United Nations | Department of Economic and Social Affairs

CEPA strategy guidance note on

Strengthening municipal finance and local finance systems

September 2023

The United Nations Committee of Experts on Public Administration (CEPA) has developed a set of principles of effective governance for sustainable development. The essential purpose of these voluntary principles is to provide interested countries with practical, expert guidance on a broad range of governance challenges associated with the implementation of the 2030 Agenda. CEPA has identified 62 commonly used strategies to assist with the operationalization of these principles. This guidance note addresses strengthening municipal finance and local finance systems, which is associated with the principle of subsidiarity and can contribute to strengthening the inclusiveness of institutions. It is part of a series of notes prepared by renowned experts under the overall direction of the CEPA Secretariat in the Division for Public Institutions and Digital Government of the United Nations Department of Economic and Social Affairs. Funding for the sub-series on the principle of subsidiarity was generously provided by the United Nations Project Office on Governance.

In reading this guidance note, individuals in government ministries and agencies who are less familiar with the topic will be able to understand the fundamentals. Those who have perhaps taken initial steps in this area with limited follow-through or impact will be able to identify how to adjust elements of their practice to achieve better results and to better embed and institutionalize the strategy in their organizations. Those who are more advanced in strengthening municipal finance and local finance systems will be able to recognize the practices which contribute to its success.

Understanding the strategy

A significant global trend over the past decades has been extensive decentralization, which has the potential to underpin inclusive, safe, resilient, and sustainable local development. This is recognized as part of the 2030 Agenda for Sustainable Development and the associated Sustainable Development Goals (SDGs), which represented a paradigm shift in global development. One of the elements is a shift towards a development trajectory that is locally owned, effective, and ensures that no one is left behind. To achieve the SDGs, governments recognize that local level engagement and involvement is key and an increasing amount of expenditure and investment is being devolved to the local level. At the same time, while more developed countries are making commensurate investments into fiscal and financial systems to support these expanded responsibilities, many developing countries do not have the same ability.

Another global trend is the current pace of urbanization, particularly in developing countries. Notably, across Asia and Africa over 900 million more people are set to live in cities over the next 30 years. This is a major opportunity because, as recognized by SDG 11 on sustainable cities and communities, a successfully managed urban transition has been a key feature of the development trajectory for most countries across the world. Yet, in terms of financing, many of these new urban areas are generating, receiving, and spending very small fractions of what they need to ensure this transition supports socially equitable and environmentally sound sustainable development. The resulting financing deficit, combined with the lack of institutional structures and human resource capacity to effectively manage the increasing local expenditure responsibilities, is substantial and especially so in developing countries.

The New Urban Agenda and the Addis Ababa Action Agenda for Financing the SDGs highlight the urgent need to strengthen municipal and local finance systems as these are critical to unlocking the growth dividends of urbanization and decentralization, and achieving the 2030 Agenda. These Agendas set out several strategies around the improvement of capacity at the domestic local level, through a combination of context-sensitive policies and frameworks, to strengthen urban and local government systems. Paragraph 34 of the Addis Ababa Action Agenda specifically acknowledges the key role local governments play in delivering services and infrastructure to local populations, while at the same time often lacking sufficient financing to fulfil their mandates. The Addis Ababa Action Agenda calls for improved domestic revenue mobilization and leveraging more private sector finance. It also continues to foresee a central role for official development assistance (ODA) but highlights that the prerogative in this respect is ensuring that ODA be catalytic.

Public financial management systems

The purpose of a public financial management (PFM) system is to ensure that revenues and expenditures match in a way that allows for fiscal discipline and the efficient allocation of resources. This is a core governance structure underpinning transparency and accountability for public spending, revenue raising, and borrowing. As such a government's PFM framework is the key instrument to delivering on its commitment for achieving the SDGs.

The foundation of both a national and a local PFM system is a budget and associated relevant plans and strategies. A local PFM system will depend on the extent that subnational governments have the authority to determine and manage the specific components of their PFM framework, including:

- *Budgeting and Planning:* Although the national government is usually responsible for setting the overall policy direction for the country, as well as the key targets, the local government and associated entities must also set their priorities within this framework.

- *Revenue:* Local governments will only have access to a subset of the revenue sources compared to a national government. These so-called own source revenues will differ depending on the legislative and institutional environment. Furthermore, local and municipal governments will receive a share of national resources in the form of intergovernmental transfers. Such transfers usually make up a significant proportion of local government revenues, particularly in developing countries.

- *Expenditure:* The type and degree of expenditure conducted at a local level is dependent on the functional capacities legally assigned to that level of government. However, in general, most local governments will be assigned those functions that have specific localized impacts, whereas national governments should retain those expenditure functions with externalities beyond the local area.

- *Borrowing:* National governments can usually resort to borrowing to help fund their expenditures, particularly for longer-term capital investments. For some local governments, particularly in North America, borrowing also forms a core part of their funding profile. However, for many other local governments, particularly in developing countries, there are significant legal restrictions on borrowing. This is often due to concerns regarding how local government borrowing will impact the debt profile and fiscal risks for the country overall.

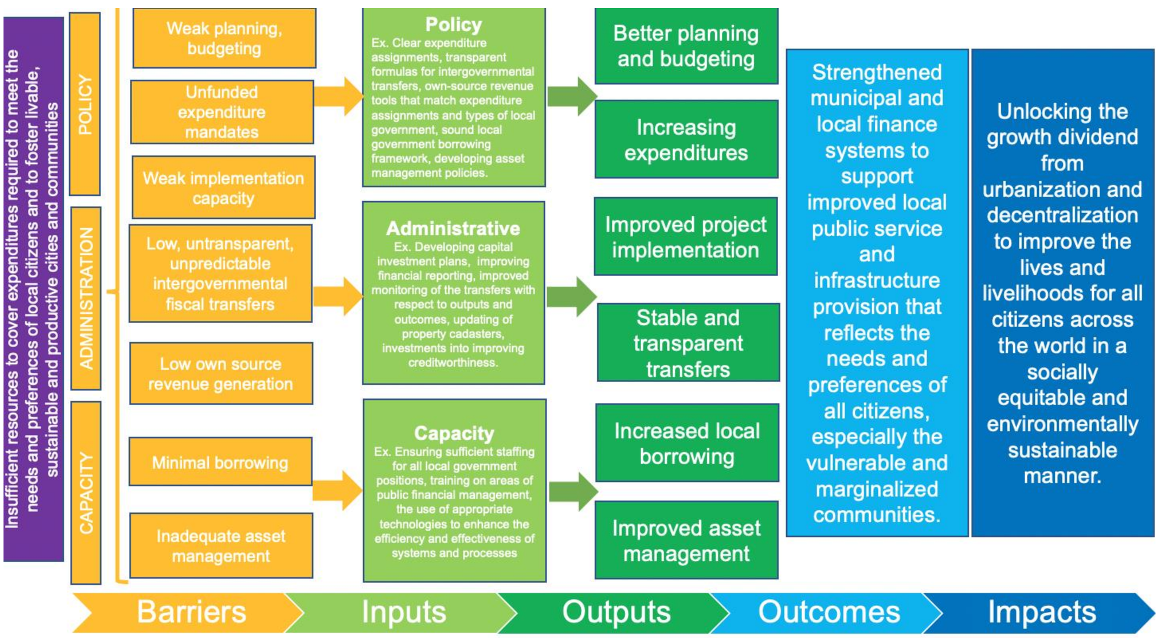
How these components of the PFM system are assigned to the national versus local level of government depends on the level of fiscal decentralization in a country. The broader principles of these decisions, including examples from different countries around the world, are detailed in a separate strategy guidance note in this series The Role of Fiscal Federalism in Public Sector Decentralization Reform.

Building on these core principles of fiscal federalism, this guidance note focuses on strategies to operationalize and strengthen the components of local and municipal finance systems, including budgets and plans, revenue-raising functions, expenditure responsibilities, borrowing and asset management.

It is important to note that, as detailed in the guidance note on fiscal federalism, in both unitary and federal structures there can be multiple levels of local government. Municipal governments are a specific category of local governments that are responsible for the administration of urban areas. Therefore, throughout this guidance note, local governments will refer to both municipal and local governments and local finance systems will refer to both local and municipal finance systems, unless otherwise specified.

What is the underlying theory of change?

Figure 1. Theory of change for strengthening municipal and local finance systems



Source: Author's own depiction.

As highlighted in Figure 1 the overall outcome and impact of strengthening local finance systems is to ensure that the sustainability of localized development outcomes, across economic, social, and environmental dimensions is promoted, and the emergence of liveable, productive, resilient, and equitable communities is supported. This requires local governments to be able to generate increasing finances to support expenditures in infrastructure and local services. The barriers that are preventing this are across the policy, administrative, and capacity spectrum that constrain different parts of the financing system, including budgets, expenditure, and asset management. The constraints limit the ability of local governments to generate sufficient own source revenues as well as borrow in a sound and sustainable way. To address these barriers, reforms are needed along policy, administration, and capacity dimensions. Although many of these reforms will be context specific, some successful ones are outlined further in the case study section of this guidance note.

What are the benefits of implementing this strategy?

If local finance systems can be improved, some of the demonstrated benefits include:

- *Sustainable implementation for localized development indicators*. For example, in Indonesia, fiscal decentralization reforms empowered local governments to not only collect local taxes, but also set their own tax rates. To correct for horizontal imbalances, intergovernmental fiscal transfers were reformed to ensure a more equitable distribution of national revenue. This has led to some improvements across several local development indicators, including decreases in unemployment and poverty rates.

