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Foreword



Maimunah Mohd Sharif
Under-Secretary-General and
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Cities and sustainable urban development are central to the sustainable development in the world, underpinned by the United Nations in the 2030 Agenda and the New Urban Agenda. From my experience as Mayor in Malaysia, I understand that access to finance is critical when developing and ensuring the long term sustainability of a city. Cities can be engines of productivity, but only when their development is properly planned and governed. This includes aligning spatial and economic development to facilitate access to finance. This can be own revenues, national government transfers, and external finance; all necessary as city managers consider development projects, matching public funds to private financing to sustain critical infrastructure and services. The importance of functional governance has been

verified by COVID-19: in the recent UN-Habitat's report on Cities and Pandemics, we recommend strengthening access to municipal finance enabling city leaders to build a new urban economy that reduces disaster risk as well as addressing climate change by developing nature-based solutions and investing in sustainable infrastructure to enable low carbon transport. This is even more important in the Global South especially regarding the surge of population growth and urbanisation estimated for the next few decades.

UN-Habitat is pleased to conduct this initiative of *Increasing financial capacities of cities from developing countries to deliver productive and sustainable urban development*. For this timely endeavour we have convened our sister entities at the United Nations,

and other partners who complement our expertise in financing sustainable urban development. We are grateful to Professor Sir Paul Collier of University of Oxford for chairing the Advisory Group, to all members of this group for lending their expertise to our joint effort, to Professor Edward L. Glaeser of Harvard University for his personal engagement along with his team of Cities that Work at the International Growth Centre, and to Professor Anthony Venables of University of Oxford who managed the IGC team. This work would have not been successful without valuable contributions of the Directorate-General of International Partnership of the European Commission, and the European Investment Bank. We hope to continue the work with an extended group of partners in the next phase of the initiative.

Foreword



Jan Olbrycht

Member of European Parliament and
President of the URBAN Intergroup

The record of access to finance of the cities in the European Union is rather intricate. As a former Mayor and later President of the region in Poland, and counting 17th year at the European Parliament, I have been involved in this story for more than 30 years. Progress has been made in Europe in the last decades in improving subnational access to finance, and it continues to get better. Yet it requires devoted effort of many actors at all levels of policymaking. With the understanding of the transformative role of urbanisation growing globally in recent years, the issue of cities' access to finance is becoming prominent in our partner countries in the Global South, too. Therefore, the European Parliament thought it worthwhile to investigate the

state of affairs beyond Europe, and we have requested the European Commission and UN-Habitat to conduct this study on *Increasing financial capacities of cities from developing countries to deliver productive and sustainable urban development*, informing us of how the partnership with the European Union can foster progress in this issue in the other parts of the world.

The journey of this initiative, looking at actual cases and deliberations of practices, lessons, and new ideas, in which many important institutions and prominent thought leaders joined us, is now ready to share its first results in this publication. To me, it has been fascinating to learn of the importance of flexibility and individual approaches

in different contexts, but also that of pragmatism - which are crucial in responding to the surge of urbanization in low-income countries, and how in this urgency we sometimes may need to stimulate the development of urban governance and institutions with investing in urgent development of urban infrastructure without waiting for a better enabling environment. However, along with some focal areas that have been determined, many more questions remain to be answered. We hope that the work continues, and that the story of success of the cities in Europe will empower countries and cities of our partner countries in Africa and elsewhere in their quest to finance better urban development.

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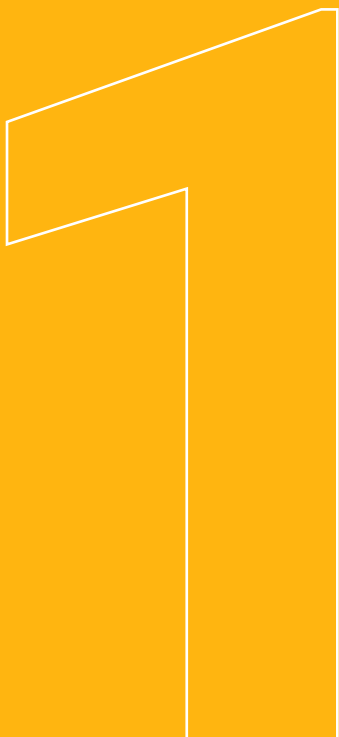
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Local Food Market, Hargeisa, Somaliland
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POLICY BRIEF

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Funded by
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About this initiative

Supporting the urban dimension of development cooperation: *Enhancing the financial positions of cities in developing countries to achieve sustainable urban development*

This initiative has been requested by the European Parliament. It is implemented by European Commission and UN-Habitat, supported by the International Growth Centre. These partners are working to identify relevant measures to help mobilise financing for urban development at all levels of government. The work has been undertaken through case studies conducted in Dakar (Senegal), Hargeisa (Somaliland, Somalia), Kampala (Uganda), Kisumu (Kenya), Mzuzu (Malawi), meetings with experts and practitioners, and empirical literature. The initiative works with an Advisory Group, chaired by Professor Sir Paul Collier from the University of Oxford, and consisting of representatives from the European Investment Bank, African Development Bank, UN Capital Development Fund, UN Economic Commission for Africa, and United Cities and Local Governments.

Fuelled by population growth and rural-to-urban migration, urbanisation in Sub-Saharan Africa is rapidly increasing, generating a massive need for investments in urban infrastructure. Africa urbanises at lower income levels and without the same degree of productivity increases seen in other regions. More than half of the residents in African cities live in informal housing, and three-quarters of this population is either unemployed or relies on informal jobs. The society faces a huge challenge in providing infrastructure and basic services for liveable and productive cities while accommodating their rapidly growing urban population.

The initial phase of this initiative has been dedicated to reviewing the issues crucial to addressing the above. Whilst the study identifies areas where more work is needed, evidently there is a connection between the trajectories of economic transformation, multi-level governance, and financing urban development. This policy brief focuses on three core issues: improving investment planning, raising local revenues, and enhancing access to external finance.

IMPROVE INVESTMENT PLANNING

When planned responsibly and based on sound, but not necessarily exhaustive, cost/benefit analysis and supported by adequate regulations, the financing and development of infrastructure can be used as an engine for the development of institutions, policies, and capacities at all levels and across all sectors of governance.

To this end, the **mandates of all levels and sectors of government should be clear, and without gaps and overlaps**. All relevant levels and sectors of government must be **involved in making decisions on investment**, instead of just those involved in collecting taxes and other revenues. It is also crucial to **improve the effectiveness of managing urban development through better collaboration between different levels and sectors of government**. Further, the success of efforts to **decentralise** responsibilities to subnational levels is **highly dependent on existing governance systems and traditions**, even if they are supported by fiscal devolution and authority of sub-sovereign borrowing.

In 2010, the government of Uganda separated the elected political arm of the city from its management functions, establishing the Kampala Capital City Authority (KCCA) that was tasked with management and operations responsibilities under the Minister of Kampala and Metropolitan Affairs. This reform streamlined certain city functions and made it easier to align them with national priorities; however, there was no clear delineation of the relationship between the various authorities that governed Kampala. Disagreements over these have therefore brought many projects to a standstill. The KCCA Act amendment enacted in 2020 attempts to clarify the decision-making hierarchy between the various Kampala authorities, specifying the roles and responsibilities of governance actors and extending broader territorial planning across the Greater Kampala Metropolitan Area.

Urban planning is crucial to prepare for the orderly expansion of cities to guide investment, prepare subdivisions of land and install skeletal infrastructure before building. Retrofitting informally built areas is complex and much more expensive.

The Hargeisa case study shows that planning for future expansion is not only useful for capturing the gains from rapid urbanisation through exaction, but also for improving future urban investment. The city government has implemented a system of 'in-kind' land value capture, or exaction through land readjustment. Within this system, landowners on the outskirts of the city who apply to convert their land from rural to urban land use must provide the city government with 30 per cent of the asset. In this way, the city can access the land it needs to provide public infrastructure to service a growing city. At the same time, rent from this land offers the city a valuable source of additional income to pay for the infrastructure development.

Promote urban planning that is suited to the context of widespread informality **well in advance of expansion of cities to make sure that investment is guided by coherent plans**. It is also important to **link long-term urban spatial and physical planning and the financing of urban investments** with a strategic approach to urban development that determines priorities and phasing and **embeds long-term investment needs in the budgeting cycles of ministries and municipalities**.

The execution of good plans and projects is equally critical. Municipalities and municipal entities must build suitable supply chain management systems for infrastructure delivery, i.e., control frameworks for the planning, design and execution of infrastructure projects, project tracking, and performance monitoring that are able to better **deliver value for money by optimally using resources to achieve intended outcomes** while minimising the scope for corruption.

Responding to the surge in urban population seems to result in either the time-consuming process of building capabilities to harmonise goals and collaborate effectively, or a tendency to address the urgency to develop infrastructure without any consideration of the former. However, **infrastructure development cannot be put on hold while perfect policies and institutions are put in place. These ends need not be mutually exclusive**: investment in urban development does not have to be withheld until fully capable institutions are in place, nor do governments need to resort to "non-invasive" planning and building of urban infrastructure regardless of institutions and policies.

Use urgent **investment as a catalyst for institutional development** so that it simultaneously supports efforts to build institutions as well as strengthen regulations. Determine the **types of infrastructure and services needed to prioritise scalability and the release of transformative potential**.

STRENGTHEN RAISING OF LOCAL REVENUES

Optimising own source revenue (OSR) is critical to sustainably enhance the financial position of cities. Opportunities for OSR optimisation often revolve around streamlining tax policy and enhancing compliance, both of which are impacted by digitalisation and the strengthening of the social contract. Yet, such administrative reforms are decisively dependent on strong leadership, and the will and ability to overcome vested interests.

Kampala has greatly improved its revenue collection from around US\$ 1 million in the financial year 2010/11 to US\$ 25 million (24 per cent of KCCA budget) in the financial year 2018/19. Increased tax compliance was achieved through digitalisation, massive taxpayer sensitisation, training revenue collectors, conducting revenue audits and allowing taxpayers to pay in instalments.

Land-based finance is one of the most promising – and underutilised – OSR streams that can be leveraged to strengthen urban management more broadly, even though it can be a complex undertaking.

The obstacles to harnessing this source of revenue include out-of-date or non-existent land cadastres, complex and informal land tenure systems, lack of systematic property addressing systems, insufficient professional capacity in surveying and valuation and the costs of these activities. Technological innovation, such as using GIS to geo-locate properties and create up to date digitised land and property records, can be used to overcome these problems. Land-based finance can also be improved through simplified valuation methods.

Hargeisa uses a simple and low-cost area-based method to tax property, calculating the tax value by multiplying a building's size with a rate based on its location. This requires only information on the building's width and depth, its number of floors, and the location band as set out by the City Council. This simplicity allows for easier maintenance and regular updating of the register, and revenues have increased by a factor of four since 2008.

Nonetheless, fully leveraging these tools will require local governments to **build capacity, show willingness to experiment, and overcome resistance from powerful landowners**. Some reforms, while technically promising, can easily fail if **the broader incentive structure** is not considered.

The Kisumu County Government has focused on digitalising its tax collection processes, undertaking capacity building initiatives, updating its valuation roll, outsourcing property tax arrears collection, and acquiring its first credit rating. However, these efforts have faced technical implementation problems, capacity bottlenecks, budget constraints and vested interests in the status-quo by landowning elites and tax collectors, who have been able to undermine fundamental changes to OSR systems. A lack of progress in OSR reform has, in turn, also compromised the County government's ability to access external sources of funding.

Help national governments to **incite local governments to fully leverage their existing tax authority by associating transfers and local revenue, and increase transparency through national government data and reporting requirements**. Support local revenue optimisation by **reducing tax complexity** and focusing collection on the most lucrative tax sources and on incentives for reform.

Consider improving ways of capturing land value increase and other revenues for the public sector. Such reforms should aim for small incremental changes and introducing transparency in the land management system to harness the support of landowners.

While it is important for building the financial capacity of subnational authorities, improving OSR may not provide sufficient finance for investment; indeed, in most countries, we expect the main sources of revenue for intermediate cities to remain as ‘transfers’ (conditional, unconditional and/or contractual) from the national to the local level through revenue sharing formulae. **Financing sustainable urban development thus needs to focus on coherence among all components of an integral system of financing**, which includes direct investments of state authorities at the city level and various forms of predictable intergovernmental transfers to local governments, efficient collection of OSR, and private and external investment.

In Malawi, central government transfers to cities make up less than 20 per cent of the total budget, while for rural local authorities, they account for 80 per cent. Development partners have provided some initial investments to ameliorate urban challenges. Mzuzu, the third largest city in the country, is an example of how intermediary cities, where revenues are often incredibly low and capacity is minimal, can innovate and lead the way to municipal finance reform. Its Revenue Mobilisation Programme – a simple and fit-for-capacity property valuation system – has yielded a seven-fold increase in revenues. Yet legal barriers in the current property valuation process inhibit further progress, underlining the importance of creating innovative tools that are legally in conformity with national policies. Thus, revenue pilferage, a lack of capacity for financial management, land ownership disputes between different spheres of the government, and a nation-wide rural policy priority bias continue to prevent Mzuzu from achieving a sustainably stable financial position.

Focus more extensively on the design **elements of intergovernmental transfers** to ensure that allocation is transparent and **commensurate to decentralised mandates**. **Assist in enhancing capacity to collect OSR**, and in effective budgeting and expenditure before exploring other financial options. Hold the city accountable for **good financial management at the local level as it is key to achieving creditworthiness**.

● ENHANCE ACCESS TO EXTERNAL FINANCING

It is often expected that improving low- and middle-income countries’ access to external finance, especially at the subnational level and without sovereign guarantees, will help finance urban development projects. However, despite the strong link between financing urban infrastructure and achieving top-tier global goals, **finding ways to attract private and/or foreign capital into public infrastructure investments through loans, municipal bonds, and public-private partnerships, especially in low-income country contexts, has proven to be difficult**. The ability to tap into domestic and international financial markets, especially for subnational governments, needs **highly developed legal and institutional frameworks, a reliable system of intergovernmental transfers and significant capacity**. Subnational borrowing is often restricted by regulations to guard against unsustainable debt obligations, and remains **risky and costly for both debtors and creditors**. Long-term debts should only be contracted for the purpose of capital expenditure on property and equipment, and be denominated in local currency and not pegged to the foreign exchange. Further, debt transparency and disclosure must be mandatory. Issuance of guarantees remain problematic and can generate significant implicit contingent liabilities.

Dakar attempted to launch a municipal bond in 2015. However, despite having been pre-approved, this move was overridden by the national government at the last minute over fears of large debt obligations and lack of precedence in this area. There have since been discussions on the national government's legal authority to reject the local government's decision.

Even where borrowing is legally permitted, many cities still lack the revenue streams, financial management capacity and creditworthiness to take on debt. Development partners can be crucial in facilitating creditworthiness reform, both in terms of technical and financial assistance.

In Kampala, many reforms in revenue systems and administration were centred on the goal of the KCCA becoming creditworthy and reducing investment risks. Since 2012, the KCCA built on efforts of the World Bank Public Private Infrastructure Advisory Facility Sub-National Technical Assistance Programme's 'Financial Recovery Action Plan', aiming to reduce the city's indebtedness and achieve clean audit reports. In 2015/16, the KCCA was given a national scale rating of A- in the short term, and A in the long term by The Global Credit Rating Co, boding well for the progress it had made within the national context.

Treat external financing as a part of a larger system of national and subnational finance. Lending to the sovereign level and 'on-lending' or 'on-granting' to the local level without additional guidance or conditions can create perverse incentives for local finance reform towards cost recovery.

Focusing only on projects that generate sufficient revenue to repay investments **may lead to disregarding the need for public or social goods** where direct monetary returns may be insufficient but the overall public benefit is significant. Such projects may need support from local or central government to become bankable so that their overall public benefits can be realised. Where development partners become involved in project design, they may wish to **promote transformative projects** that help alleviate poverty and support green agendas, while also promoting cost recovery within affordability constraints.

Development partners were crucial in facilitating creditworthiness reform, as demonstrated in the case studies, both in terms of technical and financial assistance. It can be difficult for cities to justify **investing in internal creditworthiness reforms year after year**, since its returns to the public are long term and thus generate little potential for short-term political gain.

Budget support in a decentralised context can be a catalyst to tighten economic and budgetary frameworks and to strengthen the investment and business environment, and reduce investment risks, thus enhancing sectoral policies, institutions, and regulatory frameworks. Therefore, it is essential to exploit synergies and complementarities with other tools such as blending to increase their effectiveness. Subnational application of Public Expenditure and Financial Accountability and Tax Administration Diagnostic Assessments can trigger useful reforms to improve financial management and tax administration, and thus increase creditworthiness.

Technical assistance can be **linked to loans to encourage policy reforms; guarantees provided by blended finance can offset the risk of lending to local levels.** Loan conditions can be set leading to **progress in policy and frameworks, especially in cost recovery and tariff reforms.** Pricing incentives (reducing the interest or extending maturity of loans) **may be considered as a stimulus to regulatory reform and to enhance capacity at the local level.**

Borrowing at subnational level without a sovereign guarantee is often seen as the next 'big' solution to overcome the infrastructure gap. Creating municipal investment banks or other pooled credit facilities can be a bridge to direct subnational borrowing, building on the framework for central-local fiscal relations. However, **strong governance and risk allocation are needed** to prevent subnational borrowing from creating contingent liabilities.

Support intermediary financial institutions such as municipal development banks and funds, **which have more capacity to handle investment programmes at subnational level than intermediary cities.** A **stable revenue base must be present for efficient lending** through municipal investment banks.



next steps

[financial management capacity]
 [transformative infrastructure]
 [coherent multi-level finance]
 [capital investment and operation & maintenance costs]
 [transparency of IG transfers] [OSR optimisation]
 [land value capture] [lending and ongranting]
 [investment decisions at local level]

A section of the taxi station in Kampala, Uganda © Shutterstock





CAUTION

WORKING PAPER

Financing sustainable urban development

*Supporting the Urban Dimension of Development Cooperation:
Increasing the financial capacities of cities in developing
countries to deliver productive and sustainable urban
development*

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List of abbreviations

African Sustainable Cities Initiative (ASCI)
Cities Climate Finance Leadership Alliance (CCFLA)
Excellent Design For Greater Efficiencies (EDGE)
Global Fund for Cities Development (FMDV)
Euro (EUR)
Gross domestic product (GDP)
Local Governments for Sustainability (ICLEI)
International Development Association (IDA)
International Finance Corporation (IFC)
International finance institutions (IFIs)
Kampala Capital City Authority (KCCA)
Kisumu County Government (KCG)
Malawian Kwacha (MWK)
Nigerian Naira (NGN)
Own-source revenue (OSR)
Public Financial Management (PFM)
Public-private partnership (PPP)
Resilient City Development (RECIDE)
South African Rand (ZAR)
Ugandan Shilling (UGX)
United Cities and Local Governments (UCLG)
Rapid Own Source Revenue Analysis (ROSRA)

1. Background

This working paper is the outcome of the initiative “Supporting the Urban Dimension of Development Cooperation: Increasing the financial capacities of cities in developing countries to deliver productive and sustainable urban development” requested by the European Parliament as a pilot project and funded by the European Union.

The intention of the initiative is to identify lessons on how to strengthen urban finance, building on a range of city case studies from countries selected to represent different levels of urbanisation and structural transformationⁱ, examples, and discussions with key stakeholders.

The working paper seeks to synthesise findings from fact-finding missions as well as deliberations at the meetings of the Advisory Group, and other engagements with experts and city leaders. It integrates the informed views of decision makers at various levels of government, as well as the expertise of development cooperation practitioners and academia on why it has become increasingly urgent to escalate investment from all sectors and sources in cities in developing countries, and to identify concrete and actionable measures that could help alleviate constraints on mobilising finance for sustainable urban development. We do not find all solutions in these case studies. However, they provide us with insights about various challenges faced by different types of cities and countries. Analysing the challenges, we consider and point out different areas worth focusing on in further work.

Much of the analysis in this working paper is based on the situation in sub-Saharan Africa, but many of the principles are considered also relevant to other developing countries, and complementary examples from other regions have been discussed at expert group meetings and are included as well.

The paradigm underpinning this working paper has been best expressed by Prof. Sir Paul Collier at the High-level Meeting at the European Parliament in November 2019: “Properly governed, urbanisation may serve as a crucial

driver for development and economic growth. Harnessing urbanisation is the key prerequisite for African cities to become engines for productivity and liveability.”

Urban development is often narrowly defined as provision of key urban infrastructure and services (water and sanitation, energy and mobility). In this working paper, however, it is understood in the comprehensive sense of governance, encompassing a wide range of actors engaged in steering urban development at multiple levels, with a broad sectorial scope that includes infrastructure, real estate development, housing and services, and closely linked to local development.

The working paper lays out its argument in the following sequence:

Severe lack of balanced and systematic investment in urban development in key urban infrastructure jeopardises the potential productivity and liveability of cities in developing countries. This has resulted in housing and scarce employment becoming overwhelmingly informal, and the formal segments excessively expensive. Adding pressure to this is the surge of population growth, fired by demographic factors as well as rural-to-urban migration.

Development of productive and equitable cities requires an array of conditions, which promote the availability of funds for investment, clear responsibilities, effective coordination, and efficient collaboration by governance systems. This is needed to ensure coherence and synergies of public and private spending. This working paper focuses on investment conditions and drivers, recognising the importance of flexibility to cater to a wide variety of contexts. It suggests some critical areas of support with a view towards strengthening urban finance and, in a broader sense, developing productive, liveable and equitable cities. Finally, the paper suggests the next steps needed to enhance the knowledge base on this critical area of reform.

ⁱ Case study reports have been produced under this initiative for Kisumu, Kenya; Mzuzu, Malawi; Dakar, Senegal; Hargeisa, Somaliland, Somalia; and Kampala, Uganda.

The positive relationship between urbanisation, productivity and finance

Urbanisation drives productivity through improved division of labour and specialisation, economies of scale, and agglomeration. The effectiveness of urbanisation in driving productivity depends on cities providing the setting for clustering of interdependent firms and value chains, which, in turn, transform the economy.

Public goods are needed to support this transformation, such as land markets, energy grids, connectivity and mobility. A productive city also needs to be liveable through the provision of basic services, sewerage, land rights, etc., to attract talents and skilled labour that allow for a specialisation in knowledge, skills, and management capabilities.

Good urbanisation stimulates structural transformation that can deepen the division of labour and specialisation, provide shared and efficient infrastructure and services, and facilitate the scaling up of effective markets. Such urbanisation pathways improve productivity, the quality of economy and the value of cities, enhancing their capacity to manage higher-level economic activities and productivity.

However, urbanisation can also occur in the absence of economic growth and productivity. For example, in some Sub-Saharan African countries, urbanisation has, to a large extent, occurred independent of economic development and without structural transformation. In such contexts, financial instruments alone cannot change the future of cities. For example, own source revenue (OSR) mobilisation in cities can only be realised through enhanced productivity and economic growth that enables citizens to pay taxes and fees.

If we want to enhance the financial positions of cities, we need to shift the priorities towards financing the productive assets of cities, and productivity factors in combination with better urban planning, sound budgetary management, and more stable and predictable revenues. It is key to support the structural transformation of countries through better-governed urbanisation. Achieving economic growth provides a sound foundation and power for low- and middle-income countries and cities to generate revenue and will increase their own capacity to finance such better-organised urbanisation. This, in turn, helps improve economic and social productivity and sustainability, thus creating a positive cycle of urbanisation, productivity and finance.



Farmer's market in Kampala, Uganda © Shutterstock

2. Why a strengthened focus on sustainable urban development?

This chapter introduces urban development in the context of overall economic development of cities in low- and medium-income countries with the example of sub-Saharan Africa. It explains why, in achieving sustainable urban development, it is particularly imperative to address the challenges of financing in a timely sort of way.

In sub-Saharan Africa, challenges of sustainable development are immense. It is the least urbanised region in the world (40.4 per cent) and has the highest urban growth rates; population in urban areas is projected to almost triple to 1.26 billion by 2050.¹ In most cases, both central and local governments are ill-prepared for this extraordinary growth. Internal urban population grows fast, creating a youth bulge. In addition, with predominantly poor populations migrating to urban areas looking for income, the combined growth fuels uncontrolled and informal urban sprawl. Rapid land-use change on the outskirts of cities and towns increases their need for basic infrastructure and services, which are not delivered. With a lack of urban planning and management capacity, and weak financial mechanisms, the resulting socio-economic inequalities will undermine the aims of the Sustainable Development Goals (SDGs) without immediate action to prepare for the future.

Today, Kinshasa, Abidjan and Dakar are the largest franco-phone agglomerations in the world after Paris; Cairo is the largest agglomeration in the Arab World, and Lagos and Johannesburg are among the 10 largest English-speaking agglomerations. However, it is the continued emergence of thousands of small towns and intermediary cities that is profoundly transforming African societies.² Contrary to widely held assumptions, Africa is urbanising fast mainly because of its growing towns and intermediate cities. Between 2000 and 2010, urban agglomerations with fewer than 300,000 inhabitants accounted for 58 per cent of Africa's urban growth; agglomerations with 300,000 to 1 million inhabitants accounted for only 13 per cent, while those with over 1 million inhabitants made up the remaining 29 per cent. Between 2010 and 2030, the small agglomerations are forecasted to make up 51 per cent of urban population growth, with intermediate ones making up 16 per cent and the largest, 33 per cent.³ The biggest increases are in West and East Africa.⁴

Whilst extreme poverty has been decreasing in Africa,⁵ poverty in cities is rising.⁶ In the short run, increases in poverty are likely to be exacerbated by the lockdowns due to the COVID-19 crisis, and the resultant shift in public spending priorities.

