development aid agency to coordinate its initiatives. Chinese foreign aid is based on agreements between governments. Chinese companies lead construction and operations projects; loans from the Export-Import Bank of China (China Exim Bank) pay the companies on receipt of invoices. China Exim Bank is the principal source of financing for infrastructure projects in Africa; African governments repay its loans. China Exim Bank's standard loan terms offer 2 percent interest, a 17-year term, and a 7-year grace period, equivalent to a grant element of 53 percent on average, according to the calculations of the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD). However, these parameters vary greatly between countries and projects.

Chinese financing frequently relies on a barter mechanism known as *Angola mode*, which uses loans backed by supplies of natural resources. China Exim Bank first used this mechanism in 2004, loaning \$2 billion to Angola to build infrastructure in return for 10,000 barrels of oil per day. In this mechanism, funds do not pass through an African government; the Chinese directly fund and build the infrastructure, and, in return, an African government allows a Chinese company to exploit a certain quantity of resources (Chaponnière 2008).

Until late 2007, China's infrastructure finance portfolio focused on four countries: Nigeria represented 34 percent of the total, Angola 20 percent, Ethiopia 10 percent, and Sudan 10 percent. From 2008 to 2010, this allocation changed: some projects were canceled in Nigeria, and China signed a \$3 billion framework agreement with the Democratic Republic of Congo in 2008. China's growing demand for energy and raw materials drives this diversification; priority capital investments center on major infrastructure for natural resource exploitation. However, electricity has gained a paramount place recently; from 2001 to 2007, it accounted for 40 percent of investment, rising to 60 percent from 2008 to 2010 (Foster et al. 2008, 2011).

The share of China's investments in urban areas remains relatively small and concentrated on transportation infrastructure. Among China's 2001–07 projects, Chinese aid helped build and repair urban roads in Nairobi and N'Djamena, bridges in Bamako and Niamey, and some stadiums and other major facilities. Investments in other sectors, including water and sanitation, appear to remain exceptions, such as the extension of the drinking water supply in Chalinze, Tanzania (Foster et al. 2008). In 2007, China Exim Bank

announced a \$3 billion loan to the Democratic Republic of Congo, 10 percent of which was to be allocated to urban roads in Kinshasa and other cities. These operations were postponed in 2008, when the International Monetary Fund (IMF) requested revision of the Sino-Congolese framework agreement in light of what the IMF judged as Congo's excessive debt; the planned operations should proceed soon.

We note that the Chinese provincial governments, especially coastal ones, have skills and resources allowing them to open aid offices abroad; Chinese and African local governments currently cooperate through 73 decentralized aid agreements in 28 countries (Lévy, Gaborit, and Rotteleur 2008).

Overall, we can say that Sub-Saharan African cities have received a fraction of Chinese-funded infrastructure built in their respective countries. African local governments might set a goal of capturing a greater share of these Chinese investments. They could do so more effectively if they were to show a capital investment plan, present prepared dossiers, and assume an ownership role in all its dimensions. It may prove challenging for African local governments and their other donors to coordinate and maintain coherence with Chinese-funded aid programs.

Other Emerging Countries

Development finance involves a growing number of emerging countries, such as Brazil, India, Thailand, and the Persian Gulf states (Kharas 2007). Like China, India uses its public enterprises and the Export-Import Bank of India (India Exim Bank) to finance infrastructure in Africa; between 2003 and 2007, India's contribution reached \$1.5 billion. The 2008 financial and economic crisis caused India to reduce its contribution to about \$200 million per year in 2009–10. India Exim Bank focuses primarily on the electricity sector and secondarily on transportation, particularly railways. Sudan receives the largest share of Indian funds, approximately \$400 million as of late 2010.

The Persian Gulf states finance infrastructure in Africa through specialized funds and development agencies, lending \$3 billion to development projects in 2001–07 and allocating an equal amount in 2008–10. The Organization of the Petroleum Exporting Countries (OPEC) financed the most projects, representing more than 30 percent of the Persian Gulf states' commitments; the Abu Dhabi Fund for Development, the Arab Bank for Economic Development in Africa, and the Kuwait Fund for Arab Economic Development contributed up to about 20 percent. The transportation sector receives most of the Arabian funds' resources, with the electricity sector in second place, primarily in Sudan and Niger (Foster et al. 2011).

Brazil, Thailand, Turkey, and other countries have recently emerged as development participants. Brazil currently concentrates its efforts on two countries—Mozambique and Togo. Its investment capabilities appear limited at present; however, Brazil's first aid interventions in Mozambique focused on urban areas

and housing. The same limitations probably apply to other emerging players in *South-South* cooperation—this time, African ones: in early 2011, South Africa announced that it would create a development agency, while North African countries plan similar projects. Like Brazil, these new aid contributors may be interested in urban issues and housing, given their countries' experience. Their appearance among development aid donors could constitute an opportunity for any Sub-Saharan African local government seeking partners.

Sovereign Wealth Funds and Investment Funds

Sovereign Wealth Funds

Sovereign wealth funds have helped drive the global economy's transformation in recent decades. Financed by oil revenues and Asian countries' reserves, these funds are leading financial powers. For example, the largest sovereign wealth fund, the Abu Dhabi Investment Authority (ADIA), holds an estimated \$900 billion in capital (Santiso 2008); the second-largest funds are in Norway and Singapore, worth \$400 billion and \$330 billion, respectively. In 2009, all sovereign wealth funds' combined capital amounted to \$3.8 trillion, making them the world's largest investors (IFSL 2010).

Through prudent asset management that emphasized bond investments, these sovereign wealth funds have proven quite resilient to the 2008 financial crisis, even though they halved their investments in 2009. Furthermore, many sovereign wealth funds intervened to support crisis-affected companies in their own countries. Sovereign wealth funds' growth potential remains considerable; projections show their assets reaching \$10 trillion by 2013 (IMF 2009).

The 2008 crisis led the funds to withdraw somewhat from the banking sector to invest more in industry and infrastructure. For example, the China Investment Corporation has committed nearly \$15 billion outside China, investing in energy, metals, agriculture, and alternatives such as hedge funds and private equity (IFSL 2010). As generally stable, long-term investors, the sovereign wealth funds are gradually expanding into new industries and activities, seeking better returns; Asian and Middle Eastern funds invest primarily in emerging countries' financial markets but have broadened their interests to include less developed countries.

The goal of diversifying their investment portfolios should drive sovereign wealth funds to increased participation in African private sector companies. For example, North Africa already attracts Persian Gulf funds: Dubai Investment Group acquired a 17.5 percent stake in Tunisie Telecom in 2007 (Santiso 2008). Africa might well benefit from the attractiveness of its economic growth and, consequently, from increasing sovereign wealth fund investments in the years to come.

Private Investment Funds

Investment funds, also major players in international finance, increasingly position themselves in emerging markets. Africa has attracted a growing number of investors in recent years, mainly—but not only—in intermediate-income countries such as South Africa. Investment funds have taken an interest in Botswana, Ghana, and Kenya and also postconflict countries such as Angola, Ethiopia, and Mozambique (Santiso 2008). For example, a British fund, Blakeney Management, invests specifically in risky, early-stage financial markets in Africa and the Middle East, financing private and public sector enterprises. Infrastructure investment funds have been established on the continent, including—among many others—the South Africa Infrastructure Fund (SAIF), in operation for more than 10 years, and the African Infrastructure Investment Fund, established in 2004; the latter focuses mainly on the transportation sector in South Africa and Nigeria.

Capital comes from Western financial centers—London and New York—and also African ones—Johannesburg and Lagos. Specialist hedge and investment funds seek highly profitable investments, and Africa provides a favorable context. African countries are more stable now than in the past; access to information is improving, and investments provide strong returns. Stock markets on the continent are expanding: in 2007, 522 companies were listed on Sub-Saharan African stock exchanges compared to only 66 in 2000 (Santiso 2008). An increasing number of investment funds specialize in African equities, as do newly emergent institutional finance companies. For example, Renaissance Capital, an investment bank based in London and Moscow, created a \$1 billion pan-African investment fund in 2007. Pamodzi Investment Holdings, a South African company, has established a \$1.3 billion pan-African investment fund with American partners (Santiso 2008).

A Development Challenge and Opportunity

These sovereign wealth and investment funds represent a real challenge and opportunity for Africa. If we consider the amount of money circulating, the share of sovereign wealth and private investment funds' financing may prove crucial for sectors and goals related to development strategy. From the perspective of local decision makers, particularly those who run cities, two questions arise: How can they promote and facilitate investment with better economic rates of return? How can they optimize the potential effect of these investments on local economies?

These aspects may prove even more important because the power of these funds also raises a number of questions. On the one hand, these funds sometimes serve their home country's political and strategic objectives, as seen in mining and natural resources investments and agricultural land acquisitions. On the other hand, the opacity of some of these funds immediately raises questions about the origins of their resources; for example, money-laundering operations are mentioned in connection with prestigious real estate investments in

BOX 4.9**InfraMed: A Parapublic Investment Fund**

The InfraMed investment fund was launched in 2010 as a joint initiative of France's Caisse des Dépôts et Consignations and Italy's Cassa Depositi e Prestiti: each put in €150 million. The European Investment Bank also put in €50 million; the Moroccan Caisse de Dépôt et de Gestion group provided €20 million, and the Egyptian bank EFG Hermes invested €15 million. Over time, the InfraMed investment fund aims to raise €1 billion.

InfraMed's goal is to boost equity investments—within a market-economy framework—in urban, energy, and transportation infrastructure in member countries of the Union for the Mediterranean in southern and eastern North Africa—a region that has one of the highest urban growth rates in the world. The fund intends to invest in longer-term investments than do traditional private infrastructure investment funds.

InfraMed will allocate at least 20 percent of its funding to investments in Morocco and Egypt, alongside two newly created funds, InfraMaroc and InfraEgypt, created with Morocco's Caisse de Dépôt et de Gestion group and EFG Hermes, respectively.

Source: CDC 2010.

various North African and Sahelian capitals. Moreover, it is entirely possible to conceive of investment funds more oriented toward public policy, development, and the environment. The shareholders of InfraMed chose such a model; this infrastructure fund finances urban, energy, and transportation works in southern and eastern North Africa, within the framework of the Union for the Mediterranean²² (see box 4.9).

These considerations lead us to the question of the use of African countries' sovereign wealth funds. By 2009, the largest of them, including those in Algeria, Botswana, Nigeria, Sudan, and São Tomé and Príncipe, accounted for a combined capital value of about \$120 billion (AfDB 2009). Part of this capital could be oriented toward a parapublic or hybrid investment fund targeting Africa's urban and energy infrastructure, following the InfraMed model. Furthermore, part of these sovereign wealth funds' annual profits could be allocated to economic and social development projects. We return to this point in chapter 5 in this volume (see section titled "A Special Initiative for Fragile Cities").

Carbon Finance

Chapter 1 in this volume showed that at present, capital investment projects that have received additional financing through the Clean Development Mechanism

or carbon emissions offset markets have concentrated in a small number of emerging countries²³ and a small group of sectors.²⁴ Given these conditions, only a small share of projects in urban areas on the African continent have benefited from carbon finance. A detailed analysis of transactions was made in early 2011 and confirmed these findings. We note that it is difficult to obtain an accurate count because of differences between transaction databases.²⁵ These differences arise from problems with database updates and the double-counting of projects under consideration, rejected, or subject to an Emissions Reduction Purchase Agreement (ERPA)²⁶ or those whose ERPA is under reconsideration because of technical problems. Since the ERPA system's inception, it appears that 40 to 55 projects have been submitted for approval or are under consideration; only 17 have consummated ERPAs, and one will be reconsidered. In 2011, Africa's share of ERPAs was less than 1 percent of the worldwide total.²⁷

Most ERPAs concern the mining and power generation industries. Those directly related to local investment and cities center on municipal waste management; six such projects exist in Africa—in Egypt, Nigeria, South Africa (2), Tunisia, and Uganda. Each project may involve several landfills and include methane capture, the ERPA offset element; in some cases, landfill projects generate additional receipts through compost production and sales of methane gas for electricity generation.

South Africa's eThekwin landfills are one of the first African municipal waste management projects integrating carbon finance from the outset. Two landfills on the city's outskirts have been equipped with methane recovery facilities; the gas is destined to be sold for power generation. The facilities aim to recover up to 80 percent of the methane emissions; methane fuel sales bring in additional receipts. Methane sales provide an additional advantage in relation to air pollution, because methane replaces coal that would otherwise be burned. It appears that the ERPAs' clauses have not yet been applied, because technical difficulties with one landfill have altered methane production projections. Methane production problems, combined with other types of risks and uncertainties, create challenges in organizing such projects (see box 4.10).

As noted in chapter 1 of this volume, the share of investment represented by all the receipts from carbon finance mechanisms varies depending on the type of project and its characteristics. For solid waste projects, that share probably fits a wide range—from 5 to 45 percent. In addition to fluctuations in receipt levels that depend on previously discussed factors, the wide range arises from significant differences in capital investment amounts as a percentage of expected waste volumes, especially if the cost of building access roads to new landfills is taken into account.

African local authorities and operators who wish to prepare such projects should bear these constraints in mind. Overall, carbon finance provides additional funding *a posteriori*; most frequently, it has no part in prefinancing of

BOX 4.10**Carbon Finance and Solid Waste: Managing Uncertainty**

Emissions reductions depend on the volume of landfill gas actually captured, and the latter depends on the composition of the waste, the climate, the quality of trash collection, and landfill management. Experience often shows significant differences between projected and achieved reductions. Implementations in new landfills generally occur in two phases: the first calls for methane flaring because the second—power generation—requires a history of available gas flows to plan and execute appropriate facilities.

The quantity of additional receipts generated depends on the market price for emission offsets; these vary and remain subject to great uncertainty after the expiration of the Kyoto Protocol in 2012. Carbon credit pricing methods will likely undergo changes as well. A fixed price might be determined for the initial years of future ERPAs, and after a certain period, adjustments could be made according to actual yields.

Another variable parameter concerns the quality of performance monitoring and changes in measurement methods during the facility's operating period. Generally, uncertainties about the sales value and volume of methane that can actually be produced and accounted for make it difficult to integrate carbon finance receipts into project financing plans.

Sources: World Bank 2010, 2011a.

a capital investment.²⁸ Special attention should be paid to the issue of sharing additional receipts. The fact that large investments have been made for a landfill should not obscure the fact that its performance remains completely dependent on the amount of waste it receives. In other words, landfill performance depends on the quality of upstream collection and transport services; the latter is generally the most costly element. Logically, the various waste management participants should share additional income from carbon finance. This distribution should be precisely determined at the outset, especially for PPPs.

In sum, it appears that carbon finance dossiers draw on fairly sophisticated concepts and may prove challenging to initiate. One should bear in mind that such efforts may prove useful in educating the technical staff of involved local governments. In fact, local officials and authorities who have successfully followed this path have often referred to this training as an indirect positive effect of such projects. Other important indirect positive effects concern the city's external image and the opportunity to educate residents about environmental issues. Eventually, African cities should be able to expand the areas in which they can mobilize carbon finance—notably in transportation,²⁹ street lighting, and energy-efficient public buildings—once they have clarified pending questions about methods (see chapter 5, box 5.9, in this volume).

The Stakes Surrounding Migrant Remittances

The Current Situation

Financial transfers from migrants to their families in their home countries have dramatically increased since the late 1990s. Remittances to the African continent doubled from 2004 to 2009, reaching approximately \$39 billion (World Bank 2011b)—an amount greater than that year's \$27 billion of ODA (OECD 2010). Africa received about 12 percent of worldwide transfers, a figure unchanged from 2004 to 2009. The 2008 financial crisis resulted in a moderate decrease that was quickly recovered.

Of the \$39 billion total, \$18 billion went to North Africa and \$21 billion went to Sub-Saharan Africa. The latter amount almost equaled Sub-Saharan African ODA of \$24 billion in 2009 (OECD 2010); Nigeria alone received \$10 billion. Remittance flows take on great importance in small economies. In 2009, they represented 25 percent of Lesotho's GDP and 8–10 percent of GDP for countries such as Cape Verde, The Gambia, Guinea-Bissau, Senegal, and Togo. The average annual transfer per inhabitant exceeds \$100 in North Africa versus \$24 in Sub-Saharan Africa (Ratha and Mohapatra 2011; World Bank 2011b).

These figures are probably lower than actual remittance amounts. A significant portion of these transfers use informal channels, escaping official counts. About 45 percent of worldwide transfers and more than 70 percent of remittances to Sub-Saharan Africa go through informal channels because of underdeveloped financial services (Page and Plaza 2006). With transfers through informal channels taken into account, the total value of remittances to Africa would be about \$65 billion in 2009.

The Nature of Remittances' Economic Effects

Opinions remain divided about the economic effects of money transfers. Some observers see negative effects on growth. Surveys have shown that families use these monies mainly to finance everyday expenses—food, health care, and education—not for capital investments that would have a positive effect on growth. Remittances, which increase when the recipient country's economy is poor, are likely to have a perverse countercyclical effect; beneficiaries, knowing they can count on the income, may be deterred from seeking additional income-producing activities (Barajas et al. 2009; Patriat 2009).

Some observers believe that remittances may also have negative effects when used for investment, particularly in the property sector. They may distort the price of property assets, create speculative bubbles at the local level, and ultimately exacerbate poverty by excluding poor families from the housing market (Chami and Fullenkamp 2009). In general, however, analysts see money transfers as having a positive effect when they are dedicated to investments, especially at the community level where migrants join together to finance basic infrastructure and public facilities in their locality of origin (Patriat 2009).

Local Fixed-Asset Investments Preferred

Local fixed-asset investments certainly represent the preferred target for that portion of migrant remittances actually invested. In rural communities, migrants' investments are usually made in a spirit of solidarity; the migrant helps his or her community of origin by funding basic facilities, sometimes supporting productive activities. Alongside this type of solidarity, we see another, more individualistic approach emerging in cities, used by investors who have personal and financial goals.

In Senegal, for example, one-quarter of remittance volumes already goes to land acquisition and housing construction or improvement (I2UD and Sida 2007). Migrants invest in property to either prepare for their return home or help their families improve their living conditions. Their investments may aim to generate income, allowing families to reduce their dependency on remittances. In some African cities, a market has arisen for small house sales targeting migrant customers; this trend is visible in Cameroon, Ghana, Morocco, South Africa, and other countries (AfDB 2008).

Seek to Leverage Savings

The remittances' characteristics—large, regular volumes through largely informal channels—suggest that it would be possible to set up leveraging mechanisms. The best-conceived method would use bonds to channel current transfers into safe, formal financial circuits and to draw upon migrants' savings in their host country. The Sub-Saharan African diaspora's savings capacity is estimated to be \$28 billion per year (Ratha, Mohapatra, and Plaza 2008).³⁰ Currently, most of these savings are invested outside the African continent. Targeted bond issues could collect these savings; *diaspora bonds* of this nature have long been used in developed countries, such as Israel and, more recently, Greece. Two African countries, Ethiopia and Ghana, are preparing diaspora bonds. Other countries, such as Kenya, Morocco, Nigeria, Senegal, South Africa, Uganda, Zambia, and Zimbabwe, may likely issue such bonds. In addition, diaspora bonds could possibly capture some of the \$170 billion that Sub-Saharan African residents invest outside the continent each year (Ratha, Mohapatra, and Plaza 2008).

Optimize Investment Vehicles

More individualistic migrant investors have different objectives from the solidarity investors. They present two profiles: the first has simple financial goals—a house in his or her country of origin for all or part of retirement. Even if they have a rural background, these migrants often want to settle in towns when they return after decades of living in cities in their host countries. The second profile belongs to generally younger, better-educated migrants, or even foreign-born descendants of migrants; they want to invest in rental properties or productive enterprises. These two types of investors do not share the same profitability goals, but they have the same requirements for investment safety. However, the

countries and cities where they want to invest cannot always meet these financial and property safety requirements.

With regard to financial safety, remittances may be misappropriated upon receipt. Some banks have developed specific products to collect migrants' savings in the countries where they reside. Problematic links sometimes occur between these savings products and the loans that country-of-origin banks are likely to make to facilitate the migrants' investments. The trend is to open accounts that link financial institutions bound by conventions between the residence and origin countries; this procedure gives the saver-investor an acceptable level of safety, guaranteed access to borrowing, and credit terms that reflect the person's proven savings ability.

With regard to property safety, many cities in Sub-Saharan Africa typically have no supply of improved and buildable residential or commercial land with modern legal titles or leaseholds. So an investor must acquire land on the customary rights market or from small-scale private sector land operators through intermediaries known as facilitators. The risk and uncertainty involved in this process, particularly for someone living outside the country, discourage many migrants from investing in this manner; those factors encourage them to invest their savings in other vehicles, generally inside their countries of residence.³¹ The land development industry's failures and shortcomings cause this bottleneck, which in turn causes potential losses that go beyond the local economy—depriving affected cities of the leverage these investments could have on financing urban development and employment.

Microfinance and the Missing Link of Meso-Finance

Microfinance provides low-income households access to basic financial services such as loans, savings accounts, transfers, and microinsurance. In Africa, especially in Sub-Saharan Africa, microfinance has expanded into a market segment with strong potential, because only a fraction of the population has access to the modern banking system. Traditionally, most households' financial services needs have been—and to a large extent still are—ensured by usurious moneylenders and by a vast web of traditional savings and loans cooperatives that either do not or only partially meet households' needs, such as Ghana's *susus* or Cameroon's *tontines*.

An Overview of Africa's Microfinance Sector

Microfinance answers a strong demand for credit and services that the formal financial sector does not provide; it has grown vigorously across Africa since the 1990s. It benefited from the 1980s' financial and economic crisis, the collapse of some banks, and the financial system's restructuring and privatization; the

banking network was reduced and access conditions tightened. In this context, African microfinance institutions (MFIs) developed, benefiting from the sector's explosive growth in all developing countries, the attention paid to microcredit by international aid organizations, and the MFIs' inherent strengths: national coverage, with offices in rural areas in particular; customer proximity facilitating information access and risk assessment; and a simple approach to business.

In 2007, a panel including some of the largest MFIs in Sub-Saharan Africa (160 out of more than 900 worldwide) reported having 5.2 million borrowers and 9 million savers in that year alone. Outstanding loans exceeded \$2.5 billion, and deposits exceeded \$2.1 billion. These figures corresponded to high deposit and loan growth rates—more than 60 percent in a single year (Isern, Lahaye, and Linthorst 2010).

In North Africa, microfinance made relatively late inroads because of an unconducive institutional framework. In the region, the microfinance sector has a predominately urban client base—90 percent in Egypt and 60 percent in Morocco (Brandsma and Chaouali 2004). Since 2006, the sector's growth has been extremely rapid, particularly in Egypt and Morocco—countries that accounted for more than 80 percent of the 3.3 million North African and Middle Eastern customers in 2007 (Boyé, Hajdenberg, and Poursat 2009).

The financial management of MFIs is notoriously complex. They face high operating costs for reasons inherent to the business—the small, short-term loans they grant greatly increase risk assessment and monitoring costs. MFIs without sustained deposit activity must obtain resources at sometimes disadvantageous prices. These factors have a direct effect on profitability; MFIs tend to preserve profits by raising their loan interest rates. However, these rates are already very high, more than 30 percent on average. The contradiction between microfinance's vocation to fund the most disadvantaged and the reality of high interest rates fuels debates about MFIs' profitability. Some MFIs show higher rates of return on capital than do commercial banks. Abusive situations do exist, facilitated by the sector's lack of regulation and customer safeguards. In some cases, private sector investors who take equity stakes in MFIs fuel this trend by asking for rates of return higher than those demanded by donors (Parent 2009).

Funding for Microfinance Institutions

Local financial services markets' legal frameworks and weak development determine the management of MFIs. Those MFIs that cannot take deposits depend on external financing; their ability to attract donors, specialized funds, and commercial banks proves crucial. Access to commercial bank credit varies among countries, depending on the regulatory framework governing microfinance and the banks' ability to assess the sector's risks. For example, a law common to the countries of the UEMOA, PARMEC (*Projet de Décret d'Application de la Loi Portant Réglementation des Institutions Mutualistes ou Coopératives*

d'Epargne et de Cr dit), has encouraged the rise of commercial banks as financial intermediaries for MFIs.

In Cameroon, the Cameroon Cooperative Credit Union League (CamCCUL) network consists of 191 MFIs; 70 percent are established in rural areas. CamCCUL holds 75 percent of the equity of a commercial bank it created—Union Bank. CamCCUL decided to create this entity after several bank failures in Cameroon led to a loss of deposits. In this way, CamCCUL can monitor and secure its deposits, refinance itself, and benefit from a traditional banking institution's credibility. In a contrasting case, Stanbic Bank Uganda acquired an MFI, Uganda Commercial Bank Ltd.; Stanbic aims to expand into microfinance and diversify its loan portfolio (United Nations 2006).

In general, partnerships between commercial banks and MFIs potentially benefit both entities. Such partnerships help further the desirable goal of promoting microfinance's integration into the financial services sector. This sector needs to offer a continuum of solutions to customers who need financial services. In this regard, some observers think that a link is missing between microfinance and bank credit; so-called meso-finance institutions should be created to finance micro- and small enterprises (see box 4.11).

The various forms of collaboration established between MFIs, commercial banks, and private investors demonstrate this dynamic, as does the way some MFIs have managed to fund themselves directly in financial markets, increasingly in local currencies (Abrams and Schneider-Moretto 2007). In Nairobi in 2005, Faulu Kenya—a microfinance institution—issued a bond for K Sh 500 million (\$7 million) to expand its activities. Two private sector banks, CfC Stanbic Bank in Kenya and its parent company, Standard Bank of South Africa, underwrote the bond; a donor (AFD) guaranteed it up to 75 percent.³² Some donors and development agencies have supported MFIs' bond issues with their partial guarantee instruments, as USAID has done with its Development Credit Authority (see chapter 1, box 1.2, in this volume).

An MFI that has reached critical mass and a certain financial self-sufficiency by funding itself through capital markets can remain true to its original social mandate. It also finds itself in a position to expand its activities to related markets, such as meso-finance and small businesses. It may eventually evolve into a specialized commercial bank. When the quality of an MFI's financial statements enables it to raise resources on the capital markets, it has reached a sufficient level of maturity for its supporting donors to gradually withdraw, leaving room for private sector institutional shareholders.

What Are the Implications for Local Governments?

Microfinance and meso-finance seem destined to become increasingly important for local development. Historically, microfinance arose from solidarity lending, and its activities tended to support rural development in Sub-Saharan

BOX 4.11**Meso-Finance: The Missing Link**

Micro- and small enterprises play a central role in job creation, investment, and innovation. To grow, they need suitable financial and nonfinancial services, but they often have problems obtaining bank financing. Banks consider these entities too risky; small businesses lack visibility in their project pipelines, have little strategic or financial information and insufficient capital levels, remain overly dependent on their largest customers or suppliers, and so forth. Banks also believe that managing small loans costs too much.

The concept of *meso* or intermediate finance has emerged as a response to this need; it works between microfinance and traditional bank financing and can be defined as filling the gap between microfinance loan ceilings and bank loan thresholds—a range from \$2,500 to \$150,000.

Meso-finance development programs are under way to remove the present obstacles. On the supply side, the programs help banks create lower-range products and target new customers, which are done by reworking methods and possibly by implementing partial guarantees on the banks' loan portfolios. On the demand side, the programs strengthen the micro- and small enterprises' capacities with accounting, management and technical training, and other actions. They also strengthen the capacities of small-business trade associations so that the associations can eventually take the baton in supplying nonfinancial services to their members.

Meso-finance assistance programs may also help structure mutual guarantee companies underwritten by professional associations. The assistance aims to remove barriers related to the lack of a real guarantee; this plan mostly means allocating a start-up guarantee to mutual guarantee companies and providing support as they set up their modes of governance.

Source: Penent 2008.

Africa. The professionalization of MFIs and their evolution toward commercial finance now make them more relevant in urban areas. Given the informal sector's importance to urban economics and to employment, MFIs may prove to be leading actors in these economies across the African continent. They also have a fundamental role to play in financing housing, providing microfinance for individual home improvements, and, potentially, providing meso-finance to small-scale private sector rental and construction companies. For these reasons, an efficient MFI, one also capable of positioning itself in meso-finance, serves as an asset to urban local governments.

It is remarkable how quickly the best MFIs have become more professional. A number of unfortunate and certainly regrettable incidents have occurred

in recent years because of the boom in the sector. Nevertheless, the fact that some MFIs have been able to access capital markets—conducting a business as delicate as micro-loans to individuals—within one or two decades provides a shining example for local governments. No structural reasons appear that would prevent major African cities from achieving the same result by improving their governance, their levels of staff professionalism, and their financial means with support from their central governments and the international community. Professionals in local governments, local and national authorities, and donors should all take up this challenge. We return to these points in chapter 5 in this volume.

Notes

1. This section is based on Sinet (2010).
2. In French, *le principe d'unité de caisse*.
3. The extra penny fee (*centimes additionnels communaux*) is a supplemental tax levied for communes through national taxes.
4. Two cases are worth noting: (1) countries where land taxes are applied only to modern-sector activities premises, because residential premises rarely come with proper titles and other documents, and tax abatement regimes mean that most premises are exempted from taxes because of their low value; and (2) countries that have always refused—for historical or sometimes ideological reasons—to establish direct property taxes, and instead tax only rental income (which is included in the national income tax), as in Cameroon, or apply a simplified occupancy tax, as in Burkina Faso.
5. See, for example, the Fonds Commun des Collectivités Locales (Common Fund for Local Governments, or FCCL) in Tunisia; Dotation Globale de Fonctionnement (Block Operating Fund, or DGF) in Côte d'Ivoire and Morocco; Fonds de Dotation de la Décentralisation (Endowment Fund for Decentralization, or FDD) and Fonds d'Équipement des Collectivités Locales (the Local Capital Development Fund, or FECL) in Senegal; the Equitable Share Fund in South Africa; the District Assemblies Common Fund (DACF) in Ghana; and the Local Authority Transfer Fund (LATF) in Kenya.
6. Botswana Stock Exchange; Ghana Stock Exchange; Stock Exchange of Cairo and Alexandria (the Arab Republic of Egypt); Douala Stock Exchange (Cameroon); West African Regional Bourse (Bourse Régionale des Valeurs Mobilières, or BRVM, Côte d'Ivoire); Nairobi Stock Exchange (Kenya); Namibian Stock Exchange; Stock Exchange of Mauritius; Casablanca Stock Exchange (Morocco); Maputo Stock Exchange (Mozambique); Johannesburg Stock Exchange, South African Alternative Exchange, South African Futures Exchange, and Bond Exchange of South Africa (South Africa); Khartoum Stock Exchange (Sudan); Swaziland Stock Exchange; Dar es Salaam Stock Exchange (Tanzania); Tunis Stock Exchange (Tunisia); Uganda Securities Exchange; Lusaka Stock Exchange and Zambia Agricultural Commodities Exchange (Zambia); Zimbabwe Stock Exchange; Algiers Stock Exchange (Algeria); Cape Verde Stock Exchange; Libyan Stock Exchange; Nigerian Stock Exchange and

Abuja Securities and Commodities Exchange (Nigeria); Rwanda Stock Exchange; Central African Stock Exchange (Bourse Régionale des Valeurs Mobilières d'Afrique Centrale, or BVMAC).

7. A bank is an institution registered as a bank by a central bank, whether it finances development or not. A finance institution cannot take deposits or create money; it is a *specialized financial institution* when it targets a specific sector or services.
8. The Franc Zone includes the Comoros and 14 Sub-Saharan African countries gathered into two economic unions, each with a central bank: the West African Economic and Monetary Union (Union Économique et Monétaire Ouest Africaine, or UEMOA) and its Central Bank of West African States (Banque Centrale des États de l'Afrique de l'Ouest, or BCEAO), and the Economic and Monetary Community of Central Africa (Communauté Économique et Monétaire de l'Afrique Centrale, or CEMAC) and its Bank of Central African States (Banque des États de l'Afrique Centrale, or BEAC).
9. Other institutions, such as the Regional Solidarity Bank (BRS) in the UEMOA zone, specialize in the social (not-for-profit) economy.
10. Recently, China has lent BOAD more than CFA 100 billion to finance UEMOA's regional economic plan.
11. Burundi also plans to acquire an equity interest in BDEAC.
12. These include Nigerian Industrial Development Bank, Nigerian Bank for Commerce and Industry, National Economic Reconstruction Fund, Nigerian Education Bank, Nigerian Agricultural Cooperative and Rural Development Bank, and Urban Development Bank of Nigeria (Alawode et al. 2000, cited by Honohan and Beck 2007).
13. See the next section, titled "Financing Tools and Mechanisms for Local Capital Investments," and the Nigeria case study in the appendix to this volume.
14. In an earlier period (before 2000), Zimbabwe's largest cities, benefiting from a specific institutional environment, were able to issue bonds on the domestic market fairly regularly for relatively low amounts (PDM 2008).
15. This bond issue had a special character. It was decided on in a context where external funding was frozen because of delays in the Heavily Indebted Poor Countries (HIPC) process; issuance was an emergency response to a new initiative for the country. The bond was issued without a sovereign guarantee in the strictest sense, but it was secured by a receivable that the city held on the central government in the same amount (Paulais and Stein-Sochas 2007).
16. Funding through SFIs seems to be the case in South Africa, where major cities other than Johannesburg, although credit rated, have not issued bonds.
17. CPSCCL prepaid a local bond that proved costly and then decided not to issue a second bond. Instead, it took out a loan from a donor even though CPSCCL is rated AA+ and considered a quasi-sovereign risk. See the Tunisia case study in the appendix to this volume.
18. See the Private Participation in Infrastructure (PPI) Project Database, <http://ppi.worldbank.org/index.aspx>.
19. These countries are Algeria, Cameroon, the Central African Republic, Republic of Congo, Côte d'Ivoire, the Arab Republic of Egypt, Ghana, Kenya, Mauritius, Mozambique, Namibia, Niger, Senegal, South Africa, Sudan, Tanzania, Uganda, and Zambia.

20. An example is a PPP contract between Alexandria in Egypt and a major European company for trash collection, transport, sorting, composting, and landfill operation.
21. Aid reached this amount after a \$1 billion decline in 2008 because of the financial crisis.
22. The Union for the Mediterranean brings together countries from the European Union, the Mediterranean basin, and adjacent countries.
23. Those countries are Brazil, China, and India.
24. Of those sectors, the offset markets are most concentrated in the chemicals industry.
25. The two databases are the United Nations Framework Convention on Climate Change, Clean Development Mechanism, <http://cdm.unfccc.int>, and the United Nations Environment Programme Risoe Centre, UNEP Risoe CDM/JI Pipeline Database, <http://www.cdmpipeline.org>.
26. See our discussion of ERPA in chapter 1 of this volume.
27. This percentage is based on a total of 2,942 ERPAs as of early 2011 (UNFCCC 2011).
28. See our discussion of advances made by some funds in chapter 1 of this volume.
29. For example, the Bus Rapid Transit (BRT) model in Bogotá was the subject of an ERPA.
30. We reach this figure by assuming that the expatriates earn average salaries in their host countries and that they save 20 percent of their income.
31. The information given here and previously about migrant investors is based on, among other things, informal surveys conducted by the author with migrants in various European countries from 1995 to 2005.
32. At least one MFI has raised capital on international markets without an external guarantee; the Micro Finance Bank of Azerbaijan (MFBA) issued a \$25 million bond in Luxembourg in 2008. We note that MFBA enjoys a great deal of credibility with investors; all of its equity is held by six foreign investors, including three donors: International Finance Corporation (IFC), Kreditanstalt für Wiederaufbau (KfW), and European Bank for Reconstruction and Development (EBRD).

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Outlook for 2030–50: Which Road Map(s)?

Two Imperatives: Changing Scales, Changing Paradigms

Changing Scales

In recent decades, some African countries have managed to cope with their cities' growth, providing adequate utilities and facilities. However, in most cases, efforts have fallen short of the needs brought on by population growth; the overall situation has deteriorated. In differing degrees depending on the case, this deterioration affects infrastructure and basic services, transportation, housing, and businesses. It is often accompanied by governance and urban management deficiencies and, in some cases, by unscrupulous behavior, especially in land-related matters.

To varying degrees, difficult social situations accompany these gaps and failures—pockets of poverty or even extreme poverty, high levels of underemployment, and tenuous sanitary environments. These ill effects appear particularly on the outskirts of Sub-Saharan African cities and in towns in fragile states—places where the past 20 years of urbanization have occurred in a mostly chaotic way, without supervision, planning, or utilities. In these places, inequality appears to have actually increased.

In the preceding chapters of this volume, we highlighted how extensively the African continent's governments and the international community seem to have underestimated the economic consequences of these situations—consequences that have a domino effect on social and health issues, economic activity and jobs, local governments' internally generated revenue, and local savings collection. Investment capacity is reduced, the situation deteriorates further, and a vicious circle results.

Individuals and entities responsible for running cities may be deemed to have one essential function: establish optimal conditions for resident quality of life and for business productivity (Inman 2010). From this point of view, and with few exceptions, Africa's local and national governments have apparently failed. Moreover, neither African officials nor the international community

seem to comprehend the extent of urbanization across Africa in terms of its dimensions and operational consequences. It is known that within 20 years, cities' populations will increase by at least 300 million in Sub-Saharan Africa alone. The necessary production apparatus for local infrastructure and land development, and the needed resources and financing systems, simply do not exist to meet this challenge.

The estimates presented in previous chapters highlight irreconcilable gaps between the amount of local capital investments needed to meet this growth and the local governments' theoretical capacities under present conditions, even if we assume—optimistically, given the current state of affairs—that borrowing could finance local investments. Continuing business as usual, increasing financing amounts, and executing local capital investments at current speeds will lead to a dead end. The current trajectory is unsustainable; it will result in potentially unmanageable economic, social, and political situations.

These findings call for a drastic change of scale in financing volumes for urban local investments. This change of scale will not be easy, because the necessary structural instruments are not in place. Within a short time frame, governments, with donor support, must design new systemic solutions capable of dealing with enormous needs. In conjunction with continued efforts to increase local governments' solvency and execution capacity, these parties must rethink the paradigms governing the financing of urbanization—and the financing systems themselves.

Changing Paradigms

National policies commonly lack a strategic vision of the city.¹ Urbanization remains widely perceived as a source of expenditures, rather than as a potential vehicle for sustainable economic growth. Transforming this vision of the city is an essential first step in encouraging local capital investment and the virtuous process of optimizing urban productivity.

The recent economic performance of emerging countries—especially in Asia—clearly shows how development strategies leveraging urbanization may maximize an economy's performance. This experience should particularly challenge officials in African countries, where economies' growth rates prove among the highest in the world, but which, because of population growth, often remain insufficient to ensure real per capita growth.² Improving cities' economic productivity, which is currently low because of the shortcomings and failures described in previous chapters, could probably help add one or two missing growth points.

Housing and construction, natural leading engines of economic growth in countries with high population growth, prove valuable as strong job generators; these sectors suffer from strong restrictions that hamper their normal development in most African cities. As shown previously, these restrictions stem in

particular from shortcomings and malfunctions in the land management and urban land development sectors.

In most countries, the local investment culture, like the municipal credit culture, remains limited or nonexistent. These countries often lack the knowledge, experience, and required legal and regulatory infrastructure necessary to ensure balanced operation between demand and supply. This dual investment and credit culture is undoubtedly essential for cities in general, particularly fast-growing ones.³

A total paradigm shift in the vision of the city and the way to finance it transcends technical and financial issues—it forms part of changing African societies. The issue is not limited to the city as such, but rather drives a reformulated economic model in which the city is a productive factor and municipal financing rests primarily on local, endogenous solutions. In this spirit, the next sections detail elements likely to enrich African countries' strategies for financing local capital investments and, more broadly, an urban policy. We present a set of themes and potential actions; naturally, their implementation depends on the specific context of each country or regional group. We expand the set by presenting text boxes that detail experiences in Africa and elsewhere. We note that these experiences are not necessarily perfect models; we provide them as examples that must be adapted to the realities of local investment markets and different national contexts.

Empowering Local Governments

An Assessment: Capital Investment Needs and Funding Deficits

The estimates presented in previous chapters provided the terms of the equation for Sub-Saharan Africa, excluding South Africa: the local capital investment need totaled about \$25 billion per year for a modest level of equipment, and the theoretical capacity of local government investment, including borrowings, totaled about \$10 billion for 10 years, or about \$1 billion per year. Obviously, these estimates are very approximate (see chapters 2 and 3 in this volume for their underlying assumptions). Yet they give an order of magnitude for the deficit in local governments' financing capacities for capital investments, and they emphasize the full extent to which a change of scale is required.

Local governments will very likely need to significantly increase their relative share of local investment financing, for at least two reasons. First, central governments cannot easily increase intergovernmental transfers to local governments in proportion to local investment needs. National budgets will be marshaled for sovereign expenditures—social services, legal systems, and others—which are also increasing rapidly because of overall population growth. Central government expenditures will also be used to finance major infrastructure, particularly

for the energy, transportation, and productive sectors, especially agriculture. Second, much evidence suggests that official development aid may not rise to meet the needs of the urban sector. Public aid funding shows little or no increase and generally remains focused on other equally essential matters for Sub-Saharan Africa, such as food security, global warming, major pandemics, and large-scale infrastructure.

A First Step: Strengthening the Decentralization Process

Local governments' greater involvement in financing local capital investment appears inevitable in the long term. The current trend toward disempowering local government runs against the tide of history.⁴ This greater involvement also seems desirable: local government's share of financing and implementing local investment may be considered a corollary of economic development, as the most developed countries demonstrate.⁵ Also, it is normal for fast-growing cities, as economic engines for construction, manufacturing, trade, commerce, and services, to generate their own capacity to make investments—the concrete manifestation of a successful decentralization process, in a sense. In this regard, much remains to be done in most countries.

In the preceding chapters, we described strategies that donors promote and implement to strengthen decentralization. The latest generation of this type of project aims to improve the mechanisms governing central government transfers and their efficiency. These steps are essential, given the importance of intergovernmental transfers in local government resources. If we assume greater local government borrowing and use of structured financing facilities (see the section titled “Modernizing Financing Systems” later in this chapter), the flow of transfers must remain stable, secure, and predictable. This situation is precisely not the case in many countries and is one of the main constraints hampering the development of municipal credit markets. These latest-generation support projects for decentralization and improvements to transfer mechanisms fully benefit from tools, such as those developed by the Public Expenditure and Financial Accountability (PEFA) program.⁶ The most complete decentralization projects incorporate output-based-aid incentive schemes (see box 5.1).⁷ These schemes may counteract the effects of those so-called decentralization projects that would restrict local governments' financial autonomy and ultimately disempower them to some extent.⁸

However, in conjunction with these efforts on intergovernmental transfers, and alongside continued increases in local governments' own internally generated revenues, other methods and other sources of funding for local capital investment have become increasingly necessary. These methods and sources include borrowing funds (to the extent possible), using the private sector, levying user fees in the context of partnerships, and financing through land development and land value capture.