- *Reduced need for local and municipal governments to be reliant on national government financing*. Especially for rapidly growing cities, this can help to unlock opportunities for rapid urbanization. In this respect, Colombia is an example of a country where cities have access to land value capture instruments that help them carry out investments in infrastructure. Colombia introduced a land value increment tax in 1997 on the gains to property prices because of government changes to zoning laws. Although initially this charge encountered several challenges to its implementation, administrative reforms that simplified the calculation meant that it started generating revenues in 2004 and by 2009, Bogotá had already generated USD 6 million from this revenue source.

- *Reinforcing the link between local finance and service provision to support and improve accountability and thus strengthen the social contract*. Although Nigeria has long had a decentralized finance system in place, it is the country with the lowest tax-to-GDP ratio on a federal level in the world and has struggled to raise revenues. One exception was the land use charge that was reformed to better link it to highly visible infrastructure investments. To underpin this, the Lagos State Government undertook widespread information campaigns so that citizens knew what their taxes were paying for. This resulted in a five-fold local revenue increase between 1999 and 2011, which could then be invested into infrastructure. However, subsequent challenges have eroded many of the gains that were initially made during this period.

- *Achieving local development to foster economic structural transformation as well as environmental sustainability*. Kenya, for example, instituted decentralized municipal and finance systems, following the promulgation of its constitution in 2010. One of the strengths of this system is that it opens new revenue sources for county governments, including the ability to issue county bonds. The first county to have a bond issuance approved in Kenya was Laikipia County. The revenues from this bond will be invested in county roads, among other infrastructure, to enable better connectivity and therefore spur local economic growth.

Improving a local government's creditworthiness to open additional financing in the form of borrowing. This was the case in Dakar, Senegal where attaining a city credit rating helped attract finance from several different institutional partners. Borrowing is important, particularly where local governments need to make investments in infrastructure, with high up-front capital costs, that are meant to support multiple generations of users. As such, it can help promote intergenerational equity by having the cost of these projects spread over time and across all current and future users. For cities that are urbanizing rapidly, attracting long-term capital is a key consideration, as many of these investments will be required before populations settle in order to unlock overall productivity and economic growth benefits as well as enhance livability.

Public sector situation and trends[1]

The overall trends in terms of implementing strengthened local and municipal public finance systems are intimately linked to a country's level of decentralization and the way principles of fiscal federalism have been institutionalized over time. The trends in this respect are detailed in the paper on The Role of Fiscal Federalism in Public Sector Decentralization Reform, which considers the broader structure of intergovernmental fiscal systems and notes that subnational spending, own source revenues, and borrowing tend to be considerably lower in developing countries than in more advanced countries.

This guidance note focuses on geographic trends with respect to operationalizing the core elements of PFM strategies. Data from the leading global comparative assessment is used, namely the World Observatory on Subnational Government Finance and Investment published by the Organisation for Economic Co-operation and Development (OECD) and United Cities and Local Government (UCLG). This helps illustrate how local and municipal financial management systems work in different countries and regions of the world. As will be illustrated, these trends are also often closely linked to the countries' level of development. The second part of this section looks at the indicators that are used globally to monitor reforms at a local level when it comes to PFM reforms.

Although this is the most disaggregated data available across geographies, the data combine own source revenues and shared revenues, in which central governments retain control over tax rates and tax bases, and reflects all as own source revenue overall. The high share of tax revenues in many countries is shared tax revenues, which some experts do not consider as own source revenues, and are instead treated as a part of transfers.

Trends across countries

The following section summarizes the trends on local finance across countries, which include the following:

- Less developed countries are more reliant on intergovernmental transfers, which often make up more than 60 per cent of their revenue.
- The average low-income own source revenue per capita is USD 12, compared to USD 2,944 for high-income local governments.

[1] Unless otherwise cited, data and graphs in this section are taken/calculated from UCLG and OECD (2019) *2019 Report World Observatory on Subnational Government Finance and Investment*. Paris: OECD. The time range used for this data is the latest data available at the time of the 2019 publication. This is in general is data from fiscal year 2016/2017.

- User charges are levied on services across most countries, however, collection is significantly more efficient in higher income local governments.
- Expenditures, as a percentage of GDP, vary between federal (≈16.8 per cent of GDP) and unitary governments (≈6.9 per cent of GDP).
- Across local governments, spending on salaries averages around 36 per cent, with more variance between high and low-income countries on capital expenditures.

Most local governments in low-income countries are excluded from the debt market. In high-income counties, local government borrowing can come from bonds, loans, and other debt securities.

Revenues

Local revenues are made up of intergovernmental fiscal transfers, taxes and user fees, charges, and fines. The relative proportion of own source revenue as a portion of total local revenue as well as its composition differs significantly across countries and within countries. In terms of taxes, the average is about 32.7 per cent of all local revenue, which is the equivalent of 3.3 per cent of GDP. In many federal countries, such as Argentina, Brazil, Canada, Germany, India, the Russian Federation, Spain, Switzerland and the United States, a higher proportion of local government own source revenue is made up of taxes. This is also the case in some unitary countries, including the Nordic countries, China, Italy, and Japan.

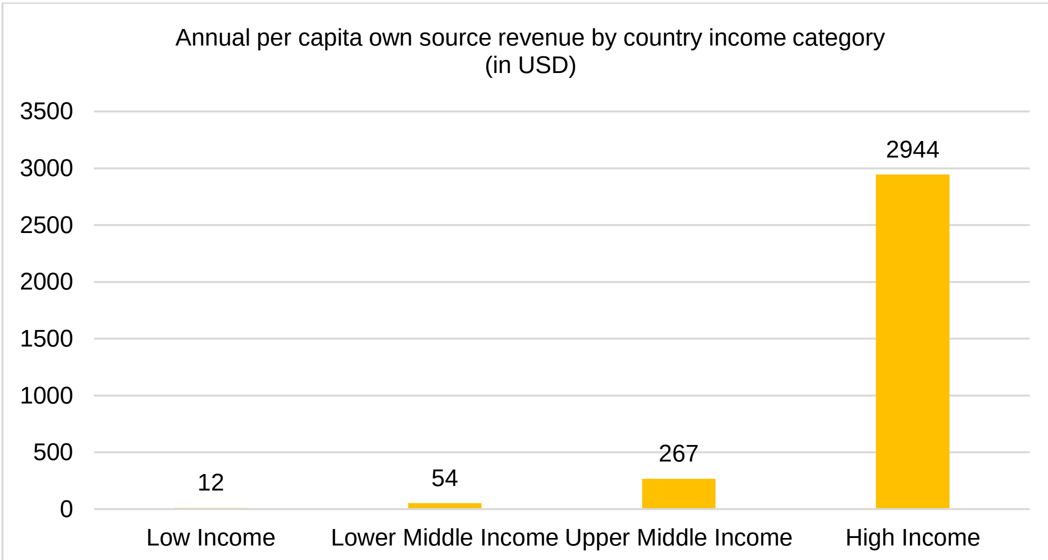
Intergovernmental fiscal transfers

The extent to which local and municipal governments are reliant on intergovernmental fiscal transfers and subsidies is highly correlated with a country's overall GDP.

On average, local governments in low-income countries generate about USD 12 per capita annually in own source revenue, compared to USD 2,944 USD per capita for high income countries (see Figure 2[2]). The implications for local governments in developing countries is that as their overall GDP grows, the share of local government revenue will also grow. However, this will not happen automatically and will require strengthening municipal and local finance systems, both from administrative and policy perspectives, which is discussed in a later section of this guidance note.

[2] Ibid 9

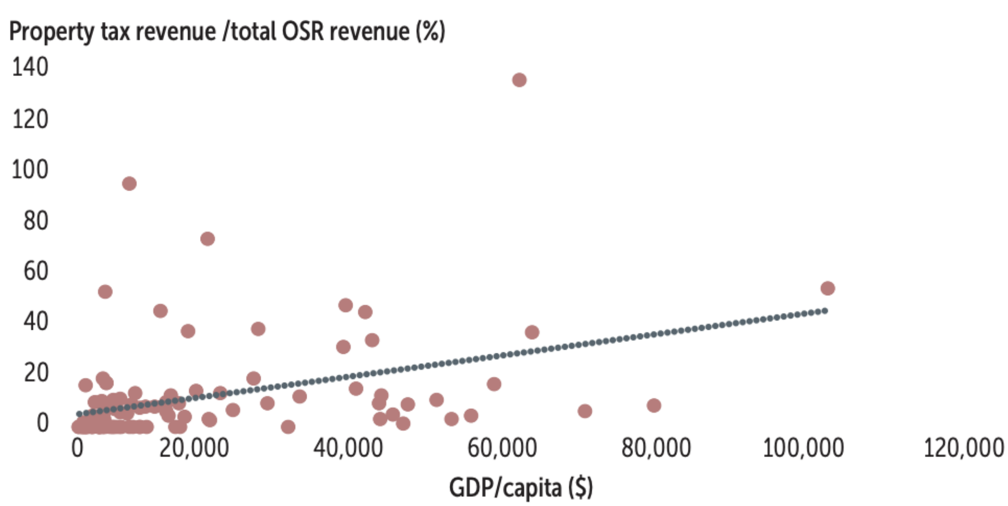
Figure 2. Relationship between GDP per capita and own source revenue



Source: [SNG-WOFI, OECD /UCLG (2019).]