The impact of COVID-19 on municipal finance in developing countries

Globally, urban areas are the epicentres of the pandemic, accounting for most of the confirmed COVID-19 cases.⁷ The COVID-19 risk factors are acute in cities in the developing world, in part due to the largely unplanned and poorly managed urbanisation process that has resulted in widespread informal settlements, and severe infrastructure and service deficits.

From a macroeconomic perspective, most measures are financed by public debt. According to the IMF, in 2020, global public debt will be around 101 per cent of Gross Domestic Product (GDP) – six times larger than the year before. In high-income countries with available vaccines and a recovering economy, the productive sector will slowly restart but probably not to a level that can support repayment. In developing countries, some debt relief and support from financial institutions will be called for in the next years to balance economies.⁸

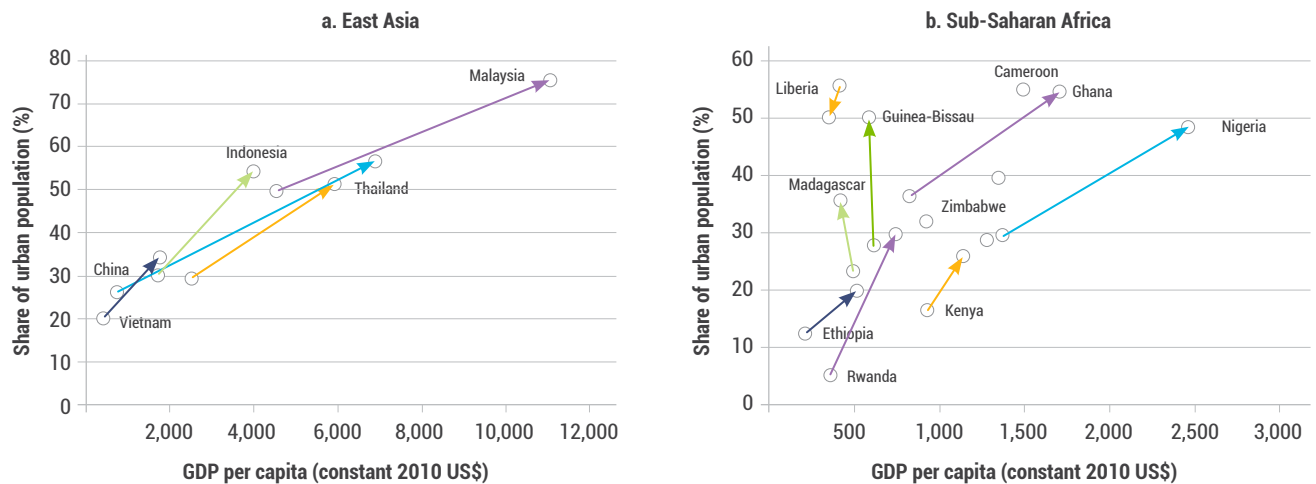
At the urban level, enterprises and sectors have undergone drastic reductions and closures, especially small and medium enterprises, which require prolonged physical human contact in customer service. Widespread loss of employment income has been registered, with informal sector workers being especially vulnerable. With many households predicted to fall back into the poverty trap, it may become a pervasive feature of urban areas. Other challenges include elevated risks of eviction and homelessness, food insecurity and information inequalities, especially among women. “As first responders in tackling the urban impacts of COVID-19, local authorities are key actors in taking measures to tackle the crisis, yet many face capacity constraints, including a loss of up to 60 per cent of their revenues.”⁹

The pandemic has deepened financial shortcomings, putting additional pressure on already strained local and regional budgets. The resources of a majority of local and regional governments have been severely affected by the non-collection of taxes, charges, and user fees due to the cessation of economic activities and a sharp drop in household incomes.

COVID-19 has also increased uncertainty about local revenues. There are risks that transfers may be affected as national governments face their own budgetary constraints. “This lack of visibility over future local revenues, combined with record sovereign debt levels, may further reduce the possibility for local and regional governments to directly access external financing.”¹⁰

Stable multi-level governance systems that foster proactive collaboration are an important precondition for effective response in this crisis, including when it comes to resource allocations. Coordination and cooperation between actors are essential, and the COVID-19 pandemic highlights the fact that functioning multi-level governance maximises responses and enhances effectiveness. National, sub-national (regional/metropolitan) and local governments have appreciated the magnitude, complexity and urgency of the challenge that the pandemic presents and are engaged in multi-level governance to complement each other’s activities and streamline their responses. All levels of governance have a role in response, and whilst these roles may differ in different settings and circumstances, vertical coordination and cross-jurisdictional collaboration is essential to achieve effectiveness of response to the COVID-19 crisis.¹¹

Productivity of African cities remains low in part because of insufficient infrastructure.¹² In addition to the lack of basic infrastructure, inadequate public services, and unaffordable housing, both living and doing business in African cities is relatively expensive,¹³ making them even less competitive globally. Between 2000 and 2018, the productivity ratio of Africa to Asia decreased from 67 to 50 per cent.¹⁴

Figure 1: Urbanisation and economic development in Asia and Sub-Saharan Africa

Source: Keynote speech by Prof. Ivan Turok, deputy executive director, Economic Performance and Development, Human Science Research Council at the UN-Habitat Governing Council in Nairobi, Kenya, in April 2013 (<http://www.hsrc.ac.za/en/review/hsrc-review-july-2013/releasing-the-transformative-power-of-urbanisation>)

Another set of (more difficult to measure) factors causing low productivity is the fragility of the rule of law, weak institutions, and low governance transparency. Some financial institutions conclude that these “infrastructure deficits are the result of decades of underinvestment, which, in turn, can be attributed to institutional and regulatory limitations (e.g., inefficient land markets, overlapping property rights and insufficient urban planning processes)”¹⁵. “As Africa’s rapid urbanisation continues apace and as its nascent democracies become more consolidated, the intersection between governance and service delivery will undoubtedly become more pronounced.”¹⁶

More than half of the urban population in sub-Saharan Africa lives in informal settlements, even if this share has decreased from two thirds of the population 30 years ago.¹⁷ Yet, the informality of a city is not limited to its housing. Urban population growth that has not been accompanied by a similar growth in urban formal sector jobs has led to urban poverty and the proliferation of informal, low-wage, and vulnerable employment. It is estimated that at least three quarters of the urban workforce in Africa is informal.¹⁸ Unemployment and underemployment in African cities are difficult to estimate due to lack of reliable data, but sources suggest that “each year, between 12 and 14 million young people enter the labour market, while only between two and three million of these find jobs”¹⁹. Such prevalence of informality has wide-ranging implications for housing conditions,

job security, health, and unemployment benefits. It is also one of the reasons for the low competitiveness of African cities relative to their global peers.

Among both international financial institutions (IFIs) and developing country governments, there is an increasing interest in harnessing the informal sector with a view to expanding the revenue base. Even if informal employment and housing grow in the cities and contribute to the economy, this growth increases the need for additional infrastructure and services. Increased cash flows from the informal sector do not contribute to revenues, thus making the ratio of need for investment to the availability of public funds even worse, generating a vicious circle.

For example, the case study of Hargeisa in Somaliland, Somalia, shows that high levels of unemployment and informality characterise the city. In 2012, estimates showed the informal economy accounting for about 77 per cent of total employment in the city. One of the critical drivers of informality is a lack of development in the formal financial sector, which constrains the ability of businesses to access finance. While mobile money systems allow for transfers, most of financial services are provided by informal Islamic banking systems that offer short-term deposit schemes and no interest on payments. At the same time, informality also results from the crippling cost of doing business. In 2012, Hargeisa was one of the top 15 most expensive cities in the

world to start a business, with 50 per cent of the expense arising from the local business license cost.

Currently, locally collected revenue in most developing cities remains inadequate due to low-income populations, informality, poor financial management and administration, and a lack of tax authority or the political will to use it. Information and systems are often out-of-date and cumbersome to navigate, and manual tax collection leaves room for pilferage, and increases the cost of levying each tax. Kampala, Uganda, prides itself on having automated its processes, moving away from manual collection, and introducing massive taxpayer sensitisation, thus improving compliance, which is now estimated by Kampala Capital City Authority (KCCA) to be slightly above 50 per cent. Although high for many tax-restrained cities, this still represents significant lost revenue and subsequent expenditure. Many improvements can be suggested, following good practice elsewhere. For example, Freetown in Sierra Leone just introduced a new way of taxing property, as part of a revamped and more progressive system, based on awarding points to determine the amount of the tax. The revised arrangement places a greater onus on the richest and could increase the capital's tax revenue five-fold.²⁰ However, as the case study of Kisumu, Kenya, demonstrates, sometimes such systems may look good on paper, and yet fail to deliver real improvement on the ground.

Intergovernmental organisations and IFIs note that "African countries are still chasing other developing countries in almost all measures of infrastructure coverage. Access to water, road transport and electricity are particularly limited. Quickly closing the infrastructural gaps would boost growth"²¹. Urban Africa fares better in the coverage of basic services, especially in comparatively richer countries. Country level access to services rates is the highest in the capital and other major cities. It is suggested that infrastructure provision gains across countries are driven by rural (low service provision) to urban (higher service provision) migration. Only 35 per cent of the population has access to electricity, with rural access rates less than a third of urban rates. Transport infrastructure is likewise lagging with sub-Saharan Africa being the only region in the world where road density has declined over the past 20 years. Access to safe water has increased, from 51 per cent of the population in 1990 to 77 per cent in 2015.²² Yet, compared to 43 per cent in 1990, only a third of the urban population had piped water on premises in 2015.²³

Researchers observe that infrastructure deficits and malfunctioning constitute one of the largest obstacles to sustained economic growth and accumulation. The regimes of infrastructure technological design, operations and management are determined by vested interests, and this is reinforced by institutional inertia. In most African contexts, dominant ruling political parties completely control public priority setting and resource allocation.²⁴ Infrastructure deficits attract an inordinate amount of political and technical attention, not least from international actors on the financing side of the development industry, always carrying a political charge.



Kisumu is one of the most urbanised Kenyan counties, with around 50 per cent of the population living in urban areas.

Its lakeside location and international airport bear the potential to make Kisumu a tourism and trading hotspot in Kenya and the region. Despite favourable overall conditions, its economic growth has slowed down over the past few years to around 3.4 per cent, placing it well below the national average of almost six per cent.²⁵ In the context of inadequate policies and implementation of land management, spatial planning and financing, rapid population growth and urbanisation have created large informal settlements, which house nearly 40 per cent of the urban population. Only around 58 per cent of the county has access to water and 46 per cent to electricity.²⁶ With only 15 per cent paved roads, Kisumu also requires significant investment in infrastructure to decrease transportation costs of agricultural produce and attract private investment in the county's underutilised rural areas. Investment is also needed in education, vocational training, and the creation of job opportunities for its young and rapidly growing workforce (around 40 per cent of the population is between the ages of 15–35). Of this young population, 60 per cent are formally unemployed. The informal sector now employs 60 per cent of the total workforce.²⁷

Prof. Edgar Pieterse said at the Cities and Experts meeting on 29 October 2020: "One of the core issues is the profound shift in the young demographic across cities and towns. Political leaders need to understand that a vast majority of jobs are informal, and we expect the labour force to triple

in the next 30 years. There are too few decent jobs, and informal work opportunities don't facilitate social mobility. People in cities are close to economic opportunities but cannot access them. The de facto urban development model in Africa undermines economic productivity.

First, across the continent, we continue to invest in a sprawled and inefficient urban form. Second, we bifurcate our cities by aggregating investments in elite developments and new towns, which sometimes get a 'green wash' (eco-green towns), but only for the top 10 percent of the urban population, while the majority lives in informal settlements. Third, cities are marked by unreliable and very expensive basic services because of the way that the transaction costs are structured.

Dramatic economic improvement has to imply radical diversification of the economic base accompanied by large-scale job creation – the two components of structural transformation.”

Even if the issues with informality, institutions, services and infrastructure could be resolved with political determination and enough investment over time, the underlying constraint

of development in sub-Saharan Africa is the slow structural transformation of economies coupled with the fast growth of employable workforce.

“National development and economic planning should apply an urban lens to establish growth strategies that prioritize resource allocations across economic sectors, programmes and investments. This would enable the acceleration of structural transformation that unlocks the potential of cities and urban systems as drivers of sustainable and inclusive growth.”²⁸ The case of Malaysia (see box on urbanisation and economic growth in Malaysia) illustrates these dynamics very well. In sub-Saharan Africa, growth of jobs will be “mainly in the services sector and non-tradable industrial sector (construction, utilities) rather than in manufacturing”²⁹. It remains to be seen if the structural transformation of Africa will be less dependent on manufacturing relative to other continents, and how fast it can occur. However, for the goals of this initiative, it also means that getting cities ready to attract firms that bring about rapid growth of productivity is important, but this will be economically sustainable only if the structural transformation of economies provides for the emergence of those firms at scale and enables sufficient specialisation.

Urbanisation and economic growth in Malaysia

(Based on a presentation by Mr. Hamdan Majeed, Director, 'Think City' at the 29 October 2020 Cities and Experts meeting, complemented by literature)

Malaysia has sustained rapid and inclusive economic growth for close to half a century. Real GDP growth has averaged 6.4 per cent annually since 1970, outperforming most of the country's regional peers.³⁰ Sub-Saharan Africa can learn from the successes but also new challenges of Malaysia's urban trajectory.

From a low-income country and rural economy in 1975, with poverty rates at 70 per cent, the country underwent a major transformation through a series of structural reforms. Malaysia's urbanisation and economic growth are highly interrelated. In transitioning from a largely agrarian to an industrialised and diversified economy, with an urbanisation rate of 74 per cent in 2015, the benefits of urbanisation were unlocked.

Malaysia's development was enabled by four factors: policies encouraged rural-urban migration (e.g., New Economic Policy 1971, National Development Policy 1991, National Transformation Policy 2011); deregulation, liberalisation, and macroeconomic management in the 1980s accelerated infrastructure development; the Malaysian economy matured from an agrarian base to a manufacturing and services economy; the liberalisation of the Malaysian economy increased trade and catalysed economic growth.

While in recent decades, many countries have implemented decentralisation drives to increase efficiency and responsiveness, Malaysia is an exception. Its federal system is more than 50 years old and has a powerful central government and state governments with diminished responsibilities. Rather than decentralising, the country has pursued a sustained centralisation drive.³¹

Since independence, Malaysia has practiced a system of centralised economic development planning with five-yearly development plans. Development planning is the responsibility of the Economic Planning Unit in the Prime Minister’s Department, which formulates the plans through an interactive process involving a broad range of stakeholders.³² In Malaysia, the urban sector plays an important role in the National Development Policy and the government sees the importance of the urban economy as a driver of gross national income (GNI) growth. This is evident in the latest plan (Eleventh Malaysia Plan (2016-2020): Anchoring Growth on People). Of the six innovative approaches that have been identified to accelerate Malaysia’s development (“game changers”), investing in competitive cities is one of them (see figure below).³³

Game Changer: Investing in competitive cities



<p>Why? Important to Malaysia</p> <p>Cities played an important role in a nation's growth by providing investment and trade opportunities, as well as improving connectivity with rural or suburban areas</p>	<p>How? will this be achieved</p> <p>City Competitiveness Master Plans will be developed for four major cities Kuala Lumpur, Johor Bahru, Kuching and Kota Kinabalu as a start, based on key principles that increase liveability and stimulate economic growth...</p>		
<p>What? Will success look like</p> <p> Four major cities in Malaysia will have undergone a step-change in their economic growth, importance as talent hubs, and liveability</p> <p> City residents will be able to afford urban housing, have adequate public transportation systems, enjoy green and open spaces and have access to economic opportunities that will enable them to provide their children with a better future</p>	<p>Strategies</p> <table border="1"> <tr> <td data-bbox="639 1059 979 1128"> <p>Developing city competitiveness master plans</p> <ul style="list-style-type: none"> Enhancing economic density Expanding Transit-oriented Development(TOD) Strengthening knowledge-based clusters Enhancing liveability Adopting green-based development and practices Ensuring inclusivity </td> <td data-bbox="1011 1059 1326 1128"> <p>Strengthening corridors to fuel regional development</p> <ul style="list-style-type: none"> Strategic review of the corridor development master plans Increased investment Improved infrastructure Improved talent and skill development </td> </tr> </table>	<p>Developing city competitiveness master plans</p> <ul style="list-style-type: none"> Enhancing economic density Expanding Transit-oriented Development(TOD) Strengthening knowledge-based clusters Enhancing liveability Adopting green-based development and practices Ensuring inclusivity 	<p>Strengthening corridors to fuel regional development</p> <ul style="list-style-type: none"> Strategic review of the corridor development master plans Increased investment Improved infrastructure Improved talent and skill development
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Image redrawn from: Malaysia Federal Department of Town and Country Planning. Ministry of Urban Wellbeing, Housing and Local Government. (2016). Malaysia National Report for the 3rd United Nations Conference on Housing and Sustainable Urban Development (HABITAT III).

Decades of growth have led to the nation’s economic maturity, reduction in poverty, and wide provision of housing and basic amenities for its population. However, Malaysia now faces new challenges caused by the externalities of rapid urbanisation. These include a middle-income trap, uncoordinated development, congestion, climate change, growing inequality, as well as air pollution. Malaysian cities are highly car-centric, with transport costs taking up a relatively high share of household incomes. Despite growth and development, Malaysian cities have a low built-up area and low job density, with city centres emptying out and urban sprawl challenging the ability to achieve sustainable urban development. This has led to a relatively flat and inefficient urban form, contributing to low economic density in comparison to cities in neighbouring countries.

The next steps in building more resilient, interconnected, and inclusive urban areas for national prosperity are therefore: the prioritisation of a compact city approach to improve residents’ access to jobs, services and amenities, and to reduce infrastructure capital cost; advancing a polycentric approach of a metropolitan network of cities, within and across national borders, with middle-sized cities as points or nodes that are linked by communication and mobility infrastructure to enable better flows of capital and people; developing a strong vision and a long-term plan to develop the country, adopting a more integrated approach to regional and city-level development; and promoting equitable economic growth distributed across the nation through spillovers from cities.



View from monorail station at Bukit Bintang in Kuala Lumpur, Malaysia © Shutterstock

When cities have effective, transparent, and accountable governance institutions and efficient infrastructure, they are a locus of productivity and economic growth, providing employment opportunities and access to basic services. Yet despite the role of cities in economic development, low-income countries have many other priorities for investment and expenditure, ranging from providing health and education to improving agricultural productivity. With comparatively low levels of public revenue, and political bias towards other priorities, governments of low- and medium-income countries chronically underinvest in transformative urban development: key infrastructure, basic services, accessibility to affordable housing, and support to creation of formal, equitable employment.

To address the current and future economic, societal and environmental challenges, prioritising investment into sustainable urban development can be a vehicle for achieving the top-tier goals of the international community, but also of the governments and the cities. These goals include eliminating the root causes of migration by improving life conditions in the source regions, enabling equitable productivity coupled with job creation to increase employment-seeking populations by bringing more firms to the cities, creating a greener economy and a cleaner, healthier and safer environment by providing basic infrastructure and services to urban dwellers.

There is considerable urgency to get this right. As the United Nations Economic Commission for Africa (UNECA) highlights, “There is a time window during which the urban transition takes place, when urban advantages need to be unlocked and exploited, and long-term growth patterns are set. In the context of Africa, the prevalence of informality and the huge backlog of investment needed to decongest and improve urban functionality make managing the urban transition uniquely challenging”³⁴.

Prof. Sir Paul Collier notes that with two thirds of the urban population by 2050 set to move into urban spaces that are not yet built, African cities have a short window of opportunity to make these investments, crowding in the mutually reinforcing benefits of productivity, sustainability and liveability for years to come. Without these public goods, cities become mega-slums that are neither productive nor liveable. The transformation of cities into productive and liveable places requires targeted public policy at national and subnational levels to support sustainable urbanisation – a process that is at a relatively early stage in most low-income countries, particularly in terms of implementation, and is always contingent on the specific context.

3. Common challenges and critical areas of support to improve financing of productive and sustainable urban development

“A good city puts in place physical and institutional infrastructure to attract firms. This requires effective investment in energy and water supply, sanitation, and mobility, but also a functioning land market and land rights, the capacity of cities to raise tax, as well as ability for urban planning and enforcement.” (Prof. Sir Paul Collier, presenting this initiative at the High-level Policy Session at the European Parliament, November 2019).

Some authors suggest that the emphasis on the role of infrastructure in enabling growth is excessive³⁵, and that human development and “cognitive capital”³⁶ are equally important. Others warn that infrastructure development serves investors more than local populations.³⁷ We also recognise that, as identified by researchers, there are international trends focusing on infrastructure development, and that the consequences go beyond increasing productivity in developing countries. Indeed, they affect much broader processes in those countries, from domestic investment focusing on real estate development to shifts of economic power within countries³⁸. This working paper does not question the importance of investing in human capital, or the need to design infrastructure so that it serves the needs of the citizens; it focuses

instead on enabling sustainable urban development, which is impossible to achieve without infrastructure and basic services. Prof. Edward Glaeser stressed while discussing this working paper that analysts and practitioners must focus on the goals, irrespective of the level of authority or sector providing them, saying, “We must focus on fundamental outcomes making our cities more habitable, and there is not only one right way of achieving this. We should be wary of trying to shoehorn city building into a preconceived ideological notion”.

Recent literature recommends focusing on several key issues to increase the productivity of cities in low-income countries. This chapter captures the findings of expert meetings, consultation/advisory meetings, case studies, and fieldwork. It covers examples of challenges that the low- and middle-income countries confront in financing sustainable urban development. It illustrates the systemic variety of challenges, and focuses on improvements in financing investment, improving coordination between levels of governance vertically and various types of revenues and expenditure horizontally, and what different groups of stakeholders can do to advance this agenda.

An example of the perceptions of key actors outlines a broad picture:

Manuel Lopes de Araújo, Mayor of Quelimane, Mozambique (Cities and Experts meeting on 29 October 2020): Many politicians still see cities in Africa as engines for trouble, not engines for growth. Yet, growth of population can be an opportunity and engine for growth if is well understood. A common challenge is a lack of understanding at the national level regarding the drivers and dynamics of urbanisation. There is a need to improve capacity to understand the dynamics and the logic of economic development and urbanisation at the national level, because local leaders are left to deal with the consequences of national level policies.

There is a constant failure of the postcolonial state in understanding the reasons for rural-urban migration and economic development. A historical example is Mozambique: Five years after independence, the government was faced with the challenge of unemployment in the city. Its failure to understand the reasons for rural-urban migration (being the collapse of the agricultural sector) led to the policy ‘Operação Produção’ that forced surplus labour towards the rural areas, with dramatic social, political, and economic consequences.

At the subnational level, a common challenge is a lack of urbanising strategies by local leaders. COVID-19 and extreme events such as cyclone Idai in 2019 have highlighted the importance of equipping mayors with the necessary tools to understand and manage challenges created by nature and/or the lack of policy understanding and implementation. These challenges are not just common at a local level, the interconnected system of global cities also make them common at an international level.

As Jan Olbrycht, Member of European Parliament, highlighted in the High-level Policy Session at the European Parliament in November 2019, there is a need for improved cooperation on urban development issues relevant to European cities and those in developing countries. The virus causing COVID-19 spreading through poor water provision or overcrowding in developing cities is also of importance to their global counterparts. In terms of financing, local governments suffer from a lack of financial autonomy. This is exacerbated by a lack of cooperation and understanding of priorities at the local and national level, hence necessitating constant and streamlined dialogue. There is a lack of financial infrastructure at local, national, and regional levels, and most African cities don't have a credit market and the capacity to borrow from the private or banking sector. Further, a lack of trained people hampers access to financial resources available at the national, regional and international levels. In this regard, the scarcity of ability to design and implement bankable projects is one of the biggest vulnerabilities.

3.1 Multi-level coordination and collaboration for financing effective investment in sustainable urban development

The lack of coordination and collaboration among the rich variety of actors, and a lack of capacity are common challenges that pervade urban governance in Africa. "The governance of most issues is characterised by fragmentation and a lack of coordination between governance actors; in the case of government actors, the ability to enforce regulations is usually quite limited. Skills and resources seem to be more thinly spread and diffused than is the case in the global North, meaning that one or two urban governance actors acting in isolation are seldom able to address many key urban challenges. As a result, key problems, such as inadequate infrastructure in marketplaces, traffic congestion and inadequate waste disposal systems are not addressed, and the problems persist and grow over time."³⁹ We know that the structure of a particular economy determines outcomes, shapes and constraints at the city scale, and we need to understand better how this happens. Development finance assessment could help us understand it better: countries could make use of the Integrated National Financing Framework Knowledge platform⁴⁰ to determine the structure and sectors of an economy as binding constraints and enablers of urban development. Here, we suggest three most important institutional conditions that underpin successful urban development in the long term. This chapter focuses on coordination and collaboration challenges, and what can be done to address them.

3.1.1 Enabling conditions: policies, harmonised goals and institutions

Ample research literature focuses on insufficient and dysfunctional infrastructure and basic services in Africa. It is not just the lack of funds that causes these deficiencies but also the underlying issue of the inability of governance systems to manage planning and delivery brought about by a lack of coordination and collaboration between levels, sectors, and actors of government. To improve access to finance for sustainable urban development, important enabling conditions must be put in place that relate to policies and the institutions implementing them.

