United Nations

INTER-AGENCY TASK FORCE ON FINANCING FOR DEVELOPMENT
Summary of the expert group meeting on subnational finance
Wednesday 29 November 2017 • 9:00-13:00 • UN Headquarters

Highlights:

- Staff from 13 member agencies of the Inter-Agency Task Force (IATF) on Financing for Development held an expert group meeting to discuss subnational finance. The co-hosts of the meeting, the United Nations Capital Development Fund and UN-Habitat, invited four experts from academia and United Cities and Local Government to contribute.
- Implementation of Addis Ababa Action Agenda paragraph 34 motivated the meeting. It notes that "expenditures and investments in sustainable development are being devolved to the sub-national level, which often lack adequate technical and technological capacity, financing and support".
- Subnational governments face significant challenges in mobilizing adequate revenue - both own source revenue and external resources such as central government transfers - to meet recurrent expenditures and making long term investments in support of inclusive and sustainable local development. Least developed countries (LDCs) and second tier cities face even steeper challenges. Increasing urbanisation will intensify the challenges.
- Participants agreed on the importance of consistency between urban development planning and the national sustainable development planning, including integrated national financing frameworks.
- An overarching principle is the need for clear assignment of authority and responsibility between national and subnational authorities.
- To boost the effectiveness of subnational governments as sustainable development actors, Member States can consider reform in four main areas: (i) appropriately empowering subnational authorities and promoting revenue raising authority; (ii) encouraging transparent and accountable management of local finance; (iii) promoting sustainable access to long-term finance, and; (iv) providing more coordinated external cooperation. In each area, national authorities can work with subnational governments to strengthen institutions and legal frameworks and develop capacity to promote access to finance.
- Participants emphasised the importance of raising revenue, particularly developing internal sources of revenue, with a focus on property taxes and tax surcharges (piggyback taxation) as relevant to many subnational governments. Land value capture and assets management were also mentioned as sources of revenues, as were luxury taxes.
- Market-based finance was seen as an option for a limited set of larger cities in developing countries, with lessons to be learned from earlier experiences, such as those of the city of Johannesburg.
- Subnational authorities can use a range of financing instruments to access long-term finance, with the choice of the type of instrument and the institutional arrangements for financing depending on the type of investment, the legal framework and the subnational government's level of income and creditworthiness.
- The importance of matching revenue raising with service delivery was emphasized as important to generating public support and compliance. Taxes and fees can also be used to dis-incentivise activities with negative externalities, such as pollution or traffic congestion.

- Frameworks to develop public-private partnerships should be designed to deliver appropriate balances of risk and reward that preserve public interest.
- Transparency is important for ensuring debt sustainability, improving public support, improving good governance and raising awareness, including in relation to budgets, debt levels, land ownership and public-private partnerships.
- A longer paper on financing local infrastructure, municipal funds and municipal development banks will be prepared to support deeper discussion on this topic in 2018.

Full Summary:

I. Background

All key agreements adopted in 2015 – the Agenda 2030 for Sustainable Development, the Addis Ababa Action Agenda, the Sendai Framework and the Paris Agreement – recognized the important role played by local authorities. As also recognised in the New Urban Agenda, the local dimension will be crucial for the implementation of the 2030 Agenda and that the 'localization' of the SDGs will be a key element to 'leave no one behind'. On Wednesday, 29 November 2017, the United Nations Capital Development Fund and UN-Habitat jointly organized an expert group meeting with the Financing for Development Office of UN DESA, to discuss subnational finance. The half-day meeting was conducted under the auspices of the Inter-Agency Task Force on Financing for Development and operated under Chatham House rule.

The expert group meeting aimed to share knowledge on how internal sources of revenue at the subnational level (e.g., taxes, user fees, land value capture) and external sources of finance (e.g., intergovernmental transfers, borrowing, aid) can be strengthened and more effectively managed for financing sustainable development at the subnational level, focusing on concrete country experiences. The meeting sought to advance substantive discussion at the interagency level on how to enhance financing flows to the subnational level and to discuss the main messages on subnational finance to be put forward in the thematic chapter of the 2018 IATF report.

The meeting brought together IATF members, academics and other external experts. Twenty-nine staff members from 13 IATF member agencies joined the meeting, including through audio connections from Bangkok, Washington DC, and Paris. Four external experts also joined the meeting, including one participating via audio from South Africa.

The meeting began with a framework setting discussion on how to strengthen subnational finance in the context of increasing urbanization, which was based on a background paper written by an external expert. This was followed by a discussion on internal and external sources of revenue.