For many countries, property tax, sales tax, and business tax make up most of a country's local own source revenue. Although property tax has high potential, in developing countries property tax still plays a comparatively small role. On average for high-income countries, property tax constitutes about 1.1 per cent of GDP. For low-income countries, it is still only 0.3 per cent of GDP and less than 20 per cent of total local tax revenue.

Figure 3. Proportion of property tax as a portion of own source revenue compared to GDP per capita across the globe

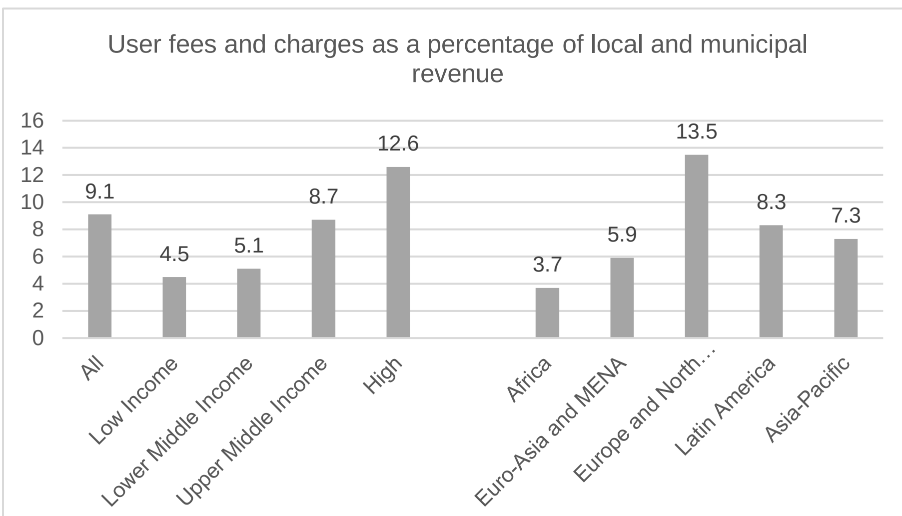


Source: [Jackson, D. (2022) Local Government Finance is Development Finance. New York : UNCDF, p.143.]

Property tax is only one form of land-based finance and some developing countries have been able to unlock other forms of such revenue to finance local infrastructure. Cities that have been able to make more extensive use of land-based revenue include Bogotá and Medellín (Colombia), Cairo (Egypt), Mumbai (India), and São Paulo (Brazil). However, in general, property tax specifically and land-based taxes more broadly remain underexploited across many developing countries and still have substantial potential.

User fees or charges are levied in all countries, but with significantly better collection efficiency in high income countries, particularly in Europe and North America (see Figure 4). A major reason for this is that since the charge is directly linked to the availability of the overall service, it requires the service to be in place and functioning. This may not be the case across many lower income local and municipal governments. Another reason for limited collection efficiency may center around concerns about perceived affordability and equal access to services in many poorer economies.

Figure 4. User charges as a percentage of local government revenue



Source: [SNG-WOFI, OECD /UCLG (2019).]

Expenditures

There are notable differences between local and municipal government responsibilities on expenditures, at a local level, across federal and unitary countries. In federal countries, the the government tends to maintain overall functional responsibilities related to defense, foreign policy, immigration, and justice, among other functions, which vary by country. The states themselves are responsible for most of the expenditures that happen at a local level. As such, across federal countries, subnational spending, which is comprised of both the state as well as local government expenditure, makes up on average about 46.9 per cent of total public expenditures, which is equal to 16.8 per cent of GDP. In unitary systems national law usually defines the division of expenditure responsibilities between national and state governments.

As such the expenditures that local and municipal governments are responsible for are much more heterogenous. Overall, local spending as a percentage of total public expenditure is much lower than in federal countries, at about 19.4 per cent, which is the equivalent of only 6.9 per cent of GDP.

Generally, within local and municipal government budgets, particularly in developing countries, more is spent on operational costs, especially on staff salaries, compared to capital development expenditure. This is expected because increased capital spending includes the cost of operation, including spending on staff. The challenge is when there are high operational expenditures, without commensurate investments in capital. This can signal overall poor performance of local governments.

On average, across the globe, spending on salaries accounts for approximately 36 per cent of total local expenditure. Aside from the countries that have overall high expenditure at a local and municipal level and can therefore allocate a larger proportion of spending to capital expenditure, in the cases where their mandates allow. There are also a few examples from developing countries where this spending comprises more than 50 per cent of total local expenditures, including in Burundi, Nicaragua, Bolivia, and Ecuador. Africa has the lowest share of public investment done by local and municipal governments, on average around 19.4 per cent of overall public expenditure, which is about 0.9 per cent of GDP.

Borrowing

Across the world outstanding gross debt for local governments accounts for about 7.5 per cent of GDP and only 11.5 per cent of total public debt. This is heavily skewed to higher income countries, with many local governments in low-income countries excluded from the debt markets completely. Most OECD and European Union countries allow for local borrowing for capital investment as well as short-term liquidity, so long as this is repaid within a budget year. In general, for federal countries, local government debt is a higher proportion of GDP than in unitary countries. It is also correlated to the overall decentralization profile of that country, and the local government's responsibility with respect to overall expenditures.

Most local government borrowing is made up of loans and debt securities. Local borrowing in many federal countries, including the United States and Canada, is dominated by borrowing via bonds whereas in Europe more borrowing is done by local governments via commercial banks or specialized institutions. More generally, the share of bonds in debt stock is higher for upper-middle income countries, than for high income countries, with Asia accounting for approximately 14 per cent of overall bond stock.

Overall capital markets for local borrowing, particularly bond markets, continue to be significantly underdeveloped across most of the world leading to low local borrowing overall. In Latin America, Rio de Janeiro was the first city to successfully float a bond for USD 125 million over 3 years in July 1996. In Africa, most bonds have been issued in South Africa, and only by large metropolitan areas. The first city was Johannesburg, which floated a USD 506 million bond in 2004. In most other countries in Africa, the legislation is not in place for cities and local governments to float bonds. Across all the markets where bonds form an important source of local and municipal revenue, domestic capital markets have evolved gradually over a long period of time under the supervision of national governments. In fact, currently the deepest capital markets and the currencies within which they are denominated in are highly biased towards the OECD and China

Assets

Many local governments and municipalities control a large portfolio of assets, including land, property, infrastructure, and equipment. However, assets across local and municipal governments are difficult to comparatively measure. A global trend in this context is that operating local assets can use up a larger share of the annual municipal budget than the actual construction or the overall acquisition of new assets across their lifecycle. Global estimates show that on average local governments spend 15 per cent to 30 per cent of their annual expenditures on construction and acquisition costs, while a further 70 per cent to 85 per cent is spent on actual operation and maintenance on the basis of life-cycle costs. Construction and acquisition costs are likely to increase further with climate change, the effects of which may put further strains on overall assets.

However, a lack of consideration for the substantial costs that need to be spent on operation and maintenance over time mean that assets can sometimes be rendered unusable and thus have significant public financial implications for the local governments overall. By some estimates from 2010 underspending in asset operations and maintenance has resulted in a loss of up to 2 per cent of GDP growth[3] for some developing countries.

Indicators for monitoring reforms to local and municipal finance systems

Most of the comparative data in this guidance note with respect to indicators and trends was extracted from The World Observatory of Subnational Government Finance and Investment, which is a joint initiative by the OECD and UCLG that collects regular standardized indicators and information on local governments across the globe, to improve data for decision making and dialogue and to serve as a capacity building tool on local government and finance. A pilot version was published in 2016. The first full version was published in 2019 with an updated version released in 2022.

There are an increasing number of databases that track indicators and reforms within local and municipal finance systems. These are listed in the peer-to-peer learning section below.

[3] Foster, V. and Bricendio-Garmendia, C. (2010) Africa's Infrastructure: Time for Transformation. Washington DC: World Bank accessed from:https://openknowledge.worldbank.org/bitstream/handle/10986/2692/521020PUB0EPI1101Official0Use0Only1.pdf?sequence=1&isAllowed=y

Methods of implementation

Budget and plans

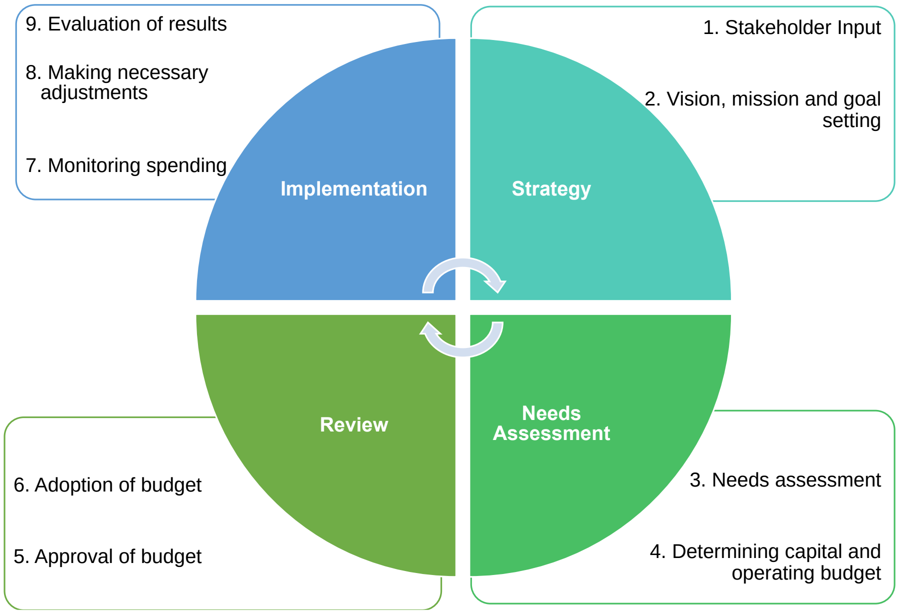
For effective long-term budgeting with regard to planning and prioritization, a local government needs (1) a capital investment plan and (2) an annual budget.