First, **for sustainable urban development to serve as a driver of productivity and a vehicle to a country's top-tier development goals, it must be integrated in national development policies and meaningfully related to priorities of structural transformation⁴¹.** "Cities and other settlements play a central role in the objectives of the African Union's Agenda 2063. These include goals related to inclusive and sustainable development, and continental integration, unity, and renaissance. The vision for Agenda 2063 is to develop cities and other settlements as hubs that enhance access to social services and improved living standards, while also creating a network of interconnected cities. Agenda 2063, therefore, prioritises critical investments in economic and social infrastructure required to accelerate structural transformation."⁴²

Edlam Yemeru, Chief, Urbanisation Section, United Nations Economic Commission for Africa (UNECA), at the 29 October 2020 cities and experts meeting: Domestic resource mobilisation is considered the main way in which African countries will implement the SDGs. However, urban revenues are too often not connected to domestic resource mobilisation agendas. National governments must explicitly and deliberately integrate urban finance into their national domestic resource mobilisation agendas, recognising the huge potential of local revenues, and the enormous role of local governments and cities in advancing the national resource mobilisation agenda and priorities.

Positioning sustainable urban development requires overcoming the rural policy bias still present in many African countries, as highlighted above by the historical example of Mozambique.



The case study of Malawi further illustrates this bias in the national governments institutional design: the supervision of local government and rural development is housed under one Ministry, while urban development falls separately under the Ministry of Lands and Housing. The result is that the development of local government is synonymous with uplifting rural areas, while urban agendas often fall between the cracks of the two Ministries. Most of the Malawian population (over 80 per cent) is still rural, hence national government efforts focus on uplifting rural districts. The four cities in Malawi – Lilongwe, Blantyre, Mzuzu, and Zomba – are therefore left mainly to their own devices in terms of providing essential services for their citizens and investing in future urban growth.

“Considering the significance of urbanisation in Africa in terms of scale and impact, it is of paramount importance to accord it an elevated, strategic and multisectoral focus in national development planning. Only then can the enormous advantages of Africa’s rapid urban transition be harnessed to accelerate national growth and transformation priorities”⁴³.

Prof. Sir Paul Collier notes that “national development plans are uniquely suited to address the role of cities and urbanisation in development. Development happens in places, and even if a society is predominantly rural, those places are predominantly urban. This is because economic development depends upon bringing people together to reap economies of scale and specialisation. This transformation in productivity can only happen in cities, but cities need active and far-sighted planning.” “While sector policies, subnational development strategies, and national urban policies can address urban issues and can play a role in implementing the vision of the national development plan, the national development plan is the only policy framework that can align economic and spatial planning under a common vision.”⁴⁴ With strong renewed interest in national development plans and strategies over the last decade, there is a need to ensure an adequate focus on how these will be financed. Integrated national financing frameworks are a tool to finance national priorities and operationalise the Addis Ababa Agenda at the national level.⁴⁵

“In Africa, there is a notable lack of interest on the part of central governments to tackle urban development. Perhaps this is a result of the stigma of rural-urban migration. The central governments need to pay more attention and offer more support to sustainable urban development. A change of perception needs to happen, and that requires a significant push.” **Amadou Oumarou, Director, Infrastructure & Urban Development, African Development Bank at the first Advisory Group Meeting**

South Africa's National Treasury City Support Programme⁴⁶

In response to the challenges and opportunities of rapid urbanisation in South Africa, the National Treasury set up the Cities Support Programme in 2011. Recognising cities as 'critical national assets', it was established as an intergovernmental platform (including eight metropolitan municipalities, national departments and provincial governments) to support more inclusive, sustainable and productive urban reform. It also partnered with external stakeholders, including the major development banks and other implementation agencies.

There were five thematic focus areas, including core city governance, human settlements, public transport, economic development, and climate resilience. And within these, there were three key areas of support:

1. **A strong fiscal framework** to ensure efficient management of resources, including stronger performance incentives for intergovernmental grants to reward integrated planning and development.
2. **An enabling inter-governmental environment** through policy and regulatory reforms, including appropriate devolution of responsibilities.
3. **Implementation support**, including specialised technical assistance, peer-learning opportunities, and collaborative performance reviews.

A differentiated approach was taken depending on the size of the municipality, the budget and their capacity to deliver.

The structure of the programme within the government avoided duplication and absorbed existing efforts, while its location within the National Treasury allowed for synergies with wider departmental processes of policy and fiscal reform, and provide greater legitimacy to the initiative. However, it also meant that some stakeholders were reluctant to engage due to perceived meddling of the national government.

Despite a number of successes, there have also been areas for improvement. As a result, a strong sentiment of experimentation or learning-by-doing was instilled in the programme, and it underwent frequent reviews to iterate and adapt based on feedback and outcomes.

"National urban development strategies can succeed when a government identifies the priorities that contribute the most to the country's long-term development strategy. Priorities must be few, to avoid scattering resources, and place-based so as to avoid the lack of co-ordination often induced by purely sectoral approaches."⁴⁷

Second, **implementing these policies requires functioning institutions that govern development and its financing in a country at all levels of governance.**⁴⁸

Prof. Edward Glaeser notes that "infrastructure needs institutions to surround it – not only to be effective and to be reasonably maintained, but to be built properly first. Infrastructure and the institutions regulating and managing it are deeply intertwined, and I have trouble imagining how you could ever do infrastructure without the institutional compo-

nent of it. I am happy with an 'infrastructure first' approach in the sense that I do not think you need eight centuries of common law before you can build a water system, but you will inevitably face the need for institutional design and institutional reform as part of the infrastructure provision process itself. In that sense, they can never be separate."

Infrastructure, incentives and institutions as a healthy and effective nexus⁴⁹

Both the history of clean water provision in 19th century New York City, USA, and modern Lusaka, Zambia, illustrate that engineering and infrastructure provision alone are not enough for infrastructure to function effectively. In New York City, the availability of health-related infrastructure and public services (water and sewerage) was not enough to persuade a majority of residents in some areas to connect with the infrastructure, until regulations were instituted requiring their connection and fines were introduced for non-compliance. The core problem with health-related infrastructure in Lusaka and in most cities in the developing world today is that the average cost of this infrastructure exceeds private ability and/or willingness to pay, leading to a “last-mile problem”. Adoption can be encouraged through incentives, either with fines imposed on non-adopters or with subsidies for adoption or both. Yet, weak institutions can make both approaches costly, because subsidies can generate waste and corruption, and fines can lead to bribery and extortion. The ability to impose penalties fairly and effectively depends on institutional strength. The capability to run a subsidised sewer system without massive waste and corruption also requires executive competence. The efficacy of new infrastructure, therefore, depends significantly on institutional strength, in either the judicial or executive branch of the government.

Implementing coordinated, integrated multi-sectoral policies and employing urban development for economic growth requires functioning multi-level and multi-sector governance and sufficient financial mechanisms to ensure adequate management, operations and maintenance. Such governance can be ensured only by transparent and effective institutions – both in governance and in implementing policies and regulations – that can harness the required capacity. The existing capacity may be found dispersed across the national and subnational levels, and across public, parastatal and private sectors, and it may be worth seeking coordination, complementarity, and coherence of such capacity first to ensure efficient collaboration. Missing elements can then be introduced where they fit best rather than building a full range of capabilities at one level and/or institution, which may result in overlaps and would thus call for a review of authority to avoid them.

Third, **functioning institutions must harmonise goals of development territorially and coordinate their implementation at all levels.** An essential function of a governance framework is the ability to plan and implement government policies across strategic, economic, and territorial dimensions so that planned infrastructure serves these goals simultaneously, creating synergies, rather than targeting a single problem, however important it may seem.

These enabling conditions take a long time to introduce, make practicable, and mature. In the short window for responding to the urgency of building infrastructure in response to the population surge, an important question arises of whether investment should be put on hold until

at least some degree of these conditions is in place. **There must be some mechanisms to guide where and how essential infrastructure is being developed in spatial and economic harmony,** otherwise, as Prof. Edward Glaeser warns, a huge amount of money may be wasted really fast.

A similar concern has emerged in shaping investment in large infrastructures. It has been well analysed in an OECD-ACET paper⁵⁰. While addressing construction of major infrastructure instead of urban development, the paper seeks an answer to the duality of any possible response to investment urgency, noting that “while mainstream development agencies are engaged in many innovative approaches to infrastructure provision and can sometimes join together in large-scale programmes, the support by external actors for infrastructure is seen to be stuck in a duality, juxtaposing the priority for building sound institutions of government that take time to develop with the expedient need for financing and constructing services for the delivery of major infrastructure within a foreseeable future.” The paper also refers to a recent book⁵¹, which “explains that one strategy in infrastructure development is to give priority to strengthening governance institutions and regulatory reform. This is essentially the stance of traditional development partners, stemming from their conceptual frameworks and their accountability towards their taxpayers and shareholders. Another strategy, taken by Chinese actors, is to work with the current political and institutional environment on the basis that speed and getting infrastructure in place is paramount in moving the development process forward, with institutional development part of a longer-term learning-by-doing process.” A similar duality exists in shaping investment in

urban development, and merits further investigation and consideration, as discussed in Chapter 4 of this paper, along the same intention of looking for ideas to explore “how the above two contrasting approaches can be combined”⁵².

A single large investment project in urban infrastructure can be parachuted in to solve a single problem without a conducive framework of governance – for example, building a bridge in a large city divided by a river will improve conditions for economic development, no matter who decides to build it with whom and how it is paid for; however choosing the optimal place for the bridge and preparing mobility, communication and infrastructure networks to make use of it requires at least some spatial planning and cost/benefit analysis.

The requirement for an effective enabling environment does not mean that protracted periods of institutional development and planning need to delay urgent investment in infrastructure development endlessly. **Whilst few low-income countries have these conditions fully developed and functioning, this should not stop governments and development partners from investing in urgently needed urban infrastructure, as long as the newly developed infrastructure is guided by robust spatial planning, sound cost-and-benefit analysis, transparent procurement and predictable financing. In conjunction with urgent investment, the opportunity should be taken to use infrastructure development programmes as vehicles to foster these conditions by institutional development and capacity building.**

3.1.2 Coordination and collaboration between different levels and sectors of government

Many national governments – including those in low-income countries – prefer to retain control on planning, financing, and implementation of major urban development projects rather than entrusting them to subnational city authorities. The reasons quoted are several: lack of planning and management capacity at the local level, the need to manage national debt, unwillingness of local authorities to take responsibility, and the desire to take political credit for development.⁵³ For example, researchers note that in Kenya, “many national ministries also play a direct role in Kisumu; for example, the National Ministry of Land and Housing allocates land within the city area.”⁵⁴

National-local relations are important not just for facilitating stable and predictable intergovernmental transfers and coordinated governance, but also because the key legisla-

tion that frames most decisive mechanisms for city finance is often ultimately adopted at the national level.

In many low-income countries, the lack of coordination and collaboration can be observed on the level of state planning, where planning of national development and implementation of these plans is seldom coherent and does not always define the role of sustainable urban development. A similar incoherence can be observed at the metropolitan and city planning level. The roles of various sectors of governance of urban development are not always clearly defined, and when defined, the sectors are sometimes not adequately empowered, making both vertical and horizontal collaboration difficult.

Harmonisation is also required among different sectors of policy: decisions taken in other sectors not directly associated with urban development (such as development of industrial parks and free economic zones) may immediately change the dynamics of local financing.

Many sources and a wide array of development actors have been arguing about lacking decentralisation as an obstacle to better funding of urban development, referring to insufficient political autonomy, inadequate funding, and deficient administrative capacity at the subnational levels of governance. Research indicates that emphasis in Africa has shifted over time, but that fiscal power of cities is still limited: “Emphasis moved from a focus on the structures, powers, and functions of local government in the early years after independence, to a focus on the management of urban services, including transport, garbage disposal, housing, water supply, and street cleaning. [...] policies have given more powers to cities and local governments since the 1980s even though financial support for cities is still weak.”⁵⁵ The African Development Bank has noted that “although African cities generate 80 per cent of national tax revenues, they receive less than 20 per cent of the resources. Consequently, they are reliant on central government for around 80 per cent of their operating revenues. In sum, local governments lack the power and incentives to raise (and retain) their own revenue streams.”⁵⁶

Whereas this initiative has not specifically focused on this issue, we note that an analysis of available data on tax authority at subnational level worldwide does not offer a conclusive proof that decentralised tax authorities alone foster development⁵⁷.

The need to coordinate authority over revenue, expenditure and investment does not mean that any degree of fiscal autonomy is more effective. For example, in OECD countries, some governments collect a smaller part of taxes and also allow subnational levels to spend a larger part of it. In Denmark, although the central government collects the largest portion of taxes, the local level spends 64 per cent, while central governments in other countries collect almost all taxes and let subnational governments spend only a small part of the revenues. In Ireland, the national government collects 95 per cent of taxes, and the subnational level spends only eight per cent of total public expenditure⁵⁸. There seems to be no one-size-fits-all solution in which certain types of taxes are most suitable for use by each level of government.⁵⁹ Furthermore, “share of expenditures is not always a good indicator of the decision-making authority of subnational governments in the selection, prioritisation, funding and execution of infrastructure projects. The several stages and decision-making steps that need to be coordinated across levels typically give rise to a complex web of accountability over results. Not surprisingly, outcomes have been mixed and vary widely from country to country and from region to region in the same country.”⁶⁰

Literature on decentralisation in Africa emphasises that “decentralisation is commonly treated as an unambiguously desirable phenomenon that can alleviate many problems of the public sector, or sometimes, as an invariably destructive force that frustrates effective government. We know that decentralisation can also have negative effects and decentralisation proponents must recognise this. Too much or inappropriate decentralisation, for example, can undermine macroeconomic control and worsen interregional income disparities. [...] Making progress requires that a number of major challenges be confronted. One is defining an intergovernmental system that makes sense in the context of a particular country. A second is to create mechanisms for coordinating activities of the multiple actors invariably involved in decentralisation and to ensure that linkages among the key dimensions of decentralisation will be built. A third is to develop an appropriate strategy for implementing decentralisation.”⁶¹

In some places, devolving tax authority may lead to efficiency losses and duplication of government tax structures across levels of government. Whilst in some circumstances, expenditure decentralisation allows central authorities to force subnational governments into more fiscal discipline by cutting central transfers, which, paired with borrowing

rules, may force effective fiscal discipline on subnational governments. It is the design of fiscal decentralisation that matters most: two important elements of that design are low levels of vertical fiscal imbalance and binding borrowing and fiscal rules.⁶² What seems certain is that **whilst highly dependent on the overall context of governance, whatever the degree of decentralisation, coherence and coordination assure more effective financing of urban development and management.**

The case studies and discussions presented below suggest that **clarity of authority of the institutions at different levels of governance, coordination of activities to achieve coherence and complementarity, and collaboration of levels and actors of investment are essential. Where lacking, they need to be promoted and supported.**

Approaches and experiences in the governance structure of cities identified by this initiative vary. It is important to note that “[e]very country has a different understanding of local government in terms of perceived roles and responsibilities between the local and regional level, politicians, officials and citizens, local government and other institutions, executive and judiciary bodies. It is of importance to gain a contextualised understanding of governance structures before employing ‘magic bullets’ in terms of legal and financial tools from one culture to the other”. (Matthew Glasser, Extraordinary Research Fellow, Law, Justice and Sustainability, North-West University, Potchefstroom, South Africa, at the 29 October 2020 Cities and Experts meeting).

In Europe, academics are looking for innovative approaches to territorial governance, revisiting the concept of decentralisation. One possible direction suggested by French think tank Terra Nova is, rather than conceiving decentralisation according to a principle of constant specialisation of competences according to the level of government, to rethink territorial public action on the basis of programmatic ‘territorial agreements’, established over specific periods of time, according to the projects on the political agenda, and the sharing of roles between all levels of government.⁶³



In Senegal, the latest Decentralisation Act has left a gap between the decentralisation of responsibilities and the fiscal decentralisation needed to finance those responsibilities, as well as a lack of clarity over the specific roles of various players. Legislation and engagement to better clarify positions and align incentives in the collection of local taxes would help enhance Dakar's financial position. Encouraging the central government to optimise revenue collection for local governments is an area highlighted for development partner support.



In Somaliland, as the country aims to decentralise, the Ministry of Finance actively coordinates revenue reform activities, and together with the Ministry of Interior, advocates for adequate central government funding for local governments.



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In Uganda, a twin track has been chosen: while Kampala is managed by KCCA, under the Ministry of Kampala and Metropolitan Affairs (a member of Government of Uganda), the other subnational authorities of the country are under the Ministry of Local Government. But even within Kampala, the situation has been confused by multiple and overlapping sources of authority. The Ministry of Kampala, the Lord Mayor of the Kampala City Council, and the Executive Director of the KCCA all have an authoritative role in the governance of Kampala, but their respective responsibilities were never made explicit. The KCCA Act has therefore recently been revised in an attempt to strengthen the Lord Mayor's office and to streamline roles and responsibilities, clarifying the organisational setup; however, it is too soon to verify its effect. Cross-territorial coordination also remains a major challenge. Considerable urban population growth in recent years has seen the city of Kampala merge with surrounding districts to form the Greater Kampala Metropolitan Area, incorporating the districts of Mpigi, Mukono and Wakiso. Each of these districts has its mayor and own local government. Significant efforts of coordination are required to plan and implement large projects that expand spatially across these different administrations. However, to date, there is no formal metropolitan governance structure, which is often the reason projects become too administratively complex to take further. In addition, daily working commuters to Kampala from the surrounding districts increase the city's population from 1.8 million at night to around four million during the day. This jump puts incredible strain on the taxpayer-to-services ratio in the KCCA's jurisdiction, as taxes are paid to the municipality one lives in, but citizens utilise services elsewhere.

State-led urban infrastructure financing in India

In India, local and state government overlap heavily, and many urban services are provided by agencies under the central government.

India is comprised of 29 states and seven Union Territories. The states have considerable autonomy, while the Union Territories are governed centrally. Within India's federal structure, the states determine the powers, functions, and revenues of local governments (urban local bodies, ULBs). Local government powers and functions vary from state to state, but most Indian states have not devolved significant authority, functions, and revenues to these bodies. Indian ULBs largely depend on intergovernmental transfers, yet most states do not provide ULBs with stable, predictable and adequate revenue. Some ULBs also impose utility taxes, property transfer taxes, and development charges, but these generate little revenue.

Most infrastructure is installed through state-controlled channels, and most subnational borrowing is state-level borrowing. Often, parallel authorities, districts, and entities are charged with building urban infrastructure. These entities borrow to finance investments and are controlled by the state.

Indian ULBs, like many local governments in sub-Saharan Africa, represent alternative centres of power with leadership from opposition political parties. As a consequence, an anti-urban bias is present at the national level. To side-step this difficulty, since the need for urban public services is still paramount, states have set up parallel financing channels with state-controlled entities. The state-controlled entities have planning and investment powers within the boundaries of ULB. Such entities include development authorities, industrial development and investment corporations, water and sanitation enterprises, and urban rail and transport authorities. They receive financial support from the state, leading to relatively higher creditworthiness, and have their own revenue instrument, enabling access to finance.

The success of these urban-focused state instruments is exemplified by the largest municipal bond in India being issued not by a city, but instead by the Andhra Pradesh Capital Regional Development Authority. The proceeds were utilised for infrastructure delivery and development of the new capital, Amaravati.⁶⁴

3.1.3 Coordinating revenues and investments at the local level

"The process of urbanisation in Africa is influenced by poor planning, which then, in turn, influences the implementation." (Dr. Ernest Nsabimana, Deputy Mayor of Kigali in charge of Urbanisation and Infrastructure, at the World Urban Forum (WUF 10) event in 2020 related to this initiative)

"It's not just about cities and regional or central authority. There are good and bad taxes (regardless of whether they are devolved or central) and there are good and bad projects (regardless of devolution)." (Prof. Anthony Venables, University of Oxford, in discussions of this working paper).

Lacking coherent and integrated planning of urban development is a major issue not only in Africa. Susan Goeransson, Director for the Municipal and Environmental Infrastructure team at the European Bank for Reconstruction and Development, presenting this initiative at an event at the World Urban Forum (WUF 10) in 2020, highlighted the issue of uncoordi-

nated investment in cities, and of poor investment coordination between different sectors and different levels of government.

We emphasise the importance of the interface of urban planning and municipal finance – **links between long-term urban, spatial and physical planning, and financing of urban**

investments – as being of instrumental importance in a strategic and long-term approach of urban development, in contrast to the “ad hoc” approach we often see today in reality. Such an approach helps in setting necessary priorities and phasing, embedding long-term investment needs in the budgeting cycles of ministries and municipalities, but also to identify early how, for instance, land value capture could become an embedded mechanism in implementing the planned development.

While proper planning is important, execution is equally critical. Municipalities and municipal entities must build a suitable supply chain management system for infrastructure delivery, that is, a control framework for the planning, design and execution of infrastructure projects, the tracking of projects, and the monitoring of performance which is better able to deliver value for money, seeking optimal use of resources to achieve intended outcomes while minimising the scope for corruption.

It is crucial to move beyond financing projects and programmes, and to focus on building sustainable domestic systems for financing urban infrastructure. These systems should include strong domestic financial institutions, municipalities that rely on a meaningful social contract with their citizens through accountability and transparency, enabling regulatory frameworks, as well as independent financial advice.

Instead of looking at projects in isolation, there is a need to focus on creating integrated city plans, making the case for investments that create overall direct and indirect returns across the city. These should clearly reflect city-level priorities and be combined with individual development partner agendas, rather than replaced by them entirely. Kisumu, Kenya, is an example where “limited skills and resources available for dealing with urban problems in a secondary city have been pooled together and used to leverage more resources, and different interests have been brought together to develop strategies that are more holistic, inclusive and sustainable”⁶⁵, and where substantial funds were raised for a range of physical upgrading projects, such as the redevelopment of marketplaces. Central to this were attempts at improved coordination, initially through the multi-stakeholder Kisumu Action Team that was later transformed into the Kisumu Local Interaction Platform, a consortium of Kisumu City, Kisumu County, the Civil Society Coalition, the Chamber of Commerce and two local universities.

The World Bank notes that “Research [...] supports the value of early investments in neighbourhood infrastructure and services. But coordination among these investments is equally crucial, given that cities are both path-dependent and interdependent. Large infrastructure projects carry high sunk costs: Like any large structures, they depreciate very slowly over decades or even centuries. And the costs of developing housing, infrastructure, and industrial premises depend on sequencing. Consider the relation of new transport systems and industrial zones. If not coordinated with one another, and with land markets and land use regulations, these projects can put cities on a counterproductive development path.”⁶⁶

IFIs can provide technical support to cities to turn integrated plans and strategies into implementation plans, and help to determine the sequencing of projects, identify the right structures of projects, including those generating revenues, potentially financed by private sector or through public private partnerships, and projects that will not attract the private sector that are financed by the city itself in collaboration with other public sector partners. Support may be given to identify which regulations could open up opportunities without the city needing to use their own funds, such as the example of building regulations: if a city’s building codes allow to build higher, the feasibility of a project can be impacted.

To achieve progress in financing sustainable urban development, to increase effectiveness and efficiency, one should look for coherence of policies and mechanisms across strategic, economic and territorial dimensions, so that planned infrastructure serves these goals simultaneously. The pace of urbanisation is fast, the priorities are many, the resources very limited, the inertia heavy, and concepts aplenty. It is necessary to look for synergies, which can only be achieved by coordination and collaboration, yet the quest for synergies must be proportional to expected benefits, and it should not delay investment in urgently needed transformative infrastructure beyond satisfying essential requirements of spatial and economic harmonisation. Prof. Edward Glaeser notes that we should not hold on to basic services such as water supply until we can have all possible synergies, saying, “I would not urge anyone to be against coordination, yet as long as we talk about things that have certain urgency and as long as you are convinced that you have a cost-benefit analysis that shows you would want to do this, you should start doing it and while doing it you should also think about the synergies. But the skeletal infrastructure comes first.”

In the next chapters, we will look at the elements individually, but the maxim of coherence must be kept in mind when considering how to get the best out of using these elements in complementarity.

3.2 Improving internal finance

In the previous chapter, we looked at the importance of integration of policies, institutions, approaches, and financial mechanisms for sustainable urban development. The next chapter looks at some key financing mechanisms separately. We focus on intergovernmental transfers and own source rev-

enues (OSR) because state agencies were not in the scope of the discussions with experts, or in the case studies.

There are four broad mechanisms in financing urban development: investment projects implemented directly by state agencies (national direct investment); unconditional, conditional and capital intergovernmental transfers from central government to subnational levels; subnational governments collecting OSR; and external funding from the private sector and donors. This section focuses on intergovernmental transfers and OSR. It outlines some of the challenges around these two revenue sources and how they can be optimised.