BOX 5.1**Indonesia: Decentralization Support Using an Output-Based Aid Mechanism**

In 2001, the advent of Indonesia's decentralization served as an opportunity to transfer many powers to local governments. More than 500 local governments now have purview over education, health, and infrastructure. In general, decentralization is funded through two channels: a general endowment fund (*Dana Alokasi Umum*) for operating expenses and a specific-purposes endowment fund (*Dana Alokasi Khusus*) for capital expenditures. Local governments' own internally generated revenues cover about 15 percent of their total budget on average.

The decentralization support project came out of observations of three conditions: underfunding of drinking water, sanitation, and roads infrastructure; lack of coordination between central and local governments; and a general problem of governance at the local level. The project covers districts in five of the country's 33 provinces, selected according to geographic diversity and performance criteria. The total project value is \$720 million, including \$220 million of funding from the World Bank. The project has three components: infrastructure financing, institutional capacity building, and results verification as required by the output-based aid (OBA) mechanism.

The OBA mechanism involves the World Bank's participation and works as follows: the central government reimburses localities for some of the costs once the investment is completed as planned, covering the share of the investment financed by the local governments' own resources. A local government's minimum share for project inclusion is 10 percent or higher, depending on the case and the type of investment. The local government must reuse the reimbursement for additional capital investments of its choosing.

Ultimately, the approach serves as an incentive; it motivates local governments to make capital investments, because they will recover the amount they have financed. It is also productive; recycling capital produces more investment. And it has an educational aspect; the local government improves its ability to manage projects through the investment monitoring system generally and through an institutional component specifically.

Source: World Bank 2010a.

Encouraging Endogenous Financing

The preceding considerations show that future local investment finance should rely, for preference, on endogenous sources, that is, African economies and those produced by urban growth's own mechanisms.

Such solutions are not new; they have financed local investment worldwide and will continue to do so. Essentially, they rest on three principles: (1) use all

local savings and investment capacity—households, businesses, pension funds, remittances, and investment funds—by offering secure investment and savings vehicles; (2) capture some of the value created by well-managed urban development through land-based mechanisms, and recycle that value into further urban development operations; and (3) increase local governments' own, internally generated resources by optimizing tax revenues based on property (land and housing).

These types of solutions have advantages and economic effects that make them particularly attractive. Using them for local capital investments will require changes in financial systems and, in most countries, the attitudes of various operators—bankers, developers, concessionaires, utilities managers, and others.

Induced Advantages and Economic Effects

Marshaling local savings for local capital investments genuinely benefits national economies: it prevents savings from being invested abroad, reduces foreign-currency borrowing requirements, and increases savers' involvement in local affairs, thereby promoting citizenship and social cohesion. African banks' excess liquidity is proof of substantial savings available on the continent.⁹ The changes taking place in African economies and societies, such as the emergence of a middle class and retail shareholders (albeit fragile and tenuous), suggest increases in local savings volumes as well.¹⁰ In addition, large volumes of migrants' savings, although not strictly local, may potentially contribute to local investment.

Land value capture mechanisms have fundamentally the same economic effects as savings, generating local-currency receipts locally. Financing through land value capture and property-based (land or housing) taxation serves as an excellent local solution, because both rest on fixed assets. Land value capture mechanisms' other economic effects arise from their potential effect on construction and housing, two sectors that create the most nonpublic jobs. Some of these subjects are discussed in the section titled "Increasing Resources and Commercial Activity by Leveraging Housing," later in this chapter. These endogenous solutions' ability to reduce dependence on external funding also provides significant benefits.

Required Transformations

Local governments' use of local savings for funding requires that they be able to borrow—loans being the medium through which they can mobilize savings. In many cases, this situation suggests changes to national legislation. It may also involve changes to provisions governing the relationship between central and local governments and must be accompanied by (new) sovereign debt monitoring and supervision mechanisms. Later in this chapter, we revisit some of these subjects in the section titled "Modernizing Financing Systems."

Endogenous financing solutions will also require major changes in bankers' and investors' attitudes and behaviors. Generally considered overly prudent and not very innovative, bankers may be changing their positions, as recent trends suggest; commercial banks, like investors, may begin to look at local investment through the bond market.¹¹ These changes may not occur everywhere spontaneously; it would certainly be appropriate for donors or development agencies to support structural reforms and provide incentives such as ad hoc funds and credit enhancement, and to lower risk for investors through whole or partial guarantees.¹² Such local savings-based solutions might work principally or only in countries with sufficiently developed financial systems and deep enough municipal credit markets.¹³

Local governments must make significant changes to use endogenous solutions. No measure will work without investor protections, which may involve guarantees or intercept agreements.¹⁴ Investor security and savers' involvement requires first-rate governance¹⁵ and accountability to investors and citizens. The same applies to land value capture financing methods, which will require professionalization of existing land management practices. Such systems can work only where transparency in transactions and public information eliminates corrupt practices by making them impossible. The list of institutional, attitudinal, and behavior changes these endogenous solutions require provides a good illustration of the stakes we evoked at the beginning of this chapter—they go beyond urban issues to touch on economic and social changes in African societies.

Bolstering Investment Financing Tools

Many countries on the African continent have no municipal financing system, and others have institutions such as investment funds, without financial capacity. A small group of countries have public or private (sometimes both) specialized financial institutions (SFIs). A very small number of local governments or SFIs can access funding on capital markets.¹⁶ The lag in the development of Africa's financing systems and tools is important, especially when considered in light of the extraordinary urban growth to come. Governments, the international community, and financial institutions must consolidate and modernize often fragile and rarely technically advanced tools, fill gaps, and modernize systems. Remedial efforts must take place pragmatically: the investment market and institutional context should determine appropriate steps. We address systems modernization and the use of capital markets, either directly or through intermediaries, later in this chapter. This section will focus on intermediation tools: the way they might be created—in what form and on what scale—where they do not exist; for existing tools, their evolution and consolidation; and alternative solutions for situations in which it appears inappropriate to create them.

Fully Understanding the Local Investment Market

A local investment market's size results from various elements, identified through supply-and-demand or resources-and-uses¹⁷ approaches. In terms of demand or uses, to some extent a country's population size, urbanization rate, and economic development level determine local investment market volumes, as do the degree of decentralization—especially financial—and the areas of authority assigned to local governments. Market size also depends on the so-called absorption capacity at the local level.¹⁸ In terms of supply (or resources), a local investment market is defined by the level of its economic development; the characteristics of its financial systems and their elements (commercial banking practices, capital markets, and institutional investors); and the laws and regulations governing municipal borrowing, where appropriate.

Naturally, dedicated financing tools form another key element of local investment markets. On the one hand, market support depends on strengthened demand through solvent local governments capable of planning and executing capital investments. On the other hand, it calls for strengthened supply through availability of financing products, product features suitable for specific types of investment, and financiers' capacity to react and adapt.

Support for local investment markets aligns with this context. Market development requires adapting or creating financing systems and tools to generate supply. As the market grows, the supply also grows, thereby creating competition. However, competitive conditions remain distinctive in African infrastructure, as distinctive as the varied market participants; both competitive conditions and varied participants lead to a relatively fluid structure. This finding suggests that, when modernizing specialized financing systems, and even more so when creating new institutions, parties should have a strategy that centers on flexibility and adaptability. We discuss new institutions next.

Should New Specialized Finance Institutions Be Created?

In countries without specialized municipal finance institutions, local governments who see them as solutions will call for their creation. But such an approach may work only in cases with an established local credit market, thereby ensuring a sufficient activity level for the SFI. The SFI must be able to cover its fixed costs and to hire workers who will adequately develop and maintain its technical and other skills.

In African countries, these conditions are rarely met. Therefore, the market (as defined previously) must decide. When a market has sufficiently developed to consider establishing an SFI, it likely will also stimulate the supply and, hence, the competition—from commercial banks, neighboring countries' SFIs, donors, or donors' subsidiaries. At least some of these competitors may have access to cheaper funding than does the SFI; the SFI will have a hard time

achieving competitiveness. Yet an SFI with low profitability in a relatively small market—whether in fact or through reduced competition—is doomed to stagnate, without the means to professionalize and grow.

Therefore, creating a specialized municipal finance institution requires a detailed feasibility study based on a comprehensive business plan and projections (see box 5.2). A negative study will require that alternatives be found, and a positive study will require further questions about the SFI's strategic opportunities before creation can proceed.

Except for special cases, it seems appropriate to set up simple and flexible arrangements that may evolve over time and to build on existing financial institutions and the private sector seeking to leverage them. This approach serves the local governments' interests as borrowers, because they ultimately pay for the municipal finance institution's cost structure. These considerations also apply to the idea—evoked periodically—of creating a continental or regional municipal finance institution (see box 5.3). We discuss alternatives to creating a traditional municipal SFI next.

Specialized Financial Institutions: Public, Parapublic, or Private?

The issue of legal status remains at the heart of development strategies for existing SFIs. Donors have often encouraged Africa's public-status institutions to become private in order to accelerate their modernization. For troubled SFIs with accumulated losses, donors have also prescribed a transition to private status as a unique and virtuous solution.¹⁹ The effects of the 2008 economic and financial crisis, particularly Dexia's problems and the collapse of private sector infrastructure investment, forced everyone involved to take a more balanced view of privatization's merits.²⁰

However, the problems posed by an SFI's public status remain, especially because state guarantees appear to back municipal loans. Local governments may conclude that they are free to renegotiate loan repayments. Sometimes, they are correct on this point; some central governments reschedule debt payments, for example, prior to municipal elections. In some cases, the fact is that loans are automatically turned into subventions eventually,²¹ and as a result, a public sector financial institution will face high default rates on its loans. However, a public status naturally lends itself well to all local government support, advice, and training, and it also facilitates the SFI's distribution of central government subventions for local capital investments.²²

Central governments reluctant to give local governments much autonomy tend to prefer the public status option; politically, this option allows for close supervision of local authorities, and technically, it facilitates control of public expenditures and subsovereign debt. Experience shows that public status is not conducive to innovation and results in financial conservatism, both in

BOX 5.2**A Feasibility Study and Business Plan for a Specialized Municipal Financial Institution**

Stakeholders commissioning a feasibility study for a financial institution specialized in lending to local governments for capital investments usually begin by defining the institution's form and activities and working out its business plan. An analyst applies the selected form, together with multiple iterations of the business plan, to calculate the conditions for the institution's ultimate viability. The institution's form and activities rest on the national institutional and economic context and on the government's strategic direction. Options to consider include (1) the institution's formal status—public, private, or parapublic; (2) planned activities in addition to loans, such as guarantees, consulting, training, implementing subventions, and so forth; and (3) funding possibilities, such as an initial capital endowment, bond issues, and donor loans. A business plan based on these options (and other assumptions) proceeds in several steps: market analysis, sales and marketing strategy development, cost-of-funding estimates, organizational and operating costs determinations, and financial analysis.

The market analysis estimates the potential volume of loan commitments, through an analysis of local governments' and other borrowers' effective (solvent) demand. "Effective demand" means investment needs weighted by repayment capacity and execution ability. The market analyst must segment demand by type of investment, particularly between revenue-generating and nonrevenue-generating projects. The analysis should also include other planned products and services, such as guarantees, and their respective business volumes. Finally, the market analyst should focus on a competitive review of existing or expected national or foreign institutions and other sources of financing. The market analysis shows sales potential over time and by type of product or service.

A marketing and sales strategy gives projections of loan and other sales growth rates; it distinguishes rising loans by facility type and from other activities, thereby aiming to constitute a solid outstanding loan base. The marketing and sales strategy also looks at the possibility of alliances with other stakeholders. It sets product price ranges, such as those for loan rates by facility type, guarantees, and fees; these prices depend on the competition and the amount that borrowers appear willing to pay. The marketing and sales strategy also provides estimates for the percentage of loans that will default or will need restructuring.

Cost-of-funding estimates are based on funding method: the amount of the initial capital endowment and other possible funds and the cost of funds borrowed from financial institutions or bond issues. Potential income from each product and service determines the SFI's structure. In keeping with growth in income and activity, corresponding operating costs must be projected over several years: employment, training, building, equipment, taxes, and administrative and other expenses. A financial analysis

continued on page 207

Box 5.2 (continued)

consolidates these data into a projected 15-year income statement and a consolidated balance sheet, based on the preceding steps' assumptions. This analysis also provides key ratios and other traditional elements—margins, return on capital, break-even points, outstanding loans and debt, and so forth.

Taking the business plan's findings together with the financial analysis, an analyst assesses the proposed municipal finance institution's viability. Ultimately, this process drives stakeholders to review the options they selected about the type of institution in the first part of the feasibility study. For clarity, we have outlined the steps in a linear fashion; in practice, analyses of the feasibility study and the business plan run simultaneously in an iterative process.

Sources: Adapted from Krishnaswamy and Paulais 2008; Conjuguer 2009.

refinancing methods and in project-financing arrangements. Obviously, this observation must be adapted to each case.

In principle, private sector status makes the SFI immune to pressure. From the central government's perspective, one advantage is that the financial institution does not weigh on public finances. It may even relieve them by financing investments that would otherwise fall within the central government's budget.

The constraints weighing on private enterprise have meant that private sector SFIs focus financing on the most creditworthy—and usually the largest—local governments and on major, revenue-generating investments. These investments present two advantages: they generate significant outstanding loans for a single loan review, and they are low risk because the creditor can pledge receipts for repayments. However, the private sector SFI can select the operations with the best yields. It may skim the market of profitable investments, risk exhausting the so-called market sooner or later, and eventually have problems finding more business.²³

As a result, other less profitable but necessary operations and projects in medium-size or fragile cities find no support. For these localities and the central government, the problem remains unsolved. A central government may choose to create a public SFI specifically dedicated to small or medium-size local governments or to investments with a social purpose, deferred profitability, and so forth. But such an option becomes even more expensive because the SFI must work in smaller markets, on smaller operations, and with risky borrowers, cut off from operations with good earnings potential that would allow it to balance its budget. Ultimately, this second financial institution may become a

BOX 5.3**Are Regionally or Continentally Focused SFIs Outdated Concepts?**

"African Cities Bank," "West African Local Credit," and other similar names—in some cases, such conceptions of regional finance, featuring continental or large regional specialized financial institutions—remain in use. Such concepts fall into one of two categories: (1) a vision of politicians who ignore market realities or (2) a private sector project based on a professional approach to municipal credit markets but apparently lacking any real strategic interest.

The first category corresponds to the traditional supply approach: local governments have local capital investment projects but are not given the means to achieve these projects. Hence, an international public SFI must be created to meet this objective; the more multilateral, big, and visible the institution, the better it will meet expectations. This idea ignores resource issues: How will such an SFI be funded? What will its credit rating be for borrowing on financial markets, given local governments' credit risk? The idea underestimates operating costs—headquarters, employee expenses, and travel expenses. It also underestimates market realities—different sizes, institutional contexts, currencies, and so forth.

The second category corresponds to more focused projects from private sources. These projects stem from the observation that although some countries' markets are too small to have their own SFI, one SFI could work for a group of countries, especially if they have a common currency and similar institutional environments. Of course, such an institution would suffer the problems previously mentioned—funding costs, operating expenses, and fragmented markets. This type of private sector SFI may initially assemble a loan portfolio by skimming off a region's most profitable projects, provided that private donors or their private sector subsidiaries support its refinancing. However, its interest for the countries involved remains questionable, because the SFI's business has nothing to do with them structurally; on the contrary, it may hamper the consolidation of their existing municipal support tools and keep local operators from entering the market.

Ultimately, these two categories of SFI projects also seem outdated for two main reasons. The first reason relates to the mid-20th century and centralized *technostructures*. The second reason concerns this century and the years preceding the 2008 crisis, when the private sector was supposed to meet all needs, with capital investments alone resolving institutional and structural issues.

Today's solutions rely more on next-generation tools that build on Africa's financial systems and institutions, primarily the African Development Bank and regional development banks. They also rely on developing guarantee and incentive mechanisms, setting up credit enhancements with commercial banks, and simultaneously supporting local governments' ownership capacities and solvency.

Source: Author.

second-tier firm, with reduced innovation capacity and less-skilled personnel, reporting losses and high loan default rates.

Private sector SFIs do not have a vocation to provide support and advice to local governments. A central government may delegate this role, but the SFI's inevitable specialization in the most promising market segments suggests that the neediest and most fragile localities will receive little benefit from such arrangements. Some private sector SFIs have used their profits or the grant element of donors' concessional loans to create investment funds for social purposes²⁴ (at the donors' request), but such initiatives remain modest in size, and they appear to serve commercial purposes. Ultimately, the central government must bear the responsibility for strengthening local governments' capacities.

A private sector SFI may eventually have refinancing difficulties—a major structural problem. Indeed, in sufficiently large and mature enough markets, commercial banks find interest in the municipal credit market once the SFI has shown that market's profitability. As deposit-taking financial institutions, commercial banks have more readily available and cheaper funding resources than do private sector SFIs. These SFIs must also fund themselves through commercial banks or on capital markets. In Africa, these SFIs have received donor funding—which, in theory, derives from donors' subsidiaries that specialize in the private sector, and therefore come without concessional terms. Overall, private sector SFIs fund themselves at relatively high cost, which reinforces their focus on rich borrowers and may compromise their business. Many factors come into play here: financial market depth, local investment market volume, commercial banks' appetite for this market, bank liquidity, and so forth. However, in some configurations, the viability of a private sector SFI may be challenged when competitors with more appropriate resources enter the market.

Between the two extremes of public and private legal status lies a vast sector known as *parapublic* or *mixed economy*. Depending on its design and management, a parapublic entity may combine many of the public and private sectors' advantages or shortcomings. A parapublic SFI's protection from political pressure depends on both the composition of its board of directors and its management's ability to shelter behind regulations. In this respect, oversight through banking laws may seem crucial for preventing abuses in risky financial commitments. In practice, however, it is difficult to prevent overseers from weighing in—one way or another—on loan commitments or an SFI's strategic direction. Experience shows that the more the parapublic SFIs' governance and management resemble that of the public sector, the higher the SFIs' default rates may be and the more their technical and innovation capabilities seem to fade over time.²⁵

However, the 2008 economic and financial crisis showed the private sector's limits regarding financing of public goods. In the wake of the upheavals the crisis caused in municipal finance systems, the solutions proposed and

implemented on different continents have a common denominator: an emerging consensus in favor of new types of institutions or instruments—what we could call *next-generation tools*.²⁶ Significantly, this consensus has appeared simultaneously in the areas of infrastructure, development, utilities (water and electricity), and public-private partnerships generally. It seems auspicious to promote such next-generation institutions and tools on the African continent at this time. We return to this point later in this chapter.

Modernizing Financing Systems

Local governments' current borrowing mechanisms—bank loans or general bonds—traditionally rest on the borrowers' good faith and presumed willingness to pay: they promise to repay principal and interest, but the lender receives no particular guarantee. Historically, in the most developed countries with well-organized institutional infrastructure, warning mechanisms, and monitoring of local finances, lenders have considered municipal credit low risk; in the event of default, central governments typically offer protections to lenders for outstanding loan amounts.

The situation is different in markets where investors and lenders perceive municipal credit risk as high, both financially and politically. In these markets, investors and lenders want to have effective safeguards before making commitments, and many devices offer such guarantees in various forms. Naturally, devices that lower risk levels also lower the cost of money. Consequently, they have become popular, used even in settings with low risk, and are essential in other settings for developing local government lending. These devices constitute *structured finance* techniques. They are neither used nor usable as matters stand with Africa's municipal financing systems—systems that seem strangely out-of-date in this regard. This is one of the factors that make the expansion of municipal loans unlikely at present; systems must be modernized, and modernization comes through the use of structured finance techniques. The primary objective of these techniques is to make borrowers credible. Central governments must change national laws and regulations to use structured finance techniques. We discuss borrower credibility and legal frameworks in the following section.

Enhancing Borrowers' Credibility²⁷

As we noted previously, there are three major types of bonds used to finance local capital investment.²⁸ Local governments use general obligation bonds to finance their current capital investment programs. They use revenue bonds to finance specific projects, based on the projects' receipts. Structured obligations are designed to reduce risk for investors; they are used in so-called structured finance.²⁹ Each of these bond categories is associated with a type of municipal

revenue that will be dedicated to debt service. All municipal revenues may be used to pay general obligation bonds. In the United States, they are the most-used form of financing for highly rated local governments. Local governments pay revenue bonds with receipts generated by the project the bonds finance—often toll roads, ports, airports, and other revenue-generating facilities.

As mentioned previously, the high level of risk that investors assign to local governments limits the use of general obligation bonds. Investors also consider revenue bonds risky, because of the multiplicity and unpredictability of the factors that delay or prevent project completions in Africa. Using bridge loans to complete a project before issuing bonds proves very expensive and does not erase all investor uncertainty, perhaps even more so in Africa because of projects' operational risks. Therefore, in the context of African financial markets, structured obligations mobilize private capital under the best conditions. For instance, investors' perceived risk levels decrease when bond issuers offer an intercept transfer mechanism that guarantees repayment regardless of events.³⁰ Intercept transfers may be used with different types of revenues; they typically accompany intergovernmental transfers or oil revenues in oil-producing regions or provinces. According to current legislation, intercept mechanisms may provide for withholding at the source, as with intergovernmental transfers, or through an escrow or irrevocable trust account.

Accessing long-term capital on financial markets requires good management endorsed by a rating from a credit rating agency.³¹ Local governments should be aware that bond-like structured obligations require strict financial discipline. Investors may pursue repayment through the courts. A local government that issues structured obligations absolutely must be able to budget and pay for debt service after meeting other expenditures, meaning that public officials must master their budgets and expenditures. The revenues pledged as collateral must cover the obligations' debt service for its duration. This revenue stream must be permanent; any changes to the fees or to intergovernmental funding through intercept transfers must be considered and weighed in light of the repayment requirement. In this regard, many experts find it desirable to make the local government experience difficulty in effecting changes of this kind, notably by requiring approvals at several levels. African local governments seeking long-term financing from domestic capital markets may find that investors require them to set aside several years of debt-service money in an ad hoc fund when they issue a bond.³²

Changing Legislative and Regulatory Infrastructure³³

In most cases, introducing use of capital markets for long-term financing in countries without a municipal credit market requires legal, regulatory, and institutional changes (see box 5.4). Of course, such legislation must comply with the country's constitution and tax system.

BOX 5.4**Modernizing Local Investment Infrastructure:
Mexico's Example**

Until recently, Mexican local governments had no access to capital markets. The local governments used bank loan financing, secured by levies and local tax receipts. This situation made long-term financing difficult except when loans were granted by a local development bank. The credit rating agencies were just beginning to provide municipalities with credit ratings; at the time, this was a relatively new condition imposed on the municipalities.

Mexico's legal and institutional infrastructure did not allow for structured finance credit enhancement, such as revenue intercepts, reserve funds, and revenue pledges. In this context, Mexican cities' debt financing remained very limited.

In 2000, Mexico launched legal and regulatory reforms. These reforms were intended to draw capital primarily from pension funds, insurance companies, corporations, and private investment companies to finance local investments. Implementation took place within a relatively rapid span of two years, mostly through a reform of public finances.

These reforms have given Mexico's local governments a variety of options for financing their investment projects, allowing them to significantly increase the size of their investment programs. The municipal bond market is gradually maturing: for the first bond issues, the amount of money required for the reserve fund equaled three years of debt service. A few years later, this amount declined to the equivalent of 18 months of debt service, on average.

Now that the market is relatively well developed, local governments may demand competitive bidding from a range of sources of debt financing or refinancing: the national development bank, private sector investment banks, and structured financing organized by specialized consulting firms. Recent examples show that structured finance solutions perform best in the Mexican market.

Source: Gama 2010.

Optimally, insurance companies and pension funds (when these exist) should receive legal authorization to invest in subsovereign debt. Such authorization helps diversify and increase the market resources available. Often, insurance companies' and pension funds' ability to invest in subsovereign debt is *the* condition for the development of a municipal credit market. Legislation can set sovereign and subsovereign ratios for these investors' portfolios; to spread risk, this legislation should establish limits on the percentage of each bond such investors may hold. Most countries restrict pension funds and insurance companies to investing only in investment-grade debt.³⁴

Laws and regulations governing the domestic capital markets must specifically authorize public subsovereign entities, including local governments, to issue bonds. Such measures should clarify the rules for publishing financial information and credit ratings; they also must stipulate compatibility with laws or regulations covering official authorization of debt. In cases where a nationwide credit rating system does not exist, one should be introduced as early as possible. A credit rating must be a legal obligation for every municipality taking on debt from financial markets and should be published for all bond issues. Regulations should also provide for an annual review of credit ratings. We note that investors generally impose such a provision in countries where an annual review is not already required.

The legislation governing financial institutions must specify what types of financial arrangements come under its authority and regulation—revolving funds, fiduciary funds, intercept transfer mechanisms, and so forth. Federal governments must clarify whether these provisions apply to states. Legislation governing the allocation of funds between central and local governments should allow local governments to assign all or part of these transfers to debt service, pledging them for several years. The law should clarify the rules governing these intercept transfer mechanisms.

Local government debt should come under a law on public debt, with appropriate regulations. In federal systems, each state must have such a law. At the minimum, this type of legislation should cover the following topics: authorizations for each type of local government debt assumption; permitted types of debt (short term, long term, loans and bonds); and setting of a debt ceiling. The law must establish a public debt registry, recording debts incurred by local governments. The authority approving the debt operation must have the necessary legal powers; regulations accompanying the legislation should specify the procedures that local governments must follow to borrow or to issue bonds on capital markets. The law should explicitly allow the relevant legislative body to make multiyear commitments (extending past the current legislative term, if necessary) to cover the debt's entire duration. The law should also explicitly limit the use of long-term debt financing—or refinancing—for capital investments, except as pertains to operating budget deficits.³⁵ Regulations may also define the types of investments subject to debt financing.³⁶ Laws governing public budgets and accounts should document how subsovereign entities must handle the debt in their accounting systems, requiring debt service to be budgeted for the debt's entire duration.

In addition to legislation establishing a legal and regulatory framework for public finances, every financial transaction requires its own legislation. An initial law should authorize debt by specifying the amount, purpose, and duration of the borrowing, thereby setting a deadline for contracting it. Laws on public budgets (revenues and expenditures) should then be amended to include debt

service. Finally, if a structured obligation uses a specific financial mechanism, such as a revolving or fiduciary fund, specific legislation is required to create the mechanism and to detail how it works.

Structured Finance Mechanisms³⁷

Structured finance may use a variety of specific mechanisms. We might consider these credit enhancements in the broadest sense, because they improve credit quality and ratings.³⁸ In practice, a structured debt product usually uses several of these mechanisms to raise funds on capital markets or to finance projects for local governments through banks and financial institutions.

Sinking fund: a separate account in the borrowers' accounting system. The borrower pays part of the annual budget into the sinking fund to accumulate the capital needed to replace a capital investment at the end of its life. For a city, the sinking fund functions like a savings account; its funds must be protected from use for purposes other than replacing its specific capital investment.

Debt service reserve fund: as mentioned previously, monies set aside by the borrower ensure debt service. The resources marshaled for this fund may come from the central (or federal) government or from donors wishing to support the infrastructure financing. The reserve fund amount must cover more than one year of principal and interest, and may cover up to three or four years. The number of annual payments to be held in reserve (known as the *multiple*) depends on potential investors' confidence in the borrower's creditworthiness and the credit enhancement device in use.

Escrow account: a bank account that allows withdrawals only for specified uses. For example, an escrow account may cover a sinking or a reserve fund. Rules governing the escrow account determine how much money may be removed, by whom, and for what purpose. These rules protect investors or lenders, for example, by ensuring sufficiently available funds are in reserve for debt service, should they be needed. Donors and development agencies also tend to prefer escrow accounts.

Fiduciary trust: in public finances, a legal entity that receives, holds, and manages assets on behalf of bondholders. The notion of *trust* comes from Anglo-American common law; in Roman continental law, the management function may be ensured by a fiscal agent under contract with a municipality. A trust manages assets—physical or other—for a beneficiary's account and profit. For example, with municipal bonds, a city makes its debt payments to the trust, which in turn pays the bondholders. Often part of a financial institution, the trust acts on behalf of the bondholders. Bondholder confidence improves when there is a trustee to manage the borrower relationship in the bondholders' best interests.

Revenue pledge: a contractual commitment to dedicate all or part of the receipts from a revenue source to repay debt. A revenue pledge may not be

revoked during the borrowing term; a local government commits to fully repaying the loan through its collateral, even if electoral or administrative events change its personnel.

Revenue intercept and guarantees: direct withholdings from revenues and full or partial guarantees that constitute credit enhancement mechanisms, narrowly and perhaps most relevantly defined. We have described and commented on these mechanisms earlier in this volume.³⁹

In emerging financial markets, such as Africa, experience shows that partial guarantees, as made by donors or their subsidiaries (see chapter 1, box 1.2, in this volume), may critically aid local government borrowing in domestic markets and foster successful bond issues.⁴⁰ The combination of a guarantee and an intercept mechanism, or a guarantee and a reserve fund with an escrow account, provides the best opportunity to attract investors and to obtain good borrowing durations and interest rates.

Using Capital Markets

The overview we presented earlier⁴¹ highlighted Africa's significant progress in the field of capital markets in recent years. It also highlighted the nascent and fragile nature of markets that need bolstering. We note that the capital markets considered here are exclusively local-currency markets, even though some local governments, such as provinces that collateralize oil revenues, could theoretically access international markets in foreign currencies.

Local governments can use capital markets to finance capital investments in two ways: by issuing bonds directly or through a financial institution. Several different conditions must be fulfilled before municipal bond issues can become more widespread. A greater number of large local governments must achieve good credit ratings and show sufficient management ability to master this mode of financing. Of course, sufficiently active capital markets must exist, with diverse investors. However, sovereign government bond issues must not exhaust these markets. The institutional, legal, and national tax environment must support municipal bond issuance; the indebtedness of local governments must be monitored and supervised, along with the structured finance tools described previously. Finally, local governments must find this strategy in their interest; the financing conditions obtained from capital markets must improve on what other funding sources offer.

For at least two reasons, these conditions may not be easy to meet across the African continent in the near future. First, the amount of money available in emerging African markets is likely to remain less than what their economies require as a whole, and less than what private companies need. The share of these resources that local governments can effectively draw upon—despite the

perception of risk associated with them—remains to be seen. Second, the question remains of the comparative advantages of municipal bond issues over bank financing. After all, except for the United States, most developed countries—particularly in Europe—make minor use of municipal bond issues.

Direct Bond Issuance

We have noted previously that a relatively small number of Africa's local governments have funded themselves directly through the bond markets in recent decades. The interest for the local government resides in the autonomy this method of financing offers and—perhaps primarily—its costs and characteristics. The funding should be in the local currency to avoid exchange rate risk. Domestic markets fulfill this objective, provided they are deep enough, but they have proven hesitant and—to date—expensive. This situation immediately raises the issue of overall costs and maturities. A case study on South Africa shows that even in a country with a particularly suitable institutional framework, municipal bond financing does not provide an unequivocally better solution (see case study in the appendix to this volume).

In light of the experience in the United States, market observers often expect that funds raised from bond markets will systematically have longer maturities and cost less than other sources. Reality proves otherwise. First, there is a correlation between overall cost and market depth, particularly relative to gross national product (GNP) or even to per capita revenue. As a result, African overall costs are often high or extremely high in narrow markets.⁴² Second, the U.S. market benefits from tax-exempt municipal bonds; the tax exemption is primarily what makes the bonds a very attractive investment. Overall, banks can often compete with the interest rates that local governments obtain—even with donor credit enhancements—in African markets, provided, of course, that the banks are interested in the municipal market, which is rare indeed. Bank credit is all the more competitive because bond issuance entails some supplemental costs for the borrower: fees for the credit rating agency, commissions for the bond arranger, commissions for the securities exchange authority, cost of advertising, and possibly commissions for credit enhancements.

Exacerbating the situation, the financing obtained for local capital investments may not prove the most favorable for local investments; it appears difficult to obtain durations of more than 7 to 10 years in the domestic bond markets of emerging countries. That is a short time for urban investments that depreciate over 15 to 20 years or more. Local governments must therefore consider a line of credit for prefinancing or refinancing, at a supplemental cost. Municipal bonds also require an owner with a high level of technical expertise. Unlike bank loans that can be made in several installments, bond funding arrives all at once, and thus, any delays in executing capital projects result in

unnecessary interest payments. Finally, the absence of grace periods in bond markets financing proves disadvantageous for most urban capital investments, especially for property development operations. (We return to these issues later in this chapter.)

Observers find it difficult to comment on the growth that direct capital markets financing will see on the African continent. For a comparison, we may consider what happened in European markets. During the 1990s, municipal bonds were not cost-effective because banks—specialized or not—operated in a highly competitive environment. Subsequently, municipal bond issues grew significantly, but local governments generally seem to use them to put pressure on banks, thereby aiming to obtain better financing terms over time. They also use bonds to diversify their debt. The coexistence of both financing methods proves beneficial to the borrower.

Given the current characteristics—low volumes and extreme fragility—of municipal credit markets in Sub-Saharan Africa, European-style changes may not occur for a long time. The largest local governments in countries with the largest and best-developed capital markets will probably find reasons to use this type of financing. But in light of the factors noted previously, we might find that direct bond issuance will remain restricted to a relatively small number of cases. However, intermediated capital markets financing through an intermediary financial institution could potentially play an important role.

Capital Market Intermediation and Bond Syndication

Financial institutions that lend to local governments issue their own bonds on capital markets. They do this as a form of refinancing and then proceed with their traditional lending business to local governments, acting as a turn-key operator. Many such institutions exist in developed countries. This model comes in several variants—for example, *bond banks* in the United States (see box 5.5) and Norway's Kommunalbanken or Sweden's Kommuninvest in Europe. These institutions allow municipalities—especially small and medium-size ones—to access capital market funding on better terms than if the municipalities issued bonds directly.

Below a certain threshold amount, issuing bonds directly on the market makes no sense; costs for commissions (for the arranger and others) and for fees and notifications prove too high, and institutional investors dislike the management costs of splitting their investments. These considerations practically exclude small towns from direct bond financing. This situation has led to the practice known as *syndicated* or *pooled* issuance, in which a financial institution—acting as an intermediary—issues a bond for a group of local governments. By these means, the bond size becomes attractive to investors.

Intermediation is also valuable because it achieves economies of scale in engineering the bond product and also allows for more sophisticated products.

BOX 5.5**State Bond Banks in the United States**

Beginning in the 1970s, several state governments in the United States set up bond banks, such as the Maine Municipal Bond Bank or the Virginia Resources Authority. A dozen now exist countrywide.

States set up bond banks as public financial institutions, usually organized as separate and independent authorities. The bonds they issue are not considered state bonds, although some states have consented to guarantee their bond banks' issues. Those banks aim to mobilize long-term financing from the private sector for capital works projects. For example, the Virginia Resources Authority can lend to finance infrastructure projects—water, solid waste, stormwater drainage, airports, car parks, and public transportation, among others.

These banks issue bonds and take on their eventual risk; local governments pay bond principal and interest to the bond bank, not to investors. Bond banks that have good credit ratings obtain favorable terms from the bond market that they can pass on to small localities. Sometimes a state bond bank has a higher credit rating than the state itself; for example, the Maine Municipal Bond Bank is rated AAA, whereas the state of Maine is rated AA. Borrowers remunerate the bond banks through commissions; given the lower cost of funding, the end-borrowers ultimately receive relatively good terms.

Sources: Anderson 2005; Painter 2009.

Pooled bond issues may benefit from the structured finance and credit enhancement devices we discussed previously. For example, the Water and Sanitation Pooled Fund in the Indian state of Tamil Nadu has used three levels of credit enhancement (see box 5.6). This example suggests that challenges remain for syndicated government bond issues in an emerging market; they require rather large public support in the form of guarantee funds and tax exemptions. Some observers see this requirement as a limitation in a system that cannot be perpetuated, but such public support is not unusual: the prosperity of municipal bond markets in the United States has long rested on crucial tax exemptions.

One of the most interesting aspects of the Water and Sanitation Pooled Fund case in India is the way the intermediary financial institution operates simultaneously as adviser to the local governments, the lender, and the capital raiser on the bond market. This role is one benefit of such a system, as is the ultimate financial result—the amount of funds actually raised on the domestic capital market, in addition to its positive effect on collection of local savings.

Syndication and Market Access: India's Water and Sanitation Pooled Fund

Tamil Nadu in southeastern India is one of the more industrial and urban states in the country. Urban underdevelopment, as in the rest of the country, has reached critical proportions, even though public sector banks in India actively finance capital infrastructure projects. In 2002, urban capital investment needs were estimated at \$11.5 billion per year; the smallest cities needed more than 75 percent of that amount. In 1998, the state government of Tamil Nadu set up a specialized financial institution, the public Municipal Urban Development Fund. It worked well for years, providing subsidized loans and distributing grants to municipalities for the account of the state. To raise funds on the capital market, the public development fund was converted into an independent entity, the Tamil Nadu Urban Development Fund (TNUDF), which is partly owned by financial institutions. In its new configuration, the development fund started operations by providing about 10 percent of the financing for an urban development project. To fund its participation in this project (mostly financed by a World Bank loan), in 2000 the development fund launched a \$23 million bond issue without a sovereign guarantee—the first of its kind in India.

Along with such operations, TNUDF developed a new area of financing over the course of a few years, based on modern financial engineering. Its most interesting initiatives included a common fund for small towns and dedicated water and sanitation operations: the Water and Sanitation Pooled Fund (WSPF). A bond issue funded the project in 2003; repayment resources will come from utilities receipts and interest on connection costs. The relatively small \$6 million bond used three levels of credit enhancement: an escrow account for receipts from involved local governments, a debt service reserve fund created by Tamil Nadu (equal to one-and-a-half years of payments), and a partial (50 percent) credit guarantee provided by the U.S. Agency for International Development's (USAID's) Development Credit Authority. The bond's overall cost was approximately 3 percent below the rate that TNUDF could offer at that time.

The Indian government has tried to replicate this arrangement in other states, with mixed success; one syndicated municipal bond issue was launched in the Bangalore region while another WSPF syndicated bond issue failed in 2007. After this failure, a period of inactivity followed for syndicated local government bonds countrywide until 2010, when the WSPF successfully raised \$19 million through a 10-year bond issued at a 7.5 percent interest rate. Local governments will see this 10-year period extended to 20 years through a loan from TNUDF.

The 2010 bond used three structured finance tools: an escrow account and a debt service reserve fund for each municipality in the syndicate, a credit enhancement reserve fund set up by the federal government and Tamil Nadu, and an intercept mechanism on Tamil Nadu's transfers to the municipalities. The bond also benefited from a tax-exempt status.

Sources: Kehew, Matsukawa, and Petersen 2005; Krishnan 2007; Krishnaswamy and Malathi 2009; Ramanujam 2010.

Mobilizing Credit Institutions

Commercial Banks as an Alternative

African commercial banks seldom show spontaneous interest in the municipal credit market. Whereas in many European countries, specialized or general banks have gradually become the leading lenders to local governments, with few exceptions, they remain absent from this market in Africa. In Sub-Saharan Africa, the banking system is notoriously underactive, creating significant returns by lending little and taking no risk.⁴³ This situation partly explains small and medium private sector companies' difficulties in finding financing. Many continental African economies are victims of this vicious circle: the banks have no incentive to lend to the private sector because they make substantial margins on sovereign bonds; a lack of credit stifles the private sector, so that central government receipts stagnate; as a result, the central government issues bonds; and the cycle repeats itself.

In these circumstances, we can understand why banks' prospective client lists include no local governments. The solvent municipal market is small and specific, and banks lack the trained staff needed to understand it. Banks also consider the municipal market riskier than the private sector, for governance-related reasons. However, in African countries with the most modern financial systems, we see trends that could augur major changes in the future. After a period of observation and study as specialized financial institution shareholders, some commercial banks in South Africa appear to have taken an interest in the municipal credit market, and now finance the capital investments of the country's largest cities.⁴⁴ In recent years, Moroccan commercial banks have become a source of financing for the Fonds d'Équipement Communal (Municipal Infrastructure Fund, or FEC); this trend may foreshadow a future interest in directly financing some municipalities or projects.⁴⁵

An example from Cape Verde shows that commercial banks can provide a credible alternative to setting up a specific specialized finance institution.⁴⁶ In this case, a donor channels funds through commercial banks to support local governments, according to a number of predefined criteria and an incentive scheme for banks. A small technical support unit provides advice to local government officials about setting up projects and arranging financing. For small economies with small municipal credit markets, such arrangements serve as an alternative to setting up a specialized finance institution that could not cover its operating costs. Of course, uncertainties remain, such as whether banks may merely profit from a windfall or how fast the market will grow.

However, this arrangement could apparently benefit much more developed markets. It accommodates changes as the market matures. Donors might set up partial guarantees to encourage bank involvement, with a high proportion of initial guarantee that gradually decreases. That solution could prove timely for a

number of Sub-Saharan African countries that currently do not have a municipal loan instrument; it also seems to make sense for countries that do (holders of local investment funds, for example).⁴⁷ Instead of trying to transform a local investment fund into a municipal lender, it may be wiser to reinforce and professionalize the investment fund and use commercial banks to make loans.

A specialized financial institution could also use a commercial bank as an operator, outsourcing all of its back-office functions and costs. In this way, the specialized financial institution could concentrate on the upstream activity of procuring long-term resources at good terms for the system. In these cases as well, a staged approach may also be appropriate to structure the market (see box 5.7).

A Role for Regional Development Banks

Regional development banks have reasons similar to those of commercial banks for not loaning to cities for urban capital investments: the municipal credit market is small, the market is perceived as risky, and regional development banks lack the expertise required to understand this market. Some of these institutions

BOX 5.7

A Specialized Financial Institution Using Commercial Banks in Colombia

Financiera de Desarrollo Territorial (Financial Corporation for the Territorial Development, or FINDETER) is a public financial institution, with 92 percent ownership by the federal government and 8 percent ownership by Colombia's departments. Founded in 1989, FINDETER aims to finance infrastructure projects that promote regional and urban progress. What makes this municipal finance institution different from the standard model is that it channels its funding through credit institutions, mainly commercial banks.