Local governments should have multiyear plans in place, as many of their intended outcomes will usually require several years to be fully realized, and thus need to be considered as part of multiple annual budgets. One way to undertake multiyear planning is with a capital investment plan (CIP), which includes multiyear capital and operating budgets for longer-term capital investments. As a starting point, a national or local level sustainable development strategy can ensure that these plans directly contribute to a country's SDG priorities. Specifically, the CIP is a tool which outlines the local government's priority investment projects over the course of a specified number of years, and the annualized financial cost associated with them. It is important that a CIP, or similar plan, reflects local needs, demands, and preferences and therefore should assign and guarantee a central role for stakeholder engagement in its formulation. In most contexts, it will also have to undergo some form of legislative approval by a higher level of administrative division.

The budget should then outline the operational and financial means to achieve local priorities. The specific role local governments will play within the budgeting process is defined by the prevailing legislation in any given country. This is outlined further in The Role of Fiscal Federalism in Public Sector Decentralization Reform. However, in most cases, local governments will have some role to play in developing their own budgets, which usually happens on an annual basis, and will subsequently need to be approved and adopted by a higher level of government. These budgets will be comprised of revenues, expenditures, and borrowing.

While the exact details of how budget planning, setting, implementation and review are conducted will differ across countries, a generic outline is illustrated in Figure 5.

Figure 5. Generic annual local government budget cycle



Source: Author's depiction adapted from [Faravaque-Vitkovic, C. and Kopanyi, M. (2014) Municipal Finances: A Handbook for Local Government. World Bank. P. 98.]

Budget setting involves a variety of institutions and individuals, ranging from the respective local or municipal government's finance department to all other departments that are involved in issuing budgets, raising revenue, and spending on public infrastructure and services. Importantly, it also usually involves political entities, such as local councils, who are required to approve expenditures, through the budget approval process, on behalf of citizens. Aligning priorities through budgets can help ensure that the SDGs are sufficiently targeted at a local level. In addition, improving transparency and accountability to citizens across the budget cycle provides accountability of local governments in developing more equal, progressive, green and health- and gender-sensitive budgets.

Budget setting is a continuous cycle, involving four major stages:

1. *Strategy and policy-setting:* This is a core component driving overall spending in a local government. This requires clarity with respect to what local or municipal governments are responsible for when it comes to expenditure.

2. *Needs assessment and planning:* This is an important stage for a local or municipal government to know and thus plan what future expenditure is going to be. This must occur across all spending departments and be consolidated at a central level. It should also include milestones that are clear and measurable to be able to monitor overall performance against the budget. Planning is also important to ensure that there are sufficient resources to meet overall spending priorities.

3. *Review and approval:* The budget must be approved usually by the local council and subsequently by a higher level of government that adopts it within its overall spending plans.

4. *Implementation*

    - *Execution:* During the execution phase, spending should be done as planned according to the budget. It is important to have sufficient expenditure controls in place, which are founded on sound accounting policies that can ensure the local or municipal government is meeting its targets in terms of spending as well as revenue.

    - *Monitoring:* Each expenditure needs to be properly accounted for, which is the role of sound financial reporting. This should include the adoption of financial reporting standards, which are usually nationally determined and may be based on international public sector financial reporting standards, which are set by the International Public Sector Accounting Standards Board.

    - *Auditing:* Particularly as a public sector institution, the local and municipal governments should have in place internal audit functions that continuously evaluate financial transactions that take place, as well as the overall institutional processes for expenditure management. This information is important in terms of understanding where reforms should be made. External audits should then be carried out periodically, which in most public sector institutions are done annually. This provides an external and independent opinion on the financial performance of the local or municipal government, as well as on whether the expenditures are leading to the intended outputs and outcomes as per the local plans.

Each of these processes requires sound financial data either at an aggregate level or individually, to track budget execution. This type of data will also support a local or municipal government beyond expenditure management, including asset and debt management, to be able to carry out other areas of work including improved forecasting of potential revenue from different sources. The ability to collect this type of regular and timely data has three primary inputs: people, technology, and information.

Having annual budgets in conjunction with longer-term planning documents and a capital investment plan in place will help local governments more aptly delineate their expenditures and thus better ensure that they have the right mix of financial resources to fund them. Without this, they may for example, run the risk of starting too many projects and then not be able to complete them due to a lack of resources. Another benefit of longer-term budget planning and prioritization is that it provides a strong indicator for external partners and investors about the local or municipal government's priorities. Most importantly, the annual budgets should incorporate the needs and preferences of local populations.

There are different ways and degrees that central governments are involved, and therefore can influence the local budgeting process. This can range from directly prescribing their budgets, in highly centralized settings, to determining budgeting rules within which local governments have to operate (such as minimum thresholds for capital expenditures or maximum thresholds for personnel expenditures), directing allocation decisions through earmarking of funds, and influencing overall prioritization through annual performance contracts.

As noted, the budget itself is split into proposed revenues, expenditure and borrowing.[4] Asset management can also be an important part of the budget.

Revenue

Local revenue policy is focused on how local governments can raise the money required to fund their expenditures. Revenue assignments are also allocated across different levels of government, either exclusively or shared with higher levels of government. This, in turn, is also intimately tied to the extent and the nature of fiscal decentralization in place in a country and involves a series of policy choices, including determining what the base unit for revenue raising is, and how this is distributed across jurisdictions; who should set rates for taxes and what these rates should be; and what vertical or horizontal gaps exist between jurisdictions and how these should be addressed. As noted, it is critical that local and municipal governments are at the very least assigned revenue-raising abilities to match their expenditure assignments.

The two main forms of revenues that local and municipal governments have access to are (1) intergovernmental fiscal transfers and (2) own source revenues.

Intergovernmental fiscal transfers[5] are one of the most important sources of funding for local and municipal governments in most countries, particularly in developing countries, as highlighted in the *Trends* section. These are revenues that are collected at a higher level of government, usually the national or state level, and then apportioned and transferred to local governments. The design of the intergovernmental fiscal transfer system will usually depend on the priorities a government is trying to achieve as well as overall political considerations. These include minimizing vertical imbalances, which are the differences between a local or municipal government's own source revenue capacity and the amount of financing it needs for expenditures, especially given the fact that at lower levels of government the expenditure requirements tend to exceed the ability to generate revenue. It also includes addressing horizontal imbalances, which are the differences that exist between governments of the same administrative level. These differences may arise due to distributions of wealth across the country, geographic advantages, or whether they are urban or rural, which impacts their tax

[4] For more information, see Fravacque-Vitkovic, C. and Kopanyi, M. (2014). *Municipal Finances: A Handbook for Local Governments*. Washington DC: World Bank; Kamiya, M. and Zhang, L-Y (2016). *Finance for City Leaders Handbook*. Nairobi: UNHabitat; and Slack, E. (2009). *Guide to Municipal Finance*. Nairobi: UNHabitat.

[5] For more information, see Cheema, G. S. and Rondinelli, D. A. (2007). *Decentralising Governance: Emerging Concepts and Practices*. Washington DC: Brookings Institution; and Gilbert, G. (2009). *Local Taxation: An economy-based guide*. Paris: Agence Française de Développment

base and expenditure needs. Intergovernmental fiscal transfers may also be in place to compensate local governments for undertaking national programs, performing functions delegated from higher tiers of government, as well as ensuring that they can comply with nationally set standards. There are various types of intergovernmental fiscal transfers, including unconditional and conditional transfers.

Intergovernmental fiscal transfers will continue to comprise an important portion of all local government revenues across the world, and are in fact the majority of local revenues in Africa and Asia. An important consideration, therefore, is how they are structured and disbursed. This should be done in a way that continues to ensure that local and municipal governments have sufficient funds to meet their necessary expenditure requirements, while not disincentivizing local revenue collection. This will require having transparency in the way they are allocated as well as predictability in terms of the size of the transfers and their overall timing, to be able to ensure adequate planning at a local level.

A further challenge when it comes to intergovernmental fiscal transfers, particularly conditional ones, is that national governments may not understand prevailing local conditions and citizen preferences. Therefore, it is important that intergovernmental transfers do not stifle local government autonomy. Furthermore, especially in developing countries, it is unlikely that national governments will be able to fully meet the funding needs of local governments. This is a particular consideration for rapidly urbanizing cities, where investment needs are likely to far outweigh what intergovernmental transfers can cover. As such it is critical that local governments have the ability and capacity to expand their own source revenue.

Own source revenues[6] are the sources of tax and nontax revenue that are exclusively in the remit of local government control and therefore can be used to target SDG needs at a local level. The exact composition of own source revenue will vary across countries, and sometimes even within jurisdictions, as shown in the *Trends* section of this guidance note. They are determined by a combination of national policies, laws, and regulations that are in place coupled with political, economic, and social factors prevailing in that respective local administration.