Diverse models of urban finance implemented by state agencies

Rwanda

The ways in which a national state invests in urban development are sometimes rather complex. The case of Rwanda illustrates this well. The former Tristar Investments Ltd, with interests in food processing, real estate, engineering, construction and services, has grown into Rwanda's largest conglomerate, now called Crystal Ventures Ltd. It is privately held, but is, in part, owned by the government of Rwanda and Rwanda's leading political party, the Rwandan Patriotic Front (RPF). Another major local investor, The Horizon Group, owned by the Rwanda Defence Force, has interests in agriculture and agricultural value addition, manufacturing (chemicals), engineering, logistics, real estate and construction. Given their connections to the state and the ruling elite, they are considered controversial by some, and have been the subject of negative media reporting. However, they are said to have made important contributions to the overall private sector development in the country, to employment creation, and to the exchequer's revenue mobilisation. Their investment flagships include hotels, housing estates mainly for the well-to-do segments of society, and office buildings. There have been opinions voiced that they crowd out private investment, yet they are said to operate as private businesses and experience the same, and sometimes even more, constraints as their local competitors.⁶⁷ At the same time, the Government of Rwanda financed and built Karama Integrated Model village in the outskirts of Kigali "in collaboration with Rwanda Defence Force (RDF) Reserve Force".⁶⁸ The government recently passed housing development regulations and funding schemes that aim to promote access to affordable houses for the low- and middle-income inhabitants of Kigali. Finally, the Second Rwanda Urban Development Project has been launched, which combines an IDA grant and loan with government funding to improve access to basic services, enhance resilience and strengthen integrated urban planning and management in the City of Kigali and the six secondary cities of Rwanda, investing in basic services and institutional capacity building.⁶⁹ The example of Rwanda shows that models of investing in urban development by a national government can be very diverse even in one country.

South Africa's Strategic Integrated Project (SIP) 7: Integrated urban space and public transport⁷⁰

Recognising a national gap in infrastructure and its strategic importance in driving economic development, creating jobs and reducing inequalities, in 2012, the South African government adopted a National Infrastructure Plan. The Presidential Infrastructure Coordinating Committee (PICC) was established to oversee this and develop a framework for implementation that would outlive political administrations. 18 Strategic Integrated Projects (SIP) were developed, with one, SIP 7, focusing explicitly on integrated urban space and public transport, including housing, bulk water, sanitation and waste management, bulk roads as well as parks and cemeteries. Twelve of the country's major cities were chosen as recipients for their demographic and economic significance, and an investment of roughly ZAR50 billion (US\$ 3.3 billion) per year has been put towards it since 2016.⁷¹ While the national government has made the funds available and the PICC maintains supervision to ensure strong coordination and accountability, implementation powers were given to the cities themselves to align with existing local efforts and priorities.

3.2.1 Intergovernmental transfers

Intergovernmental transfers are a vital part of local government finances, even if over-dependence on these transfers is not always ideal in the context of fiscal decentralisation. Improving the management of transfers often requires complex and timely reform at the national level, but ultimately, this reform is critical to set the right incentives for local governments.

Intergovernmental transfers are, in many cases, the backbone of financing sustainable urban development as the subnational authorities have limited financial instruments and mechanisms for revenue generation of their own. Dependence on transfers is more pronounced in developing countries which generate around 2.3 per cent of GDP from own revenues, compared to 6.4 per cent in developed countries. At the global level, intergovernmental transfers usually represent the primary source of revenue for subnational governments (51 per cent, on average). They range from an average of 48.9 per cent in OECD countries to 57.6 per cent in African countries. Intergovernmental transfers represent 90 per cent of local government revenues in Kenya, Tanzania and Rwanda, up to 96 per cent in Uganda, around 25 per cent in Senegal, Namibia and Eswatini, and barely four per cent in Zimbabwe. Hence, the situations are very diverse.⁷²



In Senegal, there are two main instruments through which the central government contributes to local authorities: the Local Government Endowment Fund and the Capital Investment Fund, which transfers 5.5 per cent of VAT. In the 2020 budget, the former contributed CFA 165 million (US\$ 270,000), and the latter, CFA 850 million (US\$ 1.42 million). In addition, the central government allocates resources to deliver on mandates such as education and health under the transferred Consolidated Investment Budget. Local authorities also receive rebates from the annual vehicle tax, tax on oil (50 per cent), and property transfers (50 per cent of margin on profit). Central government contributions are allocated in line with pre-determined formulas, allocating more to less fortunate localities in an attempt to equalise revenues, given that Dakar is home to the majority of economic activity. The result is that for Dakar, these central government contributions make up a minuscule proportion of the budget, far less than one per cent.

Dependence on transfers in and of itself is not wrong. Not all subnational governments have the same tax potential, and so, there is a need for intergovernmental transfers to balance support to development across the system and the country. As a result, smaller or less-developed local governments tend to have smaller tax bases, and therefore, tend to also be more dependent on the central government (see Table 1 below).

Table 1: The decentralisation of expenditure authority in selected African countries

Ethiopia	2010/11	2011/12	2012/13	2013/14	SNG's have role in most functions including police, education and courts.
National	60.77%	57.07%	52.35%	45.85%	
Sub National	39.23%	42.99%	47.65%	54.15%	
Uganda	2011/12	2012/13	2013/14	2014/15	SNG's play a prominent role in education, health, and public administration.
National	79.81%	77.67%	78.84%	81.11%	
Sub National	20.19%	22.33%	21.16%	18.89%	
Mozambique	2013	2014	2015	2016	SNG's have lead role in education and support health, public administration, and social services.
National	64.58%	64.22%	57.13%	62.68%	
Sub National	35.42%	35.78%	42.87%	37.32%	
Kenya	2013/14	2014/15	2014/15	2015/16	SNG's have service delivery role on several programs and have minor role in education, police, and courts.
National	84.30%	81.53%	80.26%	81.73%	
Sub National	15.70%	78.47%	19.74%	18.27%	

Source: Government of the Republic of Kenya, *The National Treasury and Planning (2018), Comprehensive Public Expenditure Review. From Evidence to Policy*, p. 51 (<https://www.unicef.org/esa/sites/unicef.org/esa/files/2019-05/UNICEF-Kenya-2017-Comprehensive-Public-Expenditure-Review.pdf>)

The traditional theory of fiscal federalism prescribes a very limited tax base to subnational governments, and following from it, government transfers seem inevitable. The reason for this is that local taxes can lead to competition among subnational governments and a “race to the bottom”. It could also cannibalise revenues at the national level, exacerbate income inequalities across regions, fail to incorporate externalities,⁷³ lead to inefficient duplications of government structures, and enhance corruption.⁷⁴ Indeed, it is difficult to dispute that national governments can leverage economies of scale in tax collection processes with inherent advantages of centralising information and processes.⁷⁵ Given this reality, national governments sometimes tend to devolve more expenditure responsibilities than tax authority. Even in high-income countries, local governments are not fully financially autonomous. As noted above, in practice, dependence of subnational governments on transfers differs widely, and hence, systems may also follow different reasoning. But the key insight that justifies devolving the receipts from national tax revenues to the cities in which the taxes are generated is that it gives the city government a powerful incentive to grow the local economy, since it may now capture a share of this growth. Hence, the city government learns to pay attention to the needs of local businesses, thereby accelerating the generation of productive jobs.

The central government can benefit from economies of scale in the provision of goods and services with positive externalities that cut across jurisdictions in a way local governments cannot. Indeed if, for instance, flood water management was devolved, with positive externalities for juris-

dictions downstream, there would be an underinvestment in upstream flood management. Table 2 below summarises some of the other criteria for decentralisation. Ultimately, however, there is no blueprint for a solution. Political decisions are needed to prioritise among different decentralisation criteria, and the level at which services should be provided.

Lastly, there are also local expenditures that are best paid for via transfers. According to the benefit model of local government finance, local government services, wherever possible, should be paid for on the basis of the benefits received from those services.⁷⁶ The extent to which municipalities will be able to apply the benefits-received principle, however, depends on the nature and characteristics of the services they provide.⁷⁷ There are devolved services, the benefits/costs of which extend outside the jurisdiction of local governments. In these instances, there may be an under-allocation of resources to that service because the local government providing the service would base its expenditure decisions only on the benefits captured within its own jurisdiction. The local government would not consider the benefits that accrue to populations outside its own jurisdiction. In these instances, transfers can ensure that expenditure meets overall social benefits. Furthermore, transfers are more appropriate to fund services that have a redistributive function (such as welfare assistance, health, and social housing). Using OSR streams such as user fees would defeat the purpose of redistribution, and property taxes are more regressive than income taxes and thus are not appropriate for financing redistributive services.⁷⁸

Table 2: When should services be devolved?

Criteria	Centralize
Preferences	In homogenous contexts
Economies of Scale	Yes
Negative Externalities	No
Positive Externalities	Yes
Decision Costs	If costs decrease with group size

Source: Adapted from Dafflon B and T Madiès (2009) *Assignment of powers to different levels of government, Decentralization: A Few Principles from the Theory of Fiscal Federalism*, Agence Française de Développement, Paris, Notes and Documents No. 42, p. 18.

Figure 2: Different financing tools for different services

Private	Public	Redistributive	Spillovers
Water	Police	Social assist	Roads/transit
Sewers	Fire	Social housing	Culture
Garbage	Local parks		Social assistance
Transit	Street lights		
User Fees	Property Tax	Income Tax	Transfers

Source: UN-Habitat (2009) *Guide to municipal finance. Human settlements financing tools and best practices series*. UN-Habitat, Nairobi, p.18. The term private in this figure is used to describe that the good itself is private, i.e., it is not a public good (rivalrous, excludable). It is not meant to describe that the private good is or needs to be provided by a private company.

Despite the importance of transfers, managing transfers in an effective way, so they set the right incentives and fulfil the functions outlined above, is not easy. Transfers need to be allocated equitably across territorial jurisdictions to overcome regional disparities and avoid political backlash. They also need to be well-aligned to the mandates of the cities, which, thus, must be decentralised cautiously. Unless considerations from the local level are properly formulated and conveyed to the national level and are duly taken into account there, central governments' stringent control over spending and conditionalities tied to intergovernmental fiscal transfers may carry the risk of forcing local governments to spend funds in ways that do not match local needs, undermining a key objective of decentralisation. Transfers also need to be allocated according to transparent and predictable mechanisms. When transfers are unpredictable in both timing and size, it can result in great difficulties in planning as well as haphazard delivery, and in case of lopsided political and administrative decentralisation, bring about unfunded mandates.

To date, development partners have not focused on transfers, as the allocation of intergovernmental transfers is generally politically sensitive and takes long time horizons to adjust. There is a need to focus more extensively on the design elements of these transfers, ensuring transparency of allocation and making them commensurate to decentralised mandates, whilst holding the city accountable for good financial management. The former requires a concerted effort to develop systems that encourage predictability in size and timing of payments so that cities can rely on the funds to plan and commit to longer-term investments. The

latter requires this system to be predicated on certain performance indicators such as efficiency and effectiveness in expenditure, progress in OSR generation, and overall adherence to public financial management (PFM) standards at all levels of government. More incentives for good financial management are needed at the national level, and one of the ways of doing this is through transfers. If local governments do not comply with basic PFM regulation, then this should probably be reflected in reduced national transfers. The politically controversial question here is about power and authority. If local governments do not manage their finances in a transparent and appropriate manner, what are the consequences? On the one hand, the national government should be given more control to prevent mismanagement, and on the other, it may be seen as an infringement on the autonomy of local governments, and thus potentially a step in the wrong direction.

This latter point is particularly important since transfers ultimately help define the incentives that local governments face in leveraging other sources of financing. Given the importance of OSR, as we shall see in the next section, and the overall tendency of local governments to not fully leverage it due to its political unpopularity, it is important for transfers to depend to some extent on OSR performance of local governments. Given the importance of OSR in enhancing the financial position more broadly, it would be a loss not to use this powerful resource lever as way of incentivising more serious optimization of OSR reform and concomitant solidification of the rule of law, the social contract and government accountability.

3.2.2 Own-source revenue

Optimising OSR is critical to enhance the financial position of cities in a sustainable manner. Opportunities for OSR optimisation often revolve around streamlining tax policy and enhancing compliance, both of which are impacted by digitisation and the strengthening of the social contract. However, none of these changes can happen if there is no political buy-in and ability to overcome vested interests.

It is widely accepted that successfully devolving political authority and service delivery responsibility to lower levels of government requires local governments to develop their OSR systems.⁷⁹ OSR here refers to the revenue streams (taxes, licenses, charges and fees) that are controlled and levied directly by local governments. OSR is needed to fund current expenditures, maintain large infrastructure investments that require external finance, and ensure that the government can carry on functioning in the event of untimely national transfers. OSR also enable local governments to respond to the demands of citizens in a more direct and flexible manner. It increases creditworthiness and facilitates access to external finance. Greater reliance on OSR will commonly also strengthen the accountability of local governments and incentivise improved service delivery and/or representation in exchange for tax contributions.⁸⁰

While the merits of OSR are well known, using OSR systems in an effective and efficient manner remains a challenge for many local governments, especially in developing countries.⁸¹ Low-income countries generate around US\$ 12 per capita per year from OSR in local governments, compared

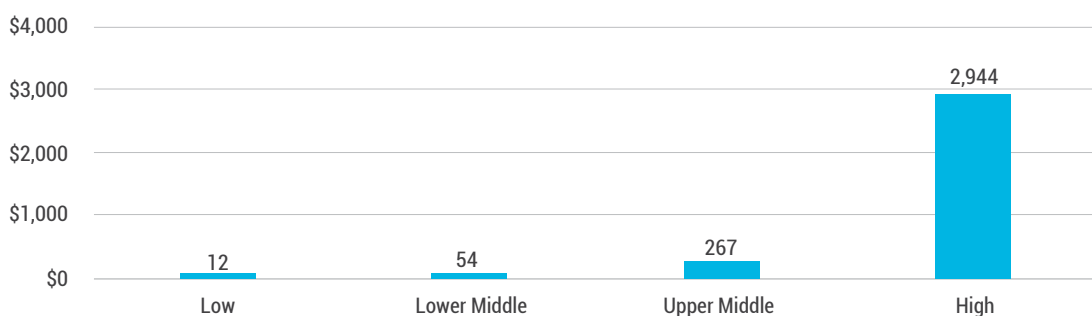
with US\$ 2,944 per capita per year in high-income countries (Figure 6). Local OSR systems are often also found to be economically distortionary, costly to administer, coercive, and corrupt.⁸²

The literature on OSR outlines some of the key drivers of sub-optimal usage of OSR systems, including insufficient tax authority,⁸³ lack of tax capacity and concomitantly poor tax policy.⁸⁴ The recommendations emanating from existing literature thus tend to be centred on revising tax policy, e.g., focusing collection efforts on a reduced number of OSR sources,⁸⁵ simplifying existing rates and exemptions,⁸⁶ increasing public participation,⁸⁷ enhancing visibility of expenditure,⁸⁸ leveraging digital payment options to reduce tax collector malpractice,⁸⁹ and/or carrying out new valuation rolls to update property values.⁹⁰

In outlining these policy recommendations, the literature also commonly emphasises on the important role of political leadership for successful OSR reform.⁹¹ It suggests that leadership is needed to overcome vested interest in the status quo, since effective OSR policies and institutions may not be in the interest of tax collectors, politicians or economic elites who benefit, in one form or another, from tax loopholes, lack of enforcement or reduced business/property tax rates.⁹²

There are several key components that support increased OSR. Certain cities, such as Kampala, have shown that local administrative reform, even without widespread policy change, can have a significant impact on increasing OSR, therefore enhancing the creditworthiness of the city. Ena-

Figure 3: OSR per capita of local governments by country GDP (income category)



Source: Based on data from UCLG and OECD (2016) and the ICTD/UNU-WIDER Dataset (2020)¹. This data may exaggerate the inadequacy of local OSR systems, since low OSR per capita naturally is also the result of lower GDP per capita in developing countries. However, even after accounting for GDP per capita, low-income countries generate roughly one tenth of the OSR in high-income countries.

bling cities to get this right before central government transfers are increased or external finance is provided is essential to avoid creating perverse incentives and inhibiting the development of local institutions, capacity, and autonomy. Key administrative reforms include automation and digitisation of OSR processes, streamlining the number of taxes, and sensitising taxpayers or building the social contract. Some city networks make a point that another issue is the leeway given (or not given) by national governments to local and regional governments to set tax bases and tax rates. Strengthening OSR also depends on the institutional environment provided by national legislation for cities to develop their fiscal autonomy. If cities do not have tax authority, then, of course, there is no optimising of OSR to begin with, and we need to devolve more authority first. However, this should not be the default starting point for reform. A lot of governments have sufficient OSR authority but are not leveraging it. We argue that this is the bigger problem than the lack of authority. If there is authority but it is not used, then we argue that we should use it properly first before providing additional revenue authority.



Hargeisa: Streamlining the number of taxes

In Hargeisa, new digital systems known as the Accounting Information Management System (AIMS) and Billing Information Management System (BIMS), both funded by UN-Habitat, were introduced in 2008 and 2010 respectively. AIMS has allowed revenue to be allocated to specific budget items, and split capital and current expenditure to ensure provision for longer-term investment in addition to meeting daily needs. BIMS has provided the first electronic link from central Hargeisa accounting to individual/neighbourhood level billing. Together, they have dramatically improved analysis capabilities, transparency, and accountability in the city, underpinning much of Hargeisa's financial improvement. While Hargeisa has made progress, there is still a long way to go. More taxes don't equate to more revenue, instead governments should increase efforts on those with the most potential.



Malawi: Cost of levying taxes outweighs the amount collected

In Malawi, a few initiatives for the digitisation of processes are under trial in several cities, including the start of basic automation of revenue systems and the use of GIS. More notably, electronic ticketing has been piloted in Zomba to enhance transparency in the collection of market fees, ground and city rates and business licences. The system reduces the chances of fee collectors skimming some of the revenues collected. One year later, the system had increased revenue collection by 53 per cent.

In Malawi, city-owned property and infrastructure often require investment and maintenance before they can become revenue-generating, and the city councils do not have enough upfront capital to invest in this. Illegal vending prevents the city from collecting the required market fees. Also, the operational costs of many markets are much higher than the money coming in from them. Business licenses are better as the costs of collection are lower. Compliance in numerous fees and taxes are low. Most cities are severely lacking in by-laws to enforce this, given the cost and technical expertise it requires. The tax base is under constraint by the fact that 60-70 per cent of the urban population in Malawi lives in low-income or informal settlements.

UN-Habitat's Rapid Own Source Revenue Analysis (ROSRA)

The ROSRA methodology diagnoses the problems of OSR systems and provides decision makers from subnational governments with strategic recommendations on how to optimise OSR. The methodology essentially consolidates international “best practices” on OSR systems and links these to a problem diagnosis. Essentially, the methodology consists of a revenue-gap analysis per revenue stream, a profitability analysis per revenue stream, and more granular process deconstruction of important revenue streams to better understand dependencies and determine useful reform entry points.

The application of this methodology in Kisumu led to findings that provided the necessary evidence to justify a strategic refocus of the revenue department away from user fees to land rates (property taxes). Among other things it found that

- The Kisumu County Government (KCG) was only collecting around 19 per cent of its total OSR potential in financial year 2018/19;
- Land rates (property taxes) received less than five per cent of the tax collection effort, while constituting nearly 40 per cent of the overall revenue gap;
- Unstructured revenue streams (user fees such as parking, bus park, and market fees) consume 75 per cent of the tax collection effort but constitute less than 15 per cent of the tax potential;
- Non-compliance of high-net individuals was the key driver of non-compliance more broadly with 90 per cent of land tax arrears being owed by the top 10 per cent wealthiest landowners, accumulating to a total of around nine times the total annual OSR of Kisumu;
- Low- and middle-income groups almost pay more in OSR than upper-income groups, with middle-income groups paying nearly twice the amount paid by higher-income groups.

Improved compliance is another major precondition for OSR optimisation. Local tax compliance in Kampala, for instance, is estimated to be slightly above 50 per cent. Stakeholders interviewed for the case studies in Hargeisa, Mzuzu and Kampala, as well as the participants at the Cities and Experts meeting in Dakar related to this initiative (for example, Freetown in Sierra Leone) highlighted that building and maintaining the social contract through participatory planning and visible service delivery is essential in increasing compliance rates. For that accountability mechanism to work, it is key to increase the visibility of OSR and the services that the local government provides with OSR. If citizens do not know whether services are paid via grants, loans or OSR, they will not demand better services for the local taxes that they pay. According to Paul Smoke, OSR compliance requires that citizens understand what their taxes are being used for.⁹³ However, when expenditure mandates are very complicated, and even at the local level, different services are provided by different levels of government, it becomes difficult for citizens to understand what their taxes are being used for, which, in turn, undermines compliance. Thus, where possible, the link between taxes and services received needs to be clear.



Kampala: Increasing tax compliance via digitisation

Kampala has greatly improved its revenue collection from around US\$ 1 million in financial year 2010/11 to US\$ 25 million in financial year 2018/19 (contributing to 24 per cent of KCCA budget). What led to this success? The process flow was improved from a manual, paper-based system that created non-compliance to an automated process that reduced turnaround time from weeks to hours. Taxpayers and local government staff were sensitised on revenue collection aspects (its nature and what they are being used for), and training KCCA staff (revenue collectors) on laws that govern tax administration, specifically local government laws. Massive taxpayer sensitisation also improved collection, coupled with KCCA-conducted revenue audits to ascertain revenue defaulters, which helped improved compliance. Regular enforcement and allowing taxpayers to pay in instalments also helped. Samuel Sserunkuuma, Director, Revenue Collection, KCCA, described the long-term merit of such

actions, saying, “With administrative change and by enhancing business processes, we deliver continuity [which] requires systems and processes to live beyond your office time.”

These administrative reforms are critically dependent on strong leadership and the will and ability to overcome vested interests of parties like landowners, tax officials, taxpayers, and local government politicians, all of whom have an interest in leaving taxes small or OSR unleveraged to exploit tax loopholes for private gain. As the Kisumu case study shows, adequate data management, reporting and control systems are critical for overcoming vested interests. Inadequate information systems make it difficult for government decision makers, as well as the public, to hold lower-level government officials accountable. Lack of information also makes it difficult to understand what is happening, and to identify culprits and financial malpractice as well as to identify, to recognise and to share good practice. In such an environment, decision makers will find it difficult to defend the need for reform initiatives, as they lack the evidence to describe the gravity of the need for reform. They will also struggle to identify the key reform entry points to quickly show results and support reform initiatives with needed legitimacy and will lack the tools to understand why reforms are not meeting the intended targets and adjust them accordingly.

To achieve this, revenue departments should be made as transparent and conducive to analysis as possible. Analyses of leakages should not be carried out as a once-off strategic capacity building initiative but should rather be streamlined into the monthly reporting systems that help expose malpractice and strategic blunders – but also improved performance and good practices – on a continuous basis. Control and monitoring should not only serve to police and punish, but also to highlight what is being done well and encourage progress. Yet, the lack of transparency is often not a capacity constraint but might be present by design. Therefore, data should be made as publicly accessible as possible. Records should be cleaned up to facilitate analysis, and ways should be found to integrate taxpayer information stored in separate records or digital platforms to gain a comprehensive understanding of tax evasion. Reforms aimed at increasing compliance by sanctioning non-payment will benefit from integrated taxpayer records.

In a similar vein, internal information systems must be strengthened. Technical reform will face challenges if not accompanied by a management reform of tax collectors. Irrespective of the quality of the digital system or the number of devices used for revenue collection, additional management reform is needed to ensure successful implementation. Reforms undertaken to automate payments need to be embedded in management systems that estimate daily revenue targets based on realistic potential of revenue stream and hold collectors accountable to achieving the pre-defined targets. While doing so, historic revenue figures should not be used to define revenue targets, as these are unlikely to provide trustworthy baselines. Instead, it is advisable to use proven methodologies, such as top-down approaches (see box on UN-Habitat ROSRA), bottom-up revenue mapping (literally counting the tax base), or manual testing. Manual testing would entail engaging new and potentially more objective tax collectors for a short time span (for example, one week) and define targets based on the amounts they collected.

Increasing OSR at subnational level is viewed by some as a stepping-stone that may help unlock access to external finance and private capital. The sustainable financing of cities and local governments will ultimately require building OSR institutions and municipal finance foundations. Gaining a better understanding of the conditions for successful OSR reform will thus help determine when the development of effective OSR institutions can be seen as a stepping stone (among others) to enhance the financial position of cities, and when it actually should be seen as a prerequisite, without which facilitating access to external finance is not advisable. OSR is essential to sound urban development; indeed, secure, predictable, and transparent OSR are strong indicators of good financial management and effective investment, making the city more creditworthy. It also gives the city autonomy to invest themselves and build a strong relationship with its citizens.

Whilst critical for good financial management, OSR is certainly not sufficient to provide enough investment in urban development. The main sources of revenue for municipalities will remain ‘transfers’ (conditional, unconditional and/or contractual) from the national to the local level through revenue sharing formulae.

3.2.3 Leveraging underutilised land-based financing options

Land-based finance is one of the most promising OSR streams that is underutilised and can be leveraged to strengthen urban management more broadly. Technological innovation has further enhanced the implementability of these mechanisms. Nonetheless, fully leveraging these tools will require local governments to build capacity, show willingness to experiment, and overcome resistance from powerful landowners.

One of the most underutilised and promising sources of own revenues for local governments is generated from one of the most valuable assets in cities: urban land. When correctly managed and utilised, land and property taxes can provide a fair and efficient form of taxation by capturing some of the rise in land values resulting from rapidly increasing urban populations and public infrastructure investments. These revenues can then, in turn, be reinvested, further driving up land values and potentially creating a virtuous cycle of urban development. For example, Samuel Sserunkuuma, Director Revenue Collection, KCCA, Uganda, noted at the Cities and Experts meeting in Dakar in February 2020: “Cities must account for the increasing value of property due to proximity to roads. Once roads are paved, the increased value of property can be taxed, creating a virtuous circle.” It can also be an important tool to tackle rising inequality, provided measures are taken to ensure that land value increases resulting from public investment accrue to the wider public in the form of equitable provision of infrastructure and services, rather than only to service the interest of land-holding elites.