FINDETER funds itself chiefly on the domestic capital market in the local currency. It also receives loans from international donors, particularly so that it can extend its funding. It also benefits from a sovereign guarantee; it covers the exchange rate risk on its own foreign-currency borrowings. Initially, FINDETER lent to local governments only; it later expanded its clients to include public or private sector utilities.

FINDETER's operating principles developed in two distinct stages. During the first stage, for a dozen years its own employees analyzed risk and ran the institution. During the second stage, these employees also provided technical support to the end-borrowers. In 2003, the market and other banking operators were deemed mature enough for FINDETER to fully delegate its risk analysis and operations. From that point on, the banks alone bore their borrowers' default risk.

Source: IADB 2010.

occasionally lend for infrastructure works, such as the Banque Ouest Africaine de Développement (West African Development Bank, or BOAD), but they do so by using sovereign loans.

This absence among institutions charged with development finance is difficult to justify: the urban sector and local governments should be their core targets. These regional financial institutions could play a decisive role in structuring the market for local capital investments and financing or refinancing, especially in regions with smaller-scale countries and cities. One of the main constraints faced by property developers, utilities, and other operators is the scarcity of long-term financing suitable for urban infrastructure production and development. Regional development banks probably have a role to play in filling this gap. They should act as a relay for major multilateral donors, receiving their funding and redistributing it at the local level through financial products tailored to local capital investments.

These regional financial institutions also have great potential to assume currency-exchange risk and collect local-currency resources. They seem optimally positioned to help groups of local governments raise funds on domestic capital markets; as we showed previously, such markets are often regional. In other words, the regional development banks' business model could gradually resemble that of the bond banks in the United States (see box 5.5). These banks' regional focus can potentially lead to a role in government bond syndication, thereby facilitating access to appropriate resources for clusters of capital works projects that pool local governments. Another business opportunity may arise in providing guarantees for foreign investors, as part of a public-private partnership.

Imagining these new roles for regional development banks assumes that many of them will strengthen their capacities, management practices, and general reputations as financial institutions. To do so, they would probably require increased collaboration with other multilateral or bilateral development finance institutions. These new roles would also entail investment in intellectual and human capital in the municipal sector. Regional financial institutions' legitimacy as a source of municipal funding derives from their proximity to local municipal markets. They are in a position to acquire deep and ongoing knowledge about local economies' challenges and prospects and about local governments' financial situations—subjects that require proximity. But gathering and sharing this knowledge presupposes the existence of stable and competent teams. Here, too, collaboration with other financial institutions and bilateral donor agencies may prove necessary or useful.

Toward a New Generation of Local Investment Funds

Changes in the international aid context, the increasing diversity of the issues involved with local investment, the increasing complexity of institutional

arrangements, and financial engineering suggest the current need for a new type of local investment fund. Specialized financial institutions and conventional investment funds no longer meet the specific needs. In light of experiences on other continents (see box 5.8 and boxes 5.9, 5.10, and 5.11 later in this chapter) and considering the objectives and constraints in the Sub-Saharan African context, we may assign three main objectives to local investment funds: (1) capturing new funding; (2) making financial products suitable for local capital investment by using and hybridizing various resources; and (3) ensuring the interface with other development institutions and agencies that allows leverage of operations.

Capturing New Funding

In Chapter 3, we highlighted the number and size of different types of new funding sources that are particularly relevant to international aid volumes. Some of these new, varied, and distinct sources of funds are remarkable for their size, such as philanthropic foundations, remittances, and sovereign wealth funds. Others are noteworthy for their sophistication, such as carbon finance mechanisms, or for their features and origins, such as Chinese like-kind investments

BOX 5.8

State Revolving Funds in the United States

In the United States, the 1972 Clean Water Act launched a federal program of grants to improve water quality. In 1987, a related amendment created the Clean Water State Revolving Fund (CWSRF). This fund is a mechanism to provide low-interest loans to the states, specifically to finance water treatment and distribution infrastructure projects. The core funds come from federal grants, and up to 20 percent of costs must be augmented from state budgets. This program has grown successfully; today all 50 states and Puerto Rico have a state revolving fund. State bond banks manage revolving funds in some states, raising additional resources through direct borrowing. The bond banks also provide loan guarantees to water operators so that they can borrow from commercial banks on favorable loan terms.

In 2009, the 51 state revolving funds received grants worth \$32.4 billion, and the funds leveraged these grants to achieve total capital investments worth \$76.3 billion. In 2008, the state revolving funds received a further \$4 billion as part of the postcrisis stimulus, the American Recovery and Reinvestment Act. The revolving funds' hybridization of grants and loans provides operators with a large subsidy; in 2009, the CWSRF program loans carried about 2.3 percent interest rates, whereas market rates hovered around 5 percent.

Sources: CWSRF 2009; Kehew, Matsukawa, and Petersen 2005.

or vertical funds in the health sector. These funding sources share a common feature: almost none of their funds go to local governments in Africa. Those local governments have a critical need to position themselves to capture some of these resources, because the resources' volumes are increasing, and to escape further marginalization.

Part of this funding—especially that targeted to the health sector—is designed to flow through central governments, but much of it targets fields within the realm of local governments. The local governments miss receiving these funds for various reasons: poor governance quality, inability to process financing applications, lack of technical expertise and know-how, and—more generally—lack of social skills and initiative. The quality of governance particularly affects relationships with philanthropic organizations, which have a results-based culture and must be accountable to their contributors. Hence, philanthropies are reluctant to engage with partners who have poor management reputations, preferring to work with professional nongovernmental organizations experienced in conducting programs. Yet many of these philanthropic foundations' programs relate—or could relate—to urban areas. Local governments lose on two counts: they lose a significant amount of funding and its effects, and they lose out on skills that officials and staff members could have acquired, for example, from finance sector partners (see box 5.14 later in this chapter).

In 2010, migrant remittances recovered to their pre-2008 economic crisis levels, and they are projected to grow 7 to 8 percent annually in the coming years. Migrants' potential savings represent about \$52 billion for all of Africa. Estimates show that by issuing diaspora bonds, Sub-Saharan Africa could potentially raise about \$5 billion to \$10 billion per year (Mohapatra, Ratha, and Silval 2011). These amounts show the scale of the stakes for local governments. The lack of tools to channel migrant remittances and investments proves most evident in the housing sector; many countries could better streamline, systematize, and exploit this sector if local governments ensured land production for this purpose. Localities lose out on uninvested capital, uncollected taxes, and inferred effects on the construction industry and employment.

Local governments' lack of technical skills affects the information and communication technologies sector and carbon finance. Funds and financing mechanisms for these sectors have not been specifically designed for local governments—far from it—but the local governments have every incentive to seek the benefits of such financing, including the valuable skills exposure that personnel may gain from promising and innovative *green economy* projects (see box 5.9).

Capturing funds from these financing sources, and more broadly attracting projects and investors, require levels of initiative, proactiveness, and expertise in technical and financial engineering that few local governments or traditional specialized financial institutions possess.

BOX 5.9**Green Finance: A Comprehensive and Experimental Approach in Amman**

Applying carbon finance mechanisms at the city scale poses methodological problems. Taken one by one, relevant sectors—energy, transportation, and waste and sanitation—already prove challenging to analyze. Consolidating the results presents even more challenges. One such challenge—determining a comprehensive method at the city scale—will prove crucial in assessing how much local governments will actually benefit from carbon finance.

In 2010, the Jordanian capital took on a pilot project for testing a citywide approach. The Amman Green Growth Program (AGGP) was launched with funding from the World Bank. Part of an integral urban strategy defined by the Amman Master Plan 2025, AGGP promotes urban development that affects the environment minimally and uses energy optimally. The program has five components: waste management with methane capture and plastics recycling; urban transportation through a Bus Rapid Transit (BRT) system; sustainable energy through public lighting, solar heating, and energy-efficient public buildings; urban forestry through wastewater reuse; and climate-change risk management, primarily through adaptation projects.

The program nominally requires the creation of a revolving fund; it should receive the emissions reductions proceeds (based on not-yet-validated assumptions) and run the energy efficiency component as part of a Public Internal Performance Contracting (PICO) scheme. This financing mechanism, already tested in European cities such as Berlin, Lyon, and Stuttgart, prefinances energy performance contracting on buildings. The resulting energy-efficiency savings finance further energy-saving investments.

The Cancun Climate Conference validated the principle of using this approach at the city scale. A technical review procedure will determine which activities would qualify for emissions-reduction credits under the Clean Development Mechanism. More generally, this type of project improves opportunities for accessing green financing, such as the Clean Technology Fund (see chapter 1, section titled “Climate Change and New Financing Mechanisms,” in this volume).

Source: World Bank 2010b.

Making Suitable Financial Products

One goal for any investment policy should be to draw on local savings, for the reasons outlined previously.⁴⁸ In African financial markets, these resources present two disadvantages—they are often expensive and usually short-term, therefore ill suited in their original form for local capital investments and perhaps even less for land-development operations. Financial products suitable for land development need two features—long durations and grace periods. Land-development operations take time to execute; traditional operations take about

12 to 15 years, and the first receipts arrive only after 5 to 7 years. Grace periods prove crucial for the ability to break even, because they allow the borrower's first capital repayments to coincide with its first receipts. These grace periods are critical for operations aiming for lowest-cost, high-quantity production.⁴⁹

In the present state of affairs, donors provide the only financing that meets these twin imperatives of long durations and grace periods. In practice, local governments rarely use donor financing to develop land under local ownership; donors remain absent from this sector, and their funding aims mainly at sovereign loans in foreign currency.⁵⁰ Therefore, a need exists for a new financial product, one that offers more of the features needed for lowest-cost land development that draws on local resources. In such cases, a local investment fund could serve as a financial arranger, mixing several resource types and using all possible credit enhancement mechanisms simultaneously. For example, to finance a specific operation, a local investment fund could raise resources on the capital market, using an intercept mechanism as a first-level credit enhancement and a donor's partial guarantee for the second level. Or these resources could combine with another donor's subsidized funding that the central government would retrocede in local currency, with funds from a philanthropic foundation or other source. In short, the idea is to hybridize diverse resources to create a product with suitable rate, duration, and grace-period characteristics, thereby leveraging donors' funds.

The expected effects justify the participation of multilateral and bilateral donors, regional development banks, and philanthropic foundations: collecting local savings and migrant remittances, promoting local investment, supporting job-creating activity, creating a private sector stock of regulated affordable and very-affordable rental housing, and addressing social issues in disadvantaged neighborhoods.

Interfaces and Leverage

In addition to the role of financial arranger previously mentioned, a local investment fund may be designed as a general or technical arranger. The need for such roles arises from the complexities of assembling and diversifying sources of financing. A capital investment program typically involves many actors: public or parapublic operators, foreign or domestic private companies involved in public-private partnerships, Chinese infrastructure-construction companies working under commercial licenses negotiated with the central government, and—at the opposite end of the spectrum—philanthropic companies and non-governmental organizations. A capital investment program may be designed to mobilize migrant remittances, a sovereign wealth fund, or carbon finance revenue streams. It may need to create several levels of credit enhancements, using intercept agreements, commodity revenue pledges, or partial guarantee promises. Aligning these elements at the outset and monitoring such systems over time require special expertise.

A local investment fund may perform these functions. More generally, a fund manager or involved team may provide the social skills needed for the success of a scheme that requires taking the initiative, particularly to attract and gain commitments from external investors, donors, and others. Investment funds provide guarantees of professionalism and integrity that reassure investors about levels of risk.

A Range of Options

New-generation local investment funds do not necessarily fulfill all of the functions described previously. In examples from other continents, two broad categories are evident: funds designed as national in scope and funds with a purely local purpose.

The national (or federal) funds usually have a financial purpose; their activity focuses on raising resources from the markets, mixing them with other resources such as grants, creating products suited to a particular type of investment, and providing financial advisory services. This model is typical in the United States, with its state bond banks and state revolving funds (see boxes 5.5 and 5.8, respectively). These two institutions may be partially interlocked in some cases, but these cases are exceptions to the rule. A project now exists to create an infrastructure bank at the federal government level. Although more focused on major capital investments, it would have some of the state-level institutions' features (see chapter 1, box 1.13, in this volume).

Investment funds designed for local use generally focus on financial engineering and assembly operations. This type of local investment fund is dedicated to a local authority, even though it is often state owned. A typical Asian model of a local investment fund appears in China and Vietnam, where such funds have grown significantly over the past two decades (see boxes 5.10 and 5.11, respectively).

There are probably a number of cases in Africa where both nationally and locally focused investment funds could take root effectively. In particular, a nationally focused model could foster reforms in specialized financial institutions or in existing investment funds that remain frozen in time, prone to following the herd, or entangled in a culture of corrupt practices. A locally focused model could prove valuable to the largest cities in emerging or pre-emergent economies. In addition to the advantages listed, a locally focused model could put some distance between investment program management and local politics. It could also skirt complications with urban agglomerations' entities and some of the difficulties related to collective ownership.⁵¹ A locally focused model could have the additional advantage of fostering staff professionalization.

In most countries, establishing a fund of this type presupposes implemented reforms to modernize financing systems, as described previously in this chapter. Again, we stress that central and local governments should base decisions on

BOX 5.10**Urban Development Investment Corporations in China**

Urban Development Investment Corporations (UDICs) were established in China in the early 1990s, when the central government, wishing to withdraw from local infrastructure financing, ordered local governments to build their own infrastructure. Yet laws regulating local governments did not allow them to borrow. State-owned companies, the UDICs were created to circumvent this constraint and, more generally, to support local governments in implementing urban development projects. There are about 360 UDICs in China, and they all belong to a national association. Their legal structure varies significantly and may be controlled by different government bodies: 70 percent of these government bodies are local governments, whereas in other cases, they may be provincial or prefectural services charged with urban construction, local management of state assets, or reforms and development.

The UDICs provide four types of functions: (1) as primarily financing platforms, they raise funds through various channels and finance projects through loans or direct investment; (2) as investors in the public sector, they invest on behalf of local authorities or national asset managers to manage state assets and protect the central government's interests; (3) as land and property developers, they develop projects on their own account and that of local authorities on lands the local authorities allocate to them through urban planning documents; and (4) as owners of certain infrastructure projects, they are responsible for project financing and implementation, as well as for subsequent management and operating costs.

The UDICs' functional scope pertains to financing, building, and operating urban infrastructure and land development projects, primarily for drinking water production and distribution, wastewater treatment, urban gas and heating supply, municipal waste treatment, and urban rail. The UDICs' project scope extends to urban roads, bridges and other superstructures, flood prevention, urban river management, and urban parks. The UDICs are generally not involved in electricity, telecommunications, transportation outside of the city (ports and airports), and other nationwide infrastructure. Some UDICs are responsible for education, health care, and other social infrastructure.

Source: World Bank 2009.

changing existing specialized financial institutions or creating local investment funds on market research and in-depth feasibility studies.⁵²

Legislative and Regulatory Infrastructure for Subsovereign Debt

The use of long-term debt requires an appropriate legal and regulatory infrastructure that outlines contractual relationships among three stakeholders: local governments and other borrowers,⁵³ the central government, and financial

BOX 5.11**Local Development Investment Funds in Vietnam**

Vietnam's Local Development Investment Funds (LDIFs) are specialized financial institutions—legal and functional tools for provincial governments to invest in urban and economic infrastructure that will provide a return on the investment. As a public financial institution, the LDIF has a legal structure that is governed by the laws of a province, but the LDIF does not consolidate capital or accounts with the province. Urban and economic infrastructure encompasses many areas: health, education, drinking water treatment and distribution, waste management, sanitation and sewage treatment, roads and bridges, transportation logistics, ports, telecommunications, construction and housing (including social housing), industrial zones, and energy transport.

In addition to the capital stock provided by the provinces, the LDIFs' main modes of financing come from short- and medium-term borrowings contracted from domestic credit institutions and bond issues. The LDIFs also receive loans from donors through the Vietnamese Ministry of Finance. The LDIFs intervene in various ways. They may make direct investments, particularly through public-private partnerships; they may provide 15-year loans and take equity stakes in companies' capital; and they may manage assets for third parties, primarily the provinces.

In 1997, a prototype LDIF was established—the Ho Chi Minh City Investment Fund for Urban Development. Its name changed to the Ho Chi Minh City Finance and Investment State-owned Company (HIFIC) after a change in legal status allowed it to take control of operations by central government consortia on its territory. The experiment was a success: infrastructure execution capabilities have improved, delays in making investments have lessened, and HIFIC has managed to involve the private sector in infrastructure financing. HIFIC has sound financial management and good profitability; the local investment fund is viable, is not dependent on government subsidies, and has a quality loan portfolio with few nonperforming loans. Donors provided the investment fund's long-term financing. In 2003, HIFIC successfully completed a domestic bond issue worth about \$127 million with 2-year and 5-year maturities. In 2004, a second issue in the same amount and market was fully subscribed, allowing the maturity for part of the raised funds—about \$25 million—to extend to 10 years.

However, the LDIF model's rapid spread across the whole country raises questions about the risk of these potentially big borrowers not consolidating their accounts with the provinces and about the new funds' level of professionalism. To increase the funds' professionalism, HIFIC may be called upon to provide training for the new entities.

Sources: AFD 2009; Albrecht, Hocquart, and Papin 2010; World Bank 2007.

institutions. For local governments, this infrastructure would define the authority empowered to borrow, along with the procedures to ensure debt contract legality and publication of financial information. From the perspective of central governments, laws and regulations aim to encourage appropriate use of debt, avoid irresponsible financial behavior by municipalities and their financial

partners, provide information about the amount of public debt, and, finally, avoid the moral hazard of implied guarantees.⁵⁴ From the perspective of credit institutions, a legal framework is essential for signing loan agreements, gaining access to information needed for risk analysis, monitoring borrowers' credit-worthiness, and regulating default procedures.

We have already addressed some of these concerns previously, in the section titled "Modernizing Financing Systems." In the following section, we briefly present the general architecture of an overall legal and regulatory framework. Naturally, the content must adapt to the legal and institutional context of regional and national assemblies and to government strategies. Most countries already have laws and regulations—such as municipal codes—that may be adapted to ensure guidance and supervision of local government debt management. Debt management legislation, regulation, and supervision traditionally fall into two broad categories: *ex ante*, or anticipatory, and *ex post*, or after-the-fact provisions (Canuto and Liu 2010; Liu and Song Tan 2009).

Ex Ante Provisions⁵⁵

Ex ante provisions usually take the form of restrictions; many experts hold that they should take the form of laws rather than of simple regulatory measures, to make them more difficult to change. Ex ante provisions may (1) define allowable uses of borrowed funds, (2) set a debt ceiling, (3) set restrictions on funding sources, (4) prohibit borrowing in foreign currencies, (5) set loan preconditions, and (6) define rules for guarantees and payment of debts in default.

1. **Defining allowable uses of loan funds.** The following principles are generally agreed on by all stakeholders: the loan must have a clear public purpose; short-term borrowing should be used only to manage cash flow for the current fiscal year; medium- and long-term borrowing should be used for physical capital investments, and the loan repayment term should preferably match the life of the investment. Provisions that prevent local governments from borrowing for non-revenue-generating projects have debatable merits; such provisions eliminate de facto essential public investments that may be paid for through taxation or through charging for related services, such as sanitation.
2. **Setting a debt ceiling.** Two criteria may determine a ceiling: the annual debt service or the total amount of debt. In practice, the second criterion is not easy to calculate because it must include loan rates and duration, and therefore, the first criterion most commonly applies. The ratio is usually a function of savings efficiency.⁵⁶ Codifying the ratio principle in a law to maintain some flexibility might be preferable; a regulatory authority, such as in a finance ministry, could calculate and adapt it according to economic circumstances. Complying with a debt ceiling determines *a priori* a given year's borrowing capacity. The regulations should specify procedures for setting debt

ceilings and their frequency and oversight. The debt ceiling rules should also integrate risks posed by *satellites*—public utility corporations, management companies, public-private partnerships, local development funds, land corporations, land developers, and others—whose outstanding loans are often guaranteed by local governments.

3. **Setting restrictions on funding sources.** Some countries choose to restrict the sources of local government financing—particularly by closing the bond market (to force use of credit institutions)—by reinforcing a specialized financial institution’s monopoly on the market for subsovereign debt or by imposing qualitative criteria such as a maximum interest rate. In some specific contexts, such restrictions may prove worthwhile, but they harm the markets’ optimal functioning by distorting competition. Eventually, such restrictions lead to reductions in available fund amounts and tend to keep interest rates high.
4. **Prohibiting borrowing in foreign currencies.** This prohibition has the desirable effect of protecting local governments and their satellites from foreign-currency exchange-rate risks. Exceptions may be possible under certain conditions for specialized financial institutions that are specifically required to raise funding in external markets, in order to lengthen the maturities they can obtain with domestic resources. Some central governments have set up currency-risk guarantee funds for their public enterprises.
5. **Setting loan preconditions.** Prerequisites for borrowing aim to prevent overindebtedness and reassure lending institutions about the borrowing’s legality and legitimacy. The rules must spell out the following points: (1) the identity of the local government entity with the power to incur debt and the borrowing conditions for that debt; and (2) the prerequisites to be completed before the borrowing takes place, such as a prospective financial analysis, a feasibility study and economic analysis for the targeted capital investment, a multiyear investment plan, an external audit or rating by a credit rating agency, and a public consultation with residents. In addition to these provisions, loan preconditions should require a formal authorization from a finance ministry, giving it the means to oversee a country’s subsovereign debt levels in real time. In these cases, questions about the central government’s implied guarantee prove particularly crucial.
6. **Defining rules for guarantees and payment of debts in default.** As we noted earlier, the moral hazard of an implicit sovereign guarantee has adverse effects on the behavior of lenders, because they may ultimately rely on the guarantee as a form of all-risk insurance. An implicit sovereign guarantee also adversely affects borrowers, who become disempowered. Therefore, regulations should clearly state that central governments do not guarantee these debts, except in circumstances that will be subject to agreement on a case-by-case basis. This

situation suggests that specific laws will exist governing the rights and duties of lenders and borrowers in the event of default. The central government retains the responsibility to help local government provide basic services, restructure its debt, and get out of financial difficulties, but credit institutions should expect to incur what may be substantial losses on their outstanding loans.

Ex Post Provisions

Local government oversight ensures—or should ensure—financial and management monitoring; in most countries, a dedicated ministry or an agency dependent on a ministry (such as an interior ministry or finance ministry) provides this oversight. This planning and supervision duty is a crucial element of public life. However, regardless of the quality of monitoring tools, regulating the municipal credit market is not in itself sufficient. Laws and regulations must require that the largest local governments, and those who borrow or who wish to borrow, conduct external audits of debt levels and risk.

Generally, an annual audit by an external accountant, accompanied by the publication of an independent report, remains the norm, at least for local governments able to borrow. Smaller localities that do not borrow may be satisfied with their oversight agency's financial report. The external audit serves to confirm that the information provided by local governments is true and in accordance with generally accepted accounting principles. This financial report is an important element for those involved in market regulation—finance ministries, central banks, and financial market authorities—and for entities such as credit institutions and credit rating agencies.

Credit rating agencies use data from annual audits to perform financial analyses—an important part of the credit rating exercise. Recent decades' experience in emerging markets has shown that rating credit is a prerequisite for developing a market for borrowing. A national-scale credit rating suffices in most cases. We note that some major credit rating agencies have several regional offices in Africa; there is also at least one internationally recognized African agency.⁵⁷ Increasingly, laws make a credit rating obligatory for all municipal borrowing. Small local governments and governments that do not borrow may use alternative methods. Prospective financial analysis, credit rating agency methods, and alternatives to credit rating agencies are explained in chapter 1, section titled “The Importance of Financial Analysis,” in this volume.

Information as a Key Element in Regulating Municipal Finance

Information is vital to the functioning of financial systems. Regardless of the market in question—and the municipal credit market is no exception—if investors and lending institutions cannot assess risk, they will take their business elsewhere. Laws and regulations should specify the conditions and modalities for disseminating financial information. Both local and central

governments are responsible for this task. In addition to their legal obligation to transmit financial data to their oversight agency, it is in local governments' best interest to make public their audit results, credit rating agencies' analyses (or alternatives), prospective analyses, and other strategic financial documents, such as debt management policies (if applicable) and multiyear investment plans.⁵⁸

It is also in central governments' best interest to make public the data from their monitoring tools and debt registries. Debt registries (explained in the previous section "Modernizing Financing Systems") must record borrowings by local governments and their satellites. Such records must include loan features—date, maturity, amount, source, interest rate, grace period, payment schedule, and so forth—with annual, year-to-date financial data: outstanding principal, principal and interest payments for the fiscal year, and so forth. If necessary, the central government must account for the way it handles distressed debt and defaults and the way it will support potential debt restructuring and turnaround plans for local governments. In general, we can say that a central government's energetic and predictive supervision of subsovereign debt signals security to investors and credit institutions and constitutes one of the market's best supports.

Using Land and Land Development to Finance the City: An Inevitable Evolution

In chapter 1, we discussed the strengths of land value capture as a means of financing local capital investments, and the methods used to do so.⁵⁹ The practice applies to all continents, but we highlighted the relevance of the Chinese example; in the past two decades, cities in China have gained more than 300 million people—the sole urbanization experience, globally, comparable in scale to that faced by Africa. With normal caveats about the differences in situations and market size, we would think that African local governments should also finance part of their local investments in this way, with different tools as appropriate.

However, we also saw that land management and production failures negatively affect more than economic activity—they also prevent most African countries from using this financing mode.⁶⁰ Eliminating property and land development bottlenecks remains crucial to road maps for progress. We discuss this issue in the following sections and examine its legal, operational, and financial aspects and risks in succession.

Legal Frameworks

Many countries have already initiated land law reforms, and others will probably follow. These reforms cover complex and numerous topics. Here, we are

interested only in the relatively small fraction of these subjects that concern the management and production of urban land.

It appears that urban land laws should have multiple but not contradictory objectives. Contradictory objectives may arise in relation to different types of concerns: (1) limiting new extensions to the urban periphery on lands without a recognized legal status, especially those that are unorganized, undeveloped, and undevelopable without restructuring; (2) producing enough legal and secure urban land to meet commercial, industrial, and residential needs, including all types of housing; (3) clarifying the mechanisms of urban land expropriation and defining a negotiation and arbitration framework; (4) promoting private sector investment; and (5) facilitating property taxation.

In most Sub-Saharan African countries, achieving these objectives requires challenging the state model⁶¹: land titling as the sole land regularization model and the cadastre as the sole instrument of land registration. Rather, these models and tools should be replaced by pragmatic and realistic solutions, assimilating processes that have practically governed urban land production for decades.

In many countries, changes are already under way. These changes include a gradual recognition of rights known as *neo-customary* and the existence of *informal land markets*. These markets now constitute the principal means of access to land. They are rapidly becoming more structured, as evidenced by the existence of intermediaries and specialized property agencies.

The range of legal solutions and tools a local government may mobilize depends on each country's specific context and should be determined on a case-by-case basis. However, common elements have appeared, such as using land pooling and negotiating to transform peripheral areas into urban land; recognizing differentiated legal statuses, such as collective rights (as seen in the U.S. Community Land Trusts); including both modern and customary legal systems, previously considered irreconcilable; using progressive, negotiated regularization procedures; and establishing a record of transactions and a land register for taxation purposes (see box 5.13 later in this chapter).

Intervention Tools

Intervention tools exist and are in use on different continents. In particular, we note two types of operational tools that seem tailored to Africa's specificities, especially the thorny issue of extensions on the urban periphery: *urban land pooling* and *guided land development*, or a combination of the two. Urban land pooling, or *land readjustment*, has been practiced in Europe since the nineteenth century and remains widespread in some countries, such as Germany (Moreau 1990). England exported the concept to India in the early 1900s. Japan made extensive use of urban land pooling to rebuild Tokyo after an earthquake in 1923, to rebuild hundreds of cities bombed during World War II, and to create new towns in the 1960s (Aveline 1997). From Japan, the concept spread

to various countries in Southeast Asia, such as Indonesia, Malaysia, and the Philippines.

The urban land pooling concept should fit well in many cases on Africa's urban outskirts, because it allows physical and legal reorganization of often densely occupied areas, through negotiations with land rights holders.⁶² The main objection to urban land pooling is the relatively long time for implementation. We emphasize that the Japanese model of land pooling differs from the European model; the Japanese model specifically includes cost recovery through sales of land that property owners retrocede to the government. Thus, it also serves as a land-based financing tool, which is why we discuss the concept again below, in its financial aspects.

The concept of *guided* land development, or *guiding grid*, made its appearance in the 1980s. It has several levels of complexity. On the simplest level, the guiding grid refers to laying out primary and secondary roads; these roads will determine organization of urban land extensions. An operator negotiates right-of-way releases with the rights holders. Roadways defined by the guiding grid may be variably terraced, compacted, or drained, as available funds allow. What matters is that they define an organization that allows water, electricity, and sewerage utilities to be installed later (Farvacque-Vitkovic and Godin 1997). Guided land development was used primarily in World Bank-funded urban development projects, such as in Conakry; since the World Bank stopped funding such projects, Africa has been left out. Recently, medium-size cities in Ecuador reactivated the concept (Angel 2008). At higher levels of complexity, guided land development may combine with some land pooling elements.

In their ultimate combination, land pooling and guided land development prove comprehensive and versatile. We see both concepts applied in Ahmedabad, India, where officials have developed the Town Planning Scheme Mechanism. This tool addresses major infrastructure across the city, and for extensions, it restructures and regularizes irregular settlements, makes new residential areas, and constitutes reserves of public land. Like the Japanese model of land pooling, the Town Planning Scheme Mechanism is a means of financing through land; we discuss it later in this chapter, in the section titled, "Land Value Capture Methods."

To be fully operational, these policy instruments should be explicitly integrated with all necessary legal frameworks for land and urban planning. Legal reforms should be designed for this purpose.

Implementation: The Need for Operators

Implementing these policy instruments as part of a land value capture development strategy requires a specific operational system. Our analysis of experiences on other continents reveals two main operational options. The choice of option depends on whether local governments separate raw land production

from land development and servicing. The usual choices of legal status and territorial jurisdiction pertain to each option.

A land operator aims to produce urban land by transforming raw or rural land or restructuring existing parcels; a land operator may also carry or create reserves of land for a local government. The land operator serves as an intermediary between local governments and land developers or investors. The operator replaces the local government in negotiations with rights holders in land pooling cases. The same is true for acquiring land or even for working through delegated authority for preemptions and expropriations. The land operator manages freed or acquired assets before retroceding them to the local government or ceding them to a third-party property developer or investor.

For a local government, working with a land operator presents two advantages: outsourcing costs and working with a more professional structure. A separation between the land operator and the land developer may be justified by the nature of their activity—two distinct task sets that require different skills—and by the nature of the risks (Vilmin 1992). Indeed, the risk is higher in land development; installing infrastructure and facilities requires investments and marketing that carry risks, whereas vacant land in urban areas and peripheries easily finds a use. For these reasons, especially for land pooling, a separate land operator appears rational in the Sub-Saharan Africa context. In many cases, the operator may simply be a small team acting as a facilitator, with no need to purchase and carry the land.

The choice of separating functions or not also rests on a more prosaic parameter: the question of financing the operator—how he or she might earn from or be paid for a project. Typically, land operators' remuneration comes through commissions on the value of land retroceded or transferred, or possibly through fees for services rendered. Land developers are remunerated through sales of developed land. As a result, depending on the market's size and characteristics, pure land operators may be unable to recover their operating costs and will require grants or subsidies to break even. In some countries, a special tax funds their activities, such as an additional fee on top of local direct taxes.

Operating conditions for pure land operators and land developers vary by country, by configuration, and by scope of intervention. These land operators and developers are offshoots of either the central government or the local government. Depending on local laws, they may be public or parapublic bodies with a variable proportion of private ownership. In practice, land operator and land developer functions may be combined and exercised within entities that have a broader field of activity. For instance, municipal investment funds such as the HIFIC in Vietnam are also land developers to a certain extent; such activity runs parallel to and feeds its infrastructure and property development. Institutions such as land development corporations provide another scenario; they are also responsible for managing land assets or even local governments' properties,

and sometimes extend their jurisdiction to economic or social development (Kaganova 2011). This is the case for the Joburg Property Company, owned by the City of Johannesburg Metropolitan Municipality.

A wide variety of options therefore exists. The terms for choosing between these options are generally the same as for a specialized financial institution⁶³ with the difference of specific parameters relating to land law and taxation. We would like to stress here again the importance of the concept of the market and the need to conduct feasibility or preconfiguration studies before choosing a particular system. However, in Sub-Saharan African countries and cities, land management and basic services in the peripheries are a priority. Organizing growth and improving land with services constitutes a first-degree strategic challenge for decades to come. Therefore, it is essential that land operators and land developers work with a new outlook and use the policy instruments described previously.

Land Value Capture Methods

Any urban extension generates an increase in land values. Land with easy road access, utilities, or even public transportation service has a greater increase in value. The question is who will benefit from this added value: the owner or rights holder alone, or also the locality that financed the capital investment? Ensuring that the locality recovers a portion of this surplus is morally justifiable and economically vital, because doing so permits financing of future capital investments. This is the principle underlying land value capture—a principle that, with few exceptions, has been ignored to date in Africa.

Among the chief methods to capture land value,⁶⁴ three methods seem likely to find use on the African continent, separately or simultaneously depending on the context: (1) direct land transfers, (2) direct contributions from owners or developers, and (3) land added-value taxation.

Direct transfers take place when the public owns the land. Provided that it has no occupants or that its occupants receive legal and fair compensation, the land may be sold to finance or refinance capital investment. A typical scenario involves building major transportation infrastructure, such as ports, airports, or tramways. Land transfers around the facilities contribute to the financing plan. If the public does not own the land, it may legitimately acquire the land with procedures allowed in the project preparation phases, well before project completion. This is one of a land corporation's traditional roles.

Direct contribution follows the notion of in-kind contribution: the owners, rights-holders, or developers retrocede part of their land to the public in exchange and as payment for the capital investments made by the public. The local government may sell the ceded land or use it as grounds for public facilities. This is a traditional development technique in Europe. It is also central to the concept of urban land pooling. Development operations occurring under

the Town Planning Scheme Mechanism in Ahmedabad, India, rely on this principle, which finances up to 40 percent of investments (Ballaney 2010).

Taxing land added value is also a standard technique practiced in many countries under various formulas. The tax on land added value, a *betterment levy* (also known as *special assessment* in the United States, or *contribución de valorización* in Latin America) can take many forms, depending on whether the tax is applied once or repeatedly. These taxes have a reputation of being complex to implement and collect, but the example of Colombia shows that they can eventually become both effective and well accepted (see box 5.12).

BOX 5.12

Colombia's Land Betterment Levy

A land added value tax, *contribución de valorización*, was introduced in Colombia in 1921 and converted into a levy in 1966. It is payable by owners of a property that has seen or will see a value gain from public works. The sole goal of this land betterment levy is to help finance new public infrastructure. Its calculation is based on three parameters: the cost to build a project, the value added to property attributable to the project, and the levy's affordability.

Levy calculations begin by defining the area in which infrastructure will have a positive effect. The next step involves assessing the increase in land value because of the completed works; the assessment uses a database of previous operations.

The National Board of Land Value Capture, under the Ministry of Public Works, determines the amount to be levied, which is then collected by the public entity carrying out the work. The receipts are either invested directly to complete the work or invested in other facilities owned by the same contracting authority. The betterment levy may be collected for up to two years before a project is completed, and for up to five years thereafter, and may be collected once or several times. It applies to all owners—new or old. If the betterment levy payment is late, interest charges apply.

This betterment levy is generally considered a success. It has been relatively well accepted by landowners; late payments remain rare—a success in a country that generally resents taxation. The largest cities have shown the betterment levy as a viable instrument for financing urban development. Since 2000, cities with more than 300,000 inhabitants have significantly increased their use of the levy. It represents 20–30 percent of municipal revenues, sometimes even more; the yield depends on project quality. The betterment levy's success largely rests on its administrators' technical and ethical standards. Its legitimacy rests on a fair and reasonable distribution of the tax burden, good communication about the benefits of the investments, and the consultative and participatory procedures that underpin its implementation.

Source: Borrero Ochoa et al. 2011.

Risk and Regulation

The principle of financing through land sometimes arouses reluctance and concerns, according to two types of arguments. The first concerns the supposed inflationary and bullish character of land value capture, and the second concerns the antisocial character of mechanisms that ipso facto exclude the poor. These are legitimate concerns, but they appear unfounded.

Land price increases go hand in hand with the phenomenon of urban growth. Essentially, prices rise when demand is high, driven by growing populations and a vibrant local economy; inversely, prices drop in cities experiencing decline or decay, as is the case for industrial cities in developed countries. The coexistence of certain public policies and certain financing products has no doubt caused bubbles in some housing markets recently,⁶⁵ such as in the United States and Spain (see chapter 1, box 1.12, in this volume) or in Thailand (Renard 2008). But in basic, conventional situations—and excluding financing products that naturally create bubbles⁶⁶—structurally inadequate supply in relation to demand drives up prices. This situation clearly occurs in countries on the African continent. Maintaining the current situation—land scarcity—will certainly not contain upward price trends; only increasing land production sufficiently to meet demand for urban development will do so.

The poor's exclusion from the market, and the middle class's difficulty in accessing land in most countries, primarily result from shortages. These shortages benefit the upper classes, particularly elites who manage—with little money—to build portfolios of often high-profit rental properties in opaque markets.⁶⁷ Reversing this situation also requires increasing land production sufficiently to meet demand for urban development. Furthermore, regular and continuous production of land, controlled by urban land development procedures, makes it possible to use cross-subsidization between high- and low-end products, thereby lowering costs for socially beneficial operations to below-market prices.⁶⁸

An urban land development policy based on land value capture is not inherently dangerous; it does not increase land prices or reduce accessibility—rather, it increases supply. The difficulty in establishing such policies in Africa concerns local governance and related phenomena, including resistance to change and special interests.⁶⁹ However, land value capture techniques certainly carry some implementation risks.

The cyclical nature of markets is one risk. Local public budgets' overreliance on land-related receipts can be dangerous; it is always advisable to diversify sources of income (Peterson 2009). Large-scale land transfers may tip markets, as may occur with transportation infrastructure. A sharp decline in land values may have ripple effects, especially because bank loans generally use underlying mortgages as collateral. Problems may worsen if several market participants—local governments, land operators, land developers, implementing agencies,

and public-private partnerships—operate in the same market simultaneously. On the one hand, the market would require supervision by the central government or a regulatory body with a system to collect information on sales, prices, and mortgages. On the other hand, oversight agencies would need to monitor receipt records and their allocation in the local government's capital investment budget (Canuto and Liu 2010; Peterson and Kaganova 2010).

Another risk lies in corruption; here, the land sector proves particularly at risk at both national and local government levels.⁷⁰ Experiences in other countries, including China,⁷¹ show that land value monitors, a policy of public communication, and required written tenders are necessary to contain corruption risks in land transfers (Peterson 2007). A more widespread risk of petty corruption occurs with direct contributions made during land development or pooling procedures and with fiscal mechanisms such as taxes on gains. More generally, these land-based financing techniques have inherent risks. Their success—and these systems' legitimacy and, ultimately, their viability—depend on their implementation quality and integrity. Contrary to expectations, residents appreciate and even desire these systems, as long as the systems are professional, transparent, and well governed (Borrero Ochoa et al. 2011). The same can probably be said for all areas of urban management.

Increasing Resources and Commercial Activity by Leveraging Housing

As we noted previously,⁷² this volume does not aim to cover housing policy and finance, which are major subjects in their own right. In this section, we will address two of their aspects that have special relevance to the problem of financing local investment. For local governments, the housing sector has great economic potential. We examine next how property taxes and support for private developers and rental companies may maximize the economic effect of this sector.

Modernizing Property Taxes and Increasing Local Resources

Urban land or property taxes have existed for centuries. They represent a very large share of local government receipts in developed countries, even if their relative contribution has tended to decline. In the United States, property tax levies still account for about 70 percent of all local taxes (Tax Foundation 2004). Economic theory considers property taxes efficient; among all types of taxes—on consumption, income, and commercial activity—property taxes probably least deter economic growth (Raphaelson 2004; Dye and England 2009). In Sub-Saharan Africa, urban property taxes represent a small share of local

government receipts, even for the largest cities. Tax collection is generally inefficient in English-speaking countries (Kelly and Musunu 2000; Kelly 2000) and French-speaking Sub-Saharan African countries (Chambas, Brun, and Rota Graziosi 2007; Monkam 2010).

The reasons for these poor results vary by country and type of taxation system, but share a clearly identifiable explanation. Value assessment mechanisms are complex, too complicated to implement and update, and difficult to understand; corruption is widespread at different stages of the process; collection is expensive, and the tax is poorly understood and highly unpopular; and local governments remain reluctant to impose the tax and possess few means of enforcing it (Bahl and Martinez-Vazquez 2006).

Nonetheless, many reasons still favor the use of property taxes. Urban property tax is the quintessential local tax, because it applies only to fixed assets. It is the ultimate manifestation of fiscal autonomy and the best tool for financing urban development, because its potential tax base expands with a city's growth. Urban extensions produce new land assets that require investment, of course; under a property tax system, they broaden the tax base at the same time. Therefore, for most cities, property taxes constitute the only source of their own sustainable revenue that can keep pace with urban extensions. For these reasons at least, the use of property taxes seems desirable, even inevitable.

A movement toward renovating and expanding urban property taxes also seems necessary. A number of countries have undertaken reforms for this purpose or are thinking about them. Reducing implementation costs will certainly require alternatives to cadastres to simplify procedures and assessment criteria. These guidelines, together with good communication about the principles governing the tax and uses of funds, will restore the property tax's public image. The link between property taxes and tenure security may prove a decisive factor (see box 5.13).

Introducing a renovated and modernized property tax requires significant efforts for preparation and implementation and a high level of local and national government involvement. Because current collection rates are low, such renovations have potential for correspondingly high gains for large cities. These cities may also derive benefits beyond the financial ones. Property taxes may genuinely help transform governance if their renewal goes hand in hand with land law and policy instrument reform, such as the pooling described previously.