While this summary will inform the Task Force's work, including its 2018 report, a more in-depth paper on subnational finance is being prepared by one of the experts to inform the 2018 ECOSOC Forum on Financing for Development follow-up. Key points raised in the meeting are summarized below.

II. Setting the stage: Strengthening subnational finance in the context of increasing urbanization

The meeting began with a review of conceptual issues in subnational finance, with the presenter emphasising that subnational governments are important development actors. Subnational governments are diverse ranging from smaller second tier cities to megalopolises, and in national contexts that range from unitary to federal systems, and from small countries to very large ones. Subnational governments both consume and generate resources, and their actions affect sustainable development not only at the local level, but also at the international level, with the potential to contribute to global public goods. A framework for financing subnational governments was discussed, including four areas of action: basic empowerment and revenue raising authority, management and accountability, long-term finance, and external cooperation.

Presentations included data on a number of aspects of subnational authority development, including the number of people settled in urban areas, their share of public and investment spending, the frequency of risk prevention planning and urban development policies, and the number of cities that use some form of participatory budgeting. It was noted that in low-income environments subnational governments can be trapped in a low-growth, low-revenue, low-investment equilibrium. As financing policies are fundamental to directing urban development, the creation and implementation of urban plans become very important. Participants agreed on the importance of consistency between urban development planning and the national sustainable development planning, including integrated national financing frameworks.

A critical point was that subnational authorities need a range of financing instruments that enables access to long-term finance. Participants agreed on the usefulness of the framework, which emphasised the linkages between different sources of finance and suggested that the choice of the type of instrument and the institutional arrangements for financing should depend on the type of investment and the subnational government's level of income and creditworthiness. A typology of three types of investment was shown, with social purpose investments requiring transfers or tax financing, while revenue generating investments could use a mix of different instruments depending on whether they are fully or only partially self-financing. Self-financing investments with sufficient revenue streams to fully repay the cost of the investment were most ripe for borrowing, including from municipal development funds and development banks or the issuance of municipal bonds.

Infrastructure, including transport and energy, was mentioned as an important sector for which subnational governments may have a role in financing depending on the local and national contexts and needs. Some speakers indicated that these types of investment should be realized at the subnational level, with increased coordination across levels of government to finance the needed investments. Others, however, stressed that a country-by-country approach was important, to match the right range of financing and delivery options to the local context. Participants agreed that which level of government bears the responsibility for financing infrastructure investment should be defined as clearly as possible before infrastructure is developed. There was also agreement that existing frameworks to develop public-private partnerships in such areas had not regularly delivered appropriate balances of risk and reward that preserved public interest.

Other issues discussed included the political economy of decentralization, the role of multilateral development banks in lending to subnational authorities, the role of official development assistance, and the need for public financial management reforms.

III. Internal sources of revenue

An overarching principle for taxation by sub-national authorities is the need for clear assignment of authority and responsibility between national and subnational authorities. This requires both a clear *de jure* legal framework as well as *de facto* autonomy and independence at appropriate levels. Participants emphasised that coherence and collaboration between central and subnational authorities is critical, as well as consideration of the capacities of staff of subnational authorities.

A participant presented the UN Habitat global municipal fiscal database. This database is the first global effort to create a dataset of municipal budgets, including revenue, debt and expenditure data, though the database's 90 contributing cities are submitting data according to their own standards so that comparability is a concern. Nonetheless, current data shows a dramatic differential between developed economies and LDCs in terms of capital budgets and per capita capital expenditures. It was also noted that the budget differentials were far larger than the differences in costs of building new infrastructure in developed and developing countries, meaning that the low capital budgets of the municipal authorities in LDCs do not allow them to cover the costs of new fixed infrastructure investment. Participants were also presented with some of the data from the first contribution to the Global Observatory on Local Finances, developed jointly by UCLG and the OECD. The pilot study assessed national accounts in 101 countries and demonstrated that, on average, subnational governments account for nearly 40 per cent of public investment. In terms of internal revenue, presenters outlined three general possibilities: taxes, fees, and the revenue potential of municipal assets.