On average, property tax accounts for 22 per cent of subnational tax revenue in developing and least developed countries, far less than in the upper and lower middle-income countries, where it accounts for over 39 per cent of subnational tax revenue.⁹⁴ Taxes can also be considered according to their relative stability or elasticity during economic crises. Property taxes are known to be rather inelastic, in that they are less likely to be unpaid or reduced drastically even in times of economic difficulties. On the contrary, taxes on economic activity are elastic, i.e., more dependent on fluctuations in national or international economic cycles.

As promising and valuable as these mechanisms may seem, they are difficult to implement. To generate revenue from land and property where cadastres are out-of-date or non-existent, with complex and informal land tenure systems, often

lacking tenure security, lack of effective property addressing systems, and insufficient professional capacity in surveying and valuation, is extremely challenging. In trying to overcome these challenges, many cities and development partners are exploring innovative ways to register land, value properties or facilitate tax payment. The use of GIS mapping provides a new, rapid and cost-effective means of geo-locating properties and creating up-to-date and digitised land and property records. Simplified valuation methods have also enabled cities to start the process without the need for accurate data from functioning property markets.

The benefits that result from successful implementation of land-based finance mechanisms can also extend beyond mere revenue generation. They can extend to improved urban planning and management (e.g., addressing issues such as urban sprawl), can be used to improve land administration, finance the upgrading of tenure security in poorer neighbourhoods, and ultimately also function as a means of strengthening land rights, and/or facilitating access to credit.



The area-based system in Hargeisa

In Hargeisa, rather than using the standard market value-based property tax system requiring complex calculations and often expensive expert valuers, the city uses a simple and low-cost area-based system instead: the building's size multiplied by a rate based on location, requiring only information on the building's width and depth, the number of floors, and the location band as set out by the City Council. This simplicity makes it far easier to maintain and update the register on a more frequent basis, and revenues have increased by a factor of four since 2008.



The points-based system in Mzuzu

The Revenue Mobilisation Programme was rolled out in Mzuzu in 2013. The process involved the identification and registration of properties in the city with GIS, and the application of a points-based method of Computer-Aided Mass Valuation to derive property tax revenues. This system is more nuanced

than a basic area-based valuation but is more straightforward to administer than a comprehensive market-based system. While there is no absolute value, points are added for positive features such as paved roads and security features, and points are deducted for negative features such as a lack of electricity. The relative values derived matched the market values very closely. Together with reforms in billing, collection processes, and sensitisation, the process resulted in a seven-fold increase in property tax revenues, and notably, the ability to capture revenues from those living informally without accurate market valuations. Despite its success, the programme is not sanctioned legally, nor has it been rolled out to other cities in Malawi due to resistance from the Surveyors Institute of Malawi. The Local Government Act stipulates that a registered valuer should do the market valuation. The Surveyors' Institute also claimed that this process was regressive and that it did not solve the fundamental challenges of property tax collection in Malawi, namely, the lack of capacity and political will to conduct valuations.

Innovation in land-based finance is not limited to valuation and registration of land. More recently, there has been a proliferation of different land-based finance and other support tools, which extend beyond the more traditional taxes on land and/or property. These additional instruments help address a range of different financing challenges applicable to different landowners and users. Some of these tools may focus on recovering the costs of planned infrastructure investments from landowners who directly benefit from that investment (betterment levies), while others may target developers and/or landowners and require the latter to provide in-kind or cash contributions to cover the costs on public infrastructure that emerge as a result of the investment (developer exaction). These tools essentially provide additional instruments for cities to capture land-value increases that arise from public investment or recover the costs on the public purse that result from private investment. They also provide a useful means of paying for urban expansion and ensuring its well-planned nature.



Innovative land-value capture in Hargeisa

In Hargeisa, to plan for and capture the gains from rapid urbanisation, the city government has implemented a system of “in-kind” land-value capture or exaction. With this system, landowners on the outskirts of the city who apply to convert their land from rural to urban land use must provide the city government with 30 per cent of the asset if their application is approved. In this way, the city can access land for needed public infrastructure to service a growing city. At the same time, rent from this land can offer the city a valuable source of additional income to pay for the required infrastructure. The Hargeisa case study also shows that planning for future expansion is not only useful for capturing the gains from rapid urbanisation through exaction, but also improves future urban investment.



Malawi: Leveraging publicly owned land

As per the updated Land Act of 2016, land in Malawi is designated as public, private or customary ownership. For public land, the central government is always the principal landlord. However, the central government is required to transfer all land within the city's jurisdiction to the custodianship of the city council. The city council then has control over the management of that land, as well as the financial benefits that accrue from investments in it. However, the full transfer of land to cities is not currently being practiced. In Lilongwe, it is asserted that the national government charges the city councils the same rate to rent the land as a private developer, even when the land is utilised to provide public infrastructure. Traditional authorities still maintain rights to large tracts of land in the city centres, and the private sector too owns parts of the city's land as a result of extensive privatisation of land during the IMF structural adjustment programmes. In the meantime, a cabinet paper is being prepared to push forward the idea that all land in cities should be transferred to the respective city council. This proposal includes dealing with the improper transfers of land to the private sector, as well as providing the necessary compensations to transfer urban land from traditional authorities. If passed, this legislation could have a dramatic benefit in aligning incentives for urban development.

Despite the potential of the various new land-value capture instruments, they remain largely unused in Africa. This is partially due to the remaining legal uncertainty over their implementability. They also require new and additional skills for tasks like, for example, assessing the resulting cost of a private investment on public infrastructure. Often, these assessments are somewhat subjective, which makes them susceptible to public criticism and resistance. It is this latter point that is particularly problematic not just for land-value capture tools, but for the more classical land and property taxes. Land-based finance instruments are particularly visible, and given their annual payment, are particularly problematic for residents from a cash-flow perspective. Local governments are also, by definition, much “closer to the people”, and are thus susceptible to the interests of powerful landlords. Taxing powerful developers or investors may be equally challenging for local governments who fear otherwise losing the investment altogether to a neighbouring locality.

Many African countries do not have proper systems or regulation to register and allocate the property rights of multistorey buildings or apartments (such as condominiums). This may have a serious impact on property taxation and also on access to finance for individuals. This is a very peculiar situation of Africa vis-a-vis other regions. Exaction and impact fees (licenses and fees) could also be mentioned as part of land-based finance in contexts where there are increasing real estate interests and investments in urban development interventions. These planning instruments can also contribute as a source of additional financing. Land readjustment is of importance as a tool, especially when the city government needs to acquire land for infrastructure development.

Successfully implementing these land-based finance tools requires a mix of administrative reform, capacity building, technical innovation, and strengthened political incentives. Some legislative processes needed to leverage land-based finance may thus benefit from being re-centralised so that national governments pass the necessary legislation for local governments to leverage land-based finance, as opposed to every local government passing its own legislation. Where there is necessary political will to introduce land-based finance mechanisms, it is important for administrations to introduce changes at the start of an administrative cycle to ensure their completion before the onset of a new administration. Similarly, reforms should aim for incremental changes and introduce transparency in the land-processes to harness the support of the smaller landowners.



Kisumu: The challenge of vested interests of landowners

Kisumu, as many of its peers, has not managed to fully leverage its revenue potential from land. In fact, nearly 70 per cent of landowners have outstanding arrears in land rates. To act upon this, the Kisumu County Government in 2016 decided to update the 2008 valuation roll, an exercise that led to an eight-fold increase in land value in Kisumu – from US\$ 127 million to just over US\$ 1 billion. It also increased the number of registered parcels from 25,284 to 55,000. Despite the rise, the valuation roll was never officially approved by Council. The third party that undertook this exercise withheld the GIS components of the roll citing repeated delays in payment. The Local Rating Act that is needed to validate this roll has also been awaiting approval since 2014. As is the case the world over, vested land interests likely have a role in halting these reforms, illustrating the importance of incentives at high political levels to enable local authorities to push through land reform.

3.3 Improving access to external finance

Initially, we did not intend to undertake a broad investigation on external finance in this initiative. However, in the course of developing the case studies, after finding little activity in this area, we realised that there are huge expectations of various experts in this direction, especially in subnational borrowing, often without sovereign guarantee. We thus briefly touch upon the findings and recommend that these mechanisms be analysed in greater extent and detail during the next steps of the initiative.

Despite the strong link between financing urban infrastructure and achieving top-tier global development goals, finding ways to attract private and/or foreign capital into public infrastructure investments through loans, municipal bonds, and public-private partnerships, especially in low-income country contexts, has proven to be difficult. “While different types of financing are available, the conditions necessary to attract capital to urban infrastructure projects are often not. Institutional and private investors need to see that cities can generate reliable sources of revenue to service debt, finance bond instruments and maintain equity investments.”⁹⁵ Some of the key bottlenecks, as well as the role of development partners in overcoming them, are discussed below.

3.3.1 Legal bottlenecks to borrowing at the city level

Subnational borrowing is often restricted by regulations guarding against unsustainable debt obligations, as examples from the case studies illustrate.



The Local Government Act in Kampala placed a cap on borrowing until early 2020, which restricted the city from borrowing more than 10 per cent of the previous year's OSR. This amount did not allow the funding of any meaningful investment in urban infrastructure. At current collection rates, this would be about UGX900million (US\$ 240,000), which would cover just 14 metres of a Bus Rapid Transit line in the city, according to a recent feasibility study.⁹⁶ In 2020, Kampala was exempt from this borrowing cap through a dispensation in the KCCA Act, while other local governments remain restricted.



In Malawi, the Public Financial Management Act stipulates that local governments cannot take loans without prior approval from the National Government Financial Committee. The Ministry of Finance accepts the risks of all loans and is, therefore, hesitant to encourage borrowing by local councils.



In Dakar, although municipal autonomy is limited with central government maintaining control over local finances, it is unusually free to take on subnational debt with few legal restrictions. The city has been able to enter into agreements with both concessionary and commercial lenders on its own accord. However, an attempt to launch a municipal bond in 2015, despite receiving pre-approval, was over-ridden by the national government at the last minute, over cited fears of large debt obligations and lack of precedence in this area. There have been discussions on their legal authority over-ride the local government's decision.

There are other regulatory challenges over and above the ability to borrow. In most developing cities, the lack of historical precedence with external financing tools, and the under-developed laws and institutions that govern them, significantly limit their ability to explore these options. For example, in Kampala, the issue of municipal bonds sits between two laws (the Companies Act and Capital Markets Act), which have competing approaches, and so the Credit Markets Authority have had to develop an interim set of guidelines to fill the gap. One of the reasons for relative investor security in Dakar was that regional regulations were already available through the West African Monetary Union, which had a process in place for dealing with investor relations and disputes, among other things.

3.3.2 Achieving creditworthiness

In many developing countries, even where borrowing is legally permitted, many cities still lack the revenue streams, financial management capacity and creditworthiness to take on debt. In this regard, the case studies show mixed results.



While Somaliland's decentralisation policy recommends authorising local governments to borrow for capital investment, none of its cities meet the requirements set out in Law 23. Therefore, they are unable to undertake longer-term borrowing at affordable rates. UN-Habitat is currently supporting a Local Government Finance Policy, which provides further guidance on borrowing and debt management.



In Kampala, many of the reforms to revenue systems and administration were centred on achieving the goal of the KCCA becoming creditworthy and reducing the risk of investment. These reforms started in 2012, building on efforts of the World Bank Public Private Infrastructure Advisory Facility Sub-National Technical Assistance Programme's 'Financial Recovery Action Plan' aimed at reducing the city's level of indebtedness and achieving clean audit reports. As a result, in 2015/16, the KCCA was given a national scale rating of A- in the short term, and A in the long term by The Global Credit Rating Co, boding well for the progress it had made within the national context.



In Dakar, building creditworthiness was a fundamental part in preparing for the bond. The Bill and Melinda Gates Foundation provided a grant of US\$ 5 million for a six-year programme (2011–2017) to improve financial management systems, alter its approach to city planning, and influence investors' perception of its creditworthiness. The international ratings agency, Moody's, was brought in from the outset to provide a confidential credit rating for the city. This was used as a benchmark against which to measure improvements before obtaining the official public rating, and provided a roadmap for improvements. Key areas for reform included the quality of debt recording and reporting, as well as poor debt sustainability analysis. A local ratings agency, Bloomfield, was then selected to conduct the follow-up rating. In September 2013, Dakar received an investment grade A3 short-term rating and BBB+ long term rating.

As highlighted in the case study references above, development partners were crucial in facilitating creditworthiness reform, both in terms of technical and financial assistance. It can become difficult for a city to justify investing in internal creditworthiness reforms year after year since their returns to the public are long-term, and thus leave minimal potential for short-term political gain. By providing technical and financial assistance, development partners can help lay the groundwork such that external finance becomes a more feasible option.

It should be noted here that in Dakar, despite the launch of the municipal bond being barred, creditworthiness reforms have greatly increased the city's potential for accessing both commercial and concessional loans. Mourade Dieye

Gueye, Secretary General, Dakar Municipality, commented on this point during the Cities and Experts meeting in Dakar in February 2020: "Thinking of other ways for funding helped a great deal in revenue collection and allowed the city to move its mindset from operating mode to investment mode. Financial management reform saw a 30 to 70 per cent split of capital investments/operations changing to 60 to 40 per cent. This change was driven mostly through controlling operating expenditures."

3.3.3 Project preparation

Designing bankable projects remains an often-cited challenge for national and city governments as well as financing organisations. Many city governments neither have the capacity to put forward a viable business case, nor the experience to understand what investors are seeking. Despite Kampala overcoming its regulatory challenges and achieving a national investment grade rating, many stakeholders believe the city will continue to struggle in attracting external finance without building the capacity to develop bankable projects. The capacity gaps highlighted include a lack of continuity and foresight in strategic plans, an inability to develop (trustworthy) feasibility studies, a lack of expertise and experience in preparing financial models, and immaturity in utilising internal controls and financial management systems.

Another issue is implementation. A 2014 analysis by Ernst and Young and the Infrastructure Consortium for Africa showed that with funds available and projects started, the gap is being closed. But it found that work had yet to begin on two-thirds of identified projects. Africa does not need to identify new sources of funding but rather ensure that planned projects are completed within a reasonable timeframe. This will ensure projects deliver returns to investors and help to attract new investment. Africa needs to remove barriers to finishing projects by lowering the cost of doing business.⁹⁷



Public space with exercise equipment in Dakar, Senegal © Shutterstock

Climate finance initiatives: The Gap Fund

Cities too often struggle with developing climate-friendly and resilient infrastructure. Especially in the global South, cities frequently lack the capacity, finance and support needed for the early stages of project preparation. This leads to impasses where cities cannot move project ideas to late-stage preparation and implementation.

Launched in September 2020, the City Climate Finance Gap Fund (the “Gap Fund”) paves the way for cities to deliver ambitious infrastructure development for low-carbon, resilient and liveable cities. The Gap Fund will support projects in cities in low- and middle-income countries, in East Asia and the Pacific, Europe and Central Asia, Latin America and the Caribbean, the Middle East and North Africa, South Asia and the rest of Africa.

The Gap Fund support will:

- Strengthen interventions in urban planning and financial management to reduce cities’ carbon footprint and improve climate change resilience;
- Provide early-stage project preparation support for investment in projects compatible with limiting temperature rises to 1.5 degrees. Such projects could include investments in energy efficiency, green buildings, sustainable cooling, nature-based solutions, local renewable energy, sustainable mobility, waste management and circular economy, and wastewater and water management. The fund will also support climate change adaptation activities that enhance resilience (e.g., in urban water and wastewater systems, energy, urban transport, public spaces and other infrastructure).

The Gap Fund’s support can cover a variety of activities ranging from city climate strategy development to project concept definition, components of pre-feasibility studies, strengthening the financing approach to improve bankability, identification of innovative or scalable financing approaches as well as matchmaking with additional support sources for later stages of project preparation. Projects supported by the Gap Fund will result in secondary social and environmental benefits, such as improvements in quality of life, clean air, health, social inclusion, the circular economy and job creation.

The Gap Fund is an initiative of the German Government and the Global Covenant of Mayors for Climate and Energy, in partnership with several other key players in the climate finance arena, including C40, ICLEI, and CCFLA. The initial donors are Germany’s Federal Ministry for the Environment, Nature Conservation and Nuclear Safety and the Federal Ministry for Economic Cooperation and Development, as well as Luxembourg’s Ministry of the Environment, Climate and Sustainable Development. Support to cities and related work is provided through two implementing agencies, the World Bank and the European Investment Bank (EIB), the latter in partnership with Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).

For more information: www.citygapfund.org

In many cases, project preparation could be facilitated through external assistance in structuring and developing feasibility studies and capacity building. The key to this assistance being successful in the long term, as with all external assistance, is in working collaboratively so that the ability to build bankable projects going forward is built internally. A good example for building internal capacity is Uganda, where the Ministry of Finance has now developed an entire unit devoted to assisting with the development of bankable projects. They have also tried to make projects

more transparent to investors, moving to a disclosure-based system whereby investors are given all the information instead of just the merits of the investment, reducing information asymmetries and enabling them to make a more clearly informed decision. Here, the more constraining issue appears to be in establishing the underlying conditions of creditworthiness.

The **International Municipal Investment Fund (IMIF)** set up by the United Nations Capital Development Fund (UNCDF) and United Cities and Local Governments (UCLG) in collaboration with the Global Fund for Cities Development (FMDV) supports intermediary cities in developing countries, including the least developed countries, in accessing national and international capital markets. It will provide cities and local governments with reimbursable funds to finance investment projects and programmes of general interest. The Fund is managed by Meridiam, a private asset manager, with a target capitalisation of EUR350 million at first closing. Through a Technical Assistance Facility (IMIF-TAF), the UNCDF-UCLG-FMDV coalition will help cities finalise the preparation of their projects and provide the necessary support to ensure that the city meets the requirements for accessing financial markets.

Serge Allou, Technical Advisor, UCLG, said at the 29 October 2020 Cities and Experts meeting, “The experience of blended finance, guarantees, and developing cities’ access to financial market shows that, in some cases, there is a disconnect between project preparation facilities and the investors. This gap should be tackled, and development partners can play a role here. Including private sector in the conversation upfront would be a key element for this.”

Examples of how development partners have started addressing issues of project preparation and implementation are mentioned in the boxes on the Gap Fund, IMIF and ASCI. Another example, which does not solely target cities, is SOURCEⁱⁱ, a multilateral platform of the Sustainable Infrastructure Foundation that is led and funded by international development banks. The initiative enables promoters to assemble project information that can be accessible to a range of IFIs and other entities involved in project financing and preparation.

While donor and IFI assistance is important, it does introduce a few challenges of its own. The cities in the case studies noted that access to donor assistance requires specific know-how for each of the donors. The lack of coordination also extends to projects implemented with multiple donors overlapping in their assistance. For example, the

city of Kampala has had more than three unique feasibility studies for a Bus Rapid Transit conducted on their behalf. More progress could have been made if they had aligned and tackled separate challenges. There is also an issue of donors tending to skew local priorities and plans to map to their own agenda. This overrides the very important planning process in cities that they aim to foster. Finally, it can also result in incentivising cities against adequately developing their own internal financial management and revenue generation. Initiatives are underway to try to make development support easier to access; for example, the Cities Climate Finance Leadership Alliance has been working to harmonise application forms for urban climate finance across the calls issued by IFIs and city networks.

Challenges are many, diverse and often specific to the particular context, and there are choices of financing for mainstream infrastructure: for instance, presumably richer, formally developed areas can largely either pay for privately developed and managed provision through user fees themselves or cover it through tax revenue. These areas are normally addressed first. However, a fundamental challenge is around financing long-term debt for infrastructure in poor and informal areas where the population has little ability to pay and contributes little tax revenue.

With its **African Sustainable Cities Initiative (ASCI)** the European Investment Bank seeks to enhance access to finance for investment for secondary cities in sub-Saharan Africa. Secondary cities have been chosen as the focus because they generally have high needs and lower capacities, and donor funds tend to target larger cities. ASCI supports secondary cities in accessing finance for their sustainable urban infrastructure needs through i) strengthening their capacities in municipal finance and supporting the development of municipal financing strategies and plans, ii) providing financial and structuring advisory services to a selected number of projects, and iii) increasing connections to potential investors and supporting knowledge sharing in general. The main focus of ASCI is on financial advisory services and the intention is to use other complementary facilities, such as the City Climate Finance Gap Fund, for technical advisory services. At the same time, ASCI can also support limited technical advisory work.

ii <https://public.sif-source.org/source/>

As highlighted in chapter 3.1, it is crucial to remember, though, that focusing only on revenue-generating, “bankable” projects, may lead to ignoring the need for public or social goods, where direct monetary returns may be small or zero, but the overall public benefit is important. Where development partners become involved in project design, they may wish to promote transformative projects that are financeable, such as green or pro-poor agendas that may not, in fact, be bankable in that context. For example, in Dakar, numerous stakeholders believed that the market to be funded by the planned municipal bond was designed to meet the pro-poor objectives of the Bill and Melinda Gates Foundation, and would not have yielded a strong return on investment had it gone ahead.

3.3.4 Reducing investment risk

With stable and transparent OSR and intergovernmental transfers in place, access to external finance becomes far more feasible. Together with other creditworthiness initiatives such as financial management and developing capabilities in designing bankable projects, the risk and therefore the costs of investment may be reduced.

However, some risks, such as currency exchange and other macroeconomic risks, are out of the city’s control. For instance, Uganda’s international credit rating has consistently stood at around B+ (Fitch), B2 (Moody’s), and B (Standard & Poor’s), which are all below investment grade. Blended finance and guarantees have been used as tools to reduce both the real and perceived risk of investing and therefore reduce the costs of investment, as investors are assured a minimum repayment.

Carla Montesi, Director, Green Deal, Digital Agenda, Directorate-General for International Partnerships of the European Commission said at the 29 October 2020 Cities and Experts meeting, “The financial instruments in the External Investment Plan are blending (providing grants combined with public or private loans) and guarantees (to de-risk investment and attract private sector) through international financial institutions. In relation to the urban sector, blending has been used to support solid waste management, sustainable urban mobility, water supply and sanitation, with a view to make loans more affordable to the cities. A key element for blending is preparation of a good pipeline of projects (that integrate the green and social agenda) that can be presented to the financial institutions. Unfortunately, not enough sustainable projects have been submitted to the financial institutions.

In terms of guarantees, we are still exploring how to optimise and streamline this tool for cities. Three key examples of how guarantees can be used include supporting resilient cities to facilitate public private partnerships (RECIDEⁱⁱⁱ); guaranteeing repayment to local banks to expand lending to cities, as well as lending in local currency, and de-risking currency risks; and offering guarantees to absorb part of the financial losses that an urban investment fund (small portfolio) may have to reduce investment risks.”

Budget support is one of the mechanisms used for example by the European Union as a means of delivering effective aid and durable results in support of EU partners’ reform efforts and the Sustainable Development Goals (SDGs).⁹⁸ In a decentralised context budget support can be a catalyst to tighten the economic and budgetary framework and strengthen the investment and business environment, to reduce investment risks, enhancing sector policies, institutions, and regulatory frameworks. Therefore, it is essential to exploit synergies and complementarities with other tools such as blending to increase their effectiveness. Subnational application of Public Expenditure and Financial Accountability and Tax Administration Diagnostic Assessment can trigger useful reforms aimed at improving financial management and tax administration and therefore increase creditworthiness.



In developing their municipal bond, the City of Dakar secured a 50 per cent guarantee from USAID under its Development Credit Authority (DCA). This meant USAID would repay at least half of the investor’s capital if actual revenues from the project did not match expectations. Since it was a non-sovereign bond, the DCA could not provide a full guarantee, and instead required the City of Dakar to create a reserve fund to finance the initial repayments. The city thus placed a coupon amounting to one year’s interest on the bond in a private bank account, which provided a first loss guarantee to investors and ensured limited liability for the central government. The wide-ranging creditworthiness reforms, combined with investment guarantees, saw the municipal bond of US\$ 40 million become viable at an annual interest rate of 6.6 per cent with a seven-year maturity.

iii Resilient City Development Guarantee under European Investment Plan; <https://ec.europa.eu/eu-external-investment-plan/projects/resilient-city-development-recide-en>.



Another critical element in the design of the bond included a two-year delay in principal repayments to save the city from having to allocate other revenue sources, such as property tax, to repay investors, which would have added significant financial pressure on the budget and constrained their ability to deliver on ongoing service delivery needs. However, the bond only had a seven-year maturity, like many other subnational loans. This creates considerable difficulty since typical infrastructure project life cycles are between 20 and 30 years. Development partners can play a role in helping extend debt cycles to match project life cycles.

While ring-fencing a project so that its income and expenditure are separate from the rest of the city budget is vital in assuring investors that revenues generated will not be spent elsewhere and ensuring that other sources of city income continue to be used for critical service delivery, it also has its downsides. For instance, imposing user fees to recover costs can render services inaccessible to the urban poor. Even amongst more affluent parts of the population, user fees require strong sensitisation, given the lack of historical precedence.