Support for Promoting Private Sector Development and Rentals

The origin of the housing deficit arises, for the most part, in land production dysfunctions. However, once the available-land bottleneck is removed, property development remains subject to a number of shortcomings, which governments normally address with housing policies. In Chapter 1 we discussed the likely

BOX 5.13**A Simplified Land Register for Tax Purposes**

In the early 1990s, various countries tested simplified land registers for tax purposes—for example, in Benin, where major cities gradually adopted them. This type of register is based on digital parcel mapping, an addressing system, and a computerized urban database drawn from field surveys. Cities using such registers have found them particularly effective in mobilizing resources, both by broadening the tax base and by improving collections. In Benin, together with the streamlining of tax procedures, the register has tripled local tax receipts in Cotonou, Parakou, and Porto Novo.

In addition to greatly improving the performance of the property tax system, such tools help clarify appropriation of urban spaces through the database and mapping. Moreover, residents are aware that—even without a formal title of occupation—registration and payment of an annual property tax levy results in *ipso facto* ownership. A change in law suffices, without having to incur additional administrative costs; tax receipts may constitute a presumption of ownership, valid in the absence of evidence to the contrary.

The setup costs for this type of tool are disproportionate compared with the cost of an authentic cadastral record; simplified land registers perform a greater number of services, in practice, but their cost remains high and probably out of reach of smaller communities. Updates present one problem; they must be continuous and seamless, or the register loses its legitimacy in the eyes of residents. Therefore, updating suggests recurring costs, which are normally covered by the additional receipts the register helps collect. Updating failures usually occur because of a lack of consistency and continuity in the effort, as happens with municipal team changes, for example.

Sources: Chambas, Brun, and Rota Graziosi 2007; Comby 2007.

effects of housing policy guidelines on the economy and on local government finances.⁷³

On the African continent, few countries have had the means to implement a real housing policy sustainable over time. This situation especially shows up in large imbalances in the structure of housing production; the informal sector ensures most production, whereas the formal sector concentrates on the very small luxury segment. One of the most striking features of housing stock is the relatively large importance of private sector rentals (UN-HABITAT 2003). This importance appears largely underestimated by officials and by those donors chiefly preoccupied with homeownership.⁷⁴

To be effective, housing policy must address all market and societal segments. Subsidized construction projects that build housing only for the poor, for example, are doomed to failure if they include no provision for the middle

classes, because the middle classes are forced to go down-market, crowding out the poor from what they perceive as “their” housing. Similarly, housing policies and financing strategies that only address homeownership—as a majority of them do—have a very limited effect because they address only a fraction of housing stocks.⁷⁵

Local governments have an interest in promoting private sector rental housing by improving its production means and operating conditions; in particular, governments can establish laws that govern relations between landlords and tenants, defining rights and duties. In general, local governments must organize a transfer from the informal to the formal sector. We can expect many and varied benefits to follow: (1) rental housing fills an essential social function for virtually all income strata, from the lowest to the highest (such as expatriate housing); (2) rentals generate high revenues in proportion to their share of housing stock, and these revenues are usually not subject to withholding taxes; (3) private rental housing is central to construction, often a city’s chief business activity and leading job producer; and (4) rentals are an excellent investment vehicle for domestic savings and potentially for external savings from migrant workers.

Property tax yields are one of the most immediate direct effects that local governments may expect from a strategy that supports housing and its transition to the formal sector. This case is especially true for rental housing, because the lessor is solvent by definition (see, for example, chapter 2, box 2.15, in this volume). This step completes the mechanism described previously in the sections on land policies; tools for urban land production; financing through land development; setting up of urban taxes; and increasing of local governments’ own, internally generated resources.

With formal sector land production ensured, relatively inexpensive systems can provide support for housing and construction. This process involves establishing incentives and support for the private sector and promoting the development of financing products tailored for property developers and operators. Here again, a secure, formal, and recognized legal status for land proves important for investors in rental properties, particularly when hypothecation finances the latter (Vance 2004).

Depending on the country, city, and market, private sector operators and property developers will be very small businesses and may use meso-financing (see chapter 4, box 4.11, in this volume); or they may be small and medium-size enterprises (Gardner 2010) that will use commercial banks or specific credit institutions that can provide suitable financing; partial guarantees; and support, coaching, and training (see box 5.14).

In the largest markets, property developers and builders form more substantial, medium-size companies. Because these companies do not spontaneously enter the affordable housing market, local officials may encourage them to do so

BOX 5.14**Support for Builders and Housing: South Africa's NURCHA**

South Africa's National Urban Reconstruction and Housing Agency (NURCHA) was originally created to provide financing, guarantees, and support for residential builders and property managers lacking access to conventional financing. It was set up in 1995 through a \$5 million donation from a charitable fund, the Soros Economic Development Fund (SEDF), and a \$5 million endowment from the South African government through the National Department of Human Settlements. The SEDF then granted another \$50 million to NURCHA to guarantee bank loans.

NURCHA has developed several types of financial instruments. It began with bank loan guarantees for small builders investing in affordable housing, sharing risk with commercial banks. Until 1999, NURCHA's guarantees covered 60 to 70 percent of the loan principal, providing good default-risk protection to commercial banks. In 1999, South Africa's currency was devalued, and interest rates soared. Some builders were unable to make their loan payments; defaults multiplied, and banks withdrew from the affordable housing market.

At this point, NURCHA moved to granting direct loans using its own capital. Commercial banks recognized NURCHA's skill and loan portfolio performance and offered refinancing. To manage its increasing loan commitments, NURCHA delegated the loans' management to intermediaries responsible for credit quality control, regulatory compliance, and disbursements. To ensure that intermediaries would monitor its lending programs, NURCHA required them to invest their own capital alongside NURCHA. This requirement freed NURCHA to focus on structuring financial products, analyzing borrowers, and supporting builders in other ways.

After a period of diversification into savings products, in 2004 NURCHA finally focused on its core business of affordable housing, expanding this to include community infrastructure, schools, clinics, and other facilities. NURCHA continues to receive donations and subventions, but has expanded its sources of refinancing; now it raises funds from commercial banks, investment companies, and private sector subsidiaries of international donors. Since its inception, NURCHA has backed the financing of 250,000 housing units and more than 250 infrastructure and community-facility projects.

Source: World Economic Forum 2006.

with financial or tax incentives. In other words, in principle, a process of interaction between public policy and the private sector may apply in all cases. Local governments must adapt several elements—incentive mechanisms, financial tools, oversight systems, and possibly contracting guidelines—to a market's size, its level of development, and its housing-related companies' size and structure. Such actions may be implemented under a national program (see box 5.15) or

BOX 5.15**Joining Housing-Land Development and Public-Private Partnership in Morocco**

Morocco has established a housing policy that articulates the roles of the land development industry and private property developers. The policy is based on the relatively long slum redevelopment experience of a specialized developer, the Agence National de Lutte Contre l'Habitat Insalubre (National Agency to Combat Substandard Housing, or ANHI). Despite occasional past involvement in construction, ANHI specializes in land and property development operations, in which it has proven expertise in cross-subsidization. This expertise allows the agency to produce improved, very-low-priced plots of titled land for controlled, self-built affordable housing. In 2004, when this system began to seize up (primarily because of public land scarcity) and it appeared that ANHI could no longer meet demand, the central government merged various operators into a holding company, the Holding Al Omran (HAO). This merger brought together ANHI with two other public companies, and in 2007, seven additional land development corporations in the region joined.

Notably, HAO implements the “Cities without Slums” program, which covers 83 cities and 325,000 households in nearly 1,000 slums. The program incorporates and extends ANHI's missions on a larger scale, dealing with slums and substandard housing through conventional redevelopment and resettlement operations, together with increased social support. HAO also implements large-scale housing construction projects using private sector property developers, especially in large cities. In this context, HAO acts as a land operator and land developer, selling the improved lots to property developers. These lots are sold at various prices, depending on the local market and targeted housing segments. Here we find the cross-subsidization concept, because part of the available land is reserved for affordable and collective housing and sold at below-market prices to property developers. These developers must contractually commit to a minimum price for the housing produced; the price includes a subsidy related to the land price and social-housing tax breaks.

Initial estimates for this program put the total public investment required at more than \$3 billion. The central government finances about one-third of this amount through a specific facility, the Fonds de Solidarité de l'Habitat (Solidarity Fund for Housing) funded by a national levy on cement sales. Donors provide most of the remaining funding; the European Union provides subventions, and the World Bank, European Investment Bank (EIB), and Agence Française de Développement (AFD) supply variably subsidized loans.

Sources: AFD 2003, 2004, 2008; World Bank 2005, 2006.

by a local government or group of governments pooling resources. In all cases, the public steering entity should have the proper expertise and powers; private sector abuses sanction an owner's shortcomings.

A Special Initiative for Fragile Cities⁷⁶

Although some Sub-Saharan African countries are at different stages of emerging from crises, others struggle with fragile situations—30–50 percent remains classified as such, depending on the criteria used. About half of all Sub-Saharan Africans live in these fragile countries; a two-tiered Africa appears possible.

Donors' responses to fragile situations often center around budget support accompanied by analyses, technical assistance, and capacity building (World Bank–AfDB 2011). The United Nations Conference on Trade and Development (UNCTAD) advocated a new generation of international support mechanisms tailored to the least developed countries (UNCTAD 2010).⁷⁷ Some authors recommend new modalities, such as public independent services authorities to ensure effective aid flows in targeted countries or territories (Bold, Collier, and Zeitlin 2009).

In previous chapters, we discussed the situation of cities in fragile countries and territories; these cities accumulate obstacles, sinking into a downward spiral over years or even decades, and often facing the twin traps of poverty and financing. These local governments deserve the title *fragile cities*: we do not see how they can actually escape these situations without external aid. With populations counted in the several millions, some of these fragile cities are larger than some of the countries benefiting from specific aid programs.⁷⁸

Reducing these cities' accumulated backlogs and deficits, positioning them on development paths, and establishing sustainable financing systems emerge as nearly unachievable challenges. All indications suggest that these challenges will remain unmet without specific support programs. In the present state of national contexts and aid architecture, no specialized tool exists to help these local governments gradually return to the path of controlled growth. Therefore, we call for the creation of a "Special Initiative for Fragile Cities."

Given the scale of the needs, such an initiative should mobilize many national and international stakeholders committed to the long term. For example, the initiative could take the form of a public-private partnership between, on the one side, commercial companies working in water, electricity, solid waste management, transportation, and other sectors and, on the other side, donors, regional development banks, large philanthropic foundations (as we have seen, some are already moderately engaged with urban issues), sovereign countries, and rich cities in the developed world, working individually and through their aid organizations.

Involving Africa's sovereign wealth funds would certainly prove a major asset for this initiative. We have seen that these funds have about \$100 billion in accumulated capital;⁷⁹ allocating even a portion of their annual gains would provide a significant sum. Because exploitation of Africa's underground resources finances these funds, it seems only proper to partially reinvest the funds in improving African urban and economic productivity. Rich partner cities in the developed world could focus on multiyear programs aimed at bolstering institutions, which is an area where advanced cities have credibility and expertise. They already have non-negligible commitments to institution building. However, given that major cities in the developed world have wealth equal to or exceeding that of many sovereign countries, it seems legitimate to ask whether their solidarity funding for poorer cities could not be larger.

This initiative does not necessarily require massive investments at first, because the absorption capacity of fragile cities remains relatively low. The initiative does not aim to transfer all of its funds to beneficiary cities as grants. More precisely, its objective would be to ready local governments for improving their own management and resources, to obtain resources locally, to promote local private sector partnerships for commercial services and revenue-generating capital investments, and to establish means to finance a city's growth through land development.

The initiative would aim to (1) support local governments financially by providing subventions, in particular to hybridize with conventional financing and output-based aid and also—principally, in some cases—to provide loan guarantees; (2) help the largest local governments set up next-generation local investment funds and land pooling, land management, and development tools; and (3) help central governments create next-generation investment funds and funding facilities or modernize existing investment funds. A financial-engineering fund integrated with the initiative could ensure the two latter actions. The special initiative for fragile cities could partially follow a suitable *fund of funds* model, exemplified by JESSICA in the European Union (see box 5.16). Pan-African institutions (such as the African Union) and financial institutions (such as the African Development Bank, regional development banks, and other lenders) could also follow this model, adapting it to African cities.

A fragile city's recovery will involve emergency infrastructure and basic services programs. These programs will require that donors increase their efforts for these localities. The programs should also offer an opportunity for next-generation public-private partnerships, engaging local operators in particular. As we have noted in different parts of this volume, local operators may provide effective basic services, land development, and construction.⁸⁰

We stress that such programs could align with existing social initiatives. Various central governments have begun these initiatives under the threat of

BOX 5.16**JESSICA: Europe's Fund of Funds**

The Joint European Support for Sustainable Investment in City Areas (JESSICA) is a fund established in 2005 to invest in urban development and revitalization programs for rundown neighborhoods. JESSICA is a joint initiative between the European Commission, the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB), conducted with support from the European Regional Development Fund (ERDF). The ERDF is a European Union structural fund that promotes economic and social cohesion by correcting regional imbalances.

JESSICA is a financial instrument serving urban development in a number of countries, which implement its loans and subventions. The fund encourages local officials to place some of the aid received from the ERDF into renewable mechanisms, such as local urban development funds, rather than using the funds as one-expenditure subventions, as long as projects meet certain criteria and can contribute to an integral, sustainable, urban development plan. Thus augmented, local urban development funds may invest in public-private partnerships and equity, serve as collateral, or make loans themselves.

Local urban development funds enhanced by the ERDF, set up with JESSICA's support, are well positioned to obtain financing from partner or external banks. Lenders look favorably on technically well-prepared funding applications in this institutional environment. In fact, JESSICA has an advice and expertise function that helps implement urban development funds; study the feasibility of integral urban development projects; and make institutional arrangements with other potential investors, such as pension funds, real estate funds, and so on.

Urban development funds set up through JESSICA include the Saxony Urban Development Fund (SUDF) in Germany, the English Cities Fund (ECF) in Great Britain, and the Regeneration Investment Fund for Wales (RIFW).

Sources: European Union, EIB, CEB.

rising precarity, as their poor struggle with external factors such as higher food prices. Social safety nets designed to support crisis-affected populations often include *workfare* programs in conjunction with other solutions, such as conditional or unconditional money or food transfers (Ravallion 2009; Wodon and Zaman 2009). Experience shows that labor-intensive work may meet three key objectives: directing assistance to residents, supporting economic activity, and improving the physical and health situations of disadvantaged neighborhoods (see box 5.17).

BOX 5.17**Highly Labor-Intensive Work and Implementing Agencies**

Over the past two or three decades, donors involved in urban areas have supported the creation of some public-works employment agencies to promote highly labor-intensive work. In Africa, these entities, collectively known as AGETIP (Agence d'Exécution des Travaux d'Intérêt Public contre le sous-emploi) have been established in 16 countries: Burundi, Djibouti, Madagascar, and Rwanda in Eastern Africa; Benin, Burkina Faso, Cape Verde, The Gambia, Guinea, Guinea-Bissau, Mali, Mauritania, Niger, Senegal, and Togo in Western Africa; and the Central African Republic in Central Africa.

Highly labor-intensive projects execute urban roads, drainage structures, public spaces, and simple public buildings. An AGETIP is responsible for identifying and selecting subprojects. It then runs the subprojects as a delegated owner, meaning that the agency assumes full responsibility for a project, from requesting study tenders through acceptance of completed works.

Ex post evaluations of this system, conducted in Africa and elsewhere (such as the West Bank and Gaza and the Pacific countries), have demonstrated its social and economic effectiveness through job creation. AGETIPs' actions have a generally positive effect, particularly in establishing or strengthening networks of small public-works and construction companies and small design offices. These companies' activities are facilitated by the transparency and speed of the bidding process and by fast payment terms. In most cases, AGETIPs provide business development and staff training support alongside work programs.

Like any delegated-ownership entity, AGETIPs have the potential to bypass municipal authorities. Some AGETIPs have been criticized for this reason, others have failed in their duties because of a lack of professionalism, and still others may be considered real successes. Apart from the AGETIP issue, highly labor-intensive work projects have indisputably supported economic activity and employment where they have had sufficient time for execution.

Sources: Breton and Foeth 2005; Diou, Henry, and Deme 2007.

By Way of Conclusion

If the paradigm shifts invoked at the beginning of this chapter can occur, the prospects do not seem unfavorable for urban growth on the African continent, either from financial or technical perspectives.

From a financial standpoint, urbanization will certainly require greater local capital investments. However, these investments are not out of proportion with the growing amounts of local savings, migrant remittances, and—more

generally—the volume that Africa's economies will produce in decades to come. After all, in Sub-Saharan African cities outside South Africa, our estimate of the minimum adequate investment needed for 2010 to 2030 amounts to only about \$40 per year per urban inhabitant. It is not unrealistic to think that the mechanics of growth itself should not generate much of the funds required. From a technical point of view, the necessary methods and operational tools have long existed and have been used successfully in other parts of the world. Absent particular physical limitations related to the environment or land availability, the African continent faces no theoretical or practical impossibility for a sustained pace of urbanization.

However, for many countries, the paradigm shifts will occur only through significant structural reforms and changes in sectoral policies. These reforms and changes will require strong determination on the part of central governments. Skeptics may readily doubt central governments' ability to reform urban management and financing mechanisms, even in an emergency. Indeed, inertia, misunderstanding of the issues, resistance to change, and capture by the elites seem to have prevailed in the urban sector for decades. That said, during the 2008 economic crisis, African societies and economies showed resilience and a remarkable ability to adapt. The rising middle class, a new generation of technicians and decision makers, the emergence of new aspirations, and the general strengthening of citizenship movements in urban societies are the most visible changes under way in most African societies and economies. These changes suggest that this moment—unlike the past—is conducive to successful reform of the urban sector's institutional environment.

In this context, how donors commit themselves could prove crucial. On the one hand, donor commitments for local investment and territorial governments remain weak, for the reasons we have given in this volume. On the other hand, we should question the nature of these commitments and their geographic targets. If we consider guidelines favoring endogenous capital-investment financing solutions justifiable for local governments, then donors should direct most of their efforts toward reform and structural changes. Donor support for the development of tools and funding mechanisms would become a priority intervention strategy. This strategy would not prevent donors from making direct commitments in subsovereign or sovereign loans, but should shift the architecture of these commitments toward building the institutional capacity of local authorities and bolstering their financial independence—factors critical to the construction of sustainable solutions.

The group of fragile cities, large in number and population burden, remains the most neglected, for reasons intrinsic to the mechanisms of development assistance. These cities need help on all fronts: investment in basic services, support for financial management and governance, institutional support, and

development of operators. In the present state of affairs, no mechanism exists that can provide them with such support in a coordinated and monitored fashion. The economic and social situation of these urban ensembles transcends the single issue of the city. The level of underemployment among youth, growing malnutrition amid rising agricultural prices, violence and the difficulties of everyday life, and general increases in inequality are all the seeds of difficulties that may affect the central governments themselves. This book argues, as just noted, for the creation of a special multigroup initiative among local governments; development banks, especially within Africa, should necessarily play a central role in this effort (see previous section, “A Special Initiative for Fragile Cities”).

Finally, we must signal Africa’s continentwide need for two necessary forms of action that do not require strong financial commitments, but that guide development assistance toward useful and preferred solutions.

The first form of action concerns institutional engineering. Nearly everywhere, local and national governments require new financial tools and specialized operators, or modernization of existing ones. This requirement creates a strong demand for consulting, market research, feasibility and business plans, and, finally, engineering specialists for installation and start-up of adopted solutions. Few local or central governments have the resources, skills, and necessary perspective to satisfy this demand. This situation justifies the creation of a revolving institutional engineering fund. Such a fund could be replenished by repayments from a successfully installed institutional entity, for example.

The second form of action concerns training local government employees. A small group of African countries have established national training centers; there are also relatively large numbers of players active in the training field.⁸¹ Their courses vary widely in themes, content, and the countries concerned. They are delivered without coordination or overview—either in terms of content, which may be the same as for other global regions and therefore not always appropriate to the African context, or in terms of the countries targeted.

Programs of this type are now developing videoconferencing and distance learning, under the same limitations. A priority in this area should be training that targets the staff of local governments, focused especially on the cultures of borrowing and investment, management, and governance. Such an initiative would unite current efforts, identify gaps, coordinate programs, and adapt these programs to contexts and needs by region and locality type. Moreover, the probable scale of need would likely justify the creation of two or three regional centers across the continent, in conjunction with existing institutions and as a relay or complement to remote programs.

Notes

1. See chapter 2, section titled "Still-Underestimated Challenges and Exploitable Opportunities," in this volume.
2. See chapter 2, section titled "Africa(s) on the Move," in this volume.
3. See chapter 1, section titled "Different Ways of Financing Local Investment," in this volume.
4. See chapter 3, sections titled "A Perspective on Decentralization" and "Local Governments' Institutional Landscape," in this volume.
5. In Europe, local governments make 65 percent of public capital investments versus less than 5 percent in Sub-Saharan Africa.
6. See chapter 1, section titled "The Importance of Financial Analysis," in this volume.
7. See chapter 1, section titled "Specific Financing Products and Techniques," in this volume.
8. See chapter 3, section titled "A Perspective on Decentralization," in this volume.
9. See chapter 4, section titled "Financial Systems and Investment Financing," in this volume.
10. See chapter 4, section titled "Financial Systems and Investment Financing," in this volume.
11. See chapter 4, section titled "Financial Systems and Investment Financing," in this volume.
12. See chapter 1, section titled "Specific Financing Products and Techniques," in this volume.
13. On the concept of local investment market, also see the case studies in the appendix.
14. See chapter 1, section titled "Specific Financing Products and Techniques," in this volume.
15. See chapter 1, section titled "Governance and the Contractual Approach," in this volume.
16. See chapter 4, section titled "Financing Tools and Mechanisms for Local Capital Investments" and case studies in the appendix to this volume.
17. See chapter 1, section titled "The Economy and Financing of Public Sector Local Investment," in this volume.
18. See chapter 1, section titled "The Economy and Financing of Public Sector Local Investment," in this volume.
19. For example, note the privatization of the Urban Development Bank of Nigeria. See the case study in the appendix.
20. See chapter 1, section titled "Some Lessons from the 2008 Financial Crisis," in this volume.
21. This situation occurred in a notorious example from Turkey; in 2003, 40 percent of the İller Bankası loan portfolio consisted of unrecoverable debts (Stoquart 2004).
22. This is the case for CPSCS (Caisse de Prêts et de Soutien des Collectivités Locales, or Loan and Support Fund for Local Authorities) in Tunisia. See the case study in the appendix.
23. The potential market for revenue-generating facilities, such as marketplaces or bus stations, often seems overestimated in SFI business plans. Many of these facilities experience constraints and management difficulties that hamper their profitability.

and borrowing ability (see chapter 4, box 4.8, in this volume.). It is not unusual for market managers to finance operations directly through retailers (Paulais and Wilhelm 2000; Impact Consultants 2009).

24. This is the case for INCA (Infrastructure Finance Corporation Limited); see the case study, titled “South Africa and DBSA, INCA, and Direct Bond Issues,” in the appendix.
25. See the case studies in the appendix to this volume.
26. See chapter 1, section titled “Some Lessons from the 2008 Financial Crisis,” in this volume.
27. This paragraph is based on Gama (2010).
28. See chapter 1, section titled “Different Ways of Financing Local Investment,” in this volume.
29. Those bonds are not to be confused with *structured products* that are combinations of options and derivatives; structured products are based on off-market parameters and have prices determined by mathematical models. Before the 2008 crisis, investment banks sold these extremely opaque products to European local governments. Many of these governments are now in trouble because of these products that proved risky.
30. The intercept transfer mechanism can significantly improve funding terms; it is a form of credit enhancement. But it may be seen as a state guarantee and, thus, it may have some adverse effects. See chapter 1, section titled “Specific Financing Products and Techniques,” in this volume.
31. See chapter 1, section titled “The Importance of Financial Analysis” and box 1.9, in this volume.
32. A *sinking fund* for debt service. See following section titled “Structured-Finance Mechanisms.”
33. This section is based on Gama (2010).
34. Investment-grade debt is rated BBB or higher. See chapter 1, section titled “Some Lessons from the 2008 Financial Crisis,” in this volume.
35. This means respecting a sacrosanct rule on borrowing. See chapter 1, section titled “Different Ways of Financing Local Investment,” in this volume.
36. For example, some African laws limit borrowing to revenue-generating investments only.
37. This section is based on Gama (2010).
38. See chapter 1, section titled “Specific Financing Products and Techniques,” in this volume.
39. See chapter 1, section titled “Specific Financing Products and Techniques,” in this volume.
40. See also chapter 4, section titled “Microfinance and the Missing Link of Meso-Finance,” in this volume.
41. See chapter 4, section titled “Financial Systems and Investment Financing,” in this volume.
42. This is true in countries such as Ghana, where the 2009 short-term interbank market rate exceeded 20 percent (Conjuguer 2009).
43. See chapter 4, section titled “Financial Systems and Investment Financing,” in this volume.

44. See case studies in the appendix to this volume.
45. See case studies in the appendix to this volume.
46. See case studies in the appendix to this volume.
47. See chapter 4, section titled "Financing Tools and Mechanisms for Local Capital Investments," in this volume.
48. See section titled "Encouraging Endogenous Financing," earlier in this chapter.
49. Luxury operations escape these constraints, because they can bear the extra costs of refinancing. Furthermore, in Africa, they often are entirely prefinanced by buyers.
50. The exceptions—local-currency loans and direct subsovereign loans—remain rare and have their own drawbacks (see chapter 4, box 4.3 in this volume.).
51. See chapter 1, section titled "Defining the Concept of Local Investment," in this volume.
52. See section titled "Bolstering Investment Financing Tools" and box 5.2, in this chapter.
53. The text refers to local governments, but most of the provisions are also suitable for public or parapublic companies working in services and local investment sectors that are likely to borrow.
54. The concept of moral hazard comes from Adam Smith. It refers to the adverse effects that may occur between two agents in certain risk situations. In this case, it refers to the fact that even private sector lenders will not do their job—examine loan applications diligently—and will take unnecessary risks because they believe the central government implicitly guarantees the loan and will pay if the local government defaults.
55. This section and the next are based on Painter (2009, 2010).
56. That is, the excess of tangible operating revenues over tangible operating expenditures.
57. The Global Credit Rating (GCR) is headquartered in South Africa.
58. See chapter 1, section titled "Selecting a Local Investment and a Strategic Framework," in this volume.
59. See chapter 1, section titled "Different Ways of Financing Local Investment," in this volume.
60. See chapter 2, sections titled "The Land Access Question" and "Land Development and Housing," and chapter 3, section titled "The Challenge of Managing Basic Services," in this volume.
61. See chapter 2, section titled "The Land Access Question," in this volume.
62. A pilot project, Mbangá-Japoma in Douala, Cameroon, may be considered a test of the concept. However, the project seems to have been managed more as a land-development operation than as a simple readjustment.
63. See previous section titled "Toward a New Generation of Local Investment Funds," in this chapter.
64. See chapter 1, section titled "Different Ways of Financing Local Investment," in this volume.
65. See chapter 1, section titled "Some Lessons from the 2008 Financial Crisis," in this volume.

66. See chapter 1, section titled “Some Lessons from the 2008 Financial Crisis,” in this volume.
67. See chapter 2, sections titled “The Land Access Question” and “Land Development and Housing,” in this volume.
68. See chapter 1, section titled “Specific Financing Products and Techniques” and box 1.3, in this volume.
69. See chapter 3, section titled “Local-Level Governance and Implementation Capacity,” in this volume.
70. See chapter 3, section titled “Local-Level Governance and Implementation Capacity,” in this volume.
71. Many land-related corruption cases have come to light in China. In 2011, the former mayor of Shenzhen was sentenced to death for taking bribes worth the equivalent of \$5 million. Following this incident, officials imposed the use of public tenders for lease transfers.
72. See chapter 1, section titled “Some Lessons from the 2008 Financial Crisis,” in this volume.
73. See chapter 1, section titled “Some Lessons from the 2008 Financial Crisis,” in this volume.
74. See chapter 2, section titled “Land Development and Housing,” in this volume.
75. See chapter 2, section titled “Land Development and Housing,” in this volume.
76. This section draws on Paulais and Pigey (2009).
77. UNCTAD does not use the fragile situations concept; it uses *least developed countries*. The two concepts overlap widely. According to UNCTAD, 33 African countries count among the least developed.
78. See chapter 3, section titled “Fragile Situations, Fragile Cities,” in this volume.
79. See chapter 4, section titled “Sovereign Wealth Funds and Investment Funds,” in this volume.
80. See chapter 3, sections titled “Fragile Situations, Fragile Cities” and “The Challenge of Managing Basic Services,” in this volume. Also see section titled “Increasing Resources and Commercial Activity by Leveraging Housing,” in this chapter.
81. Among the most noteworthy players in the training field are WBI (World Bank Institute); CEFEB (Centre d’Études Financières, Économiques et Bancaires)/AFD; UNITAR (United Nations Institute for Training and Research); RTI (RTI International)/USAID; AECID (Agencia Española de Cooperación Internacional para el Desarrollo); INWENT (Internationale Weiterbildung und Entwicklung gGmbH)/GIZ (Deutsche Gesellschaft für Internationale Zusammenarbeit) (Nguema Minko 2010).

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Case Studies: Eight Countries Paired with Their Financing Tools

About This Selection of Cases

In chapter 4, we noted that, to date, most countries considering or applying local government financing mechanisms have opted for the specialized financial institution model. The African continent offers a variety of these financial institutions; although very diverse, many of these institutions resemble investment funds or investment agencies, offering very little to no financial services or lending. In some countries, two major financing models coexist: intermediated and not intermediated. In other countries, commercial banks have begun to take interest in the municipal credit market. Moreover, the situation is fluid; financial tools come into being, disappear, or go out of use at a rapid rate. In general, the analysis of each financing tool will not make sense unless we situate it within its national context or that country's degree of decentralization.

For these reasons, and because of large differences in municipal investment market size, we chose to focus the case studies on pairings: one country plus its financing tools. We also selected examples that emphasize the diversity of situations, drawing from the entire continent to broaden the sample base and find the most potentially informative cases.

The eight pairings include the following: (1) Cape Verde and commercial banks; (2) the Arab Republic of Egypt, the National Investment Bank (NIB), and land-based financing; (3) Ghana and the District Development Fund (DDF); (4) Morocco and the Fonds d'Équipement des Communes (Municipal Infrastructure Fund, or FEC); (5) Nigeria and the Urban Development Bank of Nigeria (UDBN); (6) Senegal and the Agence de Développement Municipal (Municipal Development Agency, or ADM); (7) South Africa, the Development Bank of Southern Africa (DBSA), and direct bond issues by Infrastructure Finance Corporation Limited (INCA); and (8) Tunisia and the Caisse de Prêts et de Soutien des Collectivités Locales (Loan and Support Fund for Local Authorities, or CPSCL).

The sample represents the diversity of national economic, demographic, cultural, and institutional conditions on the African continent. It offers a spectrum that runs from the smallest country to the largest. It also presents various levels of decentralization and practically all existing financing tool configurations.

We conducted the analyses of the Mediterranean Basin countries—Egypt, Morocco, and Tunisia—prior to or during the popular and eminently urban uprisings of 2010–11, collectively known as the Arab Spring. The implications of ongoing political changes for institutions, decentralization frameworks, local governments' autonomy, and their financing systems will probably vary between countries. In all events, such changes will surely take a long time to affect the architecture of local capital investment financing mechanisms. At the very least, these case studies attest to the diversity of the systems in North Africa; to some extent, the lessons drawn may shed light on future developments in these countries as well as in others.

In general, this analysis of eight countries paired with their financing tools may serve to identify some key factors in the challenge of modernizing municipal finance on the African continent. Following these case studies, we include a review of results and an attempt to characterize these factors.

1. Cape Verde and Commercial Banks

Table A.1 Cape Verde: Key Indicators

GDP per capita (2009)	\$3,064	Main cities	Inhabitants
HDI/rank (2010)	0.534/118	Praia	127,832
Total population (2009)	0.5 M	Mindelo	70,468
Urban population (2010)	0.2 M	Assomada	12,026
Urbanization rate (2010)	61%	Pedra Badejo	9,345
Urban growth rate (2005–10)	2.7%	São Filipe	8,125

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

Cape Verde's context for financing urbanization differs significantly from other countries in the region. It has the highest gross domestic product (GDP) per capita in Western Africa,¹ given its few cities; its democratic regime has engaged in a very deliberate decentralization policy. Since 1995, municipalities have been in charge of primary basic services, infrastructure financing, and urban land development. The municipalities have had difficulties fulfilling their new roles because of internal capacity and funding shortfalls. The combination of good governance and a banking industry structured with a comprehensive investment market—necessarily small because the country is small—prompted the central government and a donor to set up an unusual financing system, based on local commercial banks.

Context: Urbanization and Decentralization

Cape Verde, independent since 1975, is an archipelago of 10 islands spread over a 4,033-square-kilometer area. Nine islands are inhabited. The six windward Barlavento islands form the archipelago's North and the four leeward Sotavento islands form the South. This particular configuration weighs heavily on the cost of infrastructure in a country with fewer than 500,000 inhabitants in 2010. The country is very poor in natural and agricultural resources and is dependent on external aid.

In this small country, only three cities had populations greater than 10,000 inhabitants in 2000, but that number is expected to triple by 2020. However, Cape Verde's urbanization rate is much higher than the Western African average, nearly 40 percent in 2000. More than half of the population (53 percent) is concentrated in the municipalities of Praia (Santiago) and Mindelo (São Vicente); about one-quarter—130,000 inhabitants—lives in the capital, Praia. Urban investment needs are growing rapidly: between 1990 and 2010, Praia's population doubled while Mindelo's increased by 40 percent, and an urban

agglomeration emerged in Santa Maria, where the population increased from 1,500 to 18,000.

The population's dispersal over nine islands imposes major constraints on the financing and planning of infrastructure and basic services, such as energy, water, sanitation, and transportation. In particular, declining water resources and the gradual salinization of groundwater in coastal areas complicates the drinking water supply. That supply has shown very strong improvement since the 1980s; 80 percent of the population has sustainable access to water. However, the most vulnerable populations in urban areas remain underserved. Sanitation infrastructure—drainage, collection and waste treatment, and sewage treatment—clearly remains insufficient, even in the largest urban centers. Housing needs are considerable, in terms of quantity and quality. A strongly growing tourism sector—very important for the national economy—fuels strong demand for basic infrastructure.

Beyond a lack of funding, local governments' poor intervention capacity also appears to underpin infrastructure and services backlogs. Infrastructure figures as one of the five programs in the central government's current development strategy. It gives priority to basic services—water, sanitation, and energy. Implementation relies heavily on a legal and regulatory framework that allows the central government to partner with the private sector and municipalities.

Nationally and locally, an active democracy characterizes Cape Verde; the country has a long tradition of municipal government. Its first laws on local powers created local and municipal elections in 1989. The 1991 municipal elections began decentralization; this is endorsed by Cape Verde's 1992 Constitution, which recognizes "the existence and autonomy of local government and the democratic decentralization of public administration." In the 2002–05 National Development Plan, decentralization is a strategic area of social and economic development and democracy strengthening for the archipelago. The government elected in 2006 confirmed its intent to strengthen municipalities' powers.

A municipality is the only decentralized administrative level below the central government. Supported by successive governments, decentralization has adapted to the municipalities' archipelagic nature—the difficult links between islands and their diverse cultures and backgrounds. Decentralization has also adjusted to the municipalities' important role as economic and social engines. Following the last administrative redistricting in 2005, Cape Verde counts 22 municipalities. Nine are on the island of Santiago, the most populated island with 55 percent of the total population and home to the archipelago's capital and largest city, Praia. The Associação Nacional dos Municípios de Cabo Verde (National Association of Cape Verde Municipalities, or ANMCV), a public-service association established in 1995, defends local governments' interests and promotes experience sharing.

Most observers recognize the democratic character of Cape Verde's decentralization, with its territorial distribution of power; election of representatives; and redistribution of functions, duties, and areas of authority under the principle of subsidiarity. A 1995 law on municipalities' status transferred many powers to local governments, including sanitation, rural development, health, housing, ground transportation, education, social welfare, culture, sports, tourism, environment, trade, civil protection, employment, vocational training, the police, and municipal investments. Municipalities have incorporated the powers and apparatus for highly labor-intensive public works into their services, including sanitation works. Municipal services assign commercial licenses for trade and mass transportation, set rates and taxes on municipal services, issue building permits, and so on.

It is up to each municipality's council to develop its own municipal development plan and create sectoral or specialized committees, such as environmental commissions to support the national antidesertification effort. However, municipalities exercising their new powers have confronted three major difficulties: uncertainty over areas of authority shared with the central government, a relative lack of skills and capacity, and insufficient material and financial resources.

Decentralization's rapid introduction in the early 1990s probably led to the inherent lack of definition in shared areas of authority. Only a few municipalities have established their own territorial development plans; these plans remain unarticulated with national strategies. For example, responsibility for social-welfare facilities remains undefined; intermediate structures proliferate, and the central government's General Directorate for Social Welfare has no way to monitor or evaluate decentralization. A new legal status for municipalities should clarify their responsibilities in relation to those of the central governments. It should also define procedures for coordinating tasks between central and local administrations and between central services and municipal enterprises and define the functioning of municipal bodies.

Although significant, the funds that the central government allocates to municipalities have not kept pace with municipalities' extra responsibilities. The municipal shortage of skilled supervisors and qualified administrative personnel hampers development and capital investments strategies. Successive National Plans have aimed to build municipal capacities and implement economic development plans. Despite a lack of direct funding for urban studies—a problem for long-term urban planning—Cape Verde's municipalities are trying to acquire the skills needed to complete financing applications, conduct design studies, and monitor public works. Each municipality has a technical office, sometimes assisted by an intercity office. Several European bilateral cooperation agencies support these two offices. Cape Verde's European-funded Municipalities Modernization Plan trains municipal government workers in

administration, urban management, and local development; the aim is to create a municipal officials corps to enhance the professionalism of municipal services. Reforms to public management and local finance administration supplement a policy of strengthening municipal powers.

Financing Mechanisms

The central government endows Cape Verde's local governments with important responsibilities and financial resources. For instance, the 2007 city budget per capita was €276, compared with €7 per capita in Senegal. Local government resources come from municipalities' own resources, central government transfers, contracted infrastructure construction programs, and direct financing through donor projects.

Under their revised status, municipal councils may use some of the public receipts they collect for operating expenditures and capital investments. Most internal municipal resources come from land management, in the form of taxes and transfers. However, these taxes and transfers are uneven and depend on each island's economic development. In fact, the country's economic growth model increases geographic disparities between localities receiving tourism revenues, such as the Municipality of Sal, and localities dependent on central government transfers, such as Santo Antão.

Central government transfers account for 28 percent of municipal budgets, on average; these transfers transmit through a municipal finance fund. The holdings of the finance fund must exceed 7 percent of the previous fiscal year's direct and indirect tax receipts. Monies are distributed among the 22 municipalities in two allocations. The first allocation comes from a general municipal grant, partly fixed and partly calculated according to population and land area, and the second allocation comes from an intermunicipality solidarity fund, which redistributes resources to municipalities where local tax receipts fall below the national average. Central government transfers have steadily grown in recent years. They represent about 10 percent of national fiscal receipts, which have markedly increased since a value added tax (VAT) was introduced.

Financing by borrowing from commercial bank loans Before the decentralization laws, Cape Verdean local governments could finance their capital investments by borrowing from banks. In recent years, cities such as Praia, São Vicente, Tarrafal, Porto Novo, and Ribeira Grande have financed commercial facilities (such as cinemas and shopping centers) with bank loans, mainly from the Caixa Económica de Cabo Verde (CECV) and the Banco Comercial do Atlântico (BCA). These loans were relatively expensive and short term, with 13 to 14 percent interest rates and 5-year terms. Banks protected themselves from default risk through the usual means: mortgages, escrow accounts, and

intergovernmental transfer intercept agreements. To limit the risk of overindebtedness, in 1998 and 2005 municipal finance laws required that budgets record the annual debt service as a line item. The debt service cannot exceed 15 percent of current receipts or 25 percent of the previous year's investments. The central government must approve all loans. In practice, little municipal borrowing occurs for capital investments, particularly because of the high interest rates; rather, some municipalities regularly use short-term borrowing to maintain cash flow.

The banking sector consists of four commercial institutions, two of which share 75 percent of the market. Long the country's sole bank, BCA, which privatized in 2000, still maintains a market share of more than 50 percent. The newer and more dynamic CECV, Banco Interatlântico (BIA), and Banco Caboverdiano de Negócios (BCN) show growth and seek customer diversification. Cape Verde's banks receive a relatively high flow of migrant remittances. However, like many other banks in Africa, they suffer from relatively low deposits that remain short term.

The central government and a bilateral donor, the Agence Française de Développement (AFD), have developed a specific project to overcome funding scarcity, encourage banks to make more loan commitments, and generally strengthen the local market. In 2005, AFD set up a €5 million line of credit with subsidized interest rates for the three main commercial banks—BIA, BCA, and CECV. The line of credit aimed to provide up to 90 percent of the funds for capital investments under favorable terms: maximum interest rate of 8 percent and minimum five-year term. At the same time, the donor awarded a grant to ANMCV to set up a consultancy unit and technical assistance that would help municipalities prepare bank-loan applications.

This project had four primary objectives: (1) improve municipalities' bank financing conditions with better interest rates and maturities; (2) develop a new municipal credit market and diversify the financial services offered; (3) improve commercial banks' understanding of municipal risk; and (4) improve municipalities' technical, financial, and management capacities and expertise.

Situation Analysis

Despite a relatively slow ramp-up and a few disbursement delays, the credit line and assistance project successfully drove local-level changes. A new credit line will be set up. The municipalities want to expand their financial relationship with the banks, thereby launching new preliminary studies to plan future investments. The banks, in turn, have succeeded in developing a new market with little risk. A fourth bank that was ineligible at the project's outset, BCN, seeks to join the project when the credit line is renewed; a proposal is currently under review.

This approach may raise questions, primarily about the system's sustainability: Will banks truly manage to build a market, or will they simply enjoy a windfall through an inexpensive credit line, 1.30 percent below Euribor? The arrangement does give the banks a relatively large margin with low business risk and minimal requirements for their expertise, because the investment project applications are reviewed for approval elsewhere. The issue is whether the market will eventually grow sufficiently to permit all stakeholders—lenders and borrowers—to assume their responsibilities. Despite these questions, the mechanism established in Cape Verde is very simple and could serve as an example for many countries with small markets.

Note

1. In 2008, Cape Verde moved into the moderately developed country (MDC) group, while maintaining a high economic vulnerability index because of its low domestic production capacity and its economy's high dependence on official development assistance and cash remittances from its expatriates.