Revenues that should be assigned to a local level are those that can be most effectively administered at that level and will not foster tax competition between different jurisdictions. For example, if one local jurisdiction charges higher income tax, then a likely outcome is that

[6] Haas, A. with Collier, P. (2017). Financing Fast Growing Cities. *IGC Growth Brief.* London: International Growth Centre; Fleck, L. (2022). "Chapter 5: Towards a Framework for Own Source Revenue Optimization." In Jackson, D. (eds.) *Local government finance is development finance*. New York: UNCDF; Freire, M. E. and Grazón, H. (2014). "Chapter 4: Managing Local Revenues." In Fravacque-Vitkovic, C. and Kopanyi, M. (eds). *Municipal Finances: A Handbook for Local Governments;* Collier, P. et al. (2017). *Land and property taxes: exploiting untapped municipal revenues*. London: International Growth Centre; Bird, R. M. (2010). Subnational Taxation in Developing Countries: A Review of the Literature. Policy Research Working Paper 5450. Washington, DC: World Bank; Franzsen, Riël, and McCluskey, William. (2017). Property Tax in Africa, Status, Challenges and Prospects. Cambridge, Massachusetts: Lincoln Institute of Land Policy; Bahl, Roy, Linn, Johannes and Wetzel, Deborah. (2013). Financing Metropolitan Governments in Developing Countries. Cambridge, Massachusetts: Lincoln Institute of Land Policy; Bird, R. and Slack, E. (2022). *Land and Property Taxation: A Review*. Washington DC: World Bank; Siegel, Y. (2022). Managing and Financing Urban Development Through Physical and Land Use Planning Processes in Kenya: A Guidebook for County Government. Nairobi: UNHabitat.

workers may move to another jurisdiction where tax rates are lower. For non-mobile bases, like land, this type of competition is not possible as the tax base cannot move. Given these criteria, some of the most common taxes assigned at a local level are property and land taxes. Less common taxes at a local level are any forms of income or sales taxes, as these have more mobile bases. Local governments usually also have the prerogative to levy different forms of business taxes, which also have more mobile bases.

Property and land taxes, if administered appropriately, will have a clear link to local service and infrastructure provision. For example, in the case where a local or municipal government invests in local infrastructure, the land and property around it will increase in value, all else being equal. Thus, the rise in value has been publicly created and therefore a property or land tax is also seen as a fair way to recapture a portion of generated private benefits and reinvest it for the public's benefit. Given this direct link, therefore, it is good practice to have revenues from property and land taxes used to finance local public goods, such as roads, street lighting, parks, and recreation.

However, property and land taxes, particularly in developing countries, are underperforming compared to their potential. This is because there are also challenges in administering these taxes. For example, to generate sufficient revenue, property and land will need to first be identified, such as in a cadaster, and then require frequent and accurate valuation, which can be costly for a local government to carry out. Perhaps the most important drawback is that property and land taxes are highly visible, and unlike an income tax they are not withheld at the source, but rather must be paid by a taxpayer in periodic payments. Furthermore, in many countries' property owners may be a strong and vocal voter base. As a result, property tax is particularly unpopular for politicians that may be required to vote on base or rate changes.

Nontax own source revenues primarily include *user fees and charges*. Local fines, linked to payment for noncompliance to a local government or city's rules, may be another source of nontax revenue. User fees may be an important component of a local government's revenue. They are usually implemented to pay for public goods and services that have the characteristics of being private goods or services. These are goods and services where people can be excluded for nonpayment and where consumption of the good or service leaves less for another consumer. As such, a user fee should reflect a payment for how much is used. They are often levied on utilities, such as water and electricity. Other user fees include licenses and permits, for example on business activity, which are often levied by local governments.

The benefit of user fees is that given users pay for exactly what they consume. User fees can provide an economic signal with respect to the demand for those services and the relative scarcity of supply. However, particularly in the case of utilities, there may be political push back to such charges, as utilities are perceived to be essential public goods. The result is that user fees in these cases are often lowered with several administrative exemptions, and therefore do not generate sufficient revenue to cover their costs. There are cases where exemptions to both taxes and user charges are justified. This is, for example, the case where a local or municipal government wants to ensure that low-income households can continue to access sufficient levels of an essential service. However, as governments implement increasing numbers of exemptions, they become more administratively complex and therefore costly and onerous to implement. Exemptions should be used sparingly and should be targeted to those who most require them, such as to meet the needs of low-income and other vulnerable groups.

Reforming own source revenue systems is important as these are revenues that, as mentioned, usually fall into the local government's direct control to administer. However, evidence suggests that in low-income countries, own source revenue systems are not efficient, cost effective or equitable. Reforming own source revenue collection is key and this can primarily happen with respect to administrative improvements and policy changes:

- *Administrative:* For many developing countries there are substantial improvements that can be made in how own source revenues are administered. In fact, evidence shows that tax collection efficiency is below 70 per cent for low-income countries compared to over 95 per cent in high-income countries. Important elements of reform include better identification of the tax base, assessment of the payment obligation, timely billing and collection, incentivizing voluntary compliance, and having effective enforcement mechanisms in place in the case of noncompliance. Inputs into administrative reforms include improving the capacity of local revenue staff, ensuring there is updated and relevant data on the aforementioned components as well as effective communication. It further includes setting performance incentives for revenue collection and shutting down opportunities for petty corruption. Technological advances can support administrative reform processes. For example, property tax collection has greatly benefitted from the use of geographic information systems and drone technology, which can facilitate faster, cheaper, and more regular updates of the property tax register.

- *Policy:* Compared to administrative reforms, policy reforms may have an even more substantial impact on the amount of revenue that can be collected at the local and municipal levels. Reforms to policy include changes to expand the tax base, increase the tax rate, or devolve a new revenue source for local governments to collect. However, these types of reforms are more difficult to implement as they are usually in the control of the national government to amend, and often will also require legislative approval. This may be a lengthy process fraught with political hurdles and often out of the local or municipal government's full control. Therefore, as a first stage, pursuing administrative reforms, which do lie within a local government's remit, are often an easier, and quicker, entry point for reform.

Another way that own source revenue can be improved is through enhanced development processes. This encompasses the end-to-end processes of development, including pre-application, review, approval of plans, granting of permits, and post-approval processes to ensure compliance. The sound implementation of such processes has great potential to generate revenues, especially for infrastructure. An added benefit is that such a mechanism for development management can also give local governments the capacity to pace and spatially position development.

Expenditure[7]

One side of the budget will detail a local or municipal government's expenditures, which determine the priority areas for spending on local infrastructure and service delivery. These are defined within an envelope of functional assignments, which outline the overall responsibilities that have been allocated to local governments within the law. In some cases, local governments are expected to undertake expenditures across several sectors as the sole provider of services. For others, they may share expenditure responsibilities with higher levels of government. Expenditures may differ for local governments and municipal governments in rural or urban areas. Overall, however, these assignments tend to be driven by the extent of decentralization within a country. In more decentralized countries, such as the Nordic countries, local governments are expected to undertake a larger share of public expenditure, compared to countries that remain more centralized.

Expenditure management involves local governments apportioning spending across different categories as well as according to their targeted priorities and plans. Expenditures themselves are split into two key categories, namely:

- Capital expenditures, which are the funds that municipalities and local governments spend on acquiring fixed assets, such as civil works on infrastructure projects or the purchase of property and land.
- Operating or current expenditures, which are the regular payments that a local government must make for its overall operations, such as wages for its staff and operation and maintenance expenses for infrastructure.

Sound expenditure management should promote overall efficiency and cost effectiveness in the provision of local infrastructure and services and is key in supporting budgetary cost control at a local level. It is closely linked to having sound procurement practices in place to ensure transparency and open competition in the selection of suppliers. It is important to note that expenditure management is a process, including planning and execution. It further involves monitoring, evaluating, and auditing the actual expenditures incurred to ensure that they were made in line with the local government's policies and plans.

The ability to undertake expenditures can empower local governments to meet the needs and preferences of their citizens in terms of service and infrastructure provision. At the same time, it is important that this happens within a framework to ensure that they continue to meet national targets and standards as well. For all of this to happen effectively, functional and expenditure assignments must be tied to a municipal or local government's revenue raising ability as covered in the next sub-section.

[7] For more information see: USAID. (2006). *Managing Municipal Services Delivery*. Washington DC: USAID and World Bank. (1998). *Public Expenditure Management Handbook*. Washington DC: World Bank.

Borrowing[8]

Borrowing is a source of finance for some local and municipal governments. This can happen from a variety of different lenders but will ultimately need to be repaid from the local government's revenue. Enhancing local and municipal borrowing is a core tenet of the Addis Ababa Action Agenda. Where the legal and policy frameworks are in place for local governments to borrow and where the local government has demonstrated sufficient creditworthiness, there are different institutions that may lend to local governments, including:

- *Public international, regional, or national development finance institutions*. These also include more specialized development institutions focused on local and municipal lending. These types of banks sometimes benefit from the credit rating of their shareholders, which is likely to be higher than those of the individual local governments. As such the financial institution can borrow from the market at more favorable terms and then on-lend or on-grant funds accordingly. This type of borrowing is particularly well-suited for infrastructure projects with longer financing tenors.
- *Private institutions, including commercial banks,* are usually better suited for shorter-term loans, especially as interest rates—which are the cost of borrowing—are likely to be significantly higher than from other types of institutions. Therefore, many local and municipal governments tend to borrow from commercial banks to help smooth overall cash flow difficulties, rather than for longer-term infrastructure projects. However, in many countries, as local governments must balance their operating budgets, they can only borrow for capital expenditure—if they can borrow at all. It is important to note, however, that liquidity borrowing, or running overdrafts, are common and often hide operating deficits by rolling over shorter-term loans for years.