In the discussion on taxation, it was noted that most cities have net financial outflows, meaning that the public revenue generated by city residents and businesses, including national or provincial taxation, are larger than the spending in the city, with the surplus being redistributed to less urbanised areas through equalization transfers. Linking tax payment to the delivery of services can strengthen the social compact between taxpayer and the subnational authority. The discussion focussed on two types of taxes: property taxes and tax surcharges (known as piggyback taxation). Property taxes are particularly useful for subnational entities. They can be progressive and have less of a distortionary impact on economic activity, and can also be harder to avoid because real estate is not moveable. The challenges emphasised in the discussion included the difficulty in developing a cadastral system for tracking ownership and assessment of the tax, how to deal with ownership in informal settlements, as well as need for continued update of the system and the valuations. Piggyback taxes are those that are imposed by the subnational authority on the same tax base and through the same collection system as taxes imposed by a higher level of authority. Participants identified the potential in these systems, and that these tend to work best in federal systems where subnational governments are more likely to already have the legal frameworks in place for such taxes. Examples include income and sales taxes. Also raised in the discussion was the possibility for luxury taxes.

User fees, which can help establish accountability for service delivery, can also be used to dis-incentivize activities with negative externalities, such as pollution or congestion. The discussion on fees emphasised that the importance of not letting this source of revenue, or some types of taxes, become a nuisance, meaning revenue with declining compliance over time and lack of buoyancy as cities experience rapid growth.

Finally, land value capture can be a tool for some subnational authorities. This involves using taxes to realise some of the gains in value in property that occurs when public authorities develop new infrastructure such as mass transit systems or water and sanitation systems. Another option is selling or leasing out of land owned by the subnational authorities, which can be part of an overall urban development plan, but land exchange or land concessions need to be carefully managed to ensure transactions remain in the public interest.

In the discussion, participants raised the issue of land being used as political favour, and the benefits of transparency around land ownership, permits for development, and taxation. However, it was stated that because subnational governments essentially “de-risk” projects by building associated infrastructure such as roads and water supply, it was fair to expect some cost recovery for the contributions the investment in the infrastructure makes to real estate project financial returns.

IV. External sources of finance

Three main types of external source revenue were considered: intergovernmental transfers, commercial borrowing, and municipal bond issuance. There was also a discussion of direct private sector involvement, including through public-private partnership (PPP) agreements. Intergovernmental transfers are the most significant in this category, as no city is self-sufficient financially.

One challenge with regard to issuing municipal debt is the risk that issuance of subnational debt might lead to countries hitting limits on overall public debt levels, possibly contributing to solvency concerns. Some participants argued that municipal debt should be secured by cities' own collateral and specific borrowing frameworks, and should not be considered in relation to overall national debt ceilings. Participants agreed that the transparency of sub-national debt is critical to ensuring that both central government debt and consolidated public and publicly-guaranteed debt are able to be monitored carefully. During the discussion, it was emphasised that there should be explicit clarity given about the level of sovereign guarantee provided by the national authorities for any subnational government borrowing.

A presentation was made about the experiences of the city of Johannesburg, South Africa which has issued a number of different types of bonds, both institutional and retail in the last decade. The most recent issuance used an innovative approach to reach retail investors. There are a number of prerequisites that enabled the city’s issuance, including a sound legal framework, careful planning, transparency, good governance, and financial sustainability. The case highlighted that there are synergies between strong own source revenue generation, which demonstrates credit worthiness, and access to market-based financing. The case study also highlighted how development banks can contribute by issuing guarantees that can help lower the cost of financing and/or lengthen the maturity of issuances.

Subnational governments have a choice between project bonds and general obligation bonds (GOBs). Project bonds are linked to projects that generate returns to repay the private investors. GOBs need to be repaid from the general budget, which can have broader implications on debt sustainability and credit-worthiness.

Overall, the discussion noted that market-based finance is not relevant to the vast majority of subnational governments in developing countries, because of a lack of creditworthiness and a lack of capacity. It was mentioned that only 94 of the largest 500 cities in developing countries had investment-grade credit ratings, and that of these only 32 had issued bonds. Participants indicated this means there is space and need for alternative structures to facilitate subnational finance, including national municipal development funds and municipal development corporations, as well as through Islamic finance mechanisms or multilateral development bank lending.

In a discussion on PPPs and other types of private participation, warnings were issued about the need for ensuring risks and rewards are shared fairly, as called for in the Addis Agenda. Many subnational governments do not yet have sufficient capacity to negotiate fair contracts or effectively regulate private operators.

V. Final discussion and conclusions

In a final discussion, participants stressed a number of other related issues that should be taken into consideration in subnational government finance. These include the costs of air pollution associated with urban development, the need to think about safeguards against badly designed PPPs, and the need to discuss the incidence of different policies on different groups, including for example on women.

The discussion concluded with an acknowledgement of the importance of subnational government finance, but that policies must match the specific national contexts in which they are being used. Overall, participants stressed the importance of subnational governments having a range of financing options to choose from that matches their own levels of development, their capacities, their national contexts and their investment needs.