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2. The Arab Republic of Egypt, the National Investment Bank, and Land-Based Financing

Table A.2 Egypt: Key Indicators

GDP per capita (2009)	\$2,270	Main cities	Inhabitants (millions)
HDI/rank (2010)	0.620/101	Cairo (2009)	10,902
Total population (2009)	83 M	Alexandria (2010)	4,387
Urban population (2010)	40 M	Port Said (2006)	578
Urbanization rate (2010)	43%		
Urban growth rate (2005–10)	2.0%		

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

Egypt is a highly centralized country, with the second-largest economy by GDP and the second-largest stock market (after South Africa) on the African continent. Egypt's real rate of urbanization is much higher than official figures suggest, because Egyptian administrative definitions undercount it. Sustained central government investment and substantial foreign aid result in relatively strong levels of basic services coverage. Most services are highly subsidized and are not subject to cost recovery. A housing shortage and housing sector dysfunctions are major problems for Egyptian society, despite the central government's decades-long and costly policy of creating what it classifies as *new urban communities*—new towns that remain mostly or completely unoccupied. Local governments have limited areas of authority, and their autonomy remains extremely low, if not nil, especially in financial matters. Egypt's National Investment Bank (NIB) allocates subsidized loans only to one decentralized level—governorates. Meanwhile, the wholly separate new towns' financing system tries to leverage land-based financing. For all these reasons, Egypt is a unique case.

Context: Urbanization and Decentralization

Egypt's population of 80 million is growing at an average rate of 2 percent annually. Its demographic transition continues by consolidating its already rapid urbanization. This urbanization results in high demand for broadly accessible urban housing. However, where public housing exists—the result of decades of highly subsidized production—it is unsuitable for demand, as evidenced by 2 million vacant homes. More than 25 million people—60 percent of the total urban population—live in illegal or informal settlements, including more than 10 million residents in Cairo alone. For nearly 30 years, the central government has pursued a policy of creating new towns, dedicating much of its investment capacity to the task. We might measure this policy's success by the fact that

about 20 of these towns combined shelter fewer than 1 million inhabitants in total.

The percentage of residents with access to basic services is quite good in urban areas, thanks to 20 years of central government investments and foreign aid financing, especially American bilateral aid. However, cities' financing needs remain well above official estimates, which greatly underestimate the urbanization rate because of the Egyptian administrative definition of "urban." Fast-growing rural districts are very rarely reclassified as urban, because doing so would require the central government to furnish more services and to change electoral districting for the parliament. If an urban area were defined as having 10,000 inhabitants or more, Egypt's 2010 urbanization rate would have been 75 percent instead of 45 percent.

Act 43, passed in 1979, governs Egypt's local administrations; it was amended several times between 1981 and 2003. This law splits Egypt into five local government levels: (1) the *Muhafaza*, comprising 28 governorates, including three that are totally urban—Cairo, Port Said, and Suez, plus the city of Luxor; (2) the *Markaz*, urban agglomerations of cities and villages; (3) the *Medina* for cities; (4) the *Hayy* for districts; and (5) the *Qari* for villages. Each level consists of two councils: an appointed Local Executive Council (*Maglis al-tanfizi*), composed of representatives from various central-government ministries, and an elected Local Popular Council (*Maglis al-mahalla*).

In practice, local governments have little decision-making power, almost no financial autonomy, and no control over their budgets. The so-called decentralization is limited to administrative deconcentration: Egypt remains one of the most centralized countries in the world. The 1979 act strengthened the role and powers of the ministries through the governorates. In their constituencies, the governors are true relays for the head of state, exercising strong supervisory power and control over lower-level councils.

The Local Popular Councils (LPCs), theoretically in charge of preparing local budgets, proposals, and project oversight, play no more than an advisory role. In addition, the prime minister may step in as substitute for these councils and directly exercise their authority; the minister of local development may dissolve the councils if he or she deems it in the public interest. Various government agencies often thwart the LPC's role by intervening with unclear and tangled missions and mandates. Moreover, despite their considerable numbers of civil servants, localities suffer from a lack of qualified and experienced personnel.

Just as the local governments' powers are limited, so is their financial independence; 80 percent of their resources come from central government grants. Local governments can scarcely leverage local savings or set their own tax rates, even though national legislation considers taxes, fees, and borrowing as local funding sources. Often, local governments must transfer their low,

locally collected receipts² back to the national budget. Most local administrations' expenditures go to civil servant salaries (65 percent), operating costs, and maintenance. Local administrations have no real budgetary power, although the 1979 act states that they are responsible for preparing their own budgets. In fact, budget preparation takes place under Ministry of Finance guidelines, in five-year plans that set out sectors for capital investments; the governorates may choose only from among those sectors and transmit their directives to lower administrative levels.

The central government closely oversees local government finances, decision making, management, and services delivery; development planning follows top-down institutional decision lines. Discrepancies commonly arise between requested budgets and received loans, and there are inevitable delays affecting project implementation, procurement, and infrastructure and services quality. Local governments' revenues do not meet their urban investment needs.

Official statements, actions, and recent reforms give the impression that the central government intends a firmer commitment to effective decentralization. The Ministry of Finance recently granted governors the right to spend their capital budgets at will and the authority to transfer funds from one budget line item to another. The Ministry of Local Development's National Decentralization Strategy encourages the decentralization of education, social solidarity, and housing by simplifying budget planning; the strategy will also reinforce the LPC's role in planning and overseeing budgets and monitoring local government spending.

Financing Mechanisms

In Egypt, a single system budgets, plans, allocates, monitors, and funds urban and rural entities, except for the new towns. Similarly, the Ministry of Finance directs funds to both urban and rural areas through the governorates or sectoral agencies, such as the Social Fund for Development. Only the National Program for Slum Upgrading, launched in 1993, and the state-run Slum Development Fund specifically target urban areas.

The central government has primary responsibility for local capital investments. There are no credit institutions that local governments could use. No law allows commercial banks to offer municipal lending. Donors' loans to governorates are theoretically permitted, but discouraged; in 2006, Egypt's Cabinet of Ministers ultimately rejected a joint project between the World Bank and the governorate of Alexandria.

NIB, under the authority of the Ministry of Finance, remains the governorates' only source of investment credit. Although the governorates have a good loan repayment rate to NIB, officials in the central government widely perceive the governorates as financially irresponsible—a view that commercial

banks, investment banks, and public development banks appear to share. A proposal to create other borrowing facilities for the governorates has not been pursued.

NIB allocates housing and infrastructure funds to governorates based on the annual national budget. The loans are subsidized and may be very long term, up to 40 years. The Housing Authorities and the New Urban Communities Authority (NUCA) may also receive these loans for specific new-town projects. NIB thoroughly controls disbursements and may conduct inspections to verify project progress. Few details are available about local government loan defaults, but such defaults appear to be rare. In addition to performing lender due diligence on borrower spending and debt levels, NIB also audits the central government's capital investment projects.

Central government infrastructure and services financing Until recently, the central government considered housing and water, drainage, and sanitation infrastructure noncommercial social services; it assumed full responsibility for these services, believing that citizens should receive them at no cost. Therefore, the central government funded the cost of infrastructure and services without any cost-recovery or cross-subsidization mechanisms.

Whether for budget allocation, planning, construction, or implementation, each governorate comes under absolutely centralized authority through the ministries or their services. Even if a governor has legal administrative and financial authority over departments with decentralized budgets, he or she does not have the right to change the ministries' revenue or expenditure allocations or their policies. For technical matters, the department heads work under the authority of their oversight ministry; for administration, they work under the authority of the governorates. This dual subordination hampers coordination and sometimes creates conflicts that impede efficiency.

These difficulties join with problems arising from a fragmented system. For example, roadways involve several participants: (1) the Ministry of Transportation through the Roads and Bridges Authority and (2) the Ministry of Housing, Utilities and Urban Communities through the Central Reconstruction Agency, which is responsible for some major urban works, such as the Ring Road in Cairo and the Corniche Road in Alexandria. Each governorate's roads and bridges department oversees funding and maintenance of secondary roadways; the NUCA is responsible for roads and highways in new towns.

The Ministry of Housing, Utilities and Urban Communities dominates the drinking water and sanitation sectors. It is responsible for setting rates, preparing development strategies, and delivering programs and services through the National Organisation for Potable Water and Sanitary Drainage in all governorates,³ with the exception of Greater Cairo and Alexandria, which have their own specialized general authority. Since 2004, the water and sanitation sectors

have seen a number of reforms to promote cost recovery; these reforms have achieved only modest success.

Using private sector partners Governorates often set up contractual arrangements with private sector services companies and infrastructure providers. The best-known examples are solid waste collection and treatment contracts with companies from Italy (Azienda Municipale Ambient), Spain (Enser and Fomento de Construcciones y Contratas), and France (Onyx) by the governorates of Giza, Cairo, and Alexandria, respectively. These contracts resemble management mandates more than they do public-private partnerships (PPPs) in the fullest sense of the term; PPPs remain uncommon. Since 2005, the central government has tried to promote PPPs,⁴ chiefly within ministries rather than local governments. However, the housing sector provides exceptions; governorates (such as Ismailia in the 2000s) have granted land, and private property developers have financed sales price-protected housing construction.

Donor financing Donors offer financing almost exclusively for capital projects; their contributions must be submitted to departments within the Ministry of Finance, Ministry of Economic Development, or line ministries. Donors' requirements for financial security, combined with the Egyptian government services' need for control, have resulted in highly centralized management and control mechanisms. Even in the few cases in which donors have allocated funds directly to governorates, the Ministry of Economic Development's governorate departments have led accounting and financial oversight. As a result, local governments seldom take ownership of donor projects, even the technical assistance efforts.

Land added-value-based financing and infrastructure costs The Egyptian government owns and controls a vast public domain. Although most of the land is desert, some areas may go to urbanization. But the government has rarely tried to capture the added value that urban development generates for such lands. Local municipalities and governorates have little incentive to step in, because they remain unable to keep or reinvest land sales revenues. These revenues must be transferred to the central government budget or used to complete national public-housing programs. The central government has only recently experimented with financing through land, and solely in the new towns (see next section).

However, governorates have the right to set up municipal services and development investment funds (*sanadiq khidmat al-al-Mahalia*) outside of the national budget, capitalized with undeveloped land sales. In most cases, these local investment funds provide a share of self-financing for central government projects, particularly in the housing sector.

The new towns' exception The new towns' financing system remains institutionally separate from that of other Egyptian cities. It rests on a Ministry of Housing program administered by NUCA. Legislation allows NUCA to acquire

public land at no cost and to sell or transfer it, retaining all receipts to finance future developments in new urban communities. Such powers are not granted to local governments. However, revenues are fungible, meaning that they ultimately go into a general budget fund.

Until the mid-2000s, and as a means of attracting investors, the new towns' lands were allocated for free or at nominal prices that barely covered infrastructure costs. Beginning in 2005, the best parcels were sold at market prices to the highest bidder through sealed-bid auctions. In 2007, the media announced land sales to foreign investors in New Cairo and 6th of October City for billions of Egyptian pounds. These sales appear to be an isolated case in response to a one-time opportunity. However, in 2009, NUCA issued an LE 4.65 billion infrastructure bond (about \$840 million at the time); a second tranche at the same scale should follow. The Ministry of Finance endorsed these two bond issues, using land as collateral. These first structured finance transactions show a radical change in how Egypt designs its capital investment financing.

Situation Analysis

Decentralization reforms that the Egyptian government has claimed to desire have made little progress. Although some encouraging steps have been taken, the Egyptian administration clearly remains reluctant to admit citizen participation in local affairs. This reluctance seems evident from the administration's cancellation of the LPCs' right to question executive decisions and from its replacement of a 1964 law that governed nongovernmental organizations (NGOs). Many observers find that the new law reduces the NGOs' activities and room to maneuver.

The local investment-financing system also remains essentially unchanged. Yet against all odds, the quasi-parallel and independent new-towns system has offered new options, with bonds leveraging land values. This bond operation, likely the first of its kind on the African continent, positions Egypt as the leader in financial innovation for local investment.

Following the 2011 uprisings—which were mostly urban—and the revolution that felled the Mubarak regime and began transforming institutions, the future of the highly centralized administrative model remains an open question. Certainly, the issue of citizen representation in urban life arises as a major social issue, as does the entire local investment management and funding system.

Notes

2. For example, the governorate receives only 50 percent of taxes on imports, exports, and commercial products and 25 percent of property taxes. Towns and villages receive 75 percent of tax revenues on agricultural land in their constituencies. Even though they collect certain taxes on car rentals or shops, the towns and villages cannot reinvest the receipts.

3. In the late 1990s, a presidential decree ordered decentralized management of these services. Administratively and financially autonomous Economic Authorities for Water and Sanitation were created in seven governorates. Their budgets remain outside the national budget, and their revenues are no longer transferred to the central government. These authorities have branch offices in cities, but do not receive urban receipts to finance their operating and maintenance costs; the receipts are transferred to the governorate.
4. In 2006, a Central PPP Unit was established within the Ministry of Finance. Its mission is to study, apply, implement, and coordinate PPPs between ministries and the private sector.

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3. Ghana and the District Development Fund

Table A.3 Ghana: Key Indicators

GDP per capita (2009)	\$1,098	Main cities	Inhabitants (millions)
HDI/rank (2010)	0.467/130	Accra	1,659
Total population (2009)	24 M	Kumasi	1,170
Urban population (2010)	12 M	Sekondi-Takoradi	404
Urbanization rate (2010)	52%	Tamale	202
Urban growth rate (2005–10)	3.6%		

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

In Ghana, local institutions created under decentralization laws are responsible for local infrastructure and services, whose financing follows a deconcentration model rather than a devolution of central government powers. Local governments have relatively little autonomy; the central government retains decision-making and financing responsibilities.

The current financing system, based chiefly on transfers, has long underserved most Ghanaian cities. Ghana's system of decentralization and deconcentration, with its singular operating modalities, has led to the largest cities' relative impoverishment. The system provides cities with no incentive to raise their own resources, or prevents them from doing so by law. It is not clear whether recently introduced financing tools will lead to a sufficient rebalancing of resources.

Context: Urbanization and Decentralization

Ghana's decentralization policy has gradually developed its classifications, especially concerning its districts and the number of local communities created since the first 1998 law. Since 1992, the district has been the only decentralized entity. The process has not gone beyond political decentralization, despite provisions in the 1992 Constitution and legislation granting broad powers and responsibilities to elected district assemblies. In particular, the assemblies have almost no influence on decisions about their own needs for services and infrastructure.

Urbanization: Second-tier cities and urban sprawl Just under half of the 24 million Ghanaians live in urban areas, a relatively high rate of urbanization in this African subregion. The city network is quite dense, with continuous sprawl a marked feature of the largest cities. In recent decades, urban growth has led to a palpable increase in the number of cities and the emergence of large, second-tier urban centers. Large cities, such as Accra, Kumasi, and Sekondi-Takoradi, have expanded rapidly.

In 2006, about 60 percent of urban residents had access to drinking water, down significantly from 85 percent in 1990, especially in the larger cities. On

average, the sanitation access rate is 30 percent, with large disparities between neighborhoods. The electricity access rate is about 90 percent in Accra, but much lower in other cities, for example, 60 percent in Tamale.

Ghana spends 4.8 percent of its GDP on infrastructure investment and maintenance. The World Bank estimates that the country should dedicate 12 percent for this purpose. Financing large cities—a district-level responsibility—proves especially problematic.

A joint process of decentralization and deconcentration Deconcentrated administrative departments—that is, departments run by specialists from the central government—have combined with local government administrations. This is a specific feature of the Ghanaian system, one that postpones local governments' ability to perform their actual functions.

Each district, regardless of its type, has a deliberative assembly and an executive council—urban, zone, or town. These two government bodies use the same model of representation. In the assembly, 70 percent of the members are elected by direct universal suffrage; the other members include local parliamentary officials and state-appointed, nonvoting members who represent chiefdoms. The assembly elects its president and pays its own members. In the executive council, the central government appoints the council's chief executive, subject to the assembly's approval.

Geographically, districts fall within regional administrative divisions. Thus, Greater Accra consists of five districts. A regional coordinating council retains a rather ineffective role and few powers; it consists of elected members representing district assemblies and representatives from the central government.

Central government oversight: Deconcentration more than power sharing Legally, the district assemblies are responsible for 86 local functions. In practice, assemblies' decision-making autonomy is small. The Ministry of Local Government and Rural Development (MLGRD) has extensive oversight authority. It evaluates the assemblies, approves their decisions, and issues directives on services rates, local taxes, and financial management. It serves as an intermediary between the assemblies and donors. The Ministry of Finance and the National Development Planning Commission audit the assemblies' accounts and can review their budgets and development plans.

The poor delegation of power, the burden of the MLGRD's oversight, the central government's appointment of the chief executive, and the expertise held solely by ministry and public agency employees in the districts limit decentralization's political dimension. Central government departments and agencies hold onto authority and resources. Administrative and fiscal decentralization prove even less efficient, because central government transfers provide districts with most of their revenue.

Financing Mechanisms

In 1993, Ghana's decentralization and deconcentration accelerated with the introduction of the District Assembly Common Fund (DACF), a dedicated central fund to finance local governments' investments. In 2007, the National Decentralization Action Plan included a series of new financing projects to expand decentralization and prepare tax reform. The plan aimed to facilitate the use of donor financing.

Apportionment of districts' financial resources and expenditures In 2004, central government transfers through the DACF represented 84 percent of districts' total income. District-specific revenue levels remain lower than those of local governments in other countries of this subregion. However, metropolitan districts have managed to significantly increase their own, internally generated revenues in the past 10 years. Districts—but not necessarily the major cities—have also received financing from Ghana's Heavily Indebted Poor Countries (HIPC) funding. We note that Ghanaian districts have few personnel costs, because the central government pays these costs; labor costs represent only about 10 percent of budgets, on average.

The District Assembly Common Fund The DACF has three notable features: (1) it receives 5 percent of national tax revenues, as allocated by the Finance Act; (2) its funds are allocated on an apportionment basis; and (3) it is managed by an ad hoc body directly connected to the presidency. The fund has seen a gradual growth in importance; it currently finances about 50 percent of local capital investments.

In practice, the DACF favors rural areas. Indeed, although the apportionment takes into account many factors—such as the extent of health and education facilities, the capacity to mobilize resources, population densities, and so forth—85 percent of the funds are actually distributed equally between districts, regardless of size. Although this formula has political merits—it equalizes subsidies across the nation—it shortchanges cities whose major investment needs increase with their size. A big-city district, such as Accra, receives almost 20 times less per capita than the least populous districts.

The District Development Fund In 2009, a group of donors created the District Development Fund (DDF) to make additional financial resources available to districts. Allocations rest on each municipality's performance, which is assessed annually using administrative, organizational, and financial indicators. The DDF funds economic, social, and environmental capital projects and maintenance. It aims to strengthen decentralization, particularly in fiscal matters; districts hold responsibility for the use of its financing.

Donors contribute the principal funding to the DDF, with additional funds from the DACF. Originally, the DDF served as an international aid repository

and a vehicle for cost-effective and coordinated aid implementation. At full strength, the DDF is expected to attain about half of the amounts paid in by the DACF.

The DDF has three budgets: it earmarks 40 percent to capital investments regardless of performance, 40 percent to capital investments based on performance, and 20 percent to capacity-building efforts. To qualify, districts must meet certain criteria for investment planning, financial management, and knowledge of public procurement processes. A Functional and Organizational Assessment Tool measures performance, working with precollected data. Performance level supplies a parameter for apportionment, which, however, depends primarily on population share.

Loan financing: Municipal Finance Authority project Given the lack of district resources and subventions relative to capital investment needs, Ghanaian officials have considered allowing major cities to borrow money. The central government has developed legislation, a financial bill, to amend current laws that prevent local governments from accessing credit. At the same time, officials have considered a specialized financial institution granting loans for local investment—the Municipal Finance Authority (MFA). They commissioned a business plan to study the institution’s feasibility and the conditions needed for it to break even over the long term.

The business plan analyzed market potential, identifying about 20 districts likely to borrow and to generate savings. These districts would need to use DACF subventions to make loan repayments. They also would need access to suitable loan products with low interest rates and long durations. Given these conditions, the MFA’s own funding terms have proven crucial for its feasibility. Ghana has rather unfavorable financial market conditions, especially because of its moderate size and its specific currency, the cedi; at the time of the market study, the yield on Ghana’s two-year bonds was 20 percent. Therefore, the proposed scheme’s viability depended on endowing the MFA with capital and giving it access to resources, such as subsidized loans or grants, from donors and African development banks. The MFA could hybridize these resources with resources collected from the local market. Moreover, the MFA’s break-even conditions depend on having minimal operating costs, relatively high margins on loans, and the ability to choose borrowers and projects selectively.

Situation Analysis

The DDF provides a number of improvements over its complement, the DACF. In particular, it features incentivizing performance measures and more fair apportionment for large cities. However, like other funds, the DDF is restricted to conveying central government transfers and subventions. Its performance measurement may prove to have limited structuring power, as comparable cases have shown.

Local governments' reliance on subventions as their sole funding tool does not motivate them to expand local savings. In this regard, Ghana's major cities should not be treated in the same way as rural districts; this false parity shows decentralization's predominantly rural bias. Whatever its qualities, the DACF-DDF model reflects the central government's reluctance to give cities financial autonomy. It perpetuates a dual dependency within local investment financing: the localities' dependence on transfers and the central government's dependence on donors.

By contrast, the MFA project specifically encourages cities to improve their savings capacity and self-financing through borrowing. Its feasibility study showed that Ghana had the smallest possible financial market size that could support a specialized financial institution; the latter is not viable below a certain business threshold. Smaller markets may prefer to leverage funding with commercial banks, as in Cape Verde (see the case study on page 263 of this appendix). Given the DACF-DDF model's limited resources relative to growing investment needs, the central government will probably need to guide its largest local governments toward endogenous solutions, thereby leveraging inter-governmental transfers. This approach will require structural reforms, because such solutions suggest a transition from deconcentration to decentralization in the fullest sense of the term. This approach also will require the addressing of governance issues in large urban agglomerations.

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4. Morocco and the FEC

Table A.4 Morocco: Key Indicators

GDP per capita (2009)	\$2,811	Main cities	Inhabitants (millions)
HDI/rank (2010)	0.567/114	Casablanca	3,284
Total population (2009)	32 M	Rabat	1,770
Urban population (2010)	19 M	Fez	1,065
Urbanization rate (2010)	58%	Marrakesh	928
Urban growth rate (2005–10)	2.3%		

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

Despite ongoing efforts, Morocco's basic-services provision has long lagged its population growth. Since the early 2000s, the central government has set up long-term strategies to improve access in three areas—water, solid waste management, and urban transportation—all of which will require significant investments over the next 20 years. At the same time, the central government has followed decentralization and deconcentration policies, adopting tax reforms favoring local governments. The Moroccan government has supported partnerships with the private sector and encouraged outsourcing for many urban services.

Context: Urbanization and Decentralization

Morocco's urbanization rate is rising rapidly, although it remains relatively moderate compared with other North African countries. Its cities show deficits particularly in urban mobility, water access, environmental quality, and solid waste management. Although the Moroccan economy maintained a 5 percent GDP growth rate in 2009, its unemployment rates (2008 saw 14 percent urban unemployment and 30 percent youth unemployment) create additional pressure on municipal economic development.

The 2004 census classified 55 percent of Moroccans (or 16.5 million) as urban, meaning that they live in cities or towns. Urban growth should slow by 2030. The urbanization rate was estimated to be 60 percent in 2008; by 2010, 70 percent of the population lived in towns of 100,000 inhabitants or more. In less than 20 years, the total urban population will reach or exceed 25 million people. The need for new investments is particularly acute north and south of Casablanca, along an approximately 150-kilometer coastal strip that includes the cities of Casablanca, Kenitra, Mohammedia, Rabat, and Salé—home to more than two-fifths of the urban population.

Despite improvements over the past 10 years, Morocco has some of the poorest service levels in the Middle Eastern and North African region, and also in

comparison with countries at the same economic level. Although the drinking water-supply connection rate is about 90 percent, in small and medium-size towns the sewerage connection rate is 40 percent. In urban areas, 70 percent of solid waste is collected, but less than 10 percent of it receives treatment according to environmental standards.⁵

Local governments' powers In 1996, a constitutional amendment established three levels of local government, dividing Morocco into 16 economic regions, 45 urban prefectures, 26 rural provinces, and 1,503 cities (*communes*). An elected council governs each of these localities. The king appoints executive councils for the regions, prefectures, and provinces, and city councils elect their own mayors. The municipalities of Casablanca, Fez, Marrakesh, Rabat, Salé, and Tangier are divided into financially and administratively autonomous districts, each managed by an assembly.

Under the 1997 Regions Act, the regions' powers include defining regional development plans and schematic designs, industrial and economic activity zones, and environmental protections. The prefectures and provinces have jurisdiction over provincial road construction and maintenance as well as intercity transportation creation and management; they also contribute to urban housing programs, upgrading of informal settlements, and urban renewal.

The municipalities have responsibility for drinking water supply and sewerage; trash collection, transport, and treatment; public lighting; transportation and traffic control; parking areas; and public markets. These services may be provided directly by municipal utilities corporations (either financially autonomous ones or those dependent on the municipality) or by private sector companies through external contracts, concessions, or delegated-services contracts.

In 2008, an amendment to the 1960 municipal charter reinforced local financial autonomy by lightening financial oversight and allowing partnerships with private sector or public entities. However, three bodies still monitor and audit municipalities—the finance ministry, interior ministry, and regional inspector-generals. Oversight by the Directorate General of Local Governments (DGLG), an interior ministry agency, sharply curtails municipal decision-making autonomy and freedom of action. The 2008 amendment did not resolve problems arising from power encroachments among the three local authority levels, or between the authority levels and the national agencies or ministries. Legislation often fails to spell out or enact clear areas of authority among these parties.

A new municipal charter provides for grouping urban agglomerations with more than 200,000 inhabitants into a contiguous territory. As soon as such a group is formed, it becomes responsible for urban planning and transportation. It must also prepare plans for urban mobility, solid waste treatment, sewerage and water treatment systems, and water and electricity supply.

Financing Mechanisms

Central government institutions charged with land planning define master urban planning schematics. Public enterprises and agencies, including 25 urban agencies in major cities, design these master plans.

Confronted with infrastructure and services needs and encroachments on authority, the Moroccan government tries to provide guidance even for areas under municipal authority, such as solid waste management and urban transportation. In 2008, more than one-third of Moroccan state-owned enterprises provided water, electricity, and transportation; the importance of these enterprises is growing.

Public utilities The Office National de l'Eau Potable (National Drinking Water Office, or ONEP) has a monopoly on drinking-water production; it is responsible for supplying 500 small and medium-size towns. ONEP executes part of the national sanitation plan in 200 cities. It also sells bulk water to municipalities. Its rates include a subvention for rural areas.

Urban municipalities have responsibility for solid waste collection, transport, and treatment, but most of them merely collect it. The 2006 Solid Waste Law was followed in 2007 by a National Household Waste Management Program. Its ultimate goals include collecting 90 percent of household trash, treating the trash in controlled landfills in all urban centers, closing 300 open-air dumps, and recovering value from 20 percent of the recyclable waste.

In 2007, urban districts spent 10 percent of their operating budgets on solid waste management, of which 85 percent went for collection and transport. Eventually, the municipalities will finance the additional costs of new landfills; the Solid Waste Law provides for levying user fees.

Organizing, managing, and investing in urban transportation require several levels of intervention, leading to jurisdictional conflicts. In general, public transportation is insufficient and inefficient; it suffers from inadequate pricing and excessive competition between private operators. The Moroccan government has adopted a New Urban Transportation Strategy. It has also created a public transportation support fund, allocating half of the fund's money to build tramway lines in Casablanca and Rabat.

Services delegation Since 1997, the Moroccan government has gradually introduced the private sector into water and sanitation services, initially through contracts awarded in four major cities; Casablanca, Rabat, Tangier, and Tetouan account for 34 percent of the urban water market. The government also awarded service-delegation contracts for public transportation, for example, in Casablanca in 2004 and Rabat in 2009.

Private operators collect and transport about two-thirds of municipal waste. Many of their contracts have revealed shortcomings. In 2006, a delegated-management law defined signatories' duties and responsibilities. It also defined

competitive bidding rules and made provisions for the overseeing and monitoring of contracts.

Restrained autonomy Despite Morocco's apparent decentralization policy, the DGLG regulates many aspects of local governments' decisions. It requires pre-approval for budget documents and changes, loans and guarantees, local taxes and fees, private operator certifications, municipal services management, and so on. The DGLG stipulates that some expenses are mandatory and must be paid before others and that two major parts of municipal budgets—current operations and investments—must be balanced. It also prohibits the use of nonrecurring income to finance operating expenses.

Implementation and absorption capacity problems Moroccan municipalities' current receipts derive from direct and indirect taxation and fees. In 2009, municipalities' own, internally generated revenues accounted for 23 percent of their receipts, whereas half of their expenditures went to personnel costs. Local taxes and fees provide about half of these internal revenues. Municipal councils may adjust the amount of taxes or fees within a range set by law, while sales of goods, assets, and utilities provide the rest of the revenues. The balance of current receipts comes from the central government's income tax redistributions. These redistributions are composed of business income taxes (municipalities receive 80 percent), an occupancy tax, and local public services taxes (municipalities receive 95 percent of occupancy and local public services taxes). In addition, the central government transfers one-third of VAT receipts to municipalities, using an apportionment formula that includes a preset amount, an equalization payment, and a compensatory sum that depends on each local government's share of collected taxes.⁶

Moroccan municipalities provide rather remarkable examples of low absorptive capacity: they cannot use up all of their investment budgets. Their actual capital expenditures fall 30–40 percent short of the amounts budgeted, which means that they end their fiscal years with these sizable surpluses. This phenomenon arises from a lack of staff and technical expertise, overlapping or conflicting jurisdictions, and general administrative procedures and public-procurement rules. Meanwhile, Moroccan municipalities borrowed up to 30 percent of their investment capital in 2009.

Debt Financing

In 2009, loans accounted for 8 percent of municipalities' resources and 30 percent of their capital expenditures, and debt service equaled 11 percent of total expenditures.

FEC: Morocco's fund for urban infrastructure Founded in 1959, the Fonds d'Équipement Communal (Municipal Infrastructure Fund, or FEC) is a

state-owned, financially autonomous banking institution. The Minister of the Interior chairs its board of directors. As a bank, it follows national banking laws. The technical assistance it may provide to local governments and public enterprises reflects its public-service mission. Its principle mission is to provide infrastructure and investment loans and short-term loans for feasibility studies. The FEC's funding comes from domestic capital markets (including its medium-term financing), multilateral and bilateral sources, and the central government. The FEC operates in capital markets without a sovereign guarantee.

In the most recent fiscal years, the FEC allocated about 80 percent of its financing to urban municipalities; half of the total went to Agadir, Casablanca, Fez, Marrakesh, and Meknes. It also grants loans to municipal utility authorities for sanitation investments, sometimes in conjunction with participating commercial banks—Banque Centrale Populaire, Attijariwafa, or others.

The FEC loans its funds at relatively high interest rates to cover its substantial margins. As a rule, it will not grant a loan on more than 40 percent of a municipality's intergovernmental fiscal transfers, even though its regulations do not prevent it from doing so. In 2009, it granted loans on only 14 percent of transfer amounts. The FEC also requires municipalities to cofinance 20 percent of a project's cost and to provide a municipal guarantee on loans to utility authorities. Since 2010, municipalities must also pay VATs, adding 10 percent to their borrowing costs.

The potential for expanding municipal credit and using commercial banks The FEC does not have a legal monopoly, but it is the only lender to local governments. Many large cities are considering additional financing through domestic bond issues or by bank loans. Morocco's financial system is relatively well structured; it has 16 banks, of which 11 are private sector and five are majority held by foreign investors. Domestic deposits provide three-quarters of the banks' funding.

The central government's approach to management and its tight control over budgetary operations do not encourage financial accountability at the municipal level. In 2007, Fitch's credit ratings for Casablanca, Marrakesh, and Salé noted that these cities did not monitor their liquidity, pursue a debt management policy, or calculate debt repayment calendars. The municipalities' low absorption capacity and poor investment production reflect their overall management and administrative weakness. In another vein, we may note that Morocco has no regulations for municipal debt restructuring. Under these conditions, financial institutions other than the FEC are unlikely to open a market for municipal loans.

Situation Analysis

During the last decade, Morocco has taken steps to address accumulated infrastructure and basic-services backlogs by developing long-term sectoral

strategies. Despite extant service provisions across major cities, legislation to create intermunicipal organizations has had no effect. Given the urgent needs of cities as a whole, the central government could move to take the initiative. However, imposed entities would require considerable assistance to function effectively.

Closely supervised by the central government, the FEC is a public institution in a monopolistic position. Borrowers criticize its slowness, extreme caution, and high margins. However, it is an indisputably well-managed financial institution that has successfully modernized itself; it even engages in innovative financing, such as the World Bank's Clean Development Mechanism (CDM) for the solid waste sector. The FEC clearly has greater flexibility in the products and services it offers than does its Tunisian counterpart, as shown by its growth in extending credit lines instead of project-related loans and by its participation in bank consortia.

Until recently, uncertainty remained about the Moroccan government's willingness to open its municipal credit market and to encourage commercial bank lending and use of capital markets. Morocco's reforms in the aftermath of the so-called Arab Spring will likely strengthen local governments' decentralization, autonomy, and accountability. Movements toward more local empowerment will also require efforts to build capacity and resolve the larger cities' fragmented responsibilities. In this regard, the municipal credit market for local investment should grow significantly, if groups of municipalities or intercity authorities can be created. Presumably, the FEC would find difficulty in maintaining its monopoly; it would need to share risk with other lenders. With further municipal empowerment, the FEC's technical and financial tool modernization should also continue, alongside reinforcement of borrower capacities.

Notes

5. This poor performance led the government to adopt a National Household Waste Management Program, supported by the World Bank.
6. See also chapter 4, box 4.1, in this volume.

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5. Nigeria and the Urban Development Bank

Table A.5 Nigeria: Key Indicators

GDP per capita (2009)	\$1,118	Main cities	Inhabitants (millions)
HDI/rank (2010)	0.423/142	Lagos	10,578
Total population (2009)	155 M	Kano	3,395
Urban population (2010)	79 M	Ibadan	2,837
Urbanization rate (2010)	50%	Kaduna	1,561
Urban growth rate (2005–10)	3.8%	Benin City	1,302
		Port Harcourt	1,104
		Ogbomoso	1,032
		Abuja	857

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

Nigeria finances local infrastructure and services through direct revenue distribution from the federal government to local governments. The design and management of this highly centralized system has not changed, even though Nigeria's return to civilian rule in 1999 allowed for local elections and resumed decentralization policies.⁷ However, the power transfers permitted under the new constitution have rarely materialized as genuine local autonomy—the aim of the most recent reforms. State and local governments depend on the federal transfer payments policy, but the allocated resources do not cover investment needs. Nevertheless, several initiatives to diversify investment financing tools have begun during the past decade. We present the most noteworthy in the following sections.

Context: Urbanization and Decentralization

Nigeria has the largest urban population in Western Africa, estimated at 79 million in 2010. Its urban residents also have some of the poorest access to infrastructure and basic services. Important constitutional and economic reforms, begun since the country's return to civilian government, aim for greater devolution of federal powers and authority. However, these reforms are still in their infancy.

A significant number of underequipped major cities Nigeria's urban network counts two fast-growing megacities—Lagos, with more than 10 million inhabitants, and Ibadan, with 3 million. Six cities have more than 1 million inhabitants, and 300 urban agglomerations have more than 50,000. These numbers remain rather approximate: in 2006, Lagos State suspected that the census had missed 1 million people and demanded the right to conduct its own count. Because

population share largely determines the resources that the federal government transfers to local governments, census data carry high stakes.

Since the late 1960s, the urban network has consolidated rapidly, as new towns emerged as a result of the oil boom and territorial decentralization. The number of states and capitals increased from 12 to 36 between 1967 and 1996. Nigeria's urban problems are similar to those of many African countries—underemployment, basic-services failures, environmental degradation, underinvestment, substandard and unsanitary housing, and management and governance shortcomings. However, the size of Nigeria's cities amplifies these problems, as do their rapid growth; territorial fragmentation; dependence on oil revenues; and the scarcity of cities' own, internally generated resources. Some of the largest deficits appear in electricity service—more than half of Nigeria's population has no access—and in housing and transportation, which consume more than 20 percent of household budgets in Lagos.

The high level of territorial fragmentation in urban agglomerations and metropolitan areas complicates their infrastructure and facilities management. For example, 13 local councils govern Ibadan, seven govern Port Harcourt, and six govern Kano. Often, this fragmentation results in interventionism as states become involved in infrastructure or create government agencies. For instance, Lagos State has established the Lagos State Waste Management Authority (LAWMA) for waste treatment, the Lagos Metropolitan Area Transport Authority (LAMATA) for transportation, and the Lagos State Traffic Management Authority (LASTMA) for traffic control. These agencies replace often-complicated institutional schemes that also involved the upper echelons of the territorial hierarchy. In Lagos, these agencies have also recently proposed initiatives to finance the metropolitan area's investments themselves.

Decentralization and its administrative roots The Nigerian federation is divided into three territorial levels: 774 local governments,⁸ about 20 per state on average, form the lowest level. The middle level consists of 36 states run by elected governors; national presidents are elected as well. The capital, Abuja, is a Federal Capital Territory, not a state; it is divided into six area councils. In this federal configuration, the middle and highest territorial levels plan decentralization strategy and governance reforms. Following the 1998 return to civilian rule—confirmed by local council and national assembly elections in each state—public finance management improved somewhat, with the adoption of a National Strategy for Empowerment and Economic Development. This strategy is an ambitious privatization program that uses concessions to improve fiscal transparency and streamline budgeting. Since 2007, Nigeria has committed to a policy of devolving power and resources to state and local governments and also has a program to reform governance and encourage local-level participation. The government also encourages use of the private sector to provide services.

However, decentralization suffers from a lack of transparency and particularly poor governance—local governments are the weakest link.⁹ Indeed, subjected to inconsistent policies by the military regime, local governments lack policy and administrative management skills and have only small territorial jurisdictions. Corruption, which has taken root at all territorial levels, is probably the most difficult obstacle to overcome.

Territorial jurisdictions: A constitutional principle and administrative rules The 1999 Nigerian Constitution divides powers among the three territorial levels—federal, state, and local governments. It transfers responsibility for education, health, and other basic services to state and local governments, requiring the federal government to allocate about one-third of its revenues to these levels. The Constitution grants virtually no exclusive powers to the 36 states; they exercise authority in concert with the federal government, particularly for federal or state roads and electricity grids. However, the Constitution is vague about effective power-sharing; this subject remains a source of confusion, and the states have repeatedly called for greater autonomy and more resources.¹⁰

The federal government encourages state and local governments to adopt policies to be consistent with its National Economic Empowerment Development Strategy (NEEDS) by developing a state-level initiative, the State Economic Empowerment Development Strategy (SEEDS), and a local-level initiative, the Local Economic Empowerment Development Strategy (LEEDS). However, although tax reform, public expenditure management, and privatization should expand in coming years, all will confront sharply different local government entities and differing human and financial resources. State budgetary control over local governments varies considerably from one state to the next. Such control depends on the state's interpretation of the coordinating functions it shares with local governments. Only Delta State grants complete financial autonomy. In many cases, local governments may not make budget-related decisions—their budgets are tied. State Bureaus of Local Government Affairs provide guidance for budget preparation, deadlines, and priorities, and the bureaus closely supervise spending. Some states allow their local governments to prepare their own budgets. However, these are often prepared unrealistically and inefficiently. Local governance suffers from pervasive corruption, unclear management arrangements, and lack of trained leadership. It also suffers from local jurisdictions' overlap with other government levels in ways that may severely affect budgets, such as when the federal government unilaterally increases teacher salaries.

The federal government's budget sources may explain their dominance—65 percent of the government's budget derives from oil revenues that operating companies pay the state directly. Progress in decentralization and local governance chiefly depends on the apportionment of powers and

related resources, which parliament constantly renegotiates with the federal government

Redistribution and Financing Mechanisms

The federal government collects most taxes and oil receipts; it distributes revenues from oil receipts directly¹¹ or redistributes them through direct transfers to state and local governments. These transfers come from two major redistribution funds. The first fund, the Federation Account, constitutes more than 90 percent of all redistributed funds: budgeted oil revenues, surplus oil revenues, and other taxes and customs duties. The Federation Account's apportionment mechanism is based on eight factors, including population size, but 40 percent of the funds are divided equally among the states. Transfers from the Federation Account represented more than 75 percent of all transfers, on average, in the 2000s. The second fund, a VAT introduced in 1994, is distributed to states: 30 percent equally, 50 percent according to population size, and 20 percent according to each state's contribution to the VAT pool. In all, the federal government transfers 55 percent of its revenues—35 percent to states and 20 percent to local governments. It also distributes oil revenues from a crude oil surplus account.¹²

Local governments also collect receipts from various local taxes and fees: property, waste collection, sanitation, parking, and other revenue-generating facilities. However, these sources have particularly low yields. Despite the amount of receipts collected tripling in absolute terms over the past decade, local governments generated no more than 4 percent of their own revenues internally. Nigeria's 1999 Constitution requires each state to pay 10 percent of its revenue to local governments, but in practice, states do not make these transfers. Ultimately, federal government transfers constitute a very large share of funding, which is proof of a halting financial decentralization.

States are similarly dependent, with the exception of Lagos State, which generates more than 60 percent of its revenue, on average. During the 2000s, the Federation Account provided up to 85 percent of states' total budgetary resources. The states' total resources fall far below what they need to cover capital expenditures related to their responsibilities. Of course, the shortfall proves greater for non-oil-producing states without oil receipts.

Investment Financing Tools

Local governments' weak financial autonomy generally results in underinvestment and poor service levels, thereby preventing the emergence of an investment and borrowing culture and, ultimately, hindering the emergence of a local municipal credit market. This is especially true in Nigeria, where investment financing mechanisms remain underused despite a potentially large local investment market, a relatively high level of economic development, and well-structured and dynamic financial and banking systems.

The fact that Lagos State has conducted the most significant financing operations in recent times only reinforces this conclusion: it is the only state in the federation to achieve high levels of internally generated revenues. Thus, it was able to reassure investors and successfully issue bonds. Moreover, Lagos State's financial autonomy also allowed it to acquire a number of ad hoc tools for technical and financial arrangements and to structure a series of PPPs for capital investments and services.