There are also a diverse set of tools that local governments can use to raise financing. These include the following:

- *Municipal bonds* are longer-term debt obligations with which the local authority promises to repay the principal as well as coupon interest rate based on a specific schedule until the bond reaches maturity. The advantages of municipal bonds are that all the money is received up front and repaid in pre-determined installments over time, as the terms of the loan are fixed for the whole period. Furthermore, the interest repayment rates on bonds are usually lower than non-concessional loans from other

[8] For more information see: Freire, M. E. (2014). "Chapter 7: Managing External Resources." In Fravacque-Vitkovic, C. and Kopanyi, M. (eds.) *Municipal Finances: A Handbook for Local Governments*; Jackson, D. (2022). "Chapter 1: Analysis and Investment Agenda for a Liveable Healthy Planet." In Jackson, D. (eds.) *Local government finance is development finance*. New York: UNCDF; Krishnaswamy, R. (2022). "Chapter 4: Linking City Financing Needs with Domestic Capital." In Jackson, D. (eds.) *Local government finance is development finance*. New York: UNCDF; UNCDF. (2015). *Strengthening Subnational Finance in LDCs*. New York: UNCDF; Freire, M., Petersen, J., Huertas, M. and Valdez, M. (2004). *Subnational Capital Markets in Developing Countries: From Theory to Practice.* Washington DC: World Bank; Bird, R. (2003). *User Charges in Local Government Finance*. Washington DC: World Bank.

financial institutions, especially from commercial banks. There are three main types of municipal bonds:

- *General obligation bonds*, which are those which are serviced from overall local government revenues and can be used to finance infrastructure and service needs within a local or municipal government's portfolio.
- *Special-purpose bonds, also known as revenue bonds,* are directly tied to identified projects and then are serviced by the revenue generated from those projects.
- *Green bonds*, which can either be general obligation or special-purpose bonds, must be spent on environmentally friendly projects or climate-change mitigation and adaptation-related projects. In these cases, therefore, there is an additional onus on the monitoring and audit requirement to ensure that the bond was used in line with its specific purpose.

- *Public-private partnerships (PPPs)* are a procurement mechanism where the public and the private sector share the risks and costs for delivering public sector infrastructure and services. PPPs aim to improve value for money and increase the efficiency of infrastructure construction and service provision. PPPs can be structured in several different ways, but in general involve handing over public assets to private sector construction firms and operators for a defined period. With respect to PPPs, although there have been some positive experiences, the evidence especially from developing countries, is decidedly mixed. This is because for PPPs to generate better value for money than strict private-sector provision, they require careful structuring, which is expensive and requires capacities that do not yet exist in many local governments and municipalities. In poorly regulated contexts, delivering public infrastructure and services through private finance may also raise the cost of services beyond what low-income populations can afford.

Even in those countries where local governments can legally borrow, they may still face significant restrictions. For example, there may be legislation that mandates that borrowing cannot exceed a certain percentage of own source revenue generation, which itself may be too small to borrow against.

In addition to the legal constraints, there are also administrative ones that keep many local governments from borrowing. These in turn can lead to a lack of creditworthiness, which demonstrates the risk of borrowing for the respective local government and can thus constrain its ability to take on debt at agreeable terms. Where there are capacity constraints in local governments, it may be administratively complex to prepare, issue, and manage local bonds. For example, bond issues require significant amounts of sound financial and economic data that the market trusts, which are not always immediately available at a local level. This complexity translates into high-risk premiums. Furthermore, there are high costs involved in issuing bonds, including for transaction advisors, for the rating agencies, and the underwriter of the bonds, among other factors. Finally, another important consideration is that borrowing necessitates a deep, diverse, and liquid domestic capital market, which may be a challenge for countries where capital markets are still underdeveloped.

As noted, a specific emphasis in the Addis Ababa Action Agenda is about opening capital markets to developing country governments to support local and municipal borrowing. As noted, this remains highly skewed to developed countries with deeper capital markets and a more permissive legal environment for city and local government borrowing. One reason for the lack of an authorizing legislative environment in many developing countries is the concern that risky local government borrowing may lead to financial instability at a national level. To prevent this, it is important that there is a strong and transparent legal framework in place, that stipulates the conditions and limits to local and municipal borrowing, as well as the systems and procedures for them to access funds. Such a framework needs to ensure that local governments and municipalities are operating under a hard budget constraint and that there are debt thresholds that ensure borrowing is kept under control.

In many low-income economies, local and municipal governments will not be sufficiently creditworthy to be able to attract lenders on favorable terms. As such a major area of reform, that is within the local or municipal government's control, is the strengthening of its financial management procedures and processes. This is key to improving operating budgets and balance sheets, which lenders will look at to ensure that local governments can pay their principal and interest payments over the tenure of the loan. This must be either from the operating surplus of their own budget or from the revenues generated by that particular infrastructure or service.

Additionally, from a local government's perspective, a capital investment plan is another important factor to attract financing. This type of plan can demonstrate that the proposed investment is not only a priority for that level of government for the longer term, but that there is also sufficient consideration with respect to both the investment budget as well as operation and maintenance costs. Finally, sound financial reporting and external audits are needed to ensure investor confidence in the information that is being provided.

A local government's creditworthiness is assessed by international credit rating agencies that can independently examine and verify an entity's financial position. Prior to undertaking a full rating, which may be costly, a city or local government may want to pursue a shadow rating, using the Public Expenditure and Financial Accountability (PEFA) or other framework, to help them understand where their strengths and weaknesses lie. These ratings consider the risk that the local government will not be able to repay the principal and interest on its loans. It is important to note that a local government is rated on its own merits. However, their overall credit rating is constrained by the overall credit rating of their national government. The local government could also be borrowing for a specific project that will then repay the debt through the revenue it generates, such as by charging user fees. In that case, the particular project will be rated on its own merits.

In those cases where the local government can borrow, they need to have a debt management strategy in place that outlines the ideal composition of their debt portfolio and how this will be administered overall. This strategy should ensure that they are not only able to repay the principal and interest on all their outstanding loans within the timelines stipulated, but that they are also able to match the most appropriate revenue streams for repayment. This will further support them in selecting between debt instruments as well as ensuring that any further debt they take on is in line with their overall priorities, thus helping them manage their risk exposure accordingly. Borrowing may require the local government to have guarantees in place to mitigate risk and, in some cases, reduce the overall cost of capital. As the Addis Ababa Action Agenda specifically calls for, more work is needed to ensure guarantees are designed and structured in accordance with the specific needs of local governments in developing countries.

Subnational financial intermediaries and institutions can support local government borrowing. In fact, due to the low creditworthiness of local and municipal governments in low-income countries, when borrowing occurs it usually takes place through intermediaries. These intermediaries may be able to borrow on better terms than individual countries or local governments would. However, even when they are creditworthy, a major challenge with these institutions is that many of them are undercapitalized. Municipal financial authorities may also pool the borrowing of several municipalities across a province or a state. Many of these institutions in Europe and North America have been successful at lowering borrowing costs for municipalities.

Assets[9]

Perhaps the most underappreciated and sometimes most neglected area of a local finance system is with respect to asset management. However, a municipality or local government's portfolio of assets, which reflect its overall local public wealth, can be substantial. Assets can come in both physical form, such as land, buildings, or vehicles, or in financial form, including investments or ownership in enterprises.

Assets can be an important source of revenue generation. Land or property can be sold or used as collateral for loans. Assets are also an important component in some specific forms of income generation, most notably land-based financing, which is a particularly high potential revenue source for rapidly growing cities. Certain assets can also generate user fees. How assets are classified underpins what local governments and municipalities can do with them, which in turn is usually determined by the legal system.

Asset management is a critical, yet often underappreciated component of a local finance system. Even in higher income countries, comprehensive asset management plans at a local or municipal government level have only recently been put in place. An up-to-date asset

[9] Kaganova, O. and Kopanyi, M. (2014). "Chapter 6: Managing Local Assets." In Fravacque-Vitkovic, C. and Kopanyi, M. (eds.) *Municipal Finances: A Handbook for Local Governments* Washington DC: World Bank; Freire, M. and Kopanyi, M. *Asset and Debt Management for Cities*. London: International Growth Centre.

register is important data for local governments and municipalities to be able to budget and manage their revenues. The first step with respect to asset management requires inventorying a local or municipal government's existing assets and classifying them. There are several different approaches to asset classification which can be by material form, by ownership, by function or by service responsibility, among others. Once the assets have been inventoried, they will need to be valued. Accurate valuation will depend on the type of asset and will importantly rely on good data.

Once the portfolio of assets of the local or municipal government has been identified, then the municipality needs to put into a place a plan to manage each asset across its lifecycle, which comprises of planning, acquiring, operating, maintaining, and then disposing of it. This will require having in place policies and regulations on asset management. These should include for example, policies that limit individual discretion with respect to the asset use, ensuring that they are employed for the overall public well-being. It will also require having in place key focal persons who are responsible for the overall asset management process, as well as across the various stages of the assets' lifecycles.

Case studies

Expenditures: Dakar, Senegal PEFA assessment[10]

In 2015, Dakar was going to launch its first municipal bond, worth USD 40 million. As part of the groundwork to prepare this bond, beginning in 2008 the city undertook several activities to improve its creditworthiness. Central to this was undergoing a Public Expenditure and Financial Accountability (PEFA) programme, with support from the World Bank. The PEFA was pursued to strengthen the city's overall financial management framework, particularly its expenditure administration, and thus improve the city's credit rating.

The PEFA assessment works with 31 indicators, organized under seven main pillars, namely:

I. Budget reliability
II. Transparency of public finances
III. Management of assets and liabilities
IV. Policy-based fiscal strategy and budgeting
V. Predictability and control in budget execution
VI. Accounting and reporting
VII. External scrutiny and audit

As a result of their PEFA assessment, Dakar was able to identify the overall weaknesses in its financial management practices and based on this develop a targeted strategy to address them.