The experience shows that in low-income countries, attracting external investment through all kinds of instruments can become risky and costly for both debtors and creditors. The issuance of bonds at local level is especially risky. Long-term debt should only be contracted for the purpose of capital expenditure on property, plant and equipment, and be denominated in local currency and not pegged to foreign exchange. Debt transparency and disclosure must be mandatory. Issuance of guarantees may remain problematic and can generate significant implicit contingent liabilities.

Gerry Muscat, Head of Urban Development Division, European Investment Bank, said at the 29 October 2020 Cities and Experts meeting, “The evolution of stable and predictable transfers has been one of the key ingredients in enabling cities in Europe to have creditworthiness and ability to borrow in their own right. While encouraging this, we should not wait for this trajectory to happen in developing countries but try to find ways to leapfrog and transition and go forward with urban investment, using other resources and guarantee

instruments. It is especially relevant in times of the COVID crisis when municipal budgets are constrained, and grants and capital expenditure support from central government are under pressure, too. IFIs can add value by trying to mitigate risk both by blending grant financing into projects, and by using catalytic capital as grants to provide a first layer in a fund that supports private investment in the urban sector. IFIs can also play a role by providing technical support. EIB focuses on the project level financing and linking support to creditworthiness in relation to investment. Through facilities such as ASCI and the Gap Fund, the improvement of credit quality at local level can be supported. Yet, there is a long way to go. Where possible, IFIs should focus on where the cash flow of projects is and try to finance at the most local level, whilst making use of national support. In many cases, IFIs will be unable to change the regulatory framework and have to achieve municipal financing within the existing framework.”

3.3.5 Municipal bonds versus loans

Municipal bonds have been promoted by some development partners; however, one needs to be careful about what prerequisites are required for this instrument to work well. Even South African experts in KwaZulu Natal consider municipal bonds premature for the vast majority of municipalities as “there is wide agreement that without an effective regulatory framework, subnational borrowing may lead to fiscal and debt crises and significantly contribute to an unstable macroeconomic environment”.⁹⁹ The bond issuance in Lagos, Nigeria, for example, was likely to be successful given the size and state of development of the city, which is very different from many others on the continent. In January 2020, the State of Lagos issued a US\$ 275 million bond for investment in infrastructure at the clearing price of 12.25 per cent per annum fixed rate in naira, (NGN), the Nigerian currency. This was not the first of its kind; an infrastructure bond of a similar scale maturing in 2024 was issued three years ago. At US\$ 1.2 billion, Lagos state accounted for 10.9 per cent of the country’s total domestic debt stock at NGN 4.04 trillion (US\$ 11.17 billion) as of 30 September 2019, according to a recent report by the Nigerian Bureau of Statistics.

The tenets of the success of a municipal bond may be worth exploring in the next phase of this initiative. So far, evidence from the Dakar case study shows that development partners can play a critical role in de-risking municipal bonds and ensuring the terms are viable both for investors, and for the city. Further, when planning to float a municipal bond,

ensuring that the denominations are low enough to enable citizens to buy in is important for strengthening the social contract.

IFIs, for example the European Investment Bank, also warn that a loan, as opposed to a bond issue, is generally much more flexible in case of non-performance, when it can be renegotiated and restructured; a bond, on the other hand, can tie up municipal revenue for years, or in the worst case, be defaulted with little possibility for the municipality to negotiate a new debt repayment schedule. Concessionary and commercial loans are therefore likely to be a better fit for many circumstances than municipal bonds, especially in less mature markets. The loans can be adapted to meet the needs of cities and have fewer transaction costs. However, local governments may also struggle to borrow from commercial banks for several reasons. Financial safeguards (increased capital requirements, increased liquidity) in response to the financial crisis of 2007-09 put in place by Basel III^{iv} forces commercial banks to charge higher margins and shorten loan maturities. There is also a lack of competition among and regulation of financial service providers who do not offer competitive interest rates, although some countries have successfully introduced requirements for loan financing to be tendered, which can increase the competitiveness for loan pricing but may also limit flexibility. Poor credit ratings of local governments make interest payments unsustainable, whether they be for bond coupons or loan repayments. We did not find enough examples in the current scope of our case studies and may need to look at this issue in the next phase.

Starting with the more favourable, smaller, flexible terms of concessionary loans and building up to commercial loans with larger, fixed and longer-term costs can be a useful model for local governments to smooth cash flow and demonstrate creditworthiness for additional financing. Only once cities have achieved a certain level of development and built financial management capacity through smaller loans, should they look to take on a municipal bond. Bond markets can also be accessed on a wholesale basis by municipal credit institutions such as municipal banks, which have more experience with financial market instruments and can potentially issue debt against pooled risk and pass on resultant pricing to municipalities; indeed, this is how most municipal banks function in Europe.

iv Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks. <https://www.bis.org/bcbs/basel3.htm>

3.3.6 Public-private partnerships

Public-private partnerships (PPPs) are seen by many cities as the answer to a multitude of infrastructure needs, but all types of partnerships with the private sector – from relatively straightforward ones such as full divestiture and concessions, to really complex ones such as joint ventures – require transparent and well-enforced regulations and accountable institutions at all levels of governance.

The EIB notes that we often talk of PPP, but PPP is about “partnership”. The “private” sector operating in a regulated framework is sometimes simpler, where there is no specific PPP contract, but rather a robust regulatory framework in which the sector operates urban services or infrastructure. Affordable housing can work in this way, purely privately, rather than through a PPP. Similarly, there are some types of PPP that are simpler than the others (e.g., DBO vs DBFO^v) and can yield efficiency benefits. In many countries, authorities still lack the capacity required to plan, coordinate and manage such projects, and are at a strong disadvantage in negotiating with private service providers equipped with experienced legal, financial and technical advisors. This often may lead to skewed or unbalanced contracts, chronic cost overruns, and often the need for national-level bail outs. The Bank concludes that cities are also often not well equipped to ascertain whether a PPP would bring efficiency gains over other types of procurement over the life of an investment.

PPPs for urban infrastructure suffer from all problems listed above and more. For instance, in Nigeria, access to finance constitutes one of the most challenging problems of housing delivery. “Numerous private developers in the programme lack the required financial capacity to deliver their projects. Insufficient funds and structural weakness in the country’s financial market constitute major causes of delay in completion of the housing projects”¹⁰⁰.



As per Kisumu’s 2018-2020 County Integrated Development Plan II, PPPs are expected to yield around US\$ 75 million to finance the County’s ambitious development. While this may seem like a relatively small amount, it is equivalent to around 75 per cent of the Kenyan

v Design Build Operate (DBO) contract is a project delivery model in which a single contractor is appointed to design and build a project and then to operate it for a period of time; Design Build Finance and Operate (DBFO) contract in which the contractor also finances the project and leases it to the client for an agreed period (perhaps 30 years) after which the development reverts to the client.

County Government's (KCG) annual budget. It is also a considerable amount given that the KCG has historically not managed to share the financial burden of infrastructure provision via PPPs. There have been several PPPs in Kisumu, but these did not feature the KCG as the contracting authority. The Kisumu Sea Port completed in 2019 and worth US\$ 80 million was managed via the Kenya Ports Authority. The Magwagwa Multipurpose Dam Development that amounted to US\$ 835.6 million, is managed by the Lake Basin Development Authority. The Transmission Grid Expansion programme worth US\$ 434 million is, similarly, managed by the Kenya Electricity Transmission Co. Ltd.



The challenge of creating PPPs according to the KCG is that the PPP process is overly complex. However, the challenge of putting in place PPPs cannot be addressed by further easing PPP regulations alone. While there is certainly room for improvement in PPP regulation, the key bottleneck is arguably elsewhere. Lack of county level PPPs needs to be tackled by addressing the inability of county governments to create conducive investment environments, adhere to existing PFM regulations, and increase OSR. By developing these foundations of municipal finance, the KCG is likely to create a more appealing environment for investment and build up internal capacity to prepare bankable projects and PPPs more quickly.



In Uganda, the PPP Act was passed in 2015, opening new opportunities to leverage private sector investment. However, lack of experience on the part of contracting authorities, weak cooperation between government institutions and little knowledge of best practices continue to restrict implementation. Currently, no projects in Uganda have gone through the process outlined in the Act but were rather negotiated and concluded under prior guidelines and frameworks. To remedy this, the national government has set up a specific PPP unit, which helps build capacity, particularly in structuring partnerships and contracts.

However, sound project development is still a preliminary issue that needs to be overcome before PPP mechanisms can be explored. PPPs require a strong authorising environment with the ability to coordinate, and research shows that they are typically only feasible for large-value projects over US\$ 50 million given the high transaction costs incurred in structuring the deal. Similar to other investment structures, they also require capacity to build bankable projects, and also face issues surrounding the affordability of user fees and resistance from the community to pay these.

PPPs are not a panacea and require very strong governance to deliver better results than traditional procurement processes. It is important to reiterate that the stage of development in the city is crucial in determining which of these options are viable. For the most part, there needs to be a focus on getting the fundamentals right and building capacity before moving on to innovative external investment tools such as municipal bonds or various forms of PPPs.

3.3.7 Pooled financing and financial intermediaries

Financial intermediaries play an important role in coordinating investments, facilitating and managing relationships, and building the financial capacity of developing cities over time. They can be as important as the investments themselves by helping avoid duplication, poorly planned or uncoordinated infrastructure, and reducing the information gap between investors and cities. Many countries have local development funds, housed with national governments, to coordinate investments from multiple donors and central government, and are usually presented to cities as grants.

As discussed in previous paragraphs, efficient lending through municipal investment banks needs a stable revenue base. The stability of the local revenue base should be a part of large decentralisation measures, with OSR being a dominant source of revenues. The cost of delegated responsibilities should be covered by the revenue base with a margin, and this margin, called the "operating surplus", is really the long-term sustainable repayment source of municipal loans.

An important issue in creating a municipal investment bank or any other pooled credit facility is to ensure strong corporate governance and risk allocation. With time, when municipal lending becomes a well-established business, commercial banks will enter this segment and will compete with the specialised institution. It is therefore important to

UCLG's Africa Territorial Agency

Following the request of members, the General Secretariat of UCLG Africa has proposed the creation of the Africa Territorial Agency (ATA), a financial institution dedicated to the financing of infrastructure and equipment of African cities and territories. The creation of the ATA will be done in two stages: (1) the establishment of a cooperative institution of the founding members of the ATA, bringing together the first 100 cities and territories that each subscribed EUR100,000 in order to release the 50.1 per cent that the cooperative institution brings to the capital of ATA; the remaining 49.9 per cent is to be sought from financial institutions in the region, among which the African Development Bank is expected to be the reference investor with a contribution of 33.3 per cent in the capital of ATA. The cooperative institution will ensure the political governance of ATA, and thus, serve as the ATA's supervisory board; (2) the establishment of a financial institution, which will be responsible for the technical management of ATA, and the management of which will be provided by a fund manager chosen after an international call for applications. The financial institution will be responsible for raising funds by issuing bonds on the financial market on the one hand, and on the other, for making loans to cities, and local and subnational governments according to commonly accepted rules.

The ATA's interest lies in the pooling the requests of the cities and local and subnational governments of Africa, and to allow each one of them to individually access the financial market at preferential interest rates. None of them, with rare exceptions, can reach levels of bond issues likely to be of interest to the financial market. The other expected advantage is that the main shareholder of the ATA is the cooperative institution made up exclusively of cities and territories in Africa, which appoints the supervisory board of the ATA and consequently ensures that the decisions made by the financial institutions are always in the interest of cities, and local and subnational governments in Africa.¹⁰¹

enable such institutions to remain financially sustainable in a competitive market. This would mean ensuring it reaches certain size, so that it can develop other profitable business segments, or be sold to private investors and become a segment in private banks' lending portfolio. These financial sustainability requirements should be taken into account when designing such institutions.



In Somaliland, the Ministry of Planning acts as a coordination mechanism for international development partner support. It is the first point of contact as well as the coordinator for development partners. A necessary delivery vehicle upon which this coordination takes place is the **Somaliland Development Fund**, which was established in 2012. This single fund ensures two important outcomes: first, that external development partners support the country's development goals, and second, critically, that all delivered development partner projects are aligned with Somaliland's National Development Plan.



In Senegal, the central government invests in cities through the National Local Development Programme and the Municipal Development Agency (ADM). Both are under the *Ministère des Collectivités territoriales, du Développement et de l'Aménagement des Territoires*, and were put in place to help smaller communes. Their aim is to assist the communes pull together their resources, identify objectives and goals, target their spending, and also get support on legal issues to ensure they are complying with the law. The ADM is a vehicle for the national government to coordinate and raise funds from various donors and allocate them to specific communes. The national government manages the investment process on their behalf, saving communes from having to negotiate with private partners, especially those that do not have the power and internal structures to go to international markets. However, it does take away their autonomy, as the national government makes the decisions and projects are simply "placed" in the commune. To rectify this, the communes could be involved in these projects to reflect local priorities, build technical capacity as well as to create capacity for maintenance and project management.



Initiatives like the **Development Fund for Local Authorities** (DFLA) in Malawi take

this a step further, expanding on the coordinative role played by local development funds by providing the funds collected from donors and central government to city governments as low-cost loans with favourable terms. They also offer capacity building on project design and financial management, with a strong incentive structure in place so that cities cannot borrow again until they have paid off previous loans and improved their practices. In this way, the structure aims to support cities to incrementally build creditworthiness in preparation for more substantial commercial borrowing. The DFLA is a revolving fund with seed capital initially provided by the World Bank in 1992. It provides both short-term commercial loans, as well as longer-term infrastructure loans. Since its inception, it has had a steady recovery rate. This recovery is likely because repayment terms are favourable, with a repayment period of up to 10 years and a 14.5% interest rate – the same as the Reserve Bank of Malawi. In contrast, commercial bank rates are around 26%. In 2017, the fund was transferred from management by World Bank consultants to management by a local CEO and team, which has reignited interest in it as a viable “lender of first resort” for local authorities. It is now actively looking to recapitalise, as there have been no injection of funds since its inception. This larger capital base would allow them to assist with larger infrastructure projects in addition to the small operational needs it currently serves.

The **Town Development Fund** (TDF) is a similar autonomous financing institution established by the Government of Nepal (GoN) in 1989. TDF is the only financial autonomous intermediary institution in the country presently providing debt financing to local governments. Several donor agencies, including the German development cooperation (GIZ) and development financing institutions (KfW), the Asian Development Bank, and the World Bank have worked with TDF since its inception. Local governments in Nepal, especially municipalities and fast-growing emerging towns, are its main clients. The GoN, especially the Ministry of Finance and the National Planning Commission view it as a key institution that has an important role to play in the urban infrastructure development of the country. The TDF

finances long-term urban infrastructure development projects through its loan and grant funding¹⁰². Maniram Singh Mahat, the TDF Director during a webinar on 29 October 2020 highlighted that since its establishment, the TDF has financed over 13,000 projects and was key to increasing access to piped clean water from only 30 per cent to 90 per cent of Nepalese people in 20 years.

Local finance institutions also play an important role in developing countries by possessing a good understanding of municipal frameworks. They can thus take local currency risks better than cities when these borrow in the market. IFIs can support them by providing long-term funding and helping them improve their credit procedures and showing them how to distinguish between corporate risk and municipal risk. A good example of this is the *Fonds d'Équipement communal* in Morocco, which lends to municipalities and regions but also channels central-local transfers and has a strong credit mechanism.

Municipal investment banks are a useful tool to build access to local credit. They have three key roles: channelling and coordinating finance, reducing investment information gaps, and building subnational capacity. With specific focus on urban investment, they can manage both national, international and development finance at a local level in a way that would otherwise be too onerous if managed individually.¹⁰³ These entities are shown to mitigate coordination problems and inaccurate targeting of needs.¹⁰⁴ They can potentially align better with national urbanisation plans as well.

With highly centralised systems of credit and finance, the costs for monitoring are large and thus inefficient for anything except large loans. As municipal development banks have closer relationships with municipalities, they can work together to close information gaps, which would otherwise result in priced risk. Finally, access to finance for city governments is limited. Only a small percentage of the 500 largest cities in developing countries can be deemed creditworthy. This is about four per cent in international financial markets and 20 per cent in local markets.¹⁰⁵

Where borrowing is available, there is a role for municipal investment banks to ensure municipalities stay within the limits of debt and borrowing set out in borrowing frameworks.¹⁰⁶ Where it is not available, the bank can move beyond financing, helping cities with capital planning, financing structuring and project evaluation. Their dual role in leveraging and coordinating existing financial flows for

investment today, as well as preparing municipalities for investment tomorrow, highlights their importance in enabling access to finance.

Successful municipal credit markets: The Tamil Nadu Urban Development Fund (TNUDF)

The TNUDF is a global leader in designing systems to attract new financing sources. It is a PPP in the urban sector between the Tamil Nadu government and three private infrastructure, financial and housing corporations. The TNUDF's mandate is to provide project services and capital expenditure financing for urban infrastructure services, such as water, sanitation, solid waste management, roads, and transportation.¹⁰⁷

Most recently, the fund issued a 15-year bond equivalent to US\$ 300 million, which sold on the domestic market to finance a ring road in Madurai. New security mechanisms to de-risk investment for investors included a) earmarking toll revenues in a separate third party (escrow) account, b) establishing an independent corporate trustee and c) certifying a backup guarantee from regional government to cover any revenue shortfall.¹⁰⁸

As Tamil Nadu is a state of India, the fund also encourages the pooling of financing from smaller government units, its municipalities. In the past, 12 municipalities designed water and sanitation projects, each underpinned with tariffs for payback. The resultant pooled bond could be backed by the reserve fund, a central government back up intended to replenish any tariff shortfall. Furthermore, there is also an external guarantee covering 50 per cent of principal repayments. This interaction outlines the urban benefit from municipal, state and central government coordination.¹⁰⁹



The streets of Madurai, Tamil Nadu, India © Shutterstock

4. Recommended focal areas for governments, development partners and IFIs

Why is there so much knowledge about financing urban development in developing countries, but insufficient progress on the ground? In current discourses worldwide, emphasis is often laid on resolving all issues with urban development either by decentralisation, or by access to external – especially, private sector – funding rather than improved coordination across levels, sectors, actors, and territories. Yet, examples show that sometimes cities develop stronger capacity to manage finance in less decentralised settings, and that a functioning multi-level system of finance is needed in the countries before they can benefit from accessing external opportunities. In debates around financing sustainable urban development, the role of OSR is sometimes exaggerated and calls are made for unconditional intergovernmental transfers and unrestricted subnational borrowing as the answers to many of the problems in financing urban development, rather than seeking vertical and horizontal integration of these financial mechanisms.

Professor Sir Paul Collier suggests that we are intervening in circumstances of radical uncertainty. Hence, it is crucial to promote the building of a common purpose of improving sustainable urban development, and engage in local, smaller scale experiments in different contexts to determine what works and to try and scale up solutions that yield results.

The proposed focal areas derive from the chapters above. They are grouped in areas of broader policy and improved governance, and technical solutions of improving instruments of financing sustainable urban development. We look at the conclusions from the current phase of the initiative where sufficient information is available and point out issues that need more work to be better defined in the next phase of the initiative.

4.1 Improving policy and governance

4.1.1 Anchor urbanisation in national development policies

Urbanisation must be included in national development planning if it is to be properly integrated and harmonised

with national priorities and used to achieve top-tier goals. Measures to address the challenges and harness the opportunities of rapid urbanisation should be clearly articulated in national-level policies and investment projects. This requires recognising the importance of urbanisation in meeting national and subnational objectives and the critical role that national level policy plays in managing it. It is especially important given that national governments are often the key interlocutor with development partners and IFIs that are willing and able to finance urban investment. Countries that have been successful in attracting urban investment and finance tend to have urban development well positioned within their national policies and priorities.

This initiative has also revealed several knowledge gaps that deserve further exploration. While it is clear that there is a need to better anchor urban policy in national development programmes, it is also important to investigate the trade-offs between rural and urban foci, regional versus urban planning, and how urban policy can promote structural transformation and productivity enhancement. How harmonisation of urban objectives with industrial development can be achieved needs to be better understood, as industrial parks and free economic zones significantly influence both urban development and OSR. We need a more explicit and clearer framework to analyse these important questions: **How does the structure of particular economy determine its enablers, constraints, outcomes, and shapes at the city scale? How is urban finance linked to structural change, and how are the linkages between the structure and the performance of the national economy, on the one hand, and the local level where economic development actually happens for communities, on the other hand?**

In the next phase, we also need to explore how urban development policies can address high intra-country variation of GDP and levels of development. In Uganda, for instance, Wakiso, an area that is part of the Greater Kampala Metropolitan Area, has a GDP of US\$ 3,250 per capita, while some rural towns have a GDP of just US\$ 60 per capita. We need to go beyond perpetual redistribution by intergovernmental transfers and think strategically about urban economic development in the national framework. For example, the potential of enhancing

manufacturing (and processing/refinement) may be more suited for smaller cities rather than large ones, depending on the context and conditions. Perhaps more secondary, intermediate cities and more countries need to be looked at in the next phase. It would also be useful to differentiate between large and medium/small cities as the economic development opportunities may be different.

4.1.2 Use investment programmes as an opportunity to foster governance frameworks

All partners should invest in fundamental governance frameworks when addressing urgent issues. Integrated policies, functioning institutions and effective coordination are still lacking, especially in Sub-Saharan Africa. The question is whether this condition should deter governments and development partners from investing in urgently needed urban infrastructure until the frameworks are significantly improved. Given the short window of opportunity to invest in infrastructure before mass population growth and settlement occurs, it is tempting to “leapfrog” missing prerequisites and focus on investment programmes. Some donors employ what they refer to as a “non-invasive” approach: the development of infrastructure without addressing policies and institutions. However, these approaches do not have to be mutually exclusive and need neither withhold investment in urban development before capable institutions are in place, nor build urban infrastructure regardless of institutions and policies. **Development partners should use investment programmes as vehicles to foster improved governance frameworks and commit dedicated effort to institutional development, targeting a more complete system of financing. In doing so, care should be taken to ensure that investment is not be done in a way which entrenches inappropriate structures or perpetuates inadequate practices.** Investment should also be used to build and join up capacity in the institutions that require development of human capital and skills. This issue merits dedicated effort and more evidence is needed to understand how these linkages work in different contexts.

The urgency of investment in urban infrastructure and services calls for quick wins to secure the support of politicians and citizens, but such investment must also be well planned to be transformative. Focusing only on revenue-generating, “bankable” projects, may lead to ignoring the need for public or social goods where direct monetary returns may be small or none, but the overall public benefit is important. Where development partners become involved in project design,

they may wish to promote transformative projects that are financeable, such as green or pro-poor agendas that may not in fact be bankable in that context. Investment decisions must also be based on sound, but not necessarily exhaustive, cost/benefit analysis and be supported by adequate regulations. A “no-regrets” approach may be required to shape such investment, targeting the resilience of cities to various risks, and implemented without much delay. It would be useful to explore how donor and private financing, especially for climate and environmental infrastructure, could help drive improved governance, and enhance urban productivity and resilience. Cities and governments that are better able to absorb climate finance will prosper. For example, the EIB is now investing in affordable housing funds in Africa and Latin America but the Bank is likely to do this only if investment programmes apply the EDGE^{vi} standard, green bond principles and other criteria set out in the EU Sustainable Finance Taxonomy^{vii}.

Many additional questions remain to be answered: for instance, what kind of investment in infrastructure and services should governments, developing partners and IFIs be focusing on to optimise benefits to society, and can stimulate and enhance local revenue generation? How can scalability be ensured, not just investing in barebone infrastructure but in the one that has transformative potential?

4.1.3 Coordinate across levels, sectors, actors, and territories

Parallel to addressing urgent investment needs in urban infrastructure, to achieve progress in financing sustainable urban development, and to increase effectiveness and efficiency, one should look for coherence of policies and mechanisms before attempting to redistribute responsibilities across different levels within the governance system. The pace of urbanisation is fast, the priorities are many, the resources very limited, the inertia heavy, and the concepts plenty. It is therefore imperative to look for synergies – harmonizing economic, social, environmental and spatial development goals in multi-level and multi-actor governance systems across various territorial scales – which can

vi EDGE is a green building certification system for emerging markets created by IFC, with free software to verify the resource efficiency of building designs. (<https://edgebuildings.com/>, last accessed on 12 April 2021)

vii The EU Sustainable Finance Taxonomy is a classification tool aimed at investors, companies and financial institutions to define environmental performance of economic activities across a wide range of industries and sets requirements corporate activities must meet to be considered sustainable. (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en, last accessed on 12 April 2021)

only be achieved by coordination and collaboration. In this context, urban planning, well-suited as it is to widespread informality, is key and must be promoted well in advance of expansion of cities to make sure investment is guided by coherent plans. Long-term urban spatial and physical planning, and financing of urban investments must be linked by a strategic approach to urban development that determines priorities and phasing and embeds investment needs in the budgeting cycles of ministries and municipalities.

Fiscal decentralisation is not always a solution to all problems. The answer to a lack of investment in urban areas and subnational governments should not always be increased fiscal decentralisation. Indeed, the empirical record on its efficacy is mixed, and success often depends on the specific context and the way in which decentralisation is implemented. When serving development goals, bringing governance and financing mechanisms closer to the people has significant advantages in terms of increasing transparency, accountability, and responsiveness of public expenditure. Yet, if ill-conceived, it may also lead to duplication of government structures, loss of economies of scale, and local elite alone capturing the benefits of urbanisation. Even if tax rates and tax raising remain nationally administered, some of the revenues that are generated from activities within a city can be devolved to the city authority to spend. This provides the most important rationale for fiscal decentralisation: that it gives the local government an incentive to grow the local economy by listening to the city's businesses, while avoiding the problems of tax competition and administrative duplication. The key obstacle for a functioning system of urban finance is the lack of clear roles and responsibilities across levels of government, actors, and territorial scales. Well-understood subsidiarity is not about delegating everything to the local level, but about ensuring that action, to be effective, is taken at the most appropriate level of government. Fiscal decentralisation is politically highly sensitive; if one waits for it to happen, one may be waiting a very long time. It is sometimes associated with fundamental shifts in society, for example, the fall of the Iron Curtain in Europe. Achieving change within the existing fiscal framework can still be effective, is much faster, and more likely politically acceptable to national government.

Besides fiscal decentralisation and devolution of mandates, other forms of decentralisation can be important. For example, greater involvement of local governments in decision making on local priorities for investment can lead to more efficient investment by building what people want and

need, not what decision makers in the capital think they want and need. Tunisia is an example of the central government still largely controlling budgets and expenditure but enabling greater local decision-making over investment priorities.

Furthermore, although fiscal decentralisation should not be a pre-requisite for shoring up urban investment, in countries that are embarking on it, this should be robustly supported by IFIs and other development partners. An example of this is Morocco where IFIs are working with decentralised administrations (municipalities, regions, municipal service enterprises and intermediary banks) to provide financing and technical assistance that can help build on the emerging fiscal freedom.

While better collaboration among different levels of government and diverse national and international stakeholders is needed to enhance access to finance for cities, it is unclear what the specific levers are to ensure such improved collaboration. In the next phase, we need to better understand the extent to which national policy levers and intergovernmental transfers can be used to set the right incentives, aligning interests across different spheres of government, without jeopardizing their autonomy.

4.2 Focus on finance

4.2.1 Use existing potential for increasing revenue before looking for new sources

Optimisation of OSR and all locally generated revenues must include technical, management, and sometimes political reform. OSR systems are often overly complex, not fit for purpose and struggling with lacking or outdated data and information, widespread pilferage, and poor compliance. Using systematic methods to devote scarce collection resources to the most lucrative taxes and employing tools such as integrated systems and digital technologies appears to be promising in remedying these issues, but to be effective, such methods need to be embedded within broader management reform. As the Kisumu case shows, the most promising technical reforms can yield very insignificant results if there is no change in the political will and associated incentives around collection and compliance.

Increasing compliance of high-net worth individuals is often one of the more effective means of enhancing OSR even if it is politically unattainable in many countries. **OSR benefits**

can be increased by introducing participatory and accountable processes that clearly showcase the usage of OSR in public expenditure to incentivise compliance.

Land-based finance tends to be particularly under-utilised at the local level and often deserves heightened attention to update land values (valuation rolls), improve collection mechanisms, and enhance compliance by removing legal ambiguity or inability to sanction non-compliance. The economic rationale for widespread exemptions also needs to be revisited. Sometimes innovative tools for increasing property tax can conflict with national rules or policies, as the case study of Mzuzu has shown, underlining the importance of confirming these tools in terms of legal validity or conformity with national policies.

There is a need to develop a method to support local governments in determining binding constraints and more effectively prioritising reform initiatives. National governments and development partners can play a role in incentivising local governments to fully leverage their existing tax authority by making transfers conditional on OSR performance variables and/or increasing the transparency with data and reporting requirements. However, care must be taken to ensure these mechanisms are not used as a way for national governments to stall or withhold payments or development partners to push their internal priorities. Therefore, the incentives must be captured in clear and objective formulas and rules.

Local governments should also enhance expenditure efficiency before accessing private finance. This can be measured via a) actual capital expenditure as a percentage of total budgets, b) actual government salaries as a percentage of total budget, c) compliance with PFM regulations in audit reports. Expenditure efficiency is a useful indicator of creditworthiness and generally provides a measure of how accountable the local government is and whether it effectively uses additional resources that it is provided with. **It is not a function of existing budgets and thus it does not need to be repaired by providing additional external resources. Local governments should be open to public scrutiny, external evaluation, and audits of the use of their resources in return for better access to external financing, with an awareness that as they do so, they expose themselves to the consequences of any malpractice.**

In the next phase, we suggest the following focus areas: (1) Enhancing local revenue optimisation through reducing tax complexity and concentrating collection on the most lucra-

tive taxes, (2) focusing on incentives for reform; (3) using local revenues for operations and maintenance (**even where central government controls development partners' financial support, there needs to be awareness and planning for the fact that the related infrastructure is to be operated and maintained using local revenues**); (4) capturing land value increases to the benefit of the public interest; and (5) using private sector capacities to complement those of public authorities while keeping the public interest uppermost on their minds (for example, a 30-year concession to provide infrastructure may look good at the outset but can become extremely challenging to get out of).

We need to explore how the conditions attached to development partners' support can be **conducive to progress in national policies and frameworks, with special regard to cost recovery and tariff reform.** Technical assistance can be linked to loans and encourage policy and reforms; guarantees can offset the risk of lending to local levels. **Pricing incentives can be considered (reducing the interest or extending maturity) to demonstrate commitment to regulatory reform and enhancing the capacity of the local level.** For example, one idea that can be explored is using financing to generate a revolving fund that would take in locally generated revenues not used for servicing the loan, providing more capacity for future investments. The initiative found examples of improved land and property taxes in Kampala and Mzuzu, but mechanisms to specifically capture increasing land value were not found except in Somaliland, which is a special case. There is thus a need to further explore how the value of urbanised land is created by cities and how this can be captured for public benefit, including the potential for various forms of land readjustment.

4.2.2 Understanding the effective sequencing and the priorities of financial interventions

This working paper as well as existing literature together suggest a wealth of potential interventions to enhance the financial position of cities. While all of these interventions in their own right may help to optimise city finances, it is not clear which ones are most applicable in which contexts and where decision makers should start. In what circumstances do municipal finance foundations, i.e., OSR capacity, effective budgeting, and expenditure, need to be in place before other financial options are explored? To what extent do different interventions to enhance access to finance support each other and where is sequencing/prioritisation of interventions needed?

Carrying out all interventions simultaneously is not feasible and likely to spread resources thin across interventions as opposed to focusing on key binding constraints.

Yet, the need to come up with a means for sequencing or prioritising interventions around key constraints is compounded by the fact that the **different interventions are not always complementary but may actually undermine each other.** For example, facilitating access to additional national grants, development assistance or private capital without clear conditions may undermine the willingness of a local government to pursue OSR optimisation. Besides, there are no clear conditions in place for local governments to unlock fairer, more predictable transfers or donor funding. Most transfer formulas around the world are not dependent on PFM or OSR performance. In instances where OSR optimisation is particularly necessary to achieve creditworthiness and strengthen basic accountability mechanisms at the local level, the lack of conditions may undermine the ability of the local government to effectively enhance its financial position in the medium- to long-term.

Simultaneously, **working on OSR optimisation in the context of insufficient tax authority may also not be the most critical lever to work on to improve a city's financial position.** Even at an extremely case-specific level, **determining which cities should realistically work towards the development of their own bonds or PPPs is critical** in ensuring the effective usage of reform resources. It is therefore important to understand better how to manage the trade-offs that exist between various municipal finance interventions and to explore the conditions under which different types of financial interventions are most suitable. Developing a simple typology of situations can be a good start towards gaining better knowledge of these issues. Further, it could be particularly worthwhile to explore how donor and private financing for climate and environmental infrastructure could help drive improved governance and OSR optimisation as well as advance urban productivity and resilience.

4.2.3 Improve delivery of better financing at city level

More research is needed to better understand how improved municipal finance can be achieved in both centralised and decentralised systems, and under what conditions deepening fiscal decentralisation is a useful approach, and where it may actually be counterproductive. Almost universally, actors complain about the lack of financial management capacity at the city level. Yet, does all capacity have to be

held by the local government? **We need to look at methods of aggregating capacity of fiscal management dispersed across levels and sectors.** How do we address the paradox that in some less decentralised countries (e.g., Senegal) larger cities have more capacity to deal with finance than in constitutionally decentralised ones (e.g., Kenya)? Or to put it another way: how can the efficiency of urban financing be improved within a centralised governance framework?

In line with the focus on decentralisation, borrowing at sub-national level without sovereign guarantee is often seen as the next “big” solution to overcome the infrastructure gap. However, tapping into domestic and international financial markets by subnational governments needs highly developed legal and institutional frameworks, a reliable system of intergovernmental transfers and significant capacity. One also needs to be aware that lending to the sovereign level and on-granting to the local level could damage efforts of local finance reform towards cost recovery, and thus, such efforts must be tailored to circumstances.

Instead of each and every urban municipality, big or small, striving to develop borrowing capacities of their own financial intermediaries can play an important role. **Efficient lending can be implemented through municipal investment banks.** Very often, a well-managed national development bank can be a very good municipal investment bank, so the **presence of a strong national development bank could mean that a government should consider developing a municipal finance function there.**

Development partners do not show much interest in inter-governmental transfers as the issue is politically sensitive and takes long time horizons to adjust. **There is a need to focus more extensively on the design elements of these transfers, ensuring transparency of allocation and commensuration to decentralised mandates.** As highlighted above, **the transfers should also be used as a lever to hold cities accountable for good financial management.** The former requires a concerted effort to develop systems that encourage predictability in size and timing of payments so that cities can rely on the funds to plan and commit to longer-term investments. The latter requires this system to be predicated on certain performance indicators such as efficiency and effectiveness in expenditure, progress in OSR generation, and overall adherence to PFM standards. More analysis on this issue is needed, as well as examples of how this has helped improve municipal finance without necessarily devolving more revenue sources.

One may wonder why Lagos has been successful with sub-national bond issues and whether its experience can be replicated across the continent and if yes, how? In the USA, successful fund raising for urban development was first widely implemented through city bonds. Europe's trajectory started with a reliance on sovereign borrowing (loans, bonds), first for the central government's own purposes, then for on-lending to local authorities, which in turn took to contracting loans or issuing bonds directly, and now urban utility companies are following suit (with or without city guarantees). The evolution of stable and predictable transfers has been one of the key ingredients in enabling cities in Europe to become creditworthy and gain the ability to borrow in their own right. **Should development partners and IFIs help this trajectory to happen in developing countries, or should they seek ways to circumvent it and go forward with urban investment?** This needs to be explored in the next phase

of the initiative, including developing tools to promote both approaches depending on the case-specific context. Conditions need to be classified by when cities and countries are travelling down this trajectory; should development partners and IFIs encourage them to do so and if so, how they can be supported; and when there are entrenched (normally political) barriers to this trajectory, should all actors try to find ways to improve urban financing within the existing frameworks?

This working paper has made the case that the comprehensive body of knowledge has not yet been fully translated into achieving sufficient effectiveness of reforms. The suggested key points worth attention and further action, as well as a wide range of means and approaches that development partners, IFIs and national governments may use to advance this agenda are summarised in the policy brief produced through this initiative.



Trading on a city street of Hargeisa, Somaliland © Shutterstock

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Enhancing the financial position of cities: evidence from Kisumu County Government

Author: Lennart Fleck

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Summary

The Kisumu County Government (KCG) provides an interesting case study of the common pitfalls of Municipal Finance reforms. Over the past few years, the KCG undertook reforms, which on paper looked promising. It digitalised its tax collection processes, carried out capacity building initiatives, updated its valuation roll, outsourced property tax arrears collection, and acquired its first credit rating. However, the clear benefits of these seemingly promising initiatives are yet to materialise. Own-source revenue (OSR) per capita, access to credit and private investment in infrastructure have remained low. The KCG's tax base has not changed, the efficiency of its collection and compliance mechanisms leave room for improvement, its property arrears remain high, and its revenue strategy

continues to be focused on regressive/low-potential revenue streams. Yet, it is the very challenges of the KCG in successfully bringing reform to fruition, which offer important lessons on why promising technical Municipal Finance interventions often do not achieve the desired outcomes.

In implementing these reforms, the KCG faced a host of challenges from technical implementation problems, to capacity bottlenecks and budget constraints. One particularly complex challenge appeared to be vested interest in the status-quo of the OSR system of various stakeholders, including landowning elites and tax collection personnel. These interest groups were firmly entrenched, benefiting from tax collection loopholes,

porous public financial management (PFM) processes and weak overall rule of law. Overcoming these interest groups required considerable political capital and political will.

Addressing Municipal Finance issues in Kisumu and other similar contexts thus requires placing greater emphasis on political realities and incentive mechanisms when designing reform initiatives. The more defective a Municipal Finance system appears to be, the greater the rents it allocates in unintended ways and the more resistant to change it may become. Overcoming such flawed but stable equilibria requires more than isolated technical tweaks.

Key messages:

- Building the capacity of local officials and providing technical support may be futile where there is insufficient political capital to sustain reforms.
- There is a need for more transparency in accounting and budgeting systems to reveal and increase the stakes of malpractice.
- The international community as well as national governments need to think more carefully about how their interaction with local governments as well as existing regulation incentivises Municipal Finance reform. This includes:
 - Conditioning larger shares of national transfer on compliance with national financial regulation in contexts of sub-optimal usage of existing OSR authority.
 - Conditioning access to capital markets, donor grants and Public Private Partnerships (PPPs) on compliance and progress in regard to key OSR indicators.

Urbanisation trends, challenges and financial needs

Over the past decade, Kenya has been touted as one of Africa's potential success stories. Significant political and economic reforms have led to steady economic growth of around 5.6 per cent since the global recession in 2008. A relatively stable political and macroeconomic environment and an investor-friendly climate have turned the country into one of the largest recipients of FDI in Africa and supported the emergence of Nairobi as one of Africa's start-up hubs. Kenya has also made progress in regard to key HDIs, including life expectancy, years of schooling, and access to health care.¹ Despite this progress, at a GDP per capita of around US\$2,000, it remains a low-income and largely agrarian country with 73 per cent of the population living in rural areas.² Fully leveraging its potential will require Kenya to address poverty, growing inequality, low private sector productivity and public sector inefficiency, among other things. This will require optimising the devolved system of governance.

Since the new 2010 Constitution, Kenya has been governed by a decentralised system of 47 county governments. At an average population of over a million, these are over six times the average size of other local governments on the continent.³ One of the economically most significant of these units is Kisumu, located in the far west of the country on the banks of Lake Victoria, home to 1.2 million inhabitants and Kenya's third largest city – Kisumu City. Kisumu is also one of the most urbanised Kenyan counties with around 50 per cent of the population living in urban areas. Its favourable

ecological and climatic conditions contribute to the production of cotton, sugarcane, rice, and horticulture. Its lakeside location and international airport also have the potential to make Kisumu a tourism and trading hotspot.

Despite these favourable overall conditions, Kisumu faces several significant challenges on its path to greater socio-economic development. Its economic growth has slowed down over the past few years to around 3.4 per cent, placing it well below the national average of almost 6 per cent.⁴ Rapid population growth and urbanisation have created large informal settlements, which house nearly 40 per cent of the urban population. These informal settlements provide inadequate housing conditions and lack access to basic services, including basic sanitation, waste management, and security. Access to basic services is also an issue in the more rural areas of the county. Only around 58 per cent of the county has access to water and 46 per cent to electricity.⁵ With only 15 per cent paved roads, Kisumu also requires significant investment in

infrastructure to decrease transportation costs of agricultural produce and attract private investment in the county's underutilised rural areas. Investment is also needed in education, vocational training and the creation of job opportunities for its young and rapidly growing workforce (around 40 per cent of the population is between the ages of 15-35). Of this young population, 60 per cent are formally unemployed, surviving on low informal sector jobs that by now employ 60 per cent of the total workforce.⁶

Overcoming these challenges requires significant public and private investments. Yet, up until now, the KCG's revenues are not sufficient to cover its significant developmental needs. With a total budget of US\$72 million in FY18/19, the KCG could spend US\$60 per person, of which less than US\$20 per person was available for developmental expenditures.⁷ To overcome the overall revenue shortfall, the KCG will need to increase its own revenues and build financial management capacity to attract grants/loans and enable private investment.



Kisumu, Kenya © UN-Habitat/Lennart Fleck

Municipal finance and urban governance structure

Urban governance structure and mandate

Following the post-election violence in 2007/8, Kenya embarked on a process of reconciliation, culminating in a unity government and an unambiguous vote for a new constitution on the 4 August, 2010. The new constitution envisioned far-reaching changes and more fair, efficient and accountable governance. An essential part of these changes was the creation of 47 new county governments, which were to replace the fragmented nature of the previous 175 Local Authorities and over 280 district administrations.⁸ The reform thus sought to streamline local service delivery and facilitate the accountability of local government to its citizens with clearly delineated and simplified functional responsibilities. In addition to merging existing subnational structures, it also sought to expand the functional responsibilities of the new county governments and concurrently reform national institutions to align them with the new service delivery framework. The devolution process in Kenya was labelled as one of the most ambitious in the world.⁹ Consequentially, seven years after the official start of the implementation of devolution in March 2013, the promises of that process are yet to fully materialise.

One area of devolution that still requires fine-tuning is the functional mandate of the counties. Kisumu and the other counties have been given responsibilities in 14 general government areas, the main devolved sectors being public health, agriculture and livestock.¹⁰ With the exception of edu-

cation, for which only early childhood development was devolved, Kenya followed international best practices with regard to the intergovernmental division of responsibilities. It assigned policy, standard setting, and public good provision (for example national security) to the national level, while devolving service delivery to the county governments. While there has been a lot of discussion around the areas of functional overlap and previously unassigned functions, the real challenge lies not with the theoretical allocation of roles but with the implementation of responsibilities at the county level. The transition to county governments has been marred by inconsistency, management issues and lack of coordination between the two levels of government. As a result, public health has increasingly become a candidate for recentralisation.¹¹

An unforeseen challenge of the new devolved system is managing the intensity of political competition among elected officials,¹² which can distract counties from carrying out their mandates. KCG, as the other 46 county governments, is run by a County Governor and an Executive Committee or cabinet, nominated by the governor. Governors are elected democratically by simple majority voting at the time of national presidential elections and take the lead in budget and development planning. Although the decisions of the executive are vetted and approved by the local legislative arm, the County Assembly, the executive has priority access to the distribution of county resources, and thus, control over patronage networks.¹³ This position of power is con-

tested by the County Senator, sitting in the Upper House of National Parliament, debating and approving National Bills concerning counties, but equipped with little own source of patronage. Rather than supporting county governments at the national level, the structure has lent itself to competition and in-fighting, undermining governance and detracting efforts from developmental agendas.

A third important dimension of the devolved governance structure, which is yet to be fully fine-tuned, is the management of urban areas. Given the importance of urban agglomerations for economic development, there is concern that in a largely rural country, urban areas will be under-resourced. The 2010 constitution, in a sense, recentralised urban management, from the smaller local authorities to the county governments, which are vested with full control over urban functions and resources. Whilst the constitution does state that “every county government shall decentralise its functions and the provision of its services to the extent that it is efficient and practicable to do so”,¹⁴ for some time, there was no clear process or framework for such delegation. The 2019 Urban Areas and Cities (Amendment) Act partially filled this void by outlining a process for putting in place urban boards appointed by county governments with responsibilities for urban management as delegated by the counties.

Kisumu City was thus created within the KCG under the leadership of the City Manager who is answerable to the City Board, which reports directly to the gov-

error. The City of Kisumu covers 14 of the 35 wards of the county and is provided with partial own revenue authority as well as own funds based on 'objective criteria' (for example, population, poverty, physical area) as defined by the KCG. In a sense, Kisumu City is like a department of the KCG, with the difference that it is managed by a board that must approve budget requests before they go to the County Treasury. While in theory, the creation of this separate entity makes sense for urban management, in many cases, it has led to the fragmentation of administrative processes between the county and the city.

Municipal finance overview

The revenue of the KCG has grown by around 77 per cent since the start of devolution to a total of US\$96 million in FY18/19.¹⁵ While this appears to be a relatively significant increase in revenue, it is almost entirely due to increases in national transfers (See Figure 1). As a

result, Kisumu by FY18/19 was 78 per cent reliant on national transfers. Own-source revenue (OSR) of Kisumu slightly increased in the first year of devolution but has stagnated since. The National Treasury initially estimated that Kisumu and the other counties would be able to cover around 50 per cent of their budgetary needs via OSR.¹⁶ Since this has not been achieved (for reasons outlined in this report), Kisumu has come under increasing budgetary pressure. Consequently, it retains only approximately US\$20 per capita for development expenditure, and is thus struggling to fulfil its ambitious development agenda outlined in its County Integrated Development Plan 2018-2022.

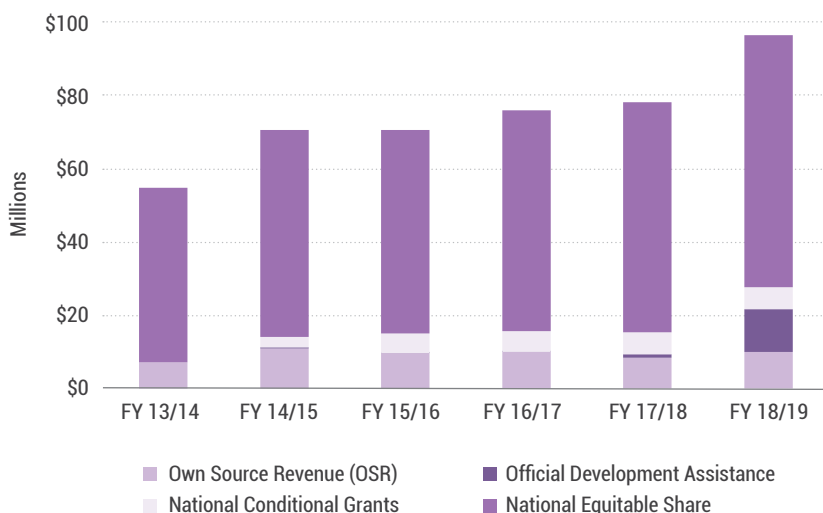
A large portion of what Kisumu receives from **central government transfers** comes from the 'Equitable Fund', which gets filled every year by a minimum of 15 per cent of the national tax revenue. The 'Equitable Fund' then allocates each county government with an 'Equitable Share' based on a formula that

includes population, poverty, land area, fiscal/OSR performance, and development.ⁱⁱ Since national tax revenue has been growing year on year, with healthy GDP growth rates, transfers have too.ⁱⁱⁱ This growth in transfers was also a result of the politics around devolution, which prompted the national government to allocate well above the mandated 15 per cent of national revenue to the counties. From FY14/15 to 19/20, it averaged 20.8 per cent.

While central funding is necessary to meet developmental needs, Kisumu's considerable dependence on governmental transfers can undermine the accountability of local governance and effective, citizen-focused spending.¹⁷ The dependence is also likely to pose a challenge in the near future since the national government is under increasing pressure to implement fiscal austerity. Kenya's debt has more than tripled since 2013, reaching 59.9 per cent of GDP in 2019 and a debt-servicing-to-revenue ratio of 50 per cent.¹⁸ While the exact effects of the recent COVID-19 pandemic are still unclear, it is likely to move the country towards an even more curtailed fiscal space. In fact, The National Treasury has already frozen the county government revenue allocation from the Equitable Fund for 2020/21.

The second, significantly smaller part of the national transfers, constituting 8.2 per cent of total national transfers in FY18/19,¹⁹ is made up of conditional grants. The purpose of these grants is

Figure 1: KCG revenue from 2013-2019ⁱ



ⁱ Budget figures were converted from KSh using the exchange rate from July of each year and drawn from yearly budget documents. Since the CBROP was not available for every year, for some years earlier budget versions are used that may not include all supplementary budget modifications.

ⁱⁱ For more detail on this see Commission on Revenue Allocation (2017) Recommendation On The Basis For Equitable Sharing Of Revenue Between National And County Governments For The Financial Year 2018/2019, Commission on Revenue Allocation

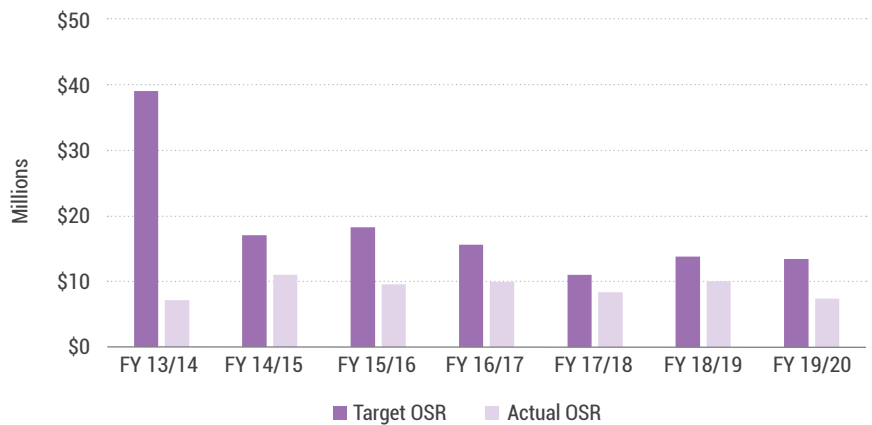
ⁱⁱⁱ National tax revenue as a % of GDP has decreased from 18% in FY 2013/14 to 14% in FY 2018/19. This decrease is more than compensated for by the annual growth in GDP. See Commission on Revenue Allocation (2019) Recommendation On The Basis For Equitable Sharing Of Revenue Between National And County Governments For The Financial Year 2018/2019, Commission on Revenue Allocation

to compensate counties for services that they provide beyond the standard devolved functions. Kisumu receives conditional grants for health-related services, the development of youth polytechnics and the maintenance of national roads.

Own-source revenue (OSR) in Kisumu since devolution has not managed to reach government targets and expectations as most other Kenyan counties have. After collecting a fraction of the targeted amount in the first year of devolution (initially defined by the National Ministry of Finance), the county adjusted its methodology of estimating OSR targets, decreasing the gap between targeted and actual amounts (See Figure 2). Nonetheless, the actual performance has remained stable at a low annual OSR of around US\$10 million, or US\$9 per capita, despite rapid population and economic growth. OSR in FY19/20 actually dropped to US\$7.4 million primarily due to a drop in revenue in Q4 following the onset of the global COVID-19 pandemic (See Figure 3). Irrespective of the latest drop in revenue, estimates of Adam Smith International/World Bank, the Ministry of Finance and UN-Habitat, suggest that the KCG has generally leveraged only 15 per cent of its potential OSR (See Figure 4).

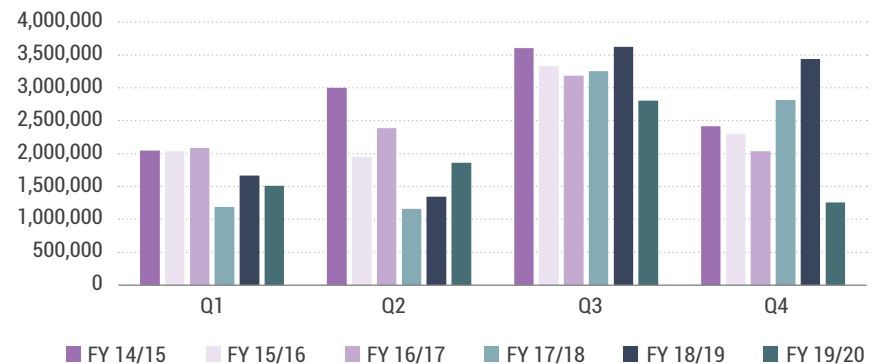
Of its existing revenue streams, the single largest source for the county is user fees from hospitals. These are administered by hospitals directly as well as the local Public Health Department. All other major revenue streams (outlined in Figure 5) fall under the control of the Revenue Department and typically constitute around 60-70 per cent of annual OSR. The most important of these streams and second most important stream overall for the KCG is trade licenses, also referred to as Single Business Permits (SBP).

Figure 2: KCG actual vs target OSR 2013-2020^{iv}



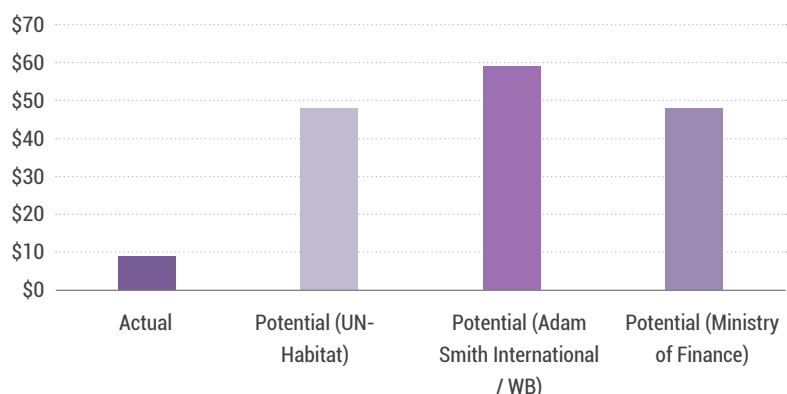
^{iv} Figures are derived from County budgets converted to US\$ based on currency exchange rates of July of each financial year

Figure 3: KCG annual OSR by quarter 2014-2020^v



^v Figures are derived from County budgets converted to US\$ based on currency exchange rates of July of each financial year

Figure 4: KCG actual OSR per capita 2018/19 vs potential OSR per capita estimates²⁰



The third most important source of OSR are land rates (property taxes) at 12.7 per cent of total OSR. This is a relatively low percentage. Property taxes are commonly the most significant revenue stream of local governments, representing 2 per cent of GDP in OECD countries and between 0.3 per cent and 0.7 per cent of GDP in developing countries. In Kisumu, they make up only 0.0004 per cent of the Kisumu County Domestic Product.^{vi} In total, the county has 30 separate revenue categories, of which 18 generate less than 1 per cent of total OSR, subsumed in Figure 5 under "Other Revenues".

A third source of financing in Kisumu that has gained importance over the years is **Official Development Assistance** (ODA). This ODA comes in the form of primarily conditional grants from the World Bank, the Danish International Development Agency (DANIDA), and the EU, that are largely tied to facilitating institutional reform (e.g. devolution, health system reform) or specific projects such as climate-smart agriculture. The most important of these is the Kenya Urban Support Program (KUSP) of the World Bank, providing around \$7 million in FY2018/19 or the equivalent of around 70 per cent of the KCG's total OSR.

In terms of expenditure, total budgeted county expenditure has stagnated somewhat since devolution at around US\$90-100 million or around US\$83 per capita. Figure 6 provides the exact budget figures in US\$. It should be noted that due to a slight depreciation in the Kenyan Shilling (KSh) in the past few years, one would observe slightly stronger revenue growth in KSh terms.

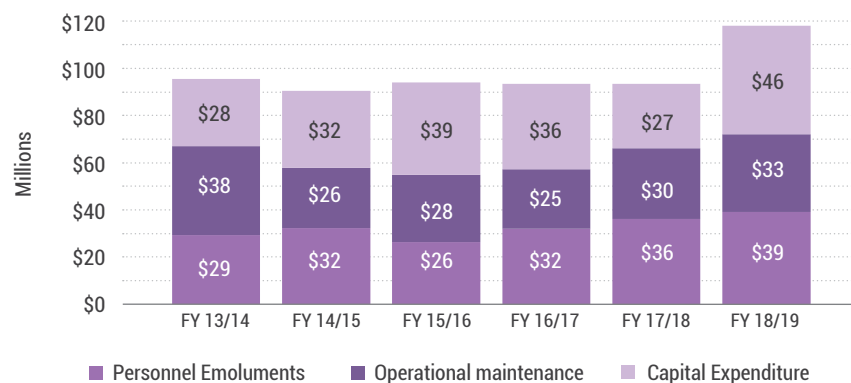
vi Kisumu's share of Kenya's national GDP of US\$78.76 billion (2017) is 2.9%, thus Kisumu has a GCP of US\$2.28 billion with land rate collections of only US\$1 million per year = 0.0004% of GCP

Figure 5: KCG breakdown of OSR in FY18/19 by revenue stream

Revenue Stream	Annual Revenue (US\$)	% of Total Annual Revenue
Health	1,762,350	17.5%
Trade license fees	1,702,144	16.9%
Land Rates (Property Tax)	1,282,888	12.7%
Paybill ^{vii}	1,229,662	12.2%
Bus park	895,504	8.9%
Sign board promotion etc.	779,191	7.7%
Market Fees	600,419	6.0%
Parking Fees	419,252	4.2%
Monthly Stickers	286,882	2.8%
Liquor licence	203,279	2.0%
Rents	172,768	1.7%
Building Plans (Building Permits)	161,995	1.6%
Other Revenues	580,450	5.7%

vii Paybill is a generic account that is used by the Revenue Department for all kinds of revenues that are received without being clearly linked to a specific revenue stream. This has happened due to mistakes with receipting and a failure of the IT system which removed existing receipts making it difficult to accurately account for existing payments.

Figure 6: KCG current vs capital expenditure from 2013 to 2019 (in US\$millions)^{viii}



viii Here we combine Use of Goods and Services, "Current transfers and Grants", "Transfers to other Government Units" and "Security Benefits" under Operations and Maintenance. Where possible these figures were taken from the County Budget Review and Outlook Paper of the respective years. For some years these documents were not accessible so other budgetary documents were taken that may not include all budget revisions. The figures are converted to US\$ amounts using exchange rates from the July of the respective year.

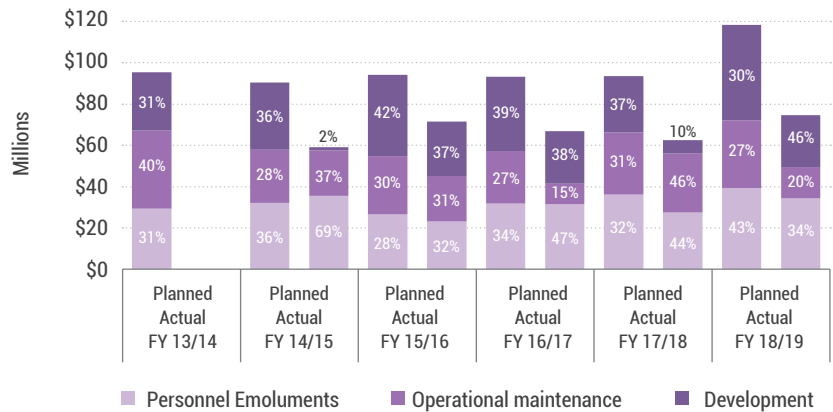
A minimum of 30 per cent of this total expenditure was budgeted year on year for capital or development expenditure, as per the Public Financial Management Act of 2012. Similarly, planned expenditure in Kisumu also did not surpass expected revenues, and allocated less than 35 per cent of the overall budget to personal emoluments.

On the whole, expenditure in Kisumu is not fully in line with prudent Public Financial Management (PFM) principles. Budget execution levels reveal that actual expenditure tends to be below budgeted expenditure, with an average absorption rate (share of actual expenditure out of budgeted expenditure) of 70 per cent. Par-

ticularly challenging in this respect is development expenditure, where there is an average absorption rate of 40 per cent, compared with 76 per cent for operational expenditures and 97 per cent for personal emoluments (see Figure 7). The county government attributes the low absorption rates to overly ambitious budgeting processes, late disbursement of national transfers and lengthy procurement procedures.^{ix} As a consequence, the county spends more than it should on wages/personal emoluments (repeatedly exceeding the 35 per cent wage threshold) while spending too little on development. The Control of Audit reveals that in FY16/17 and FY17/18, allowances made up 66 per cent and 55 per cent of the wage bill respectively – exceeding the cost of the basic salary.²¹ This has also contributed to a high unit cost of labour in Kisumu as well as in other counties, surpassing that of national-level agencies.²²

In terms of spending by department, KCG’s budget reveals that the majority of available resources are allocated towards the health department (see Figure 8). The City of Kisumu, which essentially functions as an additional department of the government tasked with providing services to the county’s urban population, received 10 per cent of the total budget in FY18/19. 15 per cent of the budget also went towards the county legislative and executive branches. Meanwhile, the revenue department, the budget of which is officially a part of the overall finance budget, received around 2 per cent of the overall budget – or US\$2.1 million. Given that it collected around 65 per

Figure 7: KCG budget execution, planned vs actual expenditure from 2013 to 2019*



* Budget figures were converted from KSh using the exchange rate from July of each year and drawn from yearly budget documents. Since the CBROP was not available for every year, for some years earlier budget versions are used that may not include all supplementary budget modifications.

Figure 8: KCG expenditure breakdown by department for FY 2018/19 (in US\$millions)

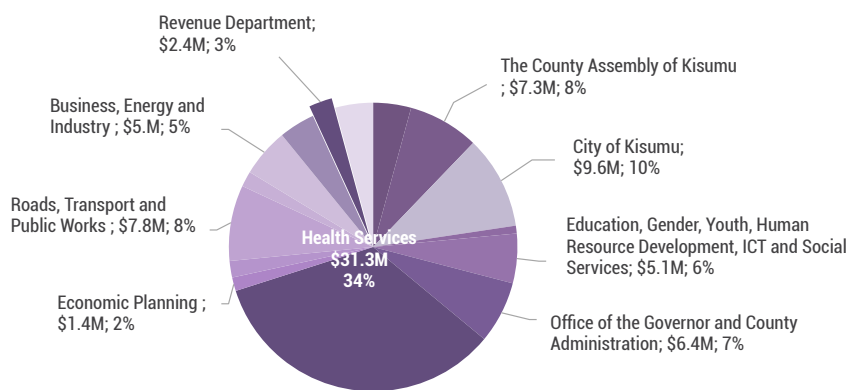
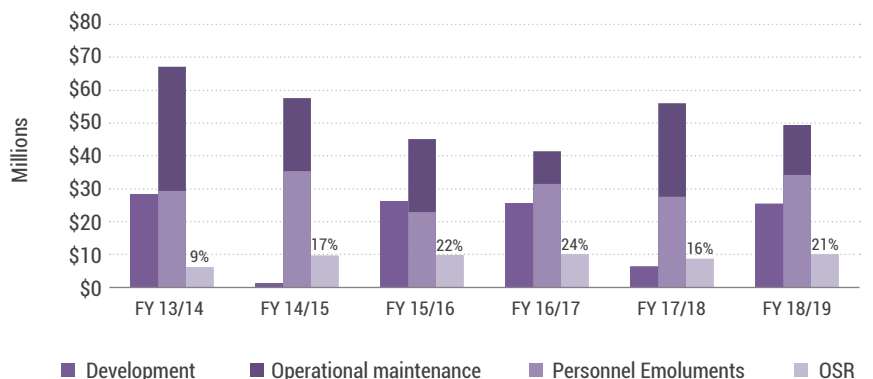


Figure 9: KCG recurrent expenditure comparison with OSR



ix Figures are derived from County budgets converted to US\$ based on currency exchange rates of July of each financial year

cent of total OSR for that year (US\$6.4 million),^{xi} over a third of the revenue generated by the department was spent on collecting that revenue.

The consequence of KCG's spending patterns is an underinvestment in development, as well as a significant reliance on national transfers to cover current expenditure. While OSR could ideally cover all of the KCG's current expenditures,²³ it currently

only covers an average of 15 per cent (Figure 9). This exposes the county to financial risk in the event of a stagnation in future national transfers. Going forward, the KCG will either have to use its available resources more effectively, or significantly increase its OSR, with the latter holding more potential to increase government accountability.

Indeed, when local governments increase reliance on OSR they are commonly forced to strengthen the reciprocal arrangements with their citizens and provide improved services

and/or representation in exchange for tax contributions.²⁴ A study of local budgets in several East African countries found that as the share of local budgets financed from local revenues increased, the share of expenditures on service delivery did as well.²⁵ In contrast, greater dependence on intergovernmental transfers and development aid was found to be associated with a higher budget share for administrative costs and employee benefits.²⁶ Thus, increasing OSR can be critically important for the KCG. In the following sections, we examine the steps it has taken to enhance its OSR.

xi The remaining OSR is collected by departments directly. For example, the Kisumu Health Department collects user fees from hospitals.



Fishing Village, Lake Victoria, Kisumu County, Kenya © Shutterstock

Reforms undertaken to enhance the city's financial position

Enhancing the capacity of city financial management

Digitalising Tax Collection

The digitalisation of tax collection processes has gained popularity in recent years and has been posited as a key reform to enhance taxation efforts. It is used to reduce compliance costs for taxpayers, and thereby enhance voluntary compliance. More importantly, it is said to decrease administrative costs, increase transparency and efficiency within tax administrations, as well as reduce opportunities for pilferage by tax collectors. Consequently, it is not surprising that digitalisation is a key component of OSR-related reform in Kenyan counties. In fact, the extent of tax collection digitalisation is often held as an indicator of success and modernisation in the country as a whole.²⁷

Kisumu, in particular, has attracted significant attention for its swift and comprehensive OSR automation. However, as explored below, automation alone has been unable to eliminate pre-existing tax collector malpractice, and consequentially has not yielded increases in OSR. This highlights the importance of complimenting digital reforms with institutional and management reforms.

In Kisumu, the main thrust of the digitalisation reform was around the digitalisation or 'automation' of tax payments. A tender was launched in 2017 for automation of market, bus

park and parking fees (other revenue streams were to be digitalised later). These streams are called *unstructured revenue streams* since they are collected on a daily basis, compared with the licenses and property taxes ('land rates'), which are paid annually. Together, these revenue streams make up around a quarter of Kisumu's total OSR, and thus represented a reasonable proportion of revenue for an initial automation pilot. Bus parks were officially included but ultimately left out – ostensibly due to their ties with politically backed gangs.²⁸

The tender for automation was won by Strathmore Research & Consultancy Center Limited (Strathmore), a firm with significant experience of automation in other Kenyan counties. The plan was to provide the KCG with Point of Sale (POS) devices, which tax collectors would use instead of a manual receipt system. These POS devices would be able to track the time of the payment, the payment recipient and payer details. Taxpayers would receive unique payment receipts, which could prevent fraud and recycling of tax receipts among taxpayers. The data would then be stored on a Strathmore software, which would allow the tax administration to oversee the process, evaluate tax collector performance and uncover potential abuse.

The original assessment carried out by Strathmore indicated that around 300 POS devices would be needed to fully automate the collection of unstructured revenues, with each device costing US\$500.²⁹ Due to budget con-

straints, the KCG proceeded with 100 devices and the Strathmore system was launched in Q1 of FY18/19. To compensate for the lack of devices, the county Revenue Department also launched a mobile money payment system via the countries' mobile payment provider, M-Pesa. Given the very high penetration rates of mobile money in Kenya (with an estimated 60 per cent of the national population actively using mobile money), this appeared to be a promising complementary digital option to POS devices.

However, as of July 2020, automation has not yet yielded intended results. By the time the Strathmore system was operational in Q1 of FY18/19, total revenues for the automated streams was already declining (see Figure 10) and automation has not been able to reverse this trend. Market fees and bus parks declined for the two consecutive years after automation. Parking fees dipped in the first year of automation and recovered slightly in FY19/20, but only to pre-automation levels.

Challenges with payment automation

Several factors may have contributed to the challenges of automation in Kisumu, including the impact of COVID-19, an insufficient number of POS devices, and lack of complimentary changes in the management of tax collectors.³⁰

COVID-19 reached Kenya at the end of March 2020 and the government responded by introducing a nation-

wide nightly curfew (on March 27, 2020), restricting public movement in the country’s largest urban agglomerations (Nairobi and Mombasa) and imposing other social distancing regulations. The government also introduced tax cuts as part of a larger economic stimulus package, although these did not include county OSR.³¹ The pandemic and the government response also impacted daily life in Kisumu, reducing overall economic activity. Consequentially, automated OSR streams experienced drastic revenue decreases (see Figure 11). The drop in revenue in Q4 of 2020 caused at least in part by COVID-19 thus might partially explains the overall drop in revenue in FY19/20 (see Figure 10).

However, it does not explain the drop between July 2018 and March 2020.

The sharp drop in the revenue collected from the automated revenue streams in the months right after automation (see July, August in FY18/19 in Figure 12, 13) can be attributed to the lack of an adequate number of POS devices. Prior to automation, around 300 tax collectors (or 75 per cent of all KCG tax collectors) were engaged in collecting unstructured revenues. With automation, only 100 collectors received POS devices and were allowed to carry on collecting taxes while nearly two-thirds of existing collectors were rendered temporarily unable to carry out their collection duties. Some collectors

started sharing devices, which was not an effective practice given the distance of locations they covered.

Realising that the lack of POS devices was a bottleneck, the Revenue Department eventually re-introduced manual receipts that enabled all tax collectors to resume work essentially meaning that the collection process went on as before automation, but with 100 collectors using an additional automated process. A few months after automation, the number of tax collectors in the *unstructured* revenue streams thus returned to pre-automation levels. However, these explanations still do not explain the apparent stagnation in revenues between October 2018 and March 2020.

Figure 10: KCG ‘unstructured revenues’ from 2013 to 2019

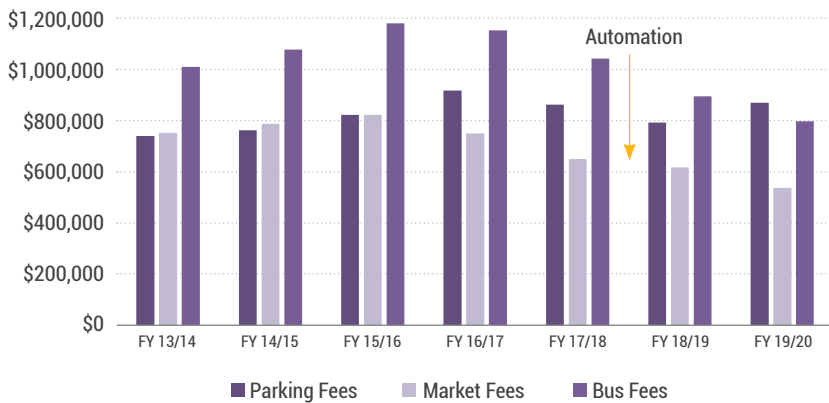
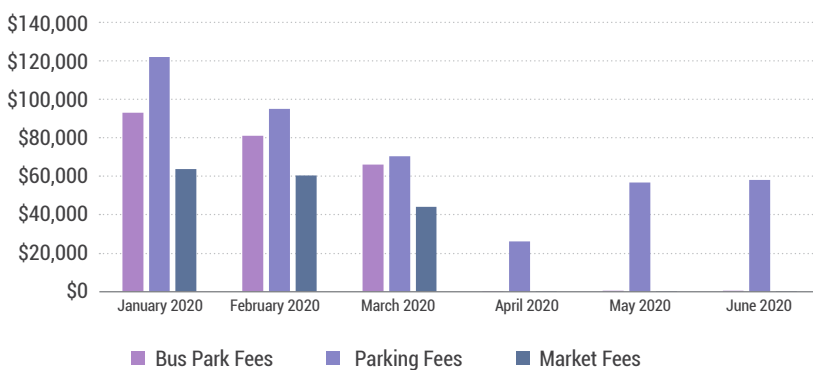
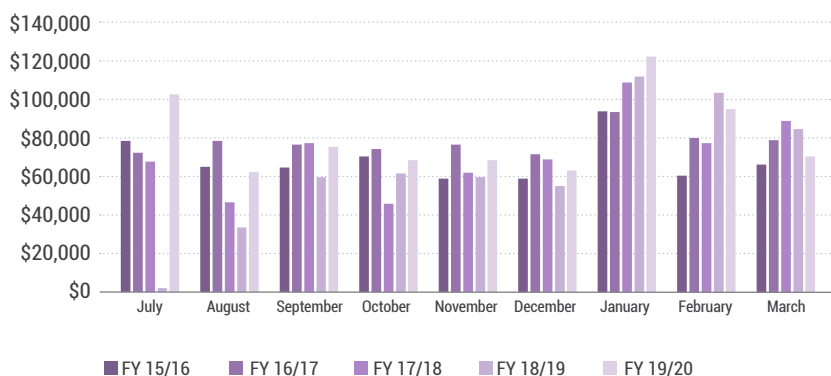


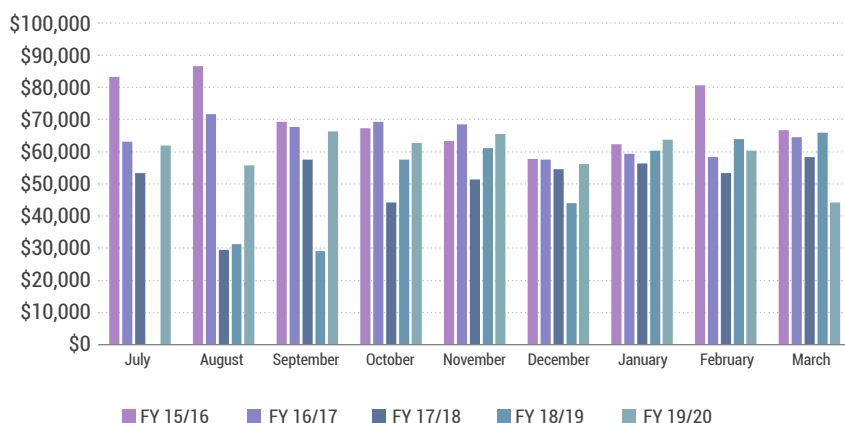
Figure 11: KCG ‘unstructured revenues’ at the beginning of the COVID-19 pandemic



The ongoing challenges with automation appear to arise from the manner in which automation was instituted ‘on top of’ a defective collection system. The OSR system in Kisumu, as in many other local governments around the world,³² lacked control, incentive and performance mechanisms to prevent tax-collector malpractice. Large annual and monthly revenue fluctuations (see Figures 12,13) called for deeper analysis to understand variances. However, there were no regular audits of tax collectors and no control mechanisms in place to probe for irregularities in daily collections (for example, by comparing daily collections to historic or potential revenue figures). There were also no processes in place for the revenue department to verify where POS devices were being used, what their daily collection should have been or whether tax collectors used them at all. There were also no salary-based performance mechanisms or sanction in response to tax collector malpractice, leaving

Figure 12: KCG parking fee revenue comparison FY15/16-FY19/20^{xii}

xii This table does not include Q4 to exclude the effects of Covid-19 analysed in the previous figure

Figure 13: Market fee revenue comparison FY15/16-FY19/20

the system solely reliant on the integrity of tax collectors.

The OSR system thus created the possibility for tax collector pilferage. Random respondents in UN-Habitat interviews reported having to regularly bribe tax collectors, while collectors attributed bribe seeking to delayed or irregular payments and to further corruption at senior levels.³³

This highlights the challenges of instituting automation to