Furthermore, Nigeria's financing tools appear strikingly weak in relation to the country's size. Nigeria privatized its state-owned specialized financial institution, the Urban Development Bank of Nigeria (UDBN). UDBN is the only financial institution operating in the municipal credit market—an abnormally small market given Nigeria's 79 million urban residents. In the following two sections, we look at the experience of Lagos State and UDBN.

Lagos State: direct bond issues and PPPs With the federal government's authorization, states have the authority to borrow on domestic capital markets and from international financial institutions. In 2008, Lagos State committed to an approximately \$1.85 billion bond program, issuing three tranches from 2008 to 2010.¹³ The borrowing will finance an infrastructure and development program for transportation, an industrial and business zone, and major roadways, mostly through public-private partnerships. One-quarter of the funds raised went to refinance existing debt.

Lagos State has a good credit rating (A+ or AA) from Fitch Ratings and two other rating agencies, Global Credit Rating and Agosto & Co. Its bond subscriptions were reserved for institutional investors and were heavily oversubscribed. Success came from tax advantages and yields superior to central government bonds: 13.0 to 14.5 percent for five to seven years. In addition, beginning with the second tranche and using its own dedicated resources, Lagos State set up a debt service reserve fund to protect investors. This subscription level demonstrates the large pool of local savings available for local investment, if local governments know how to access it.¹⁴

Lagos State mobilized the funds raised on the markets primarily for infrastructure project financing within PPPs, through build-operate-transfer or concession contracts. These PPPs center on the transportation sector: the Lekki-Epe Expressway, the Lekki Peninsula Road (a \$300 million, 30-year concession), and a Lagos light-rail, mass transit project.

Lagos State has acquired expertise in setting up and financing projects, particularly through its various agencies. In the transportation sector, the LAMATA set up its first Bus Rapid Transit (BRT) line with support from the World Bank. The BRT line carries about 150,000 passengers per day and has reduced ticket prices by 30 percent and travel times by 40 percent. Private operators run the line, in partnership with the National Union of Road Transport. Commercial banks also take part; they fund loans for purchasing the vehicles used by the private operators.

From a mostly public to a predominately private parapublic institution:

UDBN The federal government established UDBN in 1992. As its name suggests, this specialized parapublic financial institution was explicitly designed to finance urban local governments' capital investments. It was a classic specialized financial institution: the federal government underwrote its capital structure, while states, local governments, trade unions (through the Nigerian Labour Congress), and private operators held a small share—10 percent. The first iteration of UDBN was a failure on all counts. It suffered from all of the ills that affect public companies in Nigeria: weak management, poor administration, incompetence, and corruption. Fifteen years after its inception, the bank had accumulated operating losses and loan defaults; it owed its survival to regular federal government subsidies.

UDBN's transition to a mostly privately held company (not a complete privatization) began in 2008. Private and institutional investors created an investment company, Investment and Credit Holdings, Ltd. (ICHL), through which they hold 53 percent of UDBN's shares. The original UDBN investors retain the single-largest public sector shareholding, with local governments owning 20 percent. The UDBN has completely reorganized, received a capital injection, acquired a new management team, and strengthened its technical and financial intervention skills. Its privatization and restructuring received special attention from the International Finance Corporation (IFC).¹⁵ The process drew heavily on the experience of the Infrastructure Finance Corporation Limited (INCA) in South Africa, and INCA's leaders may have made personal investments in UDBN.

UDBN's communication policy does not feature regularly published, readily available information, making it difficult to assess the bank's outstanding loan portfolio performance or the extent to which it draws funds from various sources. Like most specialized financial institutions, UDBN can issue bonds. It receives financing from domestic and international commercial banks and funding from private sector-oriented donors, such as the IFC and the Export Development Bank of Canada. It also receives funding from international aid donors, at least for certain types of socially oriented projects.

Since its inception in 2008 and during the postfinancial crisis period, UDBN appears to have broadened its concerns beyond simply financing infrastructure. It has significantly enlarged partnerships in Southern Africa, signing an agreement with the Development Bank of Southern Africa (DBSA). Like DBSA, UDBN shows interest in public policy concerns, for example, by providing technical support to local governments and states for their own bond issues. It also arranges financing and offers training and other services. UDBN participates in national commissions, such as the one that promotes PPPs, and also manages revolving funds created by the federal government, such as the Public Mass Transit Revolving Fund.

Currently, UDBN lays claim to a five-part business model: lending, financial advice and arrangements, private equity investment, third-party asset management, and capacity building and technical assistance. Naturally, the question then arises: Is the program too broad for a single financial institution to achieve effectively, especially in a country as large as Nigeria?

Situation Analysis

Nigeria is unique in its large land mass and population size. Its federal organization and its administrative and political history paradoxically tend toward centralization. State and local government dependence on central government transfers, along with the weak financial autonomy of state and local governments, have proven real handicaps. The resulting underinvestment penalizes the cities.

However, the country has many opportunities and tremendous potential for developing a municipal credit market. Lagos State has shown that revised strategies for financing and setting up projects can pay off in just a few years. Its example clearly shows how financial independence, combined with sound revenue management and technical and financial know-how, can raise funds from the private sector and set an operational dynamic in motion.

Other states in the federation certainly have many lessons to learn from the Lagos State example. The states receiving oil derivation allocations from their own oil revenues have an advantage that many African localities would envy. Using oil revenues as collateral provides leverage in financial markets. Nigeria, with its highly structured and dynamic financial system, is one of the few countries on the African continent that may use leverage most effectively.

UDBN's evolution since its inception also proves instructive in another vein. Its experience shows that a parapublic status provides several benefits—above all, the ability to change the mechanism's setting from public to private without breaking it, simply by changing its capital structure.

Current state and local resources will not be able to satisfy infrastructure and local investment needs. Localities must increase their own, internally generated resources and their financial independence—crucial conditions for modernizing solutions and for leveraging debt and private sector involvement. Many of the elements needed for successful change exist, as shown by the Lagos State and UDBN examples. However, given Nigeria's size and enormous share of urban residents, the financial tools and support available to local governments remain vastly underscaled and few in number.

Notes

7. The 1976 Local Government Reform was the first decentralization program.
8. In 1990, there were only 449 local governments.
9. Some projects with a participatory approach support local city governance. For instance, the Community Based Urban Upgrading Project finances infrastructure

and basic-services improvements. It is a partnership among the World Bank, the federal government, seven state and local governments, and beneficiary groups. Each beneficiary group, in consultation with state and local government councils, defined its priorities to determine the project's priorities.

10. New donor-funded programs and projects, such as LAMATA for river transport in Lagos, do not reduce the problems of dual federal government and state jurisdictions.
11. According to the oil derivation system used since 2000, 13 percent of total crude oil revenues are reserved for the oil-producing states, in proportion to their production.
12. These receipts are not included in the general budget; they are based on a predefined reference price.
13. Lagos State bonds are discussed in chapter 4, box 4.7, in this volume.
14. Lagos has received support from the World Bank and the Public-Private Infrastructure Advisory Facility (PPIAF) for these operations.
15. The IFC is the private sector subsidiary of The World Bank Group.

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6. Senegal and the ADM

Table A.6 Senegal: Key Indicators

GDP per capita (2009)	\$1,022	Main cities	Inhabitants
HDI/rank (2010)	0.411/144	Dakar	2,396,800
Total population (2009)	12 M	Thiès	278,200
Urban population (2010)	5 M	Kaolack	193,400
Urbanization rate (2010)	42%	Saint-Louis	180,900
Urban growth rate (2005–10)	3.2%	Ziguinchor	165,100

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

In 1996, Senegal's decentralization laws provided for significant power transfers to local governments. However, the local governments did not always possess the technical, human, and material resources that their new autonomy required, especially regarding infrastructure and services. Since the end of the 1990s, several successive projects supported by donors (the World Bank and AFD) have resulted in a financing entity, the Agence de Développement Municipal (Municipal Development Agency, or ADM). ADM aims to assist urban localities through a financing mechanism for municipal investments, using self-financing, subventions, and credit. One of its main goals is to gradually introduce borrowing as a form of support, based on the city contract principle. This institutional approach to supporting local governments has had fairly mixed results, partly because neither the approach nor ADM appear to have asserted themselves in the institutional landscape; new entities have recently appeared, claiming all or some of the same objectives.

Context: Urbanization and Decentralization

Senegal has an urbanization rate similar to that of other countries in Western Africa. Its cities also have similar characteristics. They grow more than 3 percent per year and suffer from basic-services backlogs—especially water and electricity—as well as from failures in managing land and peripheral expansions.

The Dakar metropolitan area counts more than 1 million people living in unregulated and underserved areas, with pockets of extreme poverty. City officials have recently begun large-scale infrastructure projects, notably a new airport and an urban toll highway. The road system remains congested; the lack of public transportation has increased use of individual and collective taxis and private cars. The entire fleet of vehicles is in poor condition and contributes greatly to worrisome air pollution levels, made worse by industrial emissions. The relatively dense network of regional capitals generally suffers from similar problems—steady growth and enormous investment needs, particularly for basic services.

Decentralization and devolution The Local Government Code of 1996 defined three categories of local government: region, *commune* (similar to a municipality), and rural community. At end-2010, the Senegalese territory was divided into 14 regions, 45 departments, 150 communes, and 353 rural communities. The number of regions and communes has increased sharply since 1996; the last redistricting was in 2008. Many localities lack human and financial capital. The sheer number of localities does not facilitate regular and effective monitoring by central government services.

The law recognizes local governments' legal status, financial autonomy, and self-government (they are administered by elected councils). Power transfers involve nine sectors: land and natural resource management; health; population and social welfare; youth; sports and recreation; culture; education; planning and land development; and urban planning and housing. At the beginning of the 2000s, a Country Financial Accountability Assessment (CFAA) studied the public finance system; its findings stressed local governments' poor investment capacity, because of their low levels of self-financing and weak executive and technical skills.

Financing Mechanisms

Local governments' own, internally generated resources—local taxes and receipts from land use and services—fund their budgets, along with a decentralization endowment fund (Fonds de Dotation de la Décentralisation, or FDD). The FDD provides compensation for power transfers as well as financial equalization between local governments. Additional resources come from a fund for priority investments, the Fonds d'Équipement des Collectivités Locales (Local Capital Development Fund, or FECL), and a consolidated investment budget (Budget Consolidé d'Investissement, or BCI).

The FDD was created in 1996 to offset charges resulting from the transfer of powers to local governments, but it does not provide sufficient funds to cover the implied costs. The central government's decentralized services also use FDD allocations for their operations. Part of the FDD's resources come from VATs, which have risen almost continuously since their inception, but not enough to cover all costs related to the power transfers.

Established in 1977, the FECL was created to finance investments. It was supposed to make interest-free loans to local governments, but this provision never went into force. It was also supposed to provide municipal-support funds. Originally endowed by a sales tax, the FECL also receives funds from central government receipts. Its apportionment covers three large budget areas: local governments in the Dakar region, other communes, and rural communities. The FECL takes the central government's place as counterparty in donor-funded projects and programs.

The 2006 reform led to the BCI, developed in the wake of the CFAA mentioned previously. Its aim of consolidating budgets for streamlining initially

concerned only the health and education sectors. The BCI experienced significant delays early on; it still seems to suffer from stakeholders who do not really understand its working mechanisms. Over and beyond these concerns, the central government's direct funding through the FECL and BCI remains insufficient, especially in light of the power transfers and the high levels of needs; a significant part of local government financing comes from external resources and foreign aid-funded programs. These programs often operate on the budget-support concept, offering free financing while the central government contributes 10 percent of the funding granted. Examples include two European Union programs that support decentralization and local economic development, known as PADELU (Programme d'Appui au Développement Local Urbain) and PSIDEL (Programme de Soutien aux Initiatives de Développement Local), and a regional support program. Because Senegalese local governments have a legal status and financial autonomy, they may also receive direct external aid funding, for example, from European cities through *sister cities* cooperation projects.

Support for Municipal Development

During the 1990s, the Senegalese government and its partner donors (originally the World Bank, followed by AFD) built a comprehensive and structured approach to supporting municipal economic development. A strategic view of the urbanization phenomenon and a desire to develop sustainable and structuring-oriented solutions informed the resulting programs. The programs rested on a central idea: help communes enter development's virtuous circle. By improving management and increasing receipts, local governments gain access to subsidized financing (and eventually to borrowing). They may then make capital investments that improve productivity and thus their self-financing ability, and so on.

These commune-support programs—based on a sophisticated institutional approach and implemented by the expressly created ADM—have chiefly targeted municipalities. AFD has supplemented these programs with a financial support program for local governments, the Programme de Renforcement et d'Équipement des Collectivités Locales (Local Government Strengthening and Equipping Program, or PRECOL) to build municipal infrastructure and facilities. PRECOL had objectives similar to the commune support programs, but targeted the Dakar metropolitan area. Implemented by the ADM, PRECOL notably included support for new intercommunal entities.

The ADM The ADM focuses on providing financial intermediation and technical services for all commune support programs. The agency receives program funding and acts as the local governments' unique bank teller for financing investment and adjustment programs. Local governments prepare their programs with a specific set of tools; the most important is the city contract, which

includes a municipal adjustment plan, a priority investment program, and a priority maintenance program. The 3- or 5-year city contract links objectives to means, thereby building accountability into the program. The 67 Senegalese communes receiving municipal support signed city contracts.

A municipal adjustment plan helps communes improve their administrative and financial management. It also helps devolved central government administrators provide services to the communes. Grants fund the municipal adjustment plans. The program requires communes to simultaneously address physical infrastructure and municipal management issues; they have an obligation to repay loans issued under the program and to spend some of their own budgets on infrastructure maintenance. The priority investment program identifies the most urgent targets through an initial audit of various investment sectors. Investment ownership is delegated to a technical agency, the Agence d'Exécution des Travaux d'Intérêt Public contre le sous-emploi (Employment Agency for Highly Labor-Intensive Public Works, or AGETIP). As with the investment program, an audit determines priorities for the maintenance program. Financed by each commune's operating budget, the maintenance program uses 5 percent of the commune's ordinary receipts.

Fragmentation of the sector and stakeholders Senegal's ministries—the Ministry of Decentralization and Local Governments, the Ministry of the Interior, the Ministry of Planning, the Ministry of Finance, and various line ministries—provide decentralization support. In addition to the ADM, Agences Régionales de Développement (Regional Development Agencies, or ARDs) supply expertise to local councils and coordinate with local governments. The ARDs serve as regional offices for the Plan National de Développement Local (National Local Development Plan, or PNDL), a decentralization support program that operates alongside PRECOL and the commune support programs.

Senegal has a general reputation for its multiple agencies (some say there is an *agencification* of the country). It certainly has many national or local agencies in the fields of local development, decentralization, and urbanism. In addition to the agencies already cited—ADM, ARD, and AGETIP—we can mention the ADL, CETUD, AATR, FDV, and APIX, among others.¹⁶ Overlapping jurisdictions are not uncommon, and questions often arise about the articulation between these agencies' interventions and local governments.

The case of Greater Dakar is emblematic: essentially, it comprises four commune-cities that include a *department* and two other communes. A *region* includes all of these divisions. It also includes two intercity entities, the CADAK and the CAR, capped by a third entity known as *Entente intercommunale*, which is responsible for coordinating both. This situation complicates the ownership apportioned among local governments, national and local agencies, an agency responsible for large-scale presidential projects (Agence Nationale Chargée de

la Promotion de l'Investissement et des Grands Travaux, or APIX), and state-owned water and electricity companies. In such an institutional landscape, financing local investments through local government borrowing is unlikely to increase in scale.

The ADM's mixed results Evaluations of the commune-support programs generally praise their architecture and well-designed technical and operational procedures and also commend the infrastructure and improved services furnished to communes. The city contract apparatus and tools have clearly improved urban and financial needs assessment. The evaluations also generally applaud the management of communes and their relationships with central government administrations. However, local governments have hardly internalized ADM's intermediation. They have not been sufficiently consulted or actively included in approaches determined by supply and demand. Systematic use of delegated ownership has also undermined their involvement.

The financing structure's results prove modest, indeed: local governments' share of self-financing has increased only moderately, representing less than 10 percent of all funding. Capital-investment borrowing has also remained at a low level, at about 8.5 percent. Faced with these outcomes, the central government commissioned a study on the institutional evolution of the ADM. The study considered three hypotheses: sustaining ADM, transforming it, or merging it. The sustaining approach focused on ADM's current role and activities with, however, a redefined legal status. The transformation approach focused on strengthening ADM's role and expanding its capabilities, thereby turning it into a specialized financial institution. The merging approach counted on combining programs and agencies into a single structure to rationalize local development support.

The central government adopted none of the three solutions. Indeed, a new entity, Agence de Développement Local (Local Development Agency, or ADL) joined ADM and other agencies, such as the ARDs. The ADL is a type of investment fund without lending powers; it aims to unite existing programs and projects, coordinating local development and decentralization activities.

Situation Analysis

The central government's creation of the ADL seems to promote a binary pattern in which the agency would ensure subventions and support separately from lending, which donors, and possibly a specialized financial institution, would ensure. This lending role might be assigned to the Caisse des Dépôts et Consignations du Sénégal. Founded in 2006, it is legally authorized to make loans to local governments so that they can execute investments. However, such activity remains subject to the approval by the West African Economic and Monetary Union's Banking Commission.

ADM did not really engage the virtuous circle mechanism, nor did it consolidate local governments' investment capacities. The agency suffered from an inappropriate status as an association. It clearly missed its goal of gradually becoming a specialized financial institution, which would have accompanied an increase in local investment borrowing. Ultimately, ADM appears to have been perceived more as an implementing agency than as a financial institution vital to the national institutional landscape. The Senegalese government seems not to have placed ADM at the heart of its municipal and urban development strategy—even less so for the Dakar metropolitan area than elsewhere. Even the donors seem to have tired of their creation; they may gradually withdraw from this structuring type of approach, favoring direct loans or specific projects. This result does not condemn the *seeking a virtuous circle* model as such. After close examination, we might find that ADM failed for institutional reasons rather than for fundamental, conceptual reasons.

Note

16. See CETUR: Centre d'Études des Transports Urbains de Dakar (Center to Study Urban Transportation in Dakar); AATR: Agence Autonome des Travaux Routiers (Autonomous Roadworks Agency); FDV: Fondation Droit à la Ville (Rights to the City Foundation); APIX: Agence Nationale Chargée de la Promotion de l'Investissement et des Grands Travaux (National Agency for the Promotion of Investment and Major Public Works); and APRODAK: Agence pour la Propreté de Dakar (Dakar Sanitation Agency).

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7. South Africa and DBSA, INCA, and Direct Bond Issues

Table A.7 South Africa: Key Indicators

GDP per capita (2009)	\$5,786	Main cities	Inhabitants (millions)
HDI/rank (2010)	0.597/110	Cape Town	5,356
Total population (2009)	49 M	Johannesburg	3,670
Urban population (2010)	31 M	Ekurhuleni	3,202
Urbanization rate (2010)	62%	eThekweni	2,879
Urban growth rate (2005–10)	1.8%	Port Elizabeth	1,068

Sources: World Bank database, World Urbanization Prospects, City Population.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

At the current rate of investment, South Africa will not eliminate its basic infrastructure backlogs until 2065. Six major urban centers account for 45 percent of these deficits—enormous needs for roads, sewerage, and drinking water. Urban expansion and economic growth also drive a significant share of demand, creating a need for regional-scale planning, as seen in Gauteng around Johannesburg.

South Africa's new 1996 Constitution gave first-level local governments purview over infrastructure and services. Municipalities' differences in size, management ability, and potential for mobilizing internal resources have resulted in diverse financial situations.

South Africa possesses two key assets for developing a vigorous municipal credit market: a mature financial system with one of the largest emerging-country capital markets and a well-established, approximately 100-year-old municipal tradition.

Context: Urbanization and Decentralization

A 20-year adjustment period, ending in the mid-2000s, profoundly transformed municipal territories and institutions—geographic boundaries, administrative arrangements, and social and demographic composition. Between 1996 and 2004, South Africa adopted a comprehensive legal framework, revising territorial jurisdiction, local government areas of authority, and the central government's role. However, the latest territorial reorganizations also reversed the earlier decentralization of some institutions; a number of government measures and projects also seem to reinforce this trend.

In 1994, apartheid's end marked the beginning of a new decentralization policy that aimed to reduce economic inequality and poverty. The Municipal Structures Act 117 of 1998 redrew administrative boundaries, abolishing spatial segregation between traditionally "white" cities and "black" or "colored" townships. Following a period of temporary reforms during which metropolitan

and municipal councils coexisted (known as the Metropolitan Councils and the Metropolitan Local Councils, respectively), in 2000 the central government replaced existing local administrations with District Municipalities. These were divided into (1) Local Municipalities and (2) Metropolitan Municipalities in the country's largest cities. In the Metropolitan Municipalities, the Local Government: Municipal Systems Act of 2000 established a popularly elected metropolitan council, headed by a mayor with a city manager serving as administrator. Wards committees¹⁷ further decentralized lower administrative levels, even as the metropolitan merger recentralized some local institutions. In 2006, 283 municipalities were classified into six Metropolitan Municipalities, 46 District Municipalities, and 231 Local Municipalities. Between 1995 and 2000, the two successive reforms divided the number of municipalities by four. Nine provinces form the highest level of territorial division and decentralization.

One-third of South Africa's population and more than one-half of its urban residents live in six metropolitan municipalities: Johannesburg, eThekweni (includes Durban), Cape Town, Ekurhuleni (formerly East Rand), Nelson Mandela Bay (includes Port Elizabeth), and Tshwane (includes Pretoria). Johannesburg, eThekweni, and Cape Town each have about 3 million residents. These three municipalities have combined with three other municipalities—Buffalo City, Mangaung, and Msunduzi—to form the South African Cities Network, an initiative of the Ministry for Provincial and Local Government in partnership with the South African Local Government Association (SALGA).

Municipalities' powers and investment expenditures A 1998 White Paper on Local Government put municipalities at the heart of local development, giving them autonomy and responsibility for social services and basic infrastructure: water and electricity supply, waste collection, sanitation, health facilities, and local services. By contrast, the White Paper did not define national-, provincial- and municipal-level functions.

In practice, a municipality's areas of authority are divided into three broad categories:

- Planning and managing urban expansions driven by relatively strong growth.
- Eliminating the infrastructure backlogs that accumulated during the apartheid regime and the period of underinvestment that followed. At the end of the 2000s, about 30 percent of the population lacked access to sanitation and 8 percent had no access to drinking water or electricity. The Gauteng metropolitan area has the lowest services access rate in the country.
- Providing low-cost or free housing and services to the poorest citizens, a constitutional obligation. On average, one-quarter of the residents in the nine largest cities qualify for such services. These cities must produce more than 1.25 million social-housing units by 2020.

Financing Mechanisms

South African local governments enjoy a relatively high level of financial autonomy through a robust combination of their own, internally generated resources, supplemented by central government transfers and access to borrowing through the issuers described in the following sections. Metropolitan municipalities depend much less on transfers than do many of their counterparts on the African continent. However, municipalities are seeing a decline in the share of their own revenues as a percentage of total resources, largely because of the central government's institutional reforms.

Municipalities' own resources Large cities receive revenues based on economic activity: property taxes (for metropolitan and local municipalities), utilities sales (mainly electricity), and, until recently, a Regional Service Council (RSC) business tax on turnover and payroll. These receipts account for about 90 percent of metropolitan municipality revenues; this percentage is much lower for small and medium-size municipalities.

The Constitutional Council abolished the RSC in 2006. The RSC had generated 17 percent of the nine largest cities' revenues, versus 10 percent provided by central government transfers. Because such transfers did not increase by an equivalent amount, municipalities lost their financial autonomy, and their overall resources declined. Other measures also seem to diminish municipality responsibilities. For instance, electricity distribution generated significant or even large financial surpluses for large metropolises, but this service has been transferred to regional distributors. In the case of municipalities with utility upgrade backlogs, the national government plans to consolidate their capital investments into a central fund (see the section titled "Recent Developments" later in this appendix).

Central and provincial government transfers The central government has set up two types of transfers for capital investments. The Equitable Share (ES) is an equalization mechanism that handles about 50 percent of total transfers; the Municipal Infrastructure Grant (MIG) finances basic infrastructure, especially for the poorest municipalities, and totals about 35 percent of national transfers. Three other restructuring and capacity building funds account for only a small fraction of transfers: Municipal Systems Improvement Grants, Financial Management Grants, and Local Government Restructuring Grants.

Every year the central government spends a larger share of the national budget on transfers, rising from 3.3 percent in 2002 to 5.9 percent in 2006 to 6.5 percent in 2009. This increase is a clear signal to municipalities, improving their visibility for investment planning. However, the poorest municipalities receive only 12 percent of this public funding, whereas the richest receive half.

Provincial governments also provide funding to municipalities. This provision causes jurisdictional conflicts in sensitive sectors, such as housing,

primary health care, and public transportation. Large municipalities criticize the provincial governments for the unpredictability of transfer amounts and disbursement schedules. The lack of transparency in apportionment also comes under attack.

Debt Financing

South African municipalities have a tradition of borrowing that dates back to the apartheid regime, when white municipalities borrowed from commercial banks and, in some cases, issued bonds. Nonetheless, the central government provided implied guarantees; risk analysis and management mechanisms were limited. By contrast, at the end of apartheid the new constitution explicitly stated that the central government did not guarantee local government borrowing. As a result, lenders and investors withdrew from municipal credit activities.

The regulations of the 2004 Municipal Finance Management Act (MFMA) aimed to reassure investors by addressing uncertainties arising from municipal reforms. Indeed, a climate of uncertainty had arisen concerning municipalities' new administrative boundaries, the end of the state guarantee on subsovereign loans, and the legal vacuum around local government debt conditions. Increased risk and higher transaction costs had led private investors to withdraw. The MFMA established clear and encouraging rules; it supervised localities' borrowing conditions while prompting them to improve management, transparency, and expertise.

From that point onward, the municipal credit market recovered slowly but steadily. However, it has retained its focus on the six metropolitan municipalities, chiefly Johannesburg, eThekweni, and Cape Town. Under MFMA, municipal borrowing may go only to capital expenditures, and the maximum loan duration may not exceed the life of the infrastructure. Municipalities have used debt most frequently to finance water systems, electricity, and roads. The municipal credit market has remained below its potential. Laws have proved conducive to borrowing, but in practice, small and medium-size municipalities have had low debt-absorption capacities, hindering credit market development. Key stakeholders have offered highly developed forms of credit—a state-owned development bank, a private specialized financial institution, commercial banks, and capital markets.

Development Bank of Southern Africa The state-owned Development Bank of Southern Africa (DBSA) dominates the municipal credit market; at the end of the 2000s, it held nearly 50 percent of outstanding loans. DBSA was created in 1983 to improve infrastructure networks in the former black homelands and townships; it began serving local governments in the 1990s. A traditional development bank, DBSA benefits from its status as a public body, refinancing itself with favorable terms from donors and the market. Consequently,

DBSA can make long-term loans. It also offers support to local governments: its operational surpluses replenish a fund dedicated to capacity building, the DBSA Development Fund. DBSA has also gradually made a business of financing infrastructure outside South Africa, and this activity now accounts for about 25 percent of its loan commitments.

Infrastructure Finance Corporation Limited INCA is a private company founded in 1996 that focuses on infrastructure funding. The largest private municipal lender, INCA has about a 20 percent market share, behind DBSA. INCA also finances water supply companies and public or parapublic agencies involved in infrastructure development.

INCA marshals about two-thirds of its resources through bond issues and one-third through long-term loans. Although a private sector institution, INCA has received subsidized loans from donors; sometimes these loans require separation of the grant element within a specific social-welfare fund. INCA has also borrowed from the private sector subsidiaries of international donors or from investment banks. In some cases, donors provide partial guarantees, as when the U.S. Agency for International Development (USAID) provided a guarantee and Blaylock & Partners provided a loan to INCA.

Commercial banks One of the country's largest commercial banks, Amalgamated Banks of South Africa (ABSA), followed INCA's lead by offering infrastructure financing in 1997. Other banks, such as First National Bank, Nedbank, and Standard Bank, have increasingly focused on this market. Excluding INCA, the private sector's share of the municipal credit market (in its narrowest sense) remains small.

Direct funding on capital markets South Africa has mature financial and bond markets. The Johannesburg Stock Exchange (JSE) is an international financial center. We noted previously that white municipalities had already issued municipal bonds during the apartheid regime. The MFMA specifically revived this option, but the municipal bond market has not grown as much as might have been expected. In fact, only the city of Johannesburg has used this financing method, issuing a series of bonds since 2004, some with credit enhancements through guarantees from the international lender, IFC, or from DBSA (see chapter 4, box 4.6, in this volume). Market professionals welcomed these initial bond issues as forerunners heralding a new era. Disappointment followed, however, because municipal bond issues remain rare. Financial market realities took over; even the largest municipalities have found that credit institutions offer more cost-effective products in terms of rates, durations, and grace periods. As long as these conditions persist, municipal bonds seem destined to play a secondary role, even though debt diversification or greater independence from a lender may justify issuing bonds.

The System's Outcomes over the Past Few Decades

Local investment financing in South Africa indisputably benefits from a comprehensive system, involving all types of tools and lenders. However, the central government has found fault with these systems' concentration on major cities—the six major metropolitan areas. Despite successive governments' efforts, few to no capital investment loans have gone to medium-size cities, much less to small towns. Overall, smaller cities' creditworthiness has improved insufficiently or not at all; a lack of suitable financial products limits their investments. Local municipalities remain very dependent on intergovernmental transfers. They also often find it difficult to use these funds.

DBSA has been criticized in this connection. As part of its mission as a public finance institution, in the 1990s DBSA aimed to demonstrate that the private sector could finance municipal infrastructure both viably and profitably. It would encourage new lenders to enter the market, steer them toward the creditworthy borrowers, and concentrate DBSA's support and assistance on the less creditworthy. But although new private sector lenders have appeared, DBSA has remained the leading lender in the municipal credit markets; it continues to finance the up-market segment—solvent cities—and holds nearly 65 percent of the outstanding metropolitan loans. Private sector financial institutions have criticized DBSA for unfair trade practices, given that (as a state-owned institution) it receives subsidized funding. The central government has reproached DBSA for not playing its intended public-policy role.

Some of these criticisms seem a little superficial. Indeed, the central government does not give DBSA resources to provide a money-losing public service; the bank must also ensure its financial viability. Therefore, it was inevitable that DBSA would remain positioned in the solvent segment of the market. Furthermore, some private sector lenders also have had access to subsidized funding, and have not hesitated to use it competitively. Still, the central government found the outcome unsatisfactory—more lenders fiercely competing in a market for the same number of borrowers.

On another level, a less-than-robust situation arises when private sector lenders concentrate their loans among a small number of borrowers. Because DBSA is state owned and holds an even larger share of outstanding loans, private lenders may think that they too operate under an implicit government guarantee, even if regulations exclude that possibility. This situation raises a risk of moral hazard.¹⁸

The investment backlog affecting small local governments results as much or more from their low absorption capacity—their lack of human resources and know-how—as from their difficulties in accessing credit. Some aspects of the MFMA regulations may contribute to these difficulties. Such problems also affect medium-size cities to some degree. As most observers see it, the policy of

strengthening investment capacity for small- and medium-size cities appears to have failed.

We also note that fundraising through bond issues remains uncommon; Johannesburg remains the only bond-issuing municipality. This finding may disappoint observers who expected the bond funding model to gain ground rapidly, but its muted success simply reflects market realities: local governments found better financing conditions more easily from financial and credit institutions.

Recent Developments

The system just described began to change at the end of the 2000s. Two engines drove this change: (1) increased donor funding and (2) a plan to create a central fund for small municipalities. Among the donors, AFD—already engaged in refinancing DBSA and INCA—made a subsovereign loan to eThekweni; the loan had favorable terms because it funded an environmental investment program. Then, the World Bank announced its grand entrance into municipal lending by planning a \$1 billion municipal loan. In the end, South Africa's policy on indebtedness led to the canceling of this World Bank loan before it was funded. However, the fact that the loan project reached an advanced stage demonstrates its relevance and usefulness as a model. The loan project included three components: one would have fueled the central governments' transfer mechanisms to local governments; another would have helped localities access financial markets directly through credit enhancements and secondary market support; and the third would have bolstered various local and national institutions. In addition to AFD, large European lenders such as the European Investment Bank (EIB) were expected to augment the World Bank's funding.

Simultaneously, the central government planned a special centralized fund for municipalities' basic infrastructure expenditures. The fund aims to help small and medium-size cities overcome their deficiencies in project preparation and execution. Notably, the fund pools resources and intervention capacities for groups of municipalities. These two developments prove quite characteristic of changes visible in other African countries: donors commit to financing budgets through transfer mechanisms, and central governments recentralize some powers in the name of streamlining and technical efficiency.

Situation Analysis

South Africa is exemplary for several reasons. It has drawn on the best international experiences to design decentralization's institutional, legal, and regulatory frameworks. A mature capital market, an efficient financial system, and a national policy that shunned major donors allowed the system to develop three major types of financing tools: municipal bonds and both public and private specialized financial institutions.

With the first municipal bond issues of the mid-2000s, observers saw the country embarking on a new investment financing model like that of the United States. Some years later, it is striking to see how the system actually comes closer to the European model. Private sector credit institutions and state-owned specialized financial institutions continue joint operations, and some commercial banks have entered the market. However, few municipalities issue bonds directly, and then only for moderate financing volumes. The arrival of major European infrastructure financing institutions, such as the EIB and Kreditanstalt für Wiederaufbau (KfW), supports this comparison.

Faced with increasing financing needs, the central government recognized the relative failure of its efforts to strengthen small and medium-size city capacities; ultimately, it entered into agreements with donors. In its scope and characteristics, the World Bank's planned funding—with its mix of contributions from other multilateral and bilateral donors—proved a turning point, even though the loan was never made. It exemplified a next-generation intervention, akin to budget aid.

The most important part of the program is the funding of central government transfers. In addition to traditional institutional assistance, the funding supports borrowers' access to capital markets and financing through bond issues. However, as lending opportunities attract new, deep-pocketed multilateral financiers, the market's already-strong competition may intensify. This competition includes national lenders—banks and specialized financial institutions—and other donors already heavily involved in intermediated or direct subsovereign financing. Under these conditions, direct funding of capital markets is unlikely to achieve a South African market share greater than the European market share.

Notes

17. Wards (electoral divisions) become mini-municipalities, instruments of local democratic participation provided for by the Local Government: Municipal Structures Act of 1998. A locally elected official chairs a ward committee in each constituency, and the official appoints committee members. Each member takes charge of one of 10 functions: municipal relations, NGO relations, youth, women, churches, local economic development, cultural and sports activities, health, safety, and education.
18. On the notion of moral hazard, see chapter 5, section titled “Legislative and Regulatory Infrastructure for Subsovereign Debt,” in this volume.

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8. Tunisia and the CPSC

Table A.8 Tunisia: Key Indicators

		Main cities	Inhabitants (thousands)
GDP per capita (2009)	\$3,792		
HDI/rank (2010)	0.683/81	Tunis	759
Total population (2009)	10 M	Sfax	265
Urban population (2010)	7 M	Sousse	173
Urbanization rate (2010)	67%	At-Tadaman	118
Urban growth rate (2005–10)	1.6%	Kairouan	118

Sources: World Bank Database, World Urbanization Prospects, City Population, INS Tunisie 2004.

Note: GDP = gross domestic product; HDI = Human Development Index, M = million.

Tunisia is a small, middle-income country counted among the emerging nations; it underwent urbanization decades ago. Most of its urban areas have very good infrastructure and basic services. Its fragile natural environment and planned improvements to rural infrastructure will drive its future needs. Tunisia's good infrastructure coverage and services result from a centralized and sectoral approach to financing. The Tunisian government has opted for line ministry-supervised, state-owned monopolies that do, however, use private sector companies for subcontracting. In the Tunisian system, local governments have few powers and little decision-making autonomy; for the most part, they hardly have any means to develop financial and technical management skills.

Context: Urbanization and Decentralization

In 2010, the urban population, locally defined as those living in cities of 5,000 or more inhabitants, accounted for 67 percent of all Tunisians. One-third of this urban population (2.25 million) resided in Greater Tunis.

A long-term program to classify settlements as *communes* (similar to municipalities) began its current form in 1975. The program covers only 30 to 35 percent of the territory and 60 percent of the total population. There are 264 communes, and 50 have fewer than 500 inhabitants. Elected councils govern each commune, with a mayor elected from among the council members. The rest of Tunisia has only one territorial level, governorates. There are 24 governorates, each headed by an appointed governor and a regional council consisting of elected officials. Although a Commune Law provides mechanisms for intercommunal cooperation, no such institution exists at the level of the large conurbations that have formed along the Tunisian coast.¹⁹ Three-quarters of all communes' population resides in these areas, alongside industry and tourism facilities. To date, Tunisian officials have addressed conurbation management issues through strategic planning. For example, in 1995

they created an urban agency for Greater Tunis that serves 82 communes in four governorates. Local officials have also initiated a City Development Strategy (CDS) for Greater Sfax.

A good network of infrastructure and services The basic services coverage level is high: in 2010, about 98 percent of the communes' residents had access to drinking water, and 83 percent had access to a sewerage system. Urban transportation requires additional investment, as does the solid waste sector; landfills that comply with environmental and health standards serve only 35 percent of the urban population. The biggest challenge lies in improving existing infrastructure and services to counter climate change risks, especially along the approximately 1,300-kilometer (808-mile) coastal strip. Water shortages expected to arise by 2015 will require the upgrading of many public works and the creation of new water production and distribution facilities.

Sectoral organization and financing The central government is responsible for electricity, water, sanitation, and urban transportation. Several institutions are involved in each of these sectors: a line ministry for policy guidance, oversight, and regulation; public utilities; a transportation agency or office; and, to some extent, the communes, which must be consulted prior to any project implementation in their territory. The main national operators include the following public utility corporations: the state-supported Société Tunisienne de l'Électricité et du Gaz (Tunisian Electric and Gas, or STEG) and Société Nationale d'Exploitation et de Distribution des Eaux (National Water Production and Distribution Company, or SONEDE); the state-owned, financially autonomous Office National de l'Assainissement (National Sanitation Office, or ONAS); and the equally autonomous, public Agence Nationale de la Gestion des Déchets (National Waste Management Agency, or ANGED). Other, somewhat local public authorities operate under their line ministries' supervision; such authorities manage urban transportation, nationally important wholesale markets, and other facilities. The largest operators finance their investments mostly by borrowing from multilateral or bilateral donors. However, SONEDE has raised capital from the domestic market.

Private sector delegation, concessions, and outsourcing The private sector has long participated in water and sanitation services through contracts to extend networks and connections. Some service-delegation contracts also exist, particularly for sanitation and solid waste. Legislative changes made in 2004 and 2007 authorized 30-year concession contracts for facilities such as desalination plants, sewage treatment plants, and urban transportation networks.

Limited local government powers and capacities Although new laws in 2006 assigned broader decision-making power to the governors, local governments (governorates and communes) remain under central government supervision.

Municipal council deliberations, decisions, budgets, and property transactions require central approval. Both the Ministry of Interior and Local Development and the Ministry of Finance decree and approve major investment projects.

Communes' responsibility for services remains limited to roads, sidewalks, traffic, parking, drainage, street maintenance, street lighting, parks, solid waste collection and transport, pollution control, market and slaughterhouse maintenance, and public order and safety. The relative disempowerment of local governments correlates with some of their shortcomings in technical and financial management. Often, local government staff members lack the proper credentials for modern municipal activities—for example, the technical expertise a project owner would need to set up and monitor public-private partnerships.

Financing Mechanisms

Commune resources Communes' current revenues come from their own, internally generated receipts—local taxes on property and other sources, user fees for services—and from central government transfers through the Fonds Commun des Collectivités Locales (Common Local Government Fund, or FCCL). Local governments cannot adjust the decree-determined tax amounts or user fee withholding mechanisms.

The communes' own revenues have steadily increased by about 6 percent per year since 1999. This growth mainly derives from central government initiatives to raise tax rates, enlarge the tax base, and improve tax collection. The share of central government transfers in total commune expenditures has steadily declined, from 45 percent in 1989 to 25 percent in 2008. The FCCL apportions its grants according to four allocations: a fixed 10 percent to all communes, 45 percent according to population size, 41 percent according to total property taxes (*taxe sur les immeubles bâtis*), and 4 percent for equalization payments.

Commune investment programs The high levels of service and infrastructure achieved rest, essentially, on a national planning policy—one led by the central government on a sectoral basis and tied to the national budget. This policy's main tool is a five-year economic and social development plan. In use since independence, such plans form the basis for defining and approving each commune's investment plan (Plan Investissement des Communes, or PIC). In the Ninth Plan (1997–2001), borrowing financed 37 percent of communes' investments, their own revenues financed 17 percent, and a local government loan and support fund (see the following section, titled "The CPSCS") transferred 45 percent. In the Eleventh Plan (2010–14), borrowing made up a bit less than one-third.

The communes' PICs have drawn much attention over the past decade, through a series of municipal development projects (*projets de développement*

municipal), partially funded by the World Bank and AFD. The latest project focused on the communes' financial and managerial weaknesses, especially in setting up city contracts.²⁰ Meanwhile, priorities in the last five-year plan have included strengthening communes' capacities, promoting local economic development, protecting the urban environment, and preserving Tunisia's urban heritage.

The CPSCL The Caisse de Prêts et de Soutien des Collectivités Locales (Loan and Support Fund for Local Authorities, or CPSCL) is a state-owned specialized financial institution, set up in its present form in 1975. The national budget provides part of its resources; borrowing, mainly from multilateral or bilateral donors, provides the rest. To date, the CPSCL has raised capital on the domestic market only once. Its prospective customers include communes, intercommunal institutions, governorate councils, and local public institutions. The CPSCL has no decision-making autonomy. It mostly finances projects that form part of the communes' PICs. The project type determines loan interest rates and maturities, which range from 7 to 15 years. The CPSCL has a special characteristic: in addition to its lending business, it deploys the subventions it receives from the central government.

Donors urged the Tunisian government to consider a partial or total privatization of the CPSCL in order to meet three objectives: increasing the CPSCL's autonomy, enlarging the municipal credit market, and diversifying funding sources. The central government rejected the idea, unwilling to give up any control over the local sector and influenced by the fact that the CPSCL's loss of public status would probably have raised its funding costs. Indeed, the CPSCL benefits from donors' subsidized interest rates, which are available only for sovereign loans. The CPSCL also enjoys a low-cost state guarantee for foreign-exchange risk. Even a partial privatization would mean that lenders would no longer see the central government as the CPSCL's guarantor of last resort, as they do at present. Such a situation would ultimately lower the CPSCL's credit rating, especially given the communes' current debt crisis.