[10] Delbridge, V. et al. (2021). *Enhancing the financial positions of cities: evidence from Dakar*. Nairobi: UNHabitat; Gorelick, J. (2018). Supporting the future of municipal bonds in sub-Saharan Africa: the centrality of enabling environments and regulatory frameworks. *Environment and Urbanization 30(1),* 103-122; PPIAF. (2015). "PPIAF helps the City of Dakar improve its creditworthiness" Open Learning Campus. Washington DC: World Bank.

With technical assistance support these reforms helped the city achieved a BBB+ (regional scale) institutional credit rating. To date, Dakar is one of 19 local governments in sub-Saharan Africa to have undergone such a PEFA programme and assessment.

Although ultimately the bond issuance was stopped by the national government the day before it was supposed to go to market, the preparations the city undertook to strengthen its overall financial and expenditure management helped the city raise revenue through other financing mechanisms. For example, the city has since obtained infrastructure financing totalling CFA 26.8 billion (USD 46.1 million) from the French Development Agency (AFD), the West African Development Bank (BOAD), Ecobank, and the Islamic Bank of Senegal (BIS). In addition, Dakar is also only one of nine local governments in Africa who have publicized their audits and evaluations. All this work has continued to improve investor confidence in the city.

Intergovernmental fiscal transfers: the South African model[11]

Under the 1996 South African Constitution, there are three independent, but interrelated spheres of government, namely the national, provincial, and local levels. The Municipal Structures Act of 1998 created further sub-divisions at a local level with respect to municipalities, dividing them into metros, districts, and local governments. Based on these tiers of government, South Africa has developed an intergovernmental fiscal transfer system to determine how national revenue is divided between them.

As outlined by the Intergovernmental Fiscal Relations Act of 1997, transfers should be made using a transparent and equitable formula. The underpinning objectives of the transfers include:

- National interest
- Debt provisions
- Maintaining national flexibility to respond to emergencies
- Resource allocation for basic and developmental needs based on the powers and functions of the respective sphere of government
- Fiscal capacity and efficiency of the respective sphere of government
- Reducing horizontal economic disparities between different geographical jurisdictions
- Promoting sustainability and predictability of service provision

At the provincial level, the formula itself, with the average weights of each objective adjusted annually, includes the following six provisions:

- *Education:* Share of school age population (aged 5-17) and the number of learners enrolled in public schools

[11] South Africa Treasury. (2016). *Explanatory memorandum on the division of revenue*; South Africa Treasury. (2018). *South Africa's local debt legal framework, implementation and reforms*. Hendricks, C.J. (2016). *Intergovernmental fiscal transfers to provinces: How equitable is the equitable share?* South Africa: University of the Free State.

- *Health:* Based on the health risk profile as well as the public health system's case load
- *Population:* Share of national population
- *Institutional:* Equally divided component between provinces
- *Poverty:* Based on income data
- *Economic output:* Based on regional gross domestic output

At a local government level, the Intergovernmental Fiscal Relations Act determines that services for poor households should mainly be funded through transfers from the national government, with some cross-subsidization from municipalities expected. In South Africa, unlike many other African countries, local and municipal governments have wide abilities to raise own source revenue. On average, about 75 per cent of municipal budgets are funded from own source revenue, although in rural areas, where the tax base is smaller, intergovernmental fiscal transfers make up a more sizeable portion of a local government's budget. As such, for richer households, which can afford services, these should be primarily funded from a municipality's own source revenues, including taxes and user fees. To enact the transfers each year a Division of Revenue Act is passed, which considers the consultations by the Financial and Fiscal Commission.

Own-source revenue: property tax reform in Freetown, Sierra Leone[12]

Sierra Leone's 2004 Local Government Act devolves many expenditure responsibilities to local governments, including cities. However, even Freetown, the capital, and the largest city in Sierra Leone, with an annual population growth rate of about 3 per cent, struggled to meet its mandate due to insufficient revenues. The Transform Freetown agenda focused on increasing the city's own source revenue.

Central to this strategy was reforming a largely outdated property tax system, which has, to date, significantly underperformed. With support from various development partners and research institutions, an initial pilot of the valuation of 11,000 properties was launched in 2018, marking the start of one of the most comprehensive property tax reforms that any city has undertaken in Africa. The reforms in Freetown are focused on all areas of the property tax cycle, in the following ways:

- *Discovery:* The city's overall property roll was first updated, using satellite imagery which could be used to identify individual properties. This provided the foundation for the reform and increased Freetown's property roll from an initial 57,000 properties to over 120,000.

- *Valuation and Assessment:* Based on a random sample of 2,000 properties taken from the updated property roll, a set of valuation characteristics were then collected to develop a so-called points-based model. This simple model helps determine a set of

[12] Kamara, A. B., Meriggi, N., and Prichard, W. (2020). *Freetown just implemented a new property tax system that could quintuple revenue*; Kamara, A. B. (2021). *Property Tax Reform – Lessons from Freetown.*

characteristics that are primarily driving property value in the city and then uses this model to assess the taxable value for each property.

- *Billing:* Given the updated property roll, it was then also easier to distribute payment notices to all properties. An important adjustment to these notices is that they provided transparent calculations of the assessed value and therefore helped the taxpayer understand how their final bill was determined.
- *Collection:* The property tax collection was outsourced to a private firm that used the information on the property tax roll. Payments could then be made to designated banks with each property taxpayer receiving a clear identification number to help the city track individual payments and any non-compliance.
- *Enforcement:* Although the city placed a greater emphasis on encouraging voluntary compliance, including launching several communication campaigns along with the reform, a enforcement guide was still prepared for city council officials that outlined the mechanisms available to them, based on the Local Government Act.

It was estimated that based on these reforms, annual property tax revenues for Freetown could increase up to five-fold, to about 35 billion Leones. In addition, the data collected provided much clearer insight for the Freetown City Council on where to target their tax collection efforts. For example, it was estimated that 25 per cent of properties would account for 70 per cent of revenues, based on their assessed values. Although the reform programme is still ongoing and has faced several hurdles in its implementation, particularly because of political interventions by the national government, the overall process is still considered a good example of comprehensive property tax reform.

Borrowing: FINDETER Colombia[13]

Colombia is one of the countries in the world that has a long history of decentralizing expenditure as well as revenue-raising responsibilities to local governments. For example, municipalities in Colombia can borrow and, to support this, there is an overarching legal framework in place. One of the characteristics of this framework is that it helps provide an objective way to assess each municipality's borrowing capacity, and thus tailor the borrowing regulations accordingly. This so-called traffic light system, outlined in Table 1, are indicators that were established by the Ministry of Finance to assess whether a municipality can borrow and under what conditions. Municipalities meeting the criteria are able to borrow, some with permission from the national Ministry of Finance as well as a Performance Agreement with the lender.

Table 1. Colombia's traffic light system for regulating local borrowing (Law 359, 1997)

[13] Financiera de Desarrollo Territorial; World Bank. (2002). "Monitoring fiscal risks of subnational governments." *PremNotes Economic Policy 64*. Washington DC: World Bank.

Rating	Indicator	Borrowing restrictions
Green	• Interest as % of operational savings < 40% • Debt stock as % of current revenues < 80%	No restrictions
Yellow	• Interest as % of operational savings 40%- 60% • Debt stock as % of current revenues < 80%	Loans with Ministry of Finance approval
Red	• Interest as % of operational savings > 60% • Debt stock as % of current revenues > 80%	No lending without adjustment plan

To support the increased supply of finance for municipal and local governments, Financiera de Desarrollo Territorial S.A. (FINDETER), a national development bank, was established in 1989. Headquartered in Bogotá, it offers both financial and non-financial products. It also has five regional and several satellite offices to ensure that services can be locally accessed. In addition to supporting borrowing, FINDETER also supports municipalities and local governments with technical assistance in terms of planning, structuring, and assessing financial instruments for local infrastructure projects.

FINDETER can lend to both private and public entities and provides financing for up to 100 per cent of project costs for a tenor of up to 15 years. The loans may be used for capital investment or debt substitution. It specifically focuses on 11 sectors in the economy that have been identified as important to attaining the country's overall developmental objects. These sectors include water, housing, transport, and energy, among others. It now accounts for 15 per cent of overall municipal lending in Colombia. FINDETER's overarching aim is to directly impact the well-being of the Colombian population.

Currently, FINDETER has an overall long-term credit rating of BBB, which is the equivalent of the overall Colombian sovereign rating, as well as the highest local long-term credit rating of AAA. Furthermore, the Colombian Stock Exchange has awarded FINDETER with the so-called "IR - Issuer" recognition, as a result of its best practices in terms of the disclosure of information to the market and relationship with investors. Importantly for municipal governments, FINDETER can conduct local currency lending in Colombian pesos as well as being able to issue guarantees.

Peer-to-peer learning and research

The main international or regional practitioner networks working on supporting municipal and local finance systems as well as enabling peer-to-peer learning are as follows (in alphabetical order):

- C40 Cities: C40 is a network of mayors of nearly 100 world-leading cities collaborating to deliver urgent action needed to confront the climate crisis. A goal of their activities is to establish a network of chief financial officers of cities across Africa. The network aims is to support the accelerated development of climate-smart project pipelines and the creation of municipal environments favourable to investment.

- Cities Alliance: Cities Alliance is a global partnership fighting urban poverty and supporting cities to deliver sustainable development. To manage its activities, the Cities Alliance operates a multi-donor fund with UNOPS as host and Trustee. The Cities Alliance seeks to improve the lives of 60 million urban poor across 200 cities in 20 countries by 2030. To be a leading agent for urban change by supporting and implementing comprehensive programmes in countries and cities where it matters most, they leverage the collective expertise of their partnerships to catalyze urban transformation at a global level.

- Global Fund for Cities Development (FMDV): FMDV is a technical assistance and financial engineering organisation, which supports emerging and developing local authorities in accessing the necessary financial resources to finance their urban development projects. It supports local authorities throughout the entire urban development project process, from designing and planning programmes to funding, implementation, and assessment.

- Global Land Tool Network (GLTN): The GLTN is a multisectoral alliance of international partners committed to increasing access to land and tenure security for all, with a particular focus on the poor, women, and youth. The network is managed by UN-Habitat, and its partners include international rural and urban civil society organisations, research and training institutions, bilateral and multilateral organisations, and international professional bodies. One of its main focuses is on unlocking the potential for land-based financing for the development of sustainable and equitable cities and properly serviced communities. The three tools it has developed in this context are around innovative land and property taxation, land-based financing, and valuation of unregistered land and properties.

- International Centre for Tax and Development (ICTD): ICTD is a research centre supporting lower-income countries to strengthen their tax policy and practice. It runs the Local Government Revenue Initiative (LoGRI), which aims to develop policy-relevant research, knowledge, and expertise, as well as tools to support governments to raise local revenue more equitably and fairly and in ways that promote trust, transparency, and accountability. LoGRI provides support to government partners in Africa and South Asia.

- International Growth Centre (IGC): The IGC is a research centre run by the London School of Economics in partnership with the University of Oxford that works with policy makers in developing countries to promote inclusive and sustainable growth through path-breaking economic research. It leads the Cities that Work Initiative, which combines new evidence and analysis of urban economics together with the knowledge of urban planning practitioners to establish a body of policy-focused synthesis of research and a global network of individuals with a shared vision for urban policy. One of its pillars is strengthening municipal finance and urban governance.

- The International Monetary Fund Government Finance Statistics is a database with fiscal data from countries who report to it. Depending on their reporting cycle, data is available on an annual, quarterly, or monthly basis. It contains data on revenues, expenditure, transactions in financial assets and liabilities as well as balance sheet data. In addition to collecting this data at the national government level, the GFS also provides some data for local governments and associated entities.

- Lincoln Institute for Land Policy: The Lincoln Institute for Land Policy seeks to improve quality of life through the effective use, taxation, and stewardship of land. A non-profit private operating foundation whose origins date to 1946, the Lincoln Institute researches and recommends creative approaches to land as a solution to economic, social, and environmental challenges. Through education, training, publications, and events, they integrate theory and practice to inform public policy decisions worldwide.

- In order to provide more granular information with respect to local fiscal data linked to fiscal decentralization, the Local Public Sector Alliance has recently launched the Local Governance Institutions Comparative Assessment (LoGICA) Framework and Intergovernmental Fiscal and Expenditure Reviews (InFER), which are to be rolled out progressively to all countries across the world. These comparative frameworks are to assist with collecting comparative data related to decentralization, with a particular focus on fiscal decentralization and will be undertaken by multi-stakeholder country teams. This methodology is publicly available and can be applied to any country context.

- Malaga Coalition for Municipal Finance: The Malaga Global Coalition for Municipal Finance, led by UNCDF, UCLG, and FMDV, believes that solving the challenge of municipal finance is fundamental to achieving the SDGs. The Coalition promotes global policy goals necessary to unlock finance for cities in the developing world.

- The World Bank has developed several tools and manuals to both help governments track their performance as well as to support capacity building. A widely used tool at a national level is the Public Expenditure and Accountability (PEFA) framework which provides standardized quantitative public financial management diagnostic assessments. Performance is measured through 94 characteristics across 31 key components in 7 broad activity areas. It largely focuses on the expenditure part of budget management and much less on revenues, planning, debt management and capacity. A local version of the PEFA assessments is increasingly being implemented by local governments to be able to assess their strengths and weaknesses in public financial management. However, it is important to highlight that PEFAs were largely designed for donor-specific purposes, and do not include all aspects that market investors may look at.

- Another tool that has been developed by the World Bank, is the Property Tax Diagnostic Manual. This provides practical guidance, specifically aimed at local and municipal governments who wish to reform their property tax systems, on the relative technical strengths and weaknesses, and where improvements can be made.

- United Cities and Local Government (UCLG): UCLG is a global network of cities and local, regional, and metropolitan governments and their associations, and is committed to representing, defending, and amplifying the voices of local and regional governments to leave no one and no place behind. Local finance is a cross-cutting strategic priority for UCLG. UCLG uses its global and regional chapters to advance evidence-based advocacy, sharing, and peer-learning and 'taking action,' which is focused on developing an International Municipal Investment Fund and an Africa Territorial Agency to strengthen borrowing opportunities for local and municipal governments. It also hosts the Global Observatory on Local Finance in partnership with the Organisation for Economic Co-Operation and Development (OECD).

- United Nations Capital Development Fund (UNCDF): UNCDF Strategic Framework 2022–2025 continues this tradition by emphasizing UNCDF's hybrid nature as a development finance institution on the one hand and a United Nations development agency on the other. UNCDF's Local Transformative Finance team is the United Nations' local financing hub and a hybrid DFI that collaborates with other United Nations Agencies to support local financing for the SDGs. It works across the areas of fiscal decentralization, generating local development funds for public capital investment programming, structured public finance, municipal finance, small and medium enterprise finance as well as PPPs.

- United Nations Development Programme (UNDP): UNDP's Strategic Plan (2022–2025) identifies development financing as an enabler to scale up development impact and also seeks to prioritize investment of over USD 1 trillion of public expenditure and private capital in the SDGs. UNDP programming portfolios and policy engagements provide a platform from which to engage on the agenda of financing the SDGs. Unlike financial institutions, UNDP is not primarily engaged with financial transactions but can provide advice on how sustainable development can be integrated into financial transactions. UNDP runs a dedicated Sustainable Finance Hub to aggregate all of the agency's work across the globe in this area. A key comparative advantage with respect to supporting local financing for the SDGs is that UNDP's approach is rooted in governance and finance perspectives.

Voluntary Local Reviews are an assessment of implementation of the 2030 Agenda at the local level. These local government-initiated and -led reviews assess frameworks, plans, and budgets for SDG localization. To support these reviews and also to strengthen support to local governments to institutionalize the SDGs, UNDP is currently in the process of developing a local government version of their Budgeting for the SDGs approach. Through this approach they will help local governments better align their budgets to achieve a just and transformative sustainable development that leaves no one behind. The process, which will be adapted from one already adopted at the national level, will include an SDG context analysis, a review of the overall PFM system, stakeholder and institutional analysis, identifying the right reform model and then developing a road map accordingly.

International development cooperation

The following are some of the institutions providing multilateral technical assistance to countries interested in pursuing reforms in municipal and local finance:

- African Development Bank (AfDB): The AfDB has been involved in urban development for several decades. The first Urban Development Policy was approved in 1992 to provide guidance for AfDB operations in the urban sector. In 2019, the AfDB's Guidelines on Subnational Finance were issued. These provide operational and policy guidance for how the AfDB can engage directly with subnational governments/entities, by promoting appropriate legal and regulatory frameworks for their optimal functioning, and by engaging at the national level as well.

- Agence Française de Développement (AFD): The AFD implements France's policy in the area of development and international solidarity by financing the public sector through loans and grants. It also can finance non-sovereign loans which are intended for local authorities, public institutions, and non-governmental organizations and can be disbursed without a national government guarantee. Many of the AFD's loans are concessional in nature. They can offer this type of financing when the project represents a real opportunity for the country or the local government. However, to avoid any unfair competition, AFD's operations are determined by the principle of subsidiarity. This means that they only intervene when they are sure that the local financial system does not have the capacity to finance the planned operation alone.

- Asian Development Bank (ADB): The ADB has a dedicated Cities Development Initiative for Asia (CDIA) that was established in 2007. The idea of this initiative is to support cities across Asia and in the Pacific to develop bankable infrastructure projects, and directly link them to funding sources. The objectives of this initiative are poverty reduction, climate change mitigation and adaptation and environmental improvement more broadly, as well as promoting good governance.

- European Bank for Reconstruction and Development (EBRD): The EBRD's Small Municipalities Finance Facility, was set up with support from the European Union to incentivize commercial banks to lend to smaller and medium-sized municipalities (less than 100,000 people), including public utility companies in the European Union.

EBRD provides credit lines to the facility and helps in the risk assessment of the municipalities. The EBRD, through European Union financing, provides for risk sharing thus acting in the form of a guarantee as well.

- The World Bank: The World Bank is one of the largest sources of assistance, both in terms of loan financing as well as technical assistance to local and municipal governments wanting to undertake reforms to their finance systems. It does this in several ways, including establishing and supporting municipal developments. Between 1998 and 2009 it financed 190 municipal development funds. Its Public-Private Infrastructure Advisory Facility (PPIAF) Subnational Technical Assistance Programme and associated creditworthiness academy supports municipal and local governments to strengthen their local finance systems. In individual countries, it provides capacity building support and grants to further strengthen subnational finance.

The Inter-American Development Bank is working in collaboration with FINDETER on the Sustainable and Competitive Cities platform. This platform promotes investments into strategic projects, focused on the transformation of mid-sized cities through orderly planning to improve the quality of life of their citizens.

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