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Sustainable financing for urban development

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Rapid urbanisation means that cities have to modernize, expand and in many cases completely build infrastructure. This is creating massive demands for financing.

Demand for and potential sources of financing

A study conducted by the Boston Consulting Group estimates that there is an annual urban investment deficit of at least one trillion US dollars. Most of this amount stems from the developing countries and emerging economies. Considering the scale of the deficit, it is becoming increasingly clear that urban demand for financing cannot be covered by increasing direct revenues (taxes, charges) or official development assistance (ODA) alone. The focus is therefore shifting towards external financing via financial markets. These sources of financing are commonly used in industrialised countries, and are mainly justified from an economic perspective with reference to the fact that the costs of infrastructure should also be shared by future users and not just current ones. Potential third-party financiers for urban infrastructure projects include commercial banks and infrastructure funds as well as small and institutional investors (e.g. insurance companies, pension funds and charitable trusts).

Factors obstructing cities' access to the financial market

However, many countries lack even the legal foundations (i.e. fiscal autonomy) required for debt financing (e.g. loans, bonds) for cities and other local authorities. And even if these are in place, many cities lack the financial management capacity to effectively and responsibly take advantage of the potential offered by the various alternative sources of financing (e.g. risk of overindebtedness). At the same time, the local financial markets are often only functional to a limited extent and struggle to provide the long-term funding required for urban infrastructure. This is exacerbated by the fact that the cities themselves are often not seen as particularly attractive targets for potential investors (e.g. through mismanagement, no or low credit rating, unfavourable risk/return profile).

Improving city financial management

Many cities will therefore have to improve their own capacities before they can make more use of the potential debt financing that is available. This requires first of all a professional and transparent financial management. The greatest potential can often be found on the expenditure side (e.g. the systematic application of economic principles and establishment of effective accountability and control mechanisms). In suitable cases, the outsourcing of services and public-private partnerships (potentially involving compensation payments for unprofitable activities and/or the provision of basic services to disadvantaged target groups) can also be appropriate measures for reducing a city's investment, operating and maintenance costs.

But at the same time it is also essential to make sufficient use of the potential available on the revenue side before considering debt financing. This not only involves more substantial financial transfers from central government and the exploitation of a city's assets (e.g. selling land for development, leasing) but also the collection of local taxes (often taxes on businesses, land and assets as well as shares of national taxes), land value capture (through urban infrastructure improvement) and appropriate charges for municipal services. Even the recording of tax details (expansion of the tax base), charging of fees and collection of arrears are often lacking.

Sustainable and efficient municipal financial management can not only substantially reduce a city's overall demand for financing and enable an appropriate contribution from the city in the case of debt financing, but also helps to ensure a level of debt that is responsible from an economic perspective (i.e. prudent debt management) and indicates creditworthiness and professionalism to any potential investors.

How can international development cooperation help?

Financing urban development by using ODA funds can only cover a small portion of the demand for urban investment. However, it can generate a far-reaching impact if it is used to address structural bottlenecks, for example to safeguard a city's basic infrastructure and functions, to support its management (decentralisation programmes or urban planning), to set up municipal financing instruments (e.g. municipal investment funds, establishing municipal financing segments on local financial markets) or to mobilise private funds directly (co-financing, PPP models etc.).

Conclusion

Making more use of the financial markets is essential in the medium to long term in order to finance the massive demand for urban infrastructure.First, however, this will require the legal foundations to be put in place and city financial management to be made more professional in many countries. International development cooperation can provide cities assistance and support in these fields in various ways. ■