The communes' debt crisis In theory, a commune's repayment ability determines the loan amounts it receives. In practice, the goal of universal equity and funds availability seems to have secured communes' right to borrow, regardless of actual financial positions or debt levels. Pursuit of this goal means that the CPSCL cannot adjust its loan conditions according to each commune's credit risk.

In 2005, the communes' outstanding debt represented 39 percent of their total revenue; this followed a tripling of the amount of credit extended between 1993 and 2005. Debt service increased from 7.7 percent of revenues in 1993 to 15.0 percent in 2005; this average masked an untenable financial situation for many communes. For example, Tunis's loan arrears accounted for about

40 percent of the national total, consuming the city's entire budget except for its investment allocations. This situation did not arise solely from a lending policy that ignored communes' repayment abilities; it also reflects their deteriorating management of expenditures and collection of resources.

The introduction of city contracts took steps to address this deterioration. Communes were divided into three financial categories: vulnerable, weak, or healthy. Special provisions came with each category, particularly for borrowing. However, the central government, through the CPSCL, gave clear priority to helping the communes rather than protecting lenders from risk. Loan interest rates were reduced for the most vulnerable communes, and thus, contrary to basic banking practice, the strongest borrowers currently pay the highest rates. Furthermore, there is no penalty for rescheduling payments. In other words, little incentive exists to reward responsible borrowers or quality loan management; indeed, the opposite may be true. The CPSCL denies loans to only the most vulnerable communes.

Situation Analysis

Tunisia's local investment financing system has unquestionably shown itself to be successful, as seen in its basic-services coverage rate. The system is certainly highly centralized, perhaps justifiably so, when we consider the country's relatively small size and its streamlined technical and sectoral approach. Consequently, Tunisia's municipal credit market remains very small.

As matters stand, the CPSCL seems more a central government agency responsible for implementing public policy than a financial institution in the fullest sense of the term. The CPSCL lacks decision-making autonomy and operates in a narrow market without diversified funding sources. The conditions for its modernization remain suboptimal; it cannot offer borrowers innovative products and services. The CPSCL and the national agencies and offices fund themselves almost exclusively with somewhat subsidized, long-term loans from multilateral and bilateral donors. Tunisian financial services companies contribute only marginally to public infrastructure financing. It is a paradoxical situation: banks have excess liquidity, but the central government overlooks the opportunity to mobilize local savings while insuring against exchange-rate risk for loans elsewhere.

It is impossible to predict how the apportionment of powers, and decentralization in a broader sense, will evolve in the wake of the Arab Spring. Nevertheless, the communes' debt problem will remain central to these issues. Given a possible decline in central government transfers, the local financing system for urban investment will probably need reworking to make it truly viable. In this event, the CPSCL could modernize its offerings, diversify its products and funding sources, and expand its customer base to include public and private operators. Tunisians' aspirations for local democracy should inform these decisions. Proposed changes

should also meet the challenge of adapting to climate change risks and should address the institutional aspects of managing large conurbations.

Notes

19. In 2010, Greater Tunis was estimated to have 2.25 million inhabitants; the Greater Sfax metropolitan area had 500,000 in seven communes. The country's third-largest city, Sousse, is part of a conurbation formed with the City of Monastir and eight other communes that together total about 450,000 residents. Other conurbations also appear around Bizerte and Hammamet-Nabeul.
20. See also chapter 1, box 1.8, in this volume.

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Results: An Attempt to Characterize Countries and Their Tools

Table A.9 Types of Investment Financing Tool by Country

Country	Commercial banks	National banks	Decentralization funds	State-owned SFI	Private sector SFI	Bond market
Cape Verde	•					
Egypt, Arab Rep.		•				
Ghana			•			
Morocco				•		
Nigeria					•	•
Senegal			•			
South Africa				•	•	•
Tunisia				•		

Source: Author.

Note: SFI = specialized financial institution.

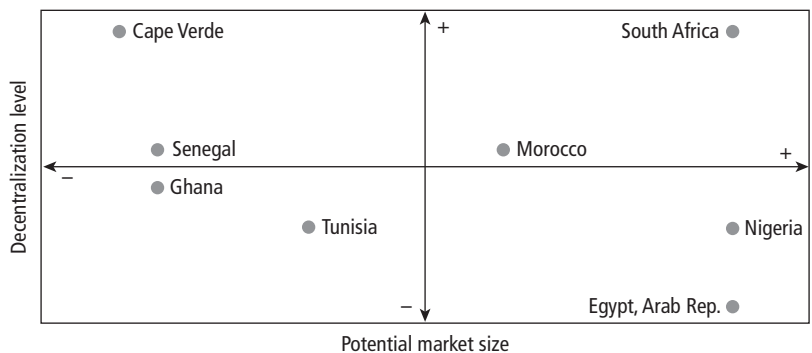
These case studies identify a relatively complex system. Financing tools vary considerably; sometimes several tools coexist and interact within a single national context (see table A.9). National contexts also prove extremely varied in their legal and administrative environments and in municipal-credit market size—the latter depending on a series of interrelated factors.

We highlight what appear to be the most important findings and lessons below.

Lesson 1. Municipal-credit market size is an ambiguous concept. We should distinguish between potential and real markets. Estimates of market potential may derive roughly from a country's population size, urbanization rate, and economic development level. These same criteria, weighted by the extent of decentralization and the scope and nature of local government powers, determine the real market (see figure A.1). Egypt's real market is small, whereas its potential market is huge, given its cities' share of population and the economy. Tunisia's real market remains well below what it could be, because the central government prefers to give infrastructure and basic investment responsibilities to national agencies and companies. Tunisia provides a stark contrast in comparison with countries where local governments' powers are broader, such as Morocco and especially South Africa.

Lesson 2. Real market size determines a financing system's viability. Below a certain threshold, a financial institution's viability cannot be guaranteed. Ghana proves instructive in this regard. Its feasibility study for a Municipal Finance Authority showed that, given the financial institution's low turnover potential,

Figure A.1 Countries Positioned According to Market Size and Decentralization Level



Source: Author.

Note: Decentralization level: + = High - = Low
Potential market size: + = Large - = Small

breaking even would be difficult, regardless of competition (see lesson 8). Overriding this consideration means moving to a public service model—combining a specialized financial institution (SFI) and a deconcentrated central government service. Such a combination may exist with varying proportions of each element, as seen in the Senegal and Tunisia case studies. Smaller markets might consider the alternative of combining commercial banks with an ad hoc incentive mechanism, as in Cape Verde.

Lesson 3. Real market size also depends heavily on local governments' expertise and implementation capacity. Expertise determines their ability to identify investments tailored to their needs, priorities, economic situation, receipts collection, and overall management quality. Implementation capacity determines the timetables for executing investments and arranging borrowings. The case of Morocco, where the largest local governments end their fiscal years with budget surpluses, proves instructive in this regard. In other words, real market size must be built and supported; this is the responsibility of oversight authorities. Tools such as city or agglomeration contracts, as in Senegal and Tunisia, may prove valuable for this approach.

Lesson 4. Public or parapublic SFIs, like those in Egypt, Morocco, and Tunisia, confront two kinds of difficulties, particularly where they hold monopolies: (1) central governments cannot always resist interfering in investment decisions, and (2) the SFI managers' status does not insulate them from outside pressures. Financing approval may rest on other than purely technical or financial criteria, giving rise to impaired loans and defaults. The defaults also tend to grow through a ripple effect. Over time, borrowers may come to count on the

central government's implicit loan guarantee and expect that it will eventually reschedule payments or cancel debts.

Lesson 5. Private sector SFIs, as in Nigeria and South Africa, confront a particular type of risk. In the absence of subsidized resources, these institutions necessarily target the most profitable and revenue-generating investments or the most creditworthy borrowers. However, this niche market is not infinite, even in Africa's largest real municipal credit markets, and, indeed, often proves quite small. Similarly, if a private sector SFI successfully grows along with such markets in their early expansion, its success ultimately attracts commercial banks, which have begun to position themselves in the same markets. Commercial banks have access to less-costly funding, especially in countries with a large deposits base. Thus, commercial banks can win market share relatively easily from the SFI—a market that the SFI needs in its entirety to remain viable.

Lesson 6. Donors sometimes endow private sector SFIs with subsidized resources, as in Nigeria and South Africa. Concessional funding usually comes with conditions; subsidized resources may only apply to social welfare investments, for instance, or may have a grant element isolated in a special account. Whatever the conditions, such practices eventually seem to distort competition one way or another. Consequently, donors' concessional funding draws blame for preventing normal bond market development (where bond markets exist) and for hindering commercial banks' entry into municipal-credit markets, and thus into mobilizing savings.

Lesson 7. Different types of financial institutions—private or parapublic SFIs or commercial banks—and different types of funding—such as direct bond-market funding without intermediation or debt financing—may coexist in major markets, as in Nigeria and South Africa. This coexistence seems desirable, considering its dynamic effects on the market. However, competition alone does not suffice. It cannot automatically meet the needs of the entire spectrum of local governments and investments, because all financial institutions naturally try to position themselves in the most profitable or creditworthy markets. Therefore, central governments should create incentives and regulations that strengthen the most fragile market segments, or set up specific means to ensure basic-services investments.

Lesson 8. Small markets, such as Ghana and Senegal, offer no room for competition between private entities, whereas competition between public entities may become exacerbated and relatively destructive. Different public entities may compete for the same market, in a conflict that the central government struggles to arbitrate. Central government services and donors may confront competing ideas of decentralization and territorial development.

Lesson 9. To date, local governments tap bond markets directly and without intermediation only in exceptional cases, as in Nigeria or South Africa. The complexity of such arrangements and their high costs hamper municipal bonds'

growth prospects. The funds raised may not have the best characteristics for executing infrastructure, particularly in terms of maturities. In current market conditions where alternatives exist, such as in South Africa, a local government with a good credit rating may obtain local-currency financing more easily from an SFI or a commercial bank.

Lesson 10. The success of SFIs in refinancing in bond markets has had different outcomes, depending on the country—Ghana, Morocco, Nigeria, South Africa, or Tunisia. Well-developed capital markets provide the first parameter. In many countries, bond markets are still in their infancy. In general, the resources SFIs can raise remain relatively expensive. For this reason, many SFIs deliberately turn to donors for funding, rather than to capital markets. This has led to absurd situations in some countries; SFIs borrow in foreign currencies to finance domestic investment although local banks have excess liquidity. However, most of the defects that hamper local governments' efforts to finance themselves on bond markets—complexity, arrangement costs, durations, and lack of grace periods—have less effect on SFIs. In principle, an SFI is better equipped technically and must refinance itself regularly in any case. For central governments, this solution has many advantages—primarily in collecting savings. For these reasons, SFI use of capital markets will probably grow in importance on the African continent, in step with the maturing of capital markets.

Lesson 11. The fact remains that the current state of African capital markets often makes it impossible for an SFI to fund itself through bond issues exclusively. The feasibility study and business plan for the Ghanaian Municipal Finance Authority highlighted two bond market challenges: high costs and short-term resources. Even if an SFI maintains the lowest operating costs, in such conditions it cannot offer products that meet local governments' largest investment needs. In this type of configuration, it follows that an SFI's viability rests on its access to subsidized resources or grants. In such situations, hybridizing subventions with local currency capital markets resources may provide an optimal solution, producing loan products with suitable interest rates and maturities.

Lesson 12. Commercial banks rarely show interest in the municipal credit market on the African continent. However, case studies from Cape Verde and South Africa show that this situation may change. In most European countries, universal commercial banks, alongside specialized agencies, have gradually gained larger shares of the municipal lending market in recent decades. In South Africa, commercial banks turned to this business naturally, once they believed that the market had sufficiently developed. At the other end of Africa's municipal credit spectrum is Cape Verde, where commercial banks—already somewhat active for historical reasons—have deepened their involvement since the central government created an incentivizing mechanism with donor support. The operation raises the usual questions about this type of approach: How will matters change if the donor withdraws? Are banks simply taking advantage of a windfall? Nevertheless,

such operations open the way to promising options. In many countries with small markets, such an arrangement could eventually facilitate access to borrowing and capacity building, without requiring the creation of a specific financial institution with operating costs that might adversely affect the system's performance.

These lessons seem worth highlighting, but this list is not exhaustive. The case studies presented here in an abbreviated form provide numerous crucial insights. They inform this volume, enriching its analyses and guidance, alongside experiences drawn from other continents.

Index

Boxes, figures, maps, notes, and tables are indicated by b, f, m, n, and t, respectively, following the page numbers.

A

- absorption capacity, 29, 133–35, 247, 284
- Abu Dhabi Fund for Development, 176
- Abu Dhabi Investment Authority
(ADIA), 177
- accountability, 135
- accounting standards, 155
- Adaptation Fund, 26
- adaptation investment financing, 24–28, 82–83
- ADIA (Abu Dhabi Investment Authority), 177
- ADL (Agence de Développement Local, Senegal), 162, 165*b*
- ADM (Agence de Développement Municipal, Senegal), 42*b*, 162, 164, 165*b*, 298–300
- administrative systems, 112–14, 135*b*
- AFD. *See* Agence Française de Développement
- AfDB. *See* African Development Bank
- affordable housing, 243–44, 244*b*, 245*b*
- Africa. *See also specific countries and regions*
 - business climate in, 64
 - cities and ports, map of, 77*m*
 - climate change risks in, 81*m*
 - defining, 2–3
 - demographic and economic changes in, 63–68, 66*t*
 - financial markets in, 154–55
 - local investment financing in. *See* local investment financing
 - regions of, 3*m*, 3–4
 - road map for. *See* road map
 - urbanization in. *See* urbanization
- Africa Infrastructure Country Diagnostic (AICD), 98, 98–99*b*
- African Development Bank (AfDB), 2, 64, 138, 158, 208*b*
- African Infrastructure Investment Fund, 178
- Africa's Infrastructure: A Time for Transformation* (World Bank), 124
- Agence de Développement Local (ADL, Senegal), 162, 165*b*
- Agence de Développement Municipal (ADM, Senegal), 42*b*, 162, 164, 165*b*, 298–300
- Agence de Gestion Foncière (AGEF, Côte d'Ivoire), 93*b*
- Agence d'Exécution des Travaux d'Intérêt Public contre le sous-emploi (AGETIP), 249*b*
- Agence Française de Développement (AFD)
 - Africa defined by, 2
 - direct loans to local governments from, 168

- Agence Française de Développement (AFD) (*continued*)
 domestic bond markets and, 157, 157*b*
 public-private partnerships and, 17
 specialized financial institutions and, 165*b*
- Agence National de Lutte Contre l'Habitat Insalubre (ANHI, Morocco), 245*b*
- Agence Nationale d'Investissement des Collectivités Territoriales (ANICT, Mali), 162
- agency credit ratings, 43, 44–46, 45*b*, 49*b*, 213, 232
- AGETIP (Agence d'Exécution des Travaux d'Intérêt Public contre le sous-emploi), 249*b*
- agglomeration, 11–13, 12*b*
- AGGP (Amman Green Growth Program, Jordan), 225*b*
- agricultural production
 capital investment needs for, 200
 climate change and, 81–82
 population growth and, 65
 Poverty Reduction Strategy Papers and, 75*b*
- AICD (Africa Infrastructure Country Diagnostic), 98, 98–99*b*
- aid effectiveness, 111
- aid orphans, 38
- airports, 16
- Algeria
 global financial crisis impact on, 64
 land market failures in, 90*b*
 local public finances in, 120, 121*t*
 public-private partnerships in, 170, 171
 sovereign wealth fund in, 63, 179
- Ambac Financial Group, Inc., 52
- American Dream Commitment program, 54
- American Recovery and Reinvestment Act of 2009, 223*b*
- Amman Green Growth Program (AGGP, Jordan), 225*b*
- Angola
 China's financing of infrastructure in, 175
 private sector investments in, 178
 refugees from, 139*b*
- Angola mode mechanism, 175
- Angola Stock Exchange, 154
- ANHI (Agence National de Lutte Contre l'Habitat Insalubre, Morocco), 245*b*
- ANICT (Agence Nationale d'Investissement des Collectivités Territoriales, Mali), 162
- aquifer salinization, 127
- Arab Bank for Economic Development in Africa, 176
- Arab Republic of Egypt. *See* Egypt
- Asian Development Bank, 138
- assessment systems for local investment financing, 43–44
- audit and control procedures, 44, 232
- Augusto and Company, 167*b*
- Austral Bank (Mozambique), 161
- Australia, land value capture mechanisms in, 19
- B**
- banking sector, 152–54, 203. *See also* commercial banks
- Bank of Central African States, 189*n*8
- Banque de Développement des États de l'Afrique Centrale (BDEAC), 160
- Banque Nationale de Développement Agricole (BNDA, Mali), 161
- Banque Nationale de Tunisie, 159*b*
- Banque Nationale pour le Développement Économique (BNDE, Morocco), 159*b*
- Banque Ouest Africaine de Développement (BOAD), 160, 222
- Barro, Robert, 29
- base-costs estimates, 99–102, 101*t*
- base localities, 112, 112*t*

- basic needs strategy, 72
- basic services
 - institutional framework for, 125*b*
 - local government's role in, 119*b*, 129–31*b*
 - management of, 4, 124–33
- BDEAC (Banque de Développement des États de l'Afrique Centrale), 160
- Belgium, Dexia crisis role of, 53*b*
- Benin
 - China trade with, 175
 - flooding risks in, 80
 - land ownership in, 86, 242*b*
 - public-works employment agency in, 249*b*
- betterment levies, 238, 238*b*
- Bill and Melinda Gates Foundation, 10, 173–74
- Blakeney Management, 178
- BNDA (Banque Nationale de Développement Agricole, Mali), 161
- BNDE (Banque Nationale pour le Développement Économique, Morocco), 159*b*
- BOAD (Banque Ouest Africaine de Développement), 160, 222
- bond banks, 217
- bond insurers, 21, 50–52, 51
- bond markets, 155–58, 157*b*. *See also*
 - domestic bond markets;
 - municipal bond market
- bond syndication, 217–19, 218–19*b*
- borrowing capacity, 122–24, 123*t*
- borrowing for local investment financing, 14–16, 32–33. *See also* debt financing
- BOT (build-operate-transfer) contracts, 171, 172
- Botswana
 - drought in, 81
 - financial markets in, 155
 - pension funds in, 156
 - private sector investments in, 178
 - sovereign wealth fund in, 63, 179
- Bourse Régionale des Valeurs Mobilières d'Afrique Central (BVMAC), 155
- Bourse Régionale des Valeurs Mobilières d'Afrique de l'Ouest (BRVM), 154–55
- Brazil
 - CDM financing in, 25
 - development assistance from, 176
 - philanthropic foundation funding to, 173
- bridge loans, 211
- BRT (Bus Rapid Transit) system, 225*b*
- BRVM (Bourse Régionale des Valeurs Mobilières d'Afrique de l'Ouest), 154–55
- budget assistance, 111
- budgetary management
 - credit ratings and, 44
 - decentralization of, 116
 - housing market and, 239
 - PEFA evaluation of, 47
- build-operate-transfer (BOT) contracts, 171, 172
- Burkina Faso
 - China trade with, 175
 - development banks in, 161
 - local governance in, 137*b*
 - philanthropic foundation funding to, 174
 - public-works employment agency in, 249*b*
 - specialized financial institutions in, 162
 - subsovereign hybrid financing in, 169*b*
 - urbanization in, 70*b*
- Burundi
 - flooding risks in, 80
 - public-works employment agency in, 249*b*
 - urbanization in, 70*b*
- business taxes, 150
- Bus Rapid Transit (BRT) system, 225*b*
- buy-down lending model, 20

BVMAC (Bourse Régionale des Valeurs Mobilières d'Afrique Central), 155

C

Caisse d'Aide à l'Équipement des Collectivités Locales (CAECL, France), 53*b*

Caisse de Dépôt et de Gestion (CDG, Morocco), 159*b*, 179*b*

Caisse de Garantie Mutuelle pour l'Habitat (CGMH, Côte d'Ivoire), 93*b*

Caisse de Prêts et de Soutien des Collectivités Locales (CPSCL, Tunisia), 42*b*, 162, 314

Caisse des Dépôts et Consignations (France), 179*b*

Caisse des Dépôts et Consignations du Sénégal, 165*b*

Caisse Nationale de Crédit Agricole (National Farm Bank, Morocco), 159*b*

Cameroon

contractual approach in, 41
domestic bond market in, 155
financial markets in, 155
HIPC appropriations to, 74
housing policy in, 92*b*
land nationalization in, 86
microfinance in, 184, 186
remittances to, 183
second-tier cities in, 70*b*
specialized financial institutions in, 162
tax policy in, 150, 151

Cameroon Cooperative Credit Union League (CamCCUL), 186

Cancun Climate Summit (2010), 25, 225*b*

Cape Verde

AICD on, 98*b*
case study, 6, 263–68
commercial banks in, 220, 266–67
decentralization in, 263–66, 318*f*
financing mechanisms in, 266–67, 317*t*
key indicators, 263*t*

public-works employment agency in, 249*b*

remittances to, 182

situation analysis, 267–68

specialized financial institutions in, 162

urbanization in, 263–66

capital markets

bond syndication, 217–19, 218–19*b*

direct bond issuance, 216–17

intermediation, 217–19

road map for, 215–19

stock exchanges and, 154

carbon finance

in investment financing frameworks, 179–81, 181*b*

in Jordan, 225*b*

for public transport, 58*n*8

Carbon Fund for Europe, 58*n*9

Cassa Depositi e Prestiti (Italy), 179*b*

Catch the Dream program (U.S.), 54

CDG (Caisse de Dépôt et de Gestion, Morocco), 159*b*, 179*b*

CDM. *See* Clean Development Mechanism

CDMH (Compte de Mobilisation pour l'Habitat, Côte d'Ivoire), 93*b*

CEB (Council of Europe Development Bank), 248*b*

CEMAC. *See* Communauté Économique et Monétaire de l'Afrique Centrale

Central Africa. *See also specific countries*
defined, 3, 3*m*

financial markets in, 155

local government financial capacity in, 123, 123*t*

local public finances in, 120, 120*t*, 122

population growth in, 68, 68*t*

UN-HABITAT on state of cities in, 76*b*

urbanization in, 70*b*

Central African Republic

public-works employment agency in, 249*b*

refugees from, 139*b*

urbanization in, 70*b*

- Central African States Development Bank, 160
- Central Bank of West African States, 189*n*8
- central government
 - agglomeration authorities and, 13
 - corruption in, 40*b*
 - decentralization and, 110–11
 - in Egypt, 272–73
 - fragile situations and, 142*b*
 - in Ghana, 277
 - land development by, 88, 103*n*11
 - local government contracts with, 40–41
 - local government powers and, 11–12
 - in South Africa, 304–5
 - waste management by, 143*n*9
- CFC (Crédit Foncier du Cameroun), 92*b*
- CfC Stanbic Bank (Kenya), 186
- CGMH (Caisse de Garantie Mutuelle pour l'Habitat, Côte d'Ivoire), 93*b*
- Chad
 - AICD on, 98*b*
 - refugees in, 139*b*
 - urbanization in, 70*b*
- chiefdoms, 135
- child mortality rates, 73*b*
- China
 - CDM financing in, 25
 - investment financing from, 174–76, 226
 - land value capture mechanisms in, 17, 240
 - local investment funds in, 227
 - Urban Development Investment Corporations (UDICs) in, 228*b*
- China Exim Bank (Export-Import Bank of China), 175–76
- China Investment Corporation, 177
- CIF (Climate Investment Fund), 25
- Cities Alliance program, 174
- "Cities without Slums" program, 245*b*
- city contract, 36, 41–42, 165, 296, 298, 300, 314–15
- civil liberties, 39*b*
- civil service, 133–34, 251
- civil society, 41
- Clean Development Mechanism (CDM), 25, 26, 179–80, 225*b*
- Clean Technology Fund (CTF), 25, 27, 83
- Clean Water Act of 1972 (U.S.), 223*b*
- Clean Water State Revolving Fund (U.S.), 20, 223*b*
- CLF (Crédit Local de France), 53*b*
- climate change
 - adaptation investment financing and, 82–83
 - agricultural production and, 81–82
 - cyclones and, 81*m*
 - droughts and, 81*m*, 81–82
 - flooding and, 80–81, 81*m*, 82*b*
 - local investment financing and, 24–28
 - migrations and, 81–82
 - mitigation investment financing and, 82–83
 - sea-level rise and, 80–81, 81*m*
 - urbanization and sectoral policies and, 80–83, 81*m*
- Climate Investment Fund (CIF), 25
- coastal areas, 80
- collaborative financial analysis, 47
- collateralization of future revenues, 21, 27
- collective action, 8–11, 234
- collective rights, 86–87
- Colombia
 - commercial banks in, 221*b*
 - land value capture in, 238*b*
- commercial banks
 - banking sector and, 203
 - in Cape Verde, 266–67
 - domestic bond markets and, 156
 - housing and, 54
 - local government debt financing via, 14, 15–16
 - microfinance and, 186
 - in Morocco, 285
 - municipal bond issuance and, 168
 - road map for, 220–21, 221*b*
 - in South Africa, 306
- Communauté Économique et Monétaire de l'Afrique Centrale (CEMAC), 155, 160, 189*n*8

- communes. *See also* local authorities
 extra penny fee for, 150, 188*n*3
 as transitional actors, 113
 in Tunisia, 313–14
- Community of Madrid, 13
- Compte de Mobilisation pour l'Habitat (CDMH, Côte d'Ivoire), 93*b*
- Compte des Terrains Urbains (CTU, Côte d'Ivoire), 93*b*
- concessional loans, 19
- Congo. *See* Democratic Republic of Congo
- Constituency Development Fund Act of 2003 (Kenya), 118*b*
- construction industry, 96, 198
- continuum of land rights, 87
- contractual approach, 38–42, 42*b*
- contribución de valorización (Colombia), 238*b*
- corruption
 economic growth and, 67
 fragile situations and, 138
 land value capture and, 18, 240
 local governance and, 36, 37*b*, 40*b*, 136
- cost-of-funding estimates, 206–7*b*
- Côte d'Ivoire
 administrative entities in, 113
 AICD on, 98*b*
 delegated funds in, 117
 domestic bond market in, 157*b*
 housing and land development policies in, 93*b*
 land development in, 90
 local government powers in, 115*b*
 regional financial market and, 155
 tax policy in, 150, 151
- Council of Europe Development Bank (CEB), 248*b*
- Country Policy and Institutional Assessment, 138
- CPSC (Caisse de Prêts et de Soutien des Collectivités Locales, Tunisia), 42*b*, 162, 314
- credit enhancement, 20–23, 23*b*, 51
- Crédit Foncier du Cameroun (CFC), 92*b*
- credit guarantees, 22
- credit institutions. *See* banking sector; commercial banks; regional development banks
- Crédit Local de France (CLF), 53*b*
- credit ratings
 financial analysis and, 43
 local investment financing and, 44–46, 45*b*, 49*b*
 road map for, 213, 232
- crony capitalism, 88, 136
- cross-border listing agreements, 155
- cross-subsidization, 24, 31*b*
- CTF. *See* Clean Technology Fund
- CTU (Compte des Terrains Urbains, Côte d'Ivoire), 93*b*
- C2D (Debt Cancellation and Development Contract, France), 74
- Currency Exchange Fund (TCX), 158
- currency exchange risk, 156, 222, 231
- cyclones, 80, 81*m*
- ## D
- DACF (District Assembly Common Fund, Ghana), 278
- DBSA (Development Bank of Southern Africa), 162, 166*b*, 305–6
- DCA (Development Credit Authority), 23*b*, 186, 219*b*
- DDF (District Development Fund, Ghana), 162, 278–79
- Debt Cancellation and Development Contract (C2D, France), 74
- debt ceilings, 213, 230–31
- debt financing. *See also* domestic bond markets; municipal bond market
 in Ghana, 279
 in Morocco, 284–85
 in South Africa, 305–6
- debt registries, 213, 233
- debt relief, 63
- debt service reserve funds, 214

decentralization, 4, 109–11
 in Africa, 110–11, 113*b*
 in Cape Verde, 263–66, 318*f*
 contractual approach and, 41
 in Egypt, 269–71, 318*f*
 in France, 53*b*
 in Ghana, 135*b*, 277, 318*f*
 measurement of, 120
 in Morocco, 281–82, 284, 318*f*
 in Nigeria, 288–91, 318*f*
 road map for, 200–201, 201*b*
 in Senegal, 296–97, 318*f*
 in South Africa, 113*b*, 302–3, 318*f*
 tax policy and, 149
 in Tunisia, 311–13, 318*f*
deconcentration, 109, 277
defaulted debt, 231–32
delegation, 109, 116, 117
democracy
 democracy in proximity concept, 109
 as governance component, 37*b*, 39*b*
Democratic Republic of Congo
 administrative entities in, 113
 China's financing of infrastructure in,
 175, 176
 local governance in, 141*b*
 local public finances in, 120
 refugees from, 139*b*
 second-tier cities in, 70*b*
demographics
 economic growth and, 198
 urbanization and, 68–72, 68*t*, 69*f*
de Soto, Hernando, 94
Development Assistance Committee
 (OECD), 175
Development Bank of Kenya, 161
Development Bank of Southern Africa
 (DBSA), 162, 166*b*, 305–6
development banks and finance
 institutions, 158–61, 159*b*
Development Credit Authority (DCA),
 23*b*, 186, 219*b*
devolution, 109, 110, 115*b*
Dexia, 52, 53*b*, 205
diaspora bonds, 183

disintermediation, 14
District Assembly Common Fund
 (DACE, Ghana), 278
District Development Fund (DDF,
 Ghana), 162, 278–79
Division of Revenue Act (South Africa),
 152*b*
Djibouti
 Poverty Reduction Strategy Papers
 in, 75*b*
 public-works employment agency in,
 249*b*
domestic bond markets, 155–58, 157*b*,
 203. *See also* municipal bond
 market
Domestic Medium-Term Note
 Programme (South Africa), 166*b*
domestic savings, 156–57, 157*b*, 183
donor financing
 bond issuance in African capital
 markets, 157*b*
 of civil service training, 134
 contractual approach and, 41
 credit enhancement mechanisms and,
 21
 decentralization and, 117
 in Egypt, 273
 land development and, 90, 91
 local governance and, 137*b*
 municipal debt issuance and, 15
 public-private partnerships and, 16–17
 specialized financial institutions and,
 164
 in strategic financing framework, 35
Douala Stock Exchange (Cameroon), 155
downward spirals, 138–40
droughts, 81*m*, 81–82
Dubai Investment Group, 177

E

East African Community (EAC), 160
East African Development Bank (EADB),
 160
East African Member States Securities
 Regulatory Authorities, 155

- Eastern Africa. *See also specific countries*
 decentralization in, 122
 defined, 3, 3*m*
 financial markets in, 155
 local government financial capacity in, 123, 123*t*
 local public finances in, 120, 120*t*
 population growth in, 68, 68*t*
 UN-HABITAT on state of cities in, 76*b*
 urbanization in, 68, 70*b*
- ECF (English Cities Fund, Great Britain), 248*b*
- economic freedom as governance component, 39*b*
- economic geography, 31
- economic growth
 land development and, 95–96
 migrant remittances and, 182
 population growth and, 198
 urban economy in Kinshasa, 79*b*
- economic rate of return (ERR), 34–35
- economic theory on public investment, 29–32, 30–31*b*
- Ecuador, guided land development in, 235
- ECX (Ethiopia Commodity Exchange), 154
- education
 African Development Bank investments in, 12*b*
 of civil service workers, 133–34, 251
 fragile situations and, 139, 142*b*
 as governance component, 39*b*
 middle class and, 64
 Poverty Reduction Strategy Papers and, 75*b*
- effective demand, 206*b*
- EFG Hermes (Egyptian bank), 179*b*
- Egypt, Arab Republic of
 banking sector in, 153
 carbon finance in, 180
 case study, 6, 269–75
 central government financing in, 272–73
 decentralization in, 269–71, 318*f*
 development banks in, 159*b*
 domestic bond market in, 156, 157*b*
 donor financing in, 273
 financial markets in, 154
 financing mechanisms in, 271–74, 317*t*
 global financial crisis impact on, 64
 infrastructure and services financing in, 272–73
 key indicators, 269*t*
 land added-value-based financing in, 273
 microfinance in, 185
 private sector partners in, 273
 refugees in, 139*b*
 situation analysis, 274
 urbanization in, 269–71
- electricity generation and distribution
 capital investment needs for, 200
 decentralization and, 119*b*
 economic growth and, 67–68
 fragile situations and, 141*b*, 142*b*
 local governance and, 137*b*
 Poverty Reduction Strategy Papers and, 75*b*
 privatization in, 119*b*
 public-private partnerships in, 16, 170, 171
 services management for, 128
 in South Africa, 143*n*11
- Emissions Reduction Purchase Agreement (ERPA), 27, 83, 180
- endogenous growth theory, 29
- endowment transfers, 116
- English Cities Fund (ECF, Great Britain), 248*b*
- English-speaking countries. *See also specific countries*
 financing mechanisms in, 149
 tax policy in, 150, 241
 territorial organization in, 114
- Environmental Protection Agency (EPA, U.S.), 20
- ERDF (European Regional Development Fund), 248*b*

- Eritrea
 refugees from, 139*b*
 urbanization in, 70*b*
 ERPA. *See* Emissions Reduction Purchase Agreement
 escrow accounts, 214
 eThekweni landfills (South Africa), 180
 Ethiopia
 child mortality rates in, 73*b*
 China's financing of infrastructure in, 175
 diaspora bonds in, 183
 land value capture in, 97*b*
 local public finances in, 120
 Poverty Reduction Strategy Papers in, 75*b*
 private sector investments in, 178
 urbanization in, 70*b*
 waste management in, 130–31*b*
 Ethiopia Commodity Exchange (ECX), 154
 Europe
 bond banks in, 217
 economic geography model in, 31
 land value capture mechanisms in, 17
 municipal bond market in, 14
 European Investment Bank, 179*b*, 245*b*, 248*b*
 European Regional Development Fund (ERDF), 248*b*
 ex ante regulatory provisions, 230–32
 Export-Import Bank of China (China Exim Bank), 175–76
 Export-Import Bank of India (India Exim Bank), 176
 ex post regulatory provisions, 232
 external shocks, 64
 extra penny fee, 150, 188*n*3
F
 failed states, 144*n*19. *See also* fragile situations
 Fannie Mae (Federal National Mortgage Association), 52, 54
 farmland degradation, 65. *See also* agricultural production
 Paulu Kenya, 186
 FEC (Fonds d'Équipement Communal, Morocco), 155, 220
 Federal Home Mortgage Corporation (Freddie Mac), 52, 54
 Federal National Mortgage Association (Fannie Mae), 52, 54
 FEICOM (Fonds Spécial d'Équipement et d'Intervention Intercommunale, Cameroon), 162
 fiduciary trusts, 214
 financial analysis for local investment financing, 42–50
 agency credit ratings and, 44–46, 45*b*, 49*b*
 assessment systems for, 43–44
 collaborative analysis, 47
 effectiveness of, 48, 50
 objectives for, 46–47
 PEFA method, 47–48
 retrospective vs. prospective, 42–43
 self-assessment, 47
 financial capacities, 117–24, 120–21*t*
 financial crisis. *See* global financial crisis (2008)
 financial decentralization, 110
 Financial Security Assurance, 52, 53*b*
 financial systems, 152–58
 in Africa, 154–55
 borrowers' credibility enhancement in, 210–11
 domestic bond markets, 155–58, 157*b*
 legislative and regulatory infrastructure for, 211–14, 212*b*
 modernization road map, 210–15
 Financiera de Desarrollo Territorial (FINDETER, Colombia), 221*b*
 financing mechanisms, 161–69. *See also specific mechanisms*
 in Cape Verde, 266–67, 317*t*
 direct local government borrowing, 168, 169*b*
 in Egypt, 271–74, 317*t*
 in Ghana, 278–79, 317*t*
 local investment funds, 162–65, 163*t*, 165*b*

financing mechanisms (*continued*)

- in Morocco, 283–85, 317*t*
- municipal bond issuance, 166–68, 166–67*b*
- in Nigeria, 291–94, 317*t*
- in Senegal, 297–98, 317*t*
- in South Africa, 304–6, 317*t*
- specialized financial institutions, 162–65, 163*t*
- in Tunisia, 313–15, 317*t*
- FINDETER (Financiera de Desarrollo Territorial, Colombia), 221*b*
- Finland, local government debt financing in, 14
- fiscal decentralization, 110, 111
- fiscal policy as governance component, 39*b*
- Fisher, Irving, 138
- Fitch Ratings, 49*b*, 166*b*, 167*b*
- floating class, 64
- flooding risks, 80–81, 81*m*, 82*b*
- Fonds de Prêts aux Collectivités Locales (FPCL, Burkina Faso), 162
- Fonds d'Équipement Communal (FEC, Morocco), 155, 220
- Fonds de Solidarité de l'Habitat (Morocco), 245*b*
- Fonds de Soutien à l'Habitat (FSH, Côte d'Ivoire), 93*b*
- Fonds Spécial d'Équipement et d'Intervention Intercommunale (FEICOM, Cameroon), 162
- food security, 65, 75*b*, 81, 200
- foreign currency. *See* currency exchange risk
- formal sector housing, 92*b*. *See also* housing
- FPCL (Fonds de Prêts aux Collectivités Locales, Burkina Faso), 162
- fragile cities, 140–42, 207, 246–48, 250
- fragile situations
 - demographics and, 65, 67
 - downward spirals, 138–40
 - local governance and, 138
 - refugees and, 139*b*
 - trapped-city syndrome, 138–40

France

- contractual approach in, 41
- Debt Cancellation and Development Contract of, 74
- decentralization in, 53*b*
- Dexia crisis and, 53*b*
- Freddie Mac (Federal Home Mortgage Corporation), 52, 54
- free water, 126
- French-speaking countries. *See also specific countries*
 - financing mechanisms in, 149
 - tax policy in, 241
 - territorial organization in, 114
- FSH (Fonds de Soutien à l'Habitat, Côte d'Ivoire), 93*b*
- fund of funds model, 247

G

Gabon

- development banks in, 161
- financial markets in, 155
- public-private partnerships in, 171
- recentralization of utilities in, 119*b*

Gambia

- public-works employment agency in, 249*b*
- remittances to, 182

garbage collection. *See* waste management

Gates Foundation, 10, 173–74

GAVI (Global Alliance for Vaccines and Immunisation), 10, 174

Gemloc (Global Emerging Markets Local Currency Bond Program), 157*b*

general obligation bonds, 210–11

generational accounting, 32

Germany

- homeownership in, 56
- urban development fund in, 248*b*
- urban land pooling in, 234

Ghana

- case study, 6, 276–80
- central government oversight in, 277
- decentralization and deconcentration in, 110, 277, 318*f*
- diaspora bonds in, 183

- District Assembly Common Fund in, 278
- District Development Fund in, 278–79
- financing mechanisms in, 278–79, 317*t*
- key indicators, 276*t*
- land ownership in, 86
- loan financing in, 279
- local governance in, 135*b*
- microfinance in, 184
- Municipal Finance Authority in, 279
- philanthropic foundation funding to, 174
- private sector investments in, 178
- remittances to, 183
- second-tier cities in, 276–77
- situation analysis, 279–80
- specialized financial institutions in, 162
- tax policy in, 150
- urbanization in, 276–77
- Global Alliance for Vaccines and Immunisation (GAVI), 10, 174
- Global Credit Rating, 167*b*
- Global Emerging Markets Local Currency Bond Program (Gemloc), 157*b*
- Global Environment Facility, 26
- global financial crisis (2008)
 - bond insurers and, 50–52
 - credit ratings and, 48, 49*b*
 - impact on African countries, 64, 250
 - lessons from, 50–57
 - municipal bond market and, 50–52, 53*b*
 - private sector financing of public goods and, 209
 - public policy's role in housing and, 52, 54, 55*b*
 - remittances and, 182
 - specialized financial institutions and, 52, 205
- Global Fund to Fight AIDS, Tuberculosis, and Malaria, 10, 173
- good governance, 37
- governance
 - African Development Bank and, 12*b*
 - economic growth and, 4, 67
 - implementation capacity limited by, 134
 - local investment financing and, 36–38, 37*b*, 39–40*b*
- Government Finance Statistics database (IMF), 143*n*14
- Graduated Tax (Uganda), 150
- grants, 14
- Great Britain, urban development fund in, 248*b*
- Greater London Authority, 13
- Greece, diaspora bonds in, 183
- Green Climate Fund, 25
- green economy projects, 224
- GSEs (government-sponsored enterprises), 52
- guarantees, 22–23, 215, 231–32
- guided land development, 234–35
- Guinea
 - local government powers in, 115*b*
 - Poverty Reduction Strategy Papers in, 75*b*
 - public-works employment agency in, 249*b*
- Guinea-Bissau
 - domestic bond market in, 156
 - public-private partnerships in, 171
 - public-works employment agency in, 249*b*
 - remittances to, 182
- H**
- HAO (Holding Al Omran, Morocco), 245*b*
- HDI (Human Development Index), 75*b*
- health care
 - collective action investments in, 8, 10
 - fragile situations and, 139, 141*b*, 142*b*
 - as governance component, 39*b*
 - poverty and, 73*b*
 - Poverty Reduction Strategy Papers and, 75*b*
- Heavily Indebted Poor Countries (HIPC)
 - initiative, 63, 74, 98*b*, 102*n*7, 122, 189*n*15
- hedge funds, 178

HIFIC (Ho Chi Minh City Finance and Investment State-owned Company, Vietnam), 229*b*, 236
 higher education, 12*b*. *See also* education
 highly labor-intensive work, 249*b*
 HIV/AIDS, 10, 67
 Ho Chi Minh City Finance and Investment State-owned Company (HIFIC, Vietnam), 229*b*, 236
 Ho Chi Minh City Investment Fund for Urban Development (Vietnam), 229*b*
 Holding Al Omran (HAO, Morocco), 245*b*
 home equity lines of credit, 54
 home-ownership-for-all strategies, 94–95
 housing
 in Algeria, 90*b*
 banking sector and, 153
 economic growth and, 56, 198
 global financial crisis (2008) and, 50, 52, 54, 55, 55*b*
 land development and, 92–95, 92–93*b*, 95*b*, 239
 private sector development of, 241–46, 244–45*b*
 property taxes and, 240–41, 242*b*
 rental market, 95*b*, 241–46
 road map for, 240–46
 Housing and Urban Development Department (HUD, U.S.), 52, 54
 Human Development Index (HDI), 75*b*
 Hungary, local government debt financing in, 14
 hybrid loans, 19–20
 hypercollective action, 8

I

IFC. *See* International Finance Corporation
 IFFIm (International Finance Facility for Immunisation), 174
 ILO (International Labour Organization), 67

IMF. *See* International Monetary Fund
 impact fees, 19
 implementation capacity, 133–38, 284
 INCA (Infrastructure Finance Corporation Limited, South Africa), 162, 306
 India
 capital markets access in, 219*b*
 CDM financing in, 25
 development assistance from, 176
 guided land development in, 235
 philanthropic foundation funding to, 173
 urban land pooling in, 235, 238
 India Exim Bank (Export-Import Bank of India), 176
 indispensable investments, 33, 34
 individual rights, 86–87
 Indonesia
 decentralization in, 201*b*
 urban land pooling in, 235
 industrialization, 77
 infant mortality rates, 67, 73*b*
 informal sector
 housing, 83, 84*b*, 87, 234
 rentals in, 95*b*
 tax schemes for, 150
 youth employment in, 67
 InfraEgypt, 179*b*
 InfraMaroc, 179*b*
 InfraMed investment fund, 179, 179*b*
 Infrastructure Finance Corporation Limited (INCA, South Africa), 162, 306
 infrastructure investments. *See also* local investment financing
 by African Development Bank, 12*b*
 AICD estimates of need for, 98–99, 98–99*b*
 defined, 7
 economic growth and, 31
 in Egypt, 272–73
 in U.S., 57*b*
 Institute of Delegated Management, 46
 institutional framework

- administrative entities created from settlements, 112–14
 - basic services management, 119*b*
 - borrowing capacity and, 122–24, 123*t*
 - for capital markets, 215
 - credit ratings and, 44
 - financial capacities and, 117–24, 120–21*t*
 - governance and, 36–37
 - implementation capacity limited by, 134
 - of local governments, 112–17, 112*t*, 115*b*, 118*b*
 - road map for, 251
 - intercept transfers, 21, 22, 215, 253*n*30
 - Intergovernmental Fiscal Relations Act of 1997 (South Africa), 152*b*
 - intergovernmental transfers, 14
 - intermediation in capital markets, 14, 168, 217–19
 - internal rate of return (IRR), 34–35
 - international air ticket tax, 10, 58*n*1
 - International Committee of the Red Cross, 173
 - International Finance Corporation (IFC), 17, 157, 157*b*, 166*b*
 - International Finance Facility for Immunisation (IFFIm), 174
 - International Labour Organization (ILO), 67
 - International Monetary Fund (IMF), 49*b*, 75*b*, 102*n*7, 116, 143*n*14, 176
 - investment financing frameworks, 5, 149–95
 - banking sector dominance of, 152–54
 - carbon finance, 179–81, 181*b*
 - China's role in, 174–76
 - development banks and finance institutions, 158–61, 159*b*
 - financial systems, 152–58
 - in Africa, 154–55
 - domestic bond markets, 155–58, 157*b*
 - financing tools and mechanisms, 161–69
 - direct local government borrowing, 168, 169*b*
 - local investment funds, 162–65, 163*t*, 165*b*
 - municipal bond issuance, 166–68, 166–67*b*
 - specialized financial institutions, 162–65, 163*t*
 - local capital investments, 158, 161–69
 - local government financing systems, 149–52, 151*b*
 - meso-finance, 187*b*
 - microfinance, 184–88
 - migrant remittances, 182–84
 - philanthropic foundations, 172–74
 - private investment funds, 178, 179*b*
 - public-private partnerships, 169–72, 170*t*
 - road map for, 203–10
 - local investment market understanding, 204
 - specialized finance institutions, 204–10, 206–8*b*
 - sovereign wealth funds, 177
 - investment-grade debt, 212, 253*n*34
 - investment grade rated bonds, 49*b*
 - investment planning, 34–35
 - IRR (internal rate of return), 34–35
 - Israel, diaspora bonds in, 183
- J**
- Japan, urban land pooling in, 234–35
 - Joburg Property Company, 237
 - Johannesburg Stock Exchange, 155
 - Joint European Support for Sustainable Investment in City Areas (JESSICA), 247, 248*b*
 - Jordan, carbon finance in, 225*b*
- K**
- Kabila, Laurent, 141*b*
 - KenGen, 166–67
 - Kenya
 - administrative entities in, 143*n*6
 - decentralization in, 114, 118*b*

Kenya (*continued*)

- development banks in, 161
- domestic bond market in, 156
- financial markets in, 155
- flooding risks in, 80
- global financial crisis impact on, 64
- local government roles in, 118*b*
- local public finances in, 120
- microfinance in, 186
- municipal bond issuance in, 166–67
- pension funds in, 156
- private sector investments in, 178
- recentralization of utilities in, 119*b*
- refugees in, 139*b*
- rental housing in, 103*n*12
- second-tier cities in, 70*b*
- tax policy in, 150
- waste management in, 130*b*

Keynesian theory, 29

Kommunalbanken (Norway), 217

Kommunalkredit (Austria), 52

Kommuninvest (Sweden), 217

Kommunkreditt (Norway), 52

Kuwait Fund for Arab Economic Development, 176

Kyoto Protocol, 25

Lland access, 39*b*, 83–88, 85*b*, 92*b*land added value tax, 238*b*

land capacity, 87

land corporations, 89, 90*b*

land development

- added-value-based financing in Egypt, 273

- banking sector and, 153

- civil service training for, 134

- collective vs. individual rights in, 86–87

- cross-subsidization and, 24

- economic consequences of, 95–96

- financial products for, 225–26

- flooding and, 82*b*

- housing, 92–95, 92–93*b*, 95*b*, 239

- informal and illegal settlements, 84*b*

- land access issues, 83–88, 85*b*

land grabbing, 89*b*land value capture and, 17, 237–38, 238*b*

legal and regulatory frameworks for, 233–34, 239–40

local investments in, 7

market failures, 90*b*production of improved land, 88–91, 97*b*property taxes, 240–41, 242*b*

road map for, 233–40

- intervention tools, 234–35

- policy implementation for, 235–37

state model for, 83–84, 88, 103*n*11, 234landfills, 27, 58*n*10, 131*b*, 180, 181*b*. *See also* waste managementland grabbing, 88, 89*b*land leases, 97*b*land operators, 89, 90*b*

land readjustment, 234

land value capture, 17–19, 97*b*, 202, 237–38, 238*b*leases on land, 97*b*

legislative and regulatory infrastructure

- allowable uses of loan funds, 230

- for basic services management, 125

- for capital markets, 215

- debt ceilings, 230–31

- defaulted debt payments, 231–32

- domestic bond markets and, 156

- ex ante provisions, 230–32

- ex post provisions, 232

- financing system modernization road map, 211–14, 212*b*

- foreign currency prohibitions, 231

- funding source restrictions, 231

- as governance component, 37*b*, 39*b*

- guarantee rules, 231–32

- housing development and, 92*b*

- land development road map for, 233–34, 239–40

- loan preconditions, 231

- in Mexico, 212*b*

- for microfinance, 185

- municipal bond financing and, 15, 213

- road map for, 228–33
 - ex ante provisions, 230–32
 - ex post provisions, 232
 - information as key element in, 232–33
- Lesotho
 - Poverty Reduction Strategy Papers in, 75*b*
 - remittances to, 182
- Libya, sovereign wealth fund in, 63
- license fees, 150
- LICUS (low-income countries under stress), 144*nn*19–20. *See also* fragile situations
- life expectancy, 67, 73*b*
- local authorities
 - agglomeration authorities and, 13
 - authorities and powers, 114–17, 115*b*
 - basic services management role of, 119*b*, 129–31*b*
 - borrowing capacity of, 122–24, 123*t*, 168, 169*b*
 - financial capacities of, 117–24, 120–21*t*
 - financing systems, 149–52, 151*b*
 - institutional framework of, 112–17, 112*t*, 118*b*
 - local investment financing and, 11–13
 - in Morocco, 282
 - road map for, 199–201
 - capital investment needs and funding deficits, 199–200
 - decentralization process, 200–201, 201*b*
 - in South Africa, 303
 - in Tunisia, 312–13
- local capital investments, 158, 161–69
- local fixed-asset investments, 183
- local governance
 - absorption capacity and, 133–35
 - administrative systems and, 135*b*
 - components of, 37*b*
 - corruption and, 40*b*
 - fragile situations and, 138
 - implementation capacity and, 133–38
 - investment capacity and, 4, 36–38
 - resistance to change and, 135–38, 137*b*
- Local Government Act of 1997 (Uganda), 113
- local investment financing, 7–62. *See also* local investment funds
 - agglomeration powers and, 11–13, 12*b*
 - base-costs need estimates, 99–102, 101*t*
 - climate change and, 24–28
 - collective action and, 8–11
 - contractual approach, 38–42, 42*b*
 - credit enhancement principles, 20–23
 - cross-subsidization, 24
 - defining, 4, 7–13, 9*f*
 - economics of, 28–33, 30–31*b*
 - financial analysis for, 42–50
 - agency credit ratings and, 44–46, 45*b*, 49*b*
 - assessment systems for, 43–44
 - collaborative analysis, 47
 - effectiveness of, 48, 50
 - objectives for, 46–47
 - PEFA method, 47–48
 - retrospective vs. prospective, 42–43
 - self-assessment, 47
 - global financial crisis impact on, 50–57
 - governance and, 36–38, 37*b*, 39–40*b*
 - investment planning, 34–35
 - local authorities and, 11–13
 - macroeconomic level ratio need estimates, 96–97, 100–102, 101*t*
 - methods of, 13–19
 - borrowing, 14–16, 32–33
 - financial resources of local government, 14
 - land value capture, 17–19
 - public-private partnerships, 16–17
 - ownership and, 8–11
 - resources-and-uses approach, 28–29
 - sectoral analysis need estimates, 98–99, 100–102
 - specific funding mechanisms, 19–20
 - strategic framework, selection of, 33–36, 36*b*
 - supply-and-demand approach, 28–29
 - urbanization and sectoral policies, 96–102

- local investment funds
 - financial products for, 225–26
 - as financing source, 162–65, 163*t*, 165*b*
 - interfaces and leverage for, 226–27
 - options for, 227–28
 - road map for, 222–28, 223*b*
- Local Transition, Facilitation, and Demarcation Act of 1993 (South Africa), 113
- long-term leases on land, 97*b*
- low-income countries under stress (LICUS), 144*nn*19–20. *See also* fragile situations
- luxury investments, 33, 34
- M**
- Madagascar
 - flooding risks in, 80
 - Poverty Reduction Strategy Papers in, 75*b*
 - public-works employment agency in, 249*b*
- MAETUR (Mission d'Aménagement et d'Équipements des Terrains Urbains et Ruraux, Cameroon), 92*b*
- Maine Municipal Bond Bank (U.S.), 218*b*
- Malawi
 - AICD on, 98*b*
 - local government powers in, 115*b*
 - pension funds in, 156
- Malaysia, urban land pooling in, 235
- Mali
 - development banks in, 161
 - domestic bond market in, 156
 - public-private partnerships in, 171
 - public-works employment agency in, 249*b*
 - specialized financial institutions in, 162
 - urbanization in, 70*b*
- malnutrition, 65, 73*b*
- manufacturing, 78
- maternal mortality rates, 73*b*
- Mauritania
 - land nationalization in, 86
 - public-works employment agency in, 249*b*
- Mauritius
 - financial system in, 153
 - pension funds in, 156
- MDGs. *See* Millennium Development Goals
- megacities, 11
- megalopolises, 11
- meso-finance, 187*b*
- methane capture, 58*n*10, 180, 181*b*
- Mexico
 - local investment infrastructure modernization in, 212*b*
 - philanthropic foundation funding to, 173
- MFA (Municipal Finance Authority, Ghana), 279
- microfinance, 159*b*, 184–88
 - funding for, 185–86
 - local governments and, 186–88
 - sector overview, 184–85
- Micro Finance Bank of Azerbaijan (MFBA), 190*n*32
- micro-operators, 129–31
- middle class
 - defined, 102*n*1
 - domestic bond markets and, 157
 - growth of, 64
 - housing development for, 94, 96
 - housing market and, 239
 - rental housing and, 243
- migrant remittances, 182–84, 224
- migrations
 - climate change and, 81–82
 - demographic changes and, 71–72
- Millennium Challenge Corporation, 38, 39*b*
- Millennium Development Goals (MDGs), 72, 75*b*, 137*b*
- Ministry of Local Government (Kenya), 118*b*

- Ministry of Public Works (Colombia), 238*b*
- Mission d'Aménagement et d'Équipements des Terrains Urbains et Ruraux (MAETUR, Cameroon), 92*b*
- mitigation investment financing, 24–28, 82–83
- mixed economy entities, 209
- Mobutu Sese Seko, 141*b*
- monolines, 49*b*, 51
- Moody's, 49*b*
- moral hazard, 231, 254*n*54
- Morocco
 - absorption capacity issues in, 284
 - banking sector in, 153
 - case study, 6, 281–86
 - commercial banks in, 220, 285
 - debt financing in, 284–85
 - decentralization in, 281–82, 284, 318*f*
 - development banks in, 159*b*
 - domestic bond market in, 155, 156, 157*b*
 - financing mechanisms in, 283–85, 317*t*
 - global financial crisis impact on, 64
 - housing development in, 245*b*
 - implementation issues in, 284
 - key indicators, 281*t*
 - local government powers in, 282
 - microfinance in, 185
 - national tax transfers in, 116
 - public-private partnerships in, 170, 171
 - public utilities in, 283
 - recentralization of utilities in, 119*b*
 - remittances to, 183
 - services delegation in, 283–84
 - situation analysis, 285–86
 - specialized financial institutions in, 162
 - urbanization in, 281–82
 - value added tax in, 143*n*10, 151*b*
- mortgage credit system, 54
- Mozambique
 - Brazil's development assistance to, 176
 - flooding risks in, 80
 - local government powers in, 115*b*
 - private sector investments in, 178
 - water sector distributors in, 128*b*
- multiplier effects, 29
- municipal bond market
 - global financial crisis impact on, 50–52, 53*b*
 - local government debt financing via, 14, 166–68, 166–67*b*
 - in Nigeria, 292
 - road map for, 216–17
 - in South Africa, 166*b*, 306
 - tax-exempt bonds in, 216
- municipal credit market, 8
- Municipal Demarcation Act of 1998 (South Africa), 113*b*, 152*b*
- Municipal Development Agency (Senegal), 165*b*
- Municipal Finance Authority (MFA, Ghana), 279
- Municipal Infrastructure Fund (Morocco), 155
- municipal technicians, 28
- Municipal Water Services Authorities (South Africa), 126*b*
- N**
- Nairobi Stock Exchange, 155
- Namibia
 - drought in, 81
 - financial markets in, 155
 - local government powers in, 115*b*
 - pension funds in, 156
- National Adaptation Plans, 26
- National Bank for Development (NBD, Egypt), 159*b*
- National Bank of Agricultural Development (Mali), 161
- National Board of Land Value Capture (Colombia), 238*b*
- National Department of Human Settlements (South Africa), 244*b*
- National Development Bank (Egypt), 159*b*
- National Farm Bank (Caisse Nationale de Crédit Agricole, Morocco), 159*b*

- national tax transfers, 116, 149
 - National Urban Reconstruction and Housing Agency (NURCHA, South Africa), 173, 244*b*
 - natural resources management, 39*b*
 - NBD (National Bank for Development, Egypt), 159*b*
 - negative equity, 54
 - neo-customary systems, 85, 85*b*, 86, 234
 - nepotism, 88, 136
 - Netherlands, homeownership in, 56
 - new public management, 40
 - next-generation tools, 210
 - Niger
 - AICD on, 98*b*
 - domestic bond market in, 156
 - public-works employment agency in, 249*b*
 - recentralization of utilities in, 119*b*
 - urbanization in, 70*b*
 - urban water sector in, 125*b*
 - Nigeria
 - banking sector in, 153
 - carbon finance in, 180
 - case study, 6, 288–95
 - China's financing of infrastructure in, 175
 - decentralization in, 110, 288–91, 318*f*
 - development banks in, 160, 292, 293–94
 - domestic bond market in, 156
 - financial markets in, 154
 - financing mechanisms in, 291–94, 317*t*
 - global financial crisis impact on, 64
 - key indicators, 288*t*
 - land ownership in, 86
 - municipal bond issuance in, 167*b*, 292
 - public-private partnerships in, 170, 292
 - remittances to, 182
 - rental housing in, 103*n*12
 - situation analysis, 294
 - sovereign wealth fund in, 63, 179
 - specialized financial institutions in, 162
 - territorial jurisdictions in, 290–91
 - urbanization in, 288–91
 - nongovernmental organizations (NGOs), 172–73
 - North Africa. *See also specific countries*
 - decentralization in, 122
 - defining, 2
 - development banks in, 159, 159*b*
 - direct local government borrowing in, 168
 - domestic bond markets in, 156
 - flooding risks in, 80
 - housing development in, 92
 - local government financial capacity in, 123, 123*t*
 - local public finances in, 120, 120*t*
 - microfinance in, 185
 - population growth in, 68, 68*t*
 - remittances to, 182
 - sovereign wealth fund investments in, 177
 - UN-HABITAT on state of cities in, 76*b*
 - Norway
 - bond banks in, 217
 - sovereign wealth funds in, 177
- O**
- occupancy-density-based approach, 71*b*
 - occupancy taxes, 150
 - official development assistance (ODA), 25, 172–74, 175
 - Olson, Mancour, 8
 - Open Society Institute, 173
 - Organisation for Economic Co-operation and Development (OECD), 2, 71*b*, 120, 175
 - Organization of the Petroleum Exporting Countries (OPEC), 176
 - output-based aid, 20
- P**
- Pamodzi Investment Holdings, 178
 - parapublic entities, 209
 - Paris Declaration (2005), 111
 - partial guarantees, 22–23
 - Pasteur Institute, 10

- patronage, 136
- PEFA. *See* Public Expenditure and Financial Accountability program
- pension funds, 212
- performance-based contracts, 40, 41
- philanthropic foundations, 172–74, 226
- Philippines, urban land pooling in, 235
- Pliny the Younger, 58*n*11
- Poland, local government debt financing in, 14
- Policy Paper on Local Government (Tanzania), 113
- political decentralization, 109–10
- political rights, 39*b*
- political risk, 22
- pooled bond issues, 217–19
- population growth
 - economic growth and, 198
 - urbanization and sectoral policies and, 68–72, 68*t*, 69*f*
- ports, map of, 77*m*
- postconflict countries, 144*n*19. *See also* fragile situations; *specific countries*
- poverty
 - basic services management and, 132
 - UN-HABITAT on, 76*b*
 - urban poverty estimations, 73*b*
- Poverty Reduction Strategy Papers (PRSPs), 74, 75*b*
- power generation. *See* electricity generation and distribution
- PPPs. *See* public-private partnerships
- private operator, 16, 127–29, 142, 157, 171, 283–84, 292–93, 315
- private sector. *See also* public-private partnerships (PPPs)
 - African Development Bank and, 12*b*
 - basic services management by, 127
 - development assistance from, 172–74
 - economic growth and, 79*b*
 - fragile situations and, 142*b*
 - housing development road map for, 241–46, 244–45*b*
 - investment funds, 178, 179*b*, 312
 - rental housing and, 95, 242–43
 - in Somalia, 142*b*
 - specialized financial institutions and, 164, 209
 - telecommunication sector and, 171
 - water sector distributors, 128*b*
- privatization, 52, 53*b*, 119*b*
- production of improved land, 88–91, 97*b*
- productivity, 74–80, 77*m*
- PROPARCO (Société de Promotion et de Participation pour la Coopération Économique), 17, 157
- property rights, 39*b*. *See also* land access
- property taxes, 150, 240–41, 242*b*, 243
- prospective financial analysis, 42–43
- PRSPs (Poverty Reduction Strategy Papers), 74, 75*b*
- public debt registry, 213, 233
- Public Expenditure and Financial Accountability (PEFA) program, 46, 47–48, 200
- Public Internal Performance Contracting scheme, 225*b*
- public policy
 - housing role of, 52, 54, 55*b*
 - land development road map, 235–37
 - urban bias in, 72
- public-private partnerships (PPPs)
 - basic services management by, 125, 129
 - contractual approach and, 41
 - in Egypt, 273
 - housing development by, 245*b*
 - investment financing from, 169–72, 170*t*
 - land development by, 18, 89
 - under local government ownership, 171
 - for local investment financing, 16–17
 - in Nigeria, 292
 - prospects for, 172
 - second-generation, 17
 - in urban areas, 170–71
- Public Service Commission (Kenya), 118*b*
- public service corporations, 98–99*b*, 126
- public transportation, 58*n*8, 144*n*16

public utilities. *See also specific services*
 economic growth and, 79*b*
 in Morocco, 283
 public-works employment agencies, 249*b*

Q

Quesnay, François, 102*n*3

R

railways, 16
 recentralization, 119*b*
 Regeneration Investment Fund for Wales
 (RIFW), 248*b*
 Régie Autonome de Gestion des
 Équipements Marchands
 (RAGEM, Burkina Faso), 169*b*
 regional development banks, 208*b*, 221–22
 Regional Solidarity Bank, 160, 189*n*9
 regressive pricing, 24
 regularization programs, 87, 88
 remittances, 182–84, 224
 Renaissance Capital, 178
 rental housing, 56, 94–95, 103*nn*12–13,
 241–46
 rent-seeking, 18
 resistance to change, 135–38, 137*b*
 resources-and-uses approach, 28–29,
 204
 results-based aid, 20
 retrospective financial analysis, 42–43
 revenue bonds, 210–11
 revenue-generating investments, 33–34
 revenue intercepts, 21, 22, 215, 253*n*30
 revenue pledges, 214–15
 revolving funds, 20
 Ricardian equivalence principle, 32
 RIFW (Regeneration Investment Fund
 for Wales), 248*b*
 risk guarantees, 22
 road map, 5, 197–259
 capital markets, 215–19
 bond syndication, 217–19, 218–19*b*
 direct bond issuance, 216–17
 intermediation, 217–19
 credit institution mobilization, 220–22
 commercial banks, 220–21, 221*b*
 regional development banks,
 221–22
 endogenous financing, 201–3
 inducements for, 202
 transformation requirements,
 202–3
 financing system modernization,
 210–15
 borrowers' credibility
 enhancement, 210–11
 legislative and regulatory
 infrastructure, 211–14, 212*b*
 fragile cities initiatives, 246–48
 housing, 240–46
 private sector development, 241–
 46, 244–45*b*
 property taxes, 240–41, 242*b*
 rental markets, 241–46
 investment financing tools, 203–10
 local investment market
 understanding, 204
 specialized finance institutions,
 204–10, 206–8*b*
 land development, 233–40
 intervention tools, 234–35
 land value capture methods, 237–
 38, 238*b*
 legal frameworks for, 233–34
 policy implementation for, 235–37
 regulatory frameworks for, 239–40
 legislative and regulatory
 infrastructure, 228–33
 ex ante provisions, 230–32
 ex post provisions, 232
 information as key element in,
 232–33
 local government empowerment,
 199–201
 capital investment needs and
 funding deficits, 199–200
 decentralization process, 200–201,
 201*b*
 local investment funds, 222–28, 223*b*
 financial products for, 225–26
 interfaces and leverage for, 226–27
 options for, 227–28

paradigm changes for, 198–99
 scale changes for, 197–98
 structured debt products, 45, 51–52, 56
 structured finance, 200, 210, 212, 214–15, 218–19, 274
 structured obligations, 210–11, 214
 Rohatyn, Felix, 57*b*
 ruralization of African cities, 127
 Rwanda
 AICD on, 98*b*
 flooding risks in, 80
 land ownership in, 86
 public-works employment agency in, 249*b*
 refugees from, 139*b*
 urbanization in, 70*b*
S
 SADC (Southern Africa Development Community), 155
 Safaricom, 167
 SAIF (South Africa Infrastructure Fund), 178
 salinization of aquifers, 127
 sanitation. *See* waste management
 São Tomé and Príncipe, sovereign wealth fund in, 63, 179
 savings, 156–57, 157*b*, 183
 Saxony Urban Development Fund (SUDF, Germany), 248*b*
 sea-level rise, 80–81, 81*m*
 second-generation PPPs, 17
 second-tier cities, 70*b*, 114, 207, 276–77
 Securities and Exchange Commission (SEC, U.S.), 49*b*
 SEEN (Société d'Exploitation des Eaux du Niger), 125*b*, 129*b*
 self-assessment financial analysis, 47, 50
 self-financing, 42
 Senegal
 case study, 6, 296–301
 contractual approach in, 41
 decentralization in, 296–97, 318*f*
 development banks in, 161
 domestic bond market in, 157*b*

 financing mechanisms in, 297–98, 317*t*
 flooding risks in, 80
 key indicators, 296*t*
 municipal development support in, 165*b*, 298–300
 Poverty Reduction Strategy Papers in, 75*b*
 public-private partnerships in, 171
 public-works employment agency in, 249*b*
 recentralization of utilities in, 119*b*
 remittances to, 182, 183
 situation analysis, 300–301
 specialized financial institutions in, 162, 165*b*
 urbanization in, 296–97
 service level, 71, 100–101, 124, 150, 281, 291
 services financing. *See also* basic services
 cross-subsidization and, 24
 in Egypt, 272–73
 in Morocco, 283–84
 regulatory framework for, 125
 SETU (Société d'Équipement des Terrains Urbains, Côte d'Ivoire), 93*b*
 sewage. *See* waste management
 SFIs. *See* specialized finance institutions
 shared taxation, 151
 SIC (Société Immobilière du Cameroun), 92*b*
 SICOI (Société Ivoirienne de Construction et de Gestion Immobilière, Côte d'Ivoire), 93*b*
 Singapore, sovereign wealth fund in, 177
 single coffer principle, 149
 sinking funds, 166*b*, 214
 slums, 76*b*, 84, 84*b*
 Smith, Adam, 29, 30–31*b*, 103*n*9, 254*n*54
 SNE (Société Nationale des Eaux, Niger), 125*b*
 social safety nets, 248
 Société de Gestion Financière de l'Habitat (SOGEFIHA, Côte d'Ivoire), 93*b*
 Société de Patrimoine des Eaux du Niger (SPEN, Niger), 125*b*, 129*b*

- Société de Promotion et de Participation pour la Coopération Économique (PROPARCO), 17, 157
- Société d'Équipement des Terrains Urbains (SETU, Côte d'Ivoire), 93*b*
- Société de Refinancement Hypothécaire (SRH, Côte d'Ivoire), 93*b*
- Société d'Exploitation des Eaux du Niger (SEEN), 125*b*, 129*b*
- Société Immobilière du Cameroun (SIC), 92*b*
- Société Ivoirienne de Construction et de Gestion Immobilière (SICOGI, Côte d'Ivoire), 93*b*
- Société Nationale des Eaux (SNE, Niger), 125*b*
- Société Tunisienne de Banque (STB), 159*b*
- solid waste management, 128–29. *See also* waste management
- Somalia
private sector initiatives in, 142*b*
refugees from, 139*b*
- Soros Economic Development Fund, 173, 244*b*
- South Africa
AICD on, 98*b*
banking sector in, 153
carbon finance in, 180
case study, 6, 302–9
central government financing in, 304–5
commercial banks in, 220, 306
debt financing in, 305–6
decentralization in, 110, 113, 113*b*, 302–3, 318*f*
development assistance from, 177
domestic bond market in, 157*b*
electricity surcharges in, 143*n*11
financial markets in, 154, 155
financial system in, 153
financing mechanisms in, 149, 304–6, 317*t*
global financial crisis impact on, 64
housing development in, 92, 94–95, 244*b*
intergovernmental fiscal system in, 152*b*
key indicators, 302*t*
land development in, 90
local government powers in, 115*b*, 303
local public finances in, 120, 121*t*
microfinance in, 186
municipal bond issuance in, 166*b*, 216, 306
pension funds in, 156
public-private partnerships in, 170
recentralization of utilities in, 119*b*
remittances to, 183
rental housing in, 103*n*13
situation analysis, 308–9
specialized financial institutions in, 162
tax policy in, 150
urbanization in, 302–3
water policy in, 126*b*
- South Africa Infrastructure Fund (SAIF), 178
- Southern Africa. *See also specific countries*
decentralization in, 122
defined, 3, 3*m*
financial markets in, 155
local government financial capacity in, 123, 123*t*
local public finances in, 120, 120*t*
population growth in, 68, 68*t*
UN-HABITAT on state of cities in, 76*b*
- Southern Africa Development Community (SADC), 155
- South-South cooperation, 177
- sovereign wealth funds, 63, 177, 247
- Soweto Agreement (South Africa), 113
- Spain, housing market in, 239
- special assessments, 238
- specialized finance institutions (SFIs)
feasibility study and business plan for, 206–7*b*
as financing source, 162–65, 163*t*
global financial crisis (2008) and, 52
in North Africa, 159*b*

- private sector and, 209
 - regional, 208*b*
 - road map for, 203, 204–10, 206–8*b*
 - SPEN (Société de Patrimoine des Eaux du Niger, Niger), 125*b*, 129*b*
 - SRH (Société de Refinancement Hypothécaire, Côte d'Ivoire), 93*b*
 - Stanbic Bank Uganda, 186
 - Standard & Poor's, 49*b*
 - Standard Bank of South Africa, 186
 - standpipe operators, 129*b*
 - state model of land ownership, 83–84, 88, 103*n*11, 234
 - The State of African Cities* (UN-HABITAT), 76*b*
 - State-Regions Planning Contract (France), 41
 - STB (Société Tunisienne de Banque), 159*b*
 - stock exchanges, 154–55
 - Strategic Climate Fund (SCF), 25
 - strategic framework for local investment financing, 33–36, 36*b*
 - structured financing mechanisms, 210, 214–15, 253*n*29
 - subcities, 130*b*
 - Subnational Finance Program (IFC–World Bank), 168
 - subprime crisis, 51, 53*b*. *See also* global financial crisis (2008)
 - Sub-Saharan Africa. *See also specific countries*
 - carbon finance opportunities in, 83
 - China official development assistance to, 175
 - decentralization in, 111
 - defining, 2
 - development banks in, 159, 160
 - domestic bond markets in, 217
 - floodling risks in, 80
 - fragile situations in, 138
 - housing development in, 92, 94
 - infrastructure investment needs in, 100, 250
 - land development in, 90, 234, 236
 - local government financial capacity in, 123
 - microfinance in, 185
 - philanthropic foundation funding to, 173
 - population growth in, 65, 66*t*, 78
 - poverty rate in, 65, 67
 - property taxes in, 240–41
 - remittances to, 182
 - subsidiarity principle, 116
 - subsovereign debt. *See also* domestic bond markets; municipal bond market
 - bond issuance, 156
 - hybrid financing, 169*b*, 279, 320
 - loans, 15
 - Sudan
 - China's financing of infrastructure in, 175
 - India's development assistance to, 176
 - refugees from, 139*b*
 - sovereign wealth fund in, 63, 179
 - SUDF (Saxony Urban Development Fund, Germany), 248*b*
 - supply-and-demand approach, 28–29, 204
 - Sweden
 - bond banks in, 217
 - homeownership in, 56
 - Switzerland, homeownership in, 56
 - syndicated bond issues, 217–19
 - synthetic taxes, 150
- ## T
- Tamil Nadu Urban Development Fund (TNUDF, India), 219*b*
 - Tanzania
 - decentralization in, 113
 - domestic bond market in, 156
 - financial markets in, 155
 - financing mechanisms in, 149
 - floodling risks in, 80
 - housing rental market in, 95*b*
 - land development in, 91*b*
 - local public finances in, 120
 - national tax transfers in, 116–17
 - refugees in, 139*b*
 - urbanization definitions in, 71*b*

- tax-exempt municipal bonds, 216
- tax increment financing, 19
- tax policy
 - business taxes, 150
 - capital markets and, 215
 - decentralization and, 111, 118*b*
 - financing mechanisms and, 149–50
 - housing and, 55*b*
 - international air ticket tax, 10, 58*n*1
 - land added value tax, 238*b*
 - land value capture and, 19
 - national tax transfers, 116, 149
 - occupancy taxes, 150
 - property taxes, 150, 240–41, 242*b*, 243
 - shared taxation, 151
 - synthetic taxes, 150
 - value added taxes (VATs), 14, 116, 143*n*10, 151*b*
 - waste management services and, 131
- TCX (Currency Exchange Fund), 158
- telecommunications sector
 - banking sector financing of, 154
 - public-private partnerships in, 16, 170, 171
 - services management for, 144*n*16
- tenancy, 76, 86–87, 89, 97, 137
- territorial jurisdictions, 290–91. *See also*
 - local authorities
- Thailand
 - development assistance from, 176
 - housing market in, 239
- TNUDG (Tamil Nadu Urban Development Fund, India), 219*b*
- Togo
 - Brazil's development assistance to, 176
 - China trade with, 175
 - local government control in, 132*b*
 - public-works employment agency in, 249*b*
 - remittances to, 182
- Town Planning Scheme Mechanism (India), 235, 238
- toxic debt assets, 51
- trade policy, 39*b*
- training of civil service, 133–34, 251
- transparency, 44, 135
- transportation sector
 - capital investment needs for, 200
 - carbon finance for, 58*n*8
 - China's financing of, 175
 - economic growth and, 68
 - land value capture and, 18
 - Poverty Reduction Strategy Papers and, 75*b*
 - public-private partnerships in, 16, 170, 171
 - waste management and, 130*b*, 131
- trapped-city syndrome, 138–40
- Tunisia
 - banking sector in, 153
 - carbon finance in, 180
 - case study, 6, 311–16
 - commune resources and investment programs in, 313–14
 - contractual approach in, 41
 - decentralization in, 311–13, 318*f*
 - development banks in, 159*b*
 - financing mechanisms in, 313–15, 317*t*
 - key indicators, 311*t*
 - local government powers in, 115*b*, 312–13
 - private sector financing in, 312
 - situation analysis, 315–16
 - specialized financial institutions in, 162
 - urbanization in, 311–13
- Tunisie Telecom, 177
- Turkey, development assistance from, 176
- U**
- UCLG (United Cities and Local Governments), 2
- UDBN. *See* Urban Development Bank of Nigeria
- UDICs (Urban Development Investment Corporations, China), 228*b*
- Uganda
 - AICD on, 98*b*
 - carbon finance in, 180

- decentralization and deconcentration
 - in, 110, 113, 116
- development banks in, 161
- financial markets in, 155
- financing mechanisms in, 149
- flooding risks in, 80
- local public finances in, 120
- microfinance in, 186
- national tax transfers in, 117
- philanthropic foundation funding to, 174
- refugees in, 139*b*
- tax policy in, 150
- urbanization in, 70*b*
- Uganda Commercial Bank Ltd., 186
- Unauthorized subdivisions, 84*b*
- underwater mortgages, 54
- Union Bank (Cameroon), 186
- Union for the Mediterranean, 190*n*22
- UNITAID, 10, 58*n*1
- United Cities and Local Governments (UCLG), 2
- United Kingdom, urban development funds in, 248*b*
- United Nations
 - Africa defined by, 2
 - Millennium Development Goals (MDGs), 72, 75*b*
 - philanthropic foundations and, 173, 174
 - urbanization forecasts by, 114
- United Nations Conference on Trade and Development (UNCTAD), 246
- United Nations High Commissioner for Refugees (UNHCR), 139*b*
- United Nations Human Settlements Programme (UN-HABITAT), 76*b*, 84
- United Nations Programme on HIV/AIDS (UNAIDS), 10
- United Nations Refugee Agency, 173
- United States
 - credit enhancement mechanisms in, 21
 - global financial crisis and, 50–51
 - housing market in, 239
 - housing policy in, 54
 - impact fees in, 19
 - infrastructure investment bank
 - proposal for, 57*b*
 - land value capture mechanisms in, 17, 19
 - municipal bond market in, 14, 211, 216
 - official development assistance from, 172
 - property taxes in, 240
 - state bond banks in, 218*b*
 - state revolving funds in, 223*b*
- universal banks, 159*b*, 160
- urban bias, 72
- Urban Community of Lille, 13
- urban corridors, 11
- Urban Development Bank of Nigeria (UDBN), 161, 292, 293–94
- Urban Development Investment Corporations (UDICs, China), 228*b*
- urban investment, 7. *See also* local investment financing
- urbanization, 4, 63–108
 - in Cape Verde, 263–66
 - challenges of, 72–74
 - climate change and, 80–83, 81*m*
 - adaptation investment financing and, 82–83
 - agricultural production and, 81–82
 - cyclones and, 81*m*
 - droughts and, 81*m*, 81–82
 - floodings and, 80–81, 81*m*, 82*b*
 - migrations and, 81–82
 - mitigation investment financing and, 82–83
 - sea-level rise and, 80–81, 81*m*
 - defining, 71*b*
 - in Egypt, 269–71
 - in Ghana, 276–77
 - land development, 83–95
 - collective vs. individual rights in, 86–87

urbanization, land development
 (*continued*)
 economic consequences of, 95–96
 housing, 92–95, 92–93*b*, 95*b*, 239
 informal and illegal settlements, 84*b*
 land access issues, 83–88, 85*b*
 land grabbing, 89*b*
 market failures, 90*b*
 production of improved land,
 88–91, 97*b*
 state model for, 88
 local investment needs, 96–102
 base-costs estimates of, 99–102, 101*t*
 macroeconomic level ratio estimates
 of, 96–97, 100–102, 101*t*
 sectoral analysis estimates of,
 98–99, 100–102
 measurement of, 70*b*
 in Morocco, 281–82
 in Nigeria, 288–91
 opportunities, 74–80, 79*b*
 population growth and, 68–72, 68*t*,
 69*f*
 productivity improvement and, 74–80,
 77*m*
 in Senegal, 296–97
 in South Africa, 302–3
 in Tunisia, 311–13
 UN-HABITAT report on, 76*b*
 urban land leases, 97*b*
 urban land pooling, 234–35, 237–38
 urban population, 11–12, 68–70, 76, 84,
 97, 114, 121, 132, 139, 141
 U.S. Agency for International
 Development (USAID), 23, 23*b*,
 164, 186, 219*b*
 U.S. President's Emergency Plan for AIDS
 Relief (PEPFAR), 10
 utilities. *See also specific services*
 economic growth and, 79*b*
 in Morocco, 283

V

value added taxes (VATs), 14, 116,
 143*n*10, 151*b*

value assessment mechanisms, 241
 value increment financing, 19
 Vietnam
 local development investment funds
 in, 229*b*
 local investment funds in, 227
 Virginia Resources Authority (U.S.), 218*b*
 virtuous circle, 35, 36*b*, 165*b*

W

Wales, urban development fund in, 248*b*
 waste management
 carbon finance for, 180
 central government and, 143*n*9
 in Ethiopia, 130–31*b*
 public-private partnerships in, 170,
 171
 services management for, 127, 130*b*
 transportation costs for, 130*b*, 131
 Water and Sanitation for the Urban Poor
 (NGO), 173
 Water and Sanitation Pooled Fund
 (India), 218, 219*b*
 Water and Sanitation Program (World
 Bank), 173
 water sector
 agricultural production and, 65
 decentralization and, 119*b*
 fragile situations and, 141*b*, 142*b*
 hybrid supply systems, 127
 institutional framework for, 125*b*
 local governance and, 137*b*
 in Mozambique, 128*b*
 privatization in, 119*b*
 public-private partnerships in, 170, 171
 services management in, 126, 132
 in South Africa, 126*b*
The Wealth of Nations (Smith), 30–31*b*,
 103*n*9
 West African Development Bank, 160
 West African Economic and Monetary
 Union, 143*n*14, 154–55, 160,
 189*n*8
 Western Africa. *See also specific countries*
 decentralization in, 122

defined, 3, 3*m*
 financial markets in, 154–55
 flooding risks in, 80
 local government financial capacity in,
 123, 123*t*
 local public finances in, 120, 120*t*
 population growth in, 68, 68*t*
 UN-HABITAT on state of cities in,
 76*b*
 urbanization in, 70*b*
 workfare programs, 248
 World Bank
 Africa defined by, 2
 basic needs strategy of, 72
 carbon finance and, 27
 domestic bond markets and, 157, 157*b*
 on fragile situations, 138, 144*n*19
 on governance, 36–37, 37*b*
 HIPC initiative and, 102*n*7
 land development and, 90, 93*b*
 municipal development programs, 42*b*
 output-based aid mechanism and,
 201*b*
 philanthropic foundations and, 174
 poverty reduction and, 75*b*
 on public infrastructure development
 needs, 96

 on public-private partnerships, 169
 public-private partnerships and, 17
 specialized financial institutions and,
 164, 165*b*
World Development Report 2009:
 Reshaping Economic Geography
 (World Bank), 3
 World Health Organization (WHO), 10,
 67, 173

Y

youth population trends, 67

Z

Zambia
 domestic bond market in, 156
 local government powers in, 115*b*
 Poverty Reduction Strategy Papers
 in, 75*b*
 tax policy in, 150
 Zimbabwe
 administrative entities in, 143*n*6
 domestic bond issuance in, 189*n*14
 tax policy in, 150

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The African continent is experiencing the world's highest rate of urban expansion. The next 20 years will see Sub-Saharan African cities alone gain 300 million more inhabitants. Failures and insufficient infrastructure already seriously hamper the economic productivity of most African cities, while also compromising the living conditions of their residents. In most cases, effective urban investments appear not only to lag but also to fall still further behind the enormous needs suggested by this urban population growth. A change in the scale of capital investment funding must occur for African cities to become engines of economic growth and job creation, as cities have done in Asia's emerging economies. At the same time, the situation requires rethinking the efforts to increase local government solvency and executive capacity, along with the modalities of financing systems.

Local investment financing is an element of vast national financial systems and of local government finances that necessarily involves many issues, such as decentralization; fiscal matters; subsovereign debt limits; local governance; and urban policies, especially for land, property development, and housing.

Financing Africa's Cities presents rarely conducted syntheses and situational analyses of these diverse subjects. It offers a methodical clarification of local investment issues for policy makers and professionals working in the field. Through a series of African case studies and many examples from other continents, this book proposes workable avenues to modernize local investment financing systems, promote endogenous financing solutions, and mobilize new sources of funding.

The 2008 financial crisis revealed how local government finances and housing policies are deeply intertwined with all financial systems and the economy as a whole. From this perspective, local investment financing appears as a common thread in a reading of complex and crucial issues for societies on the African continent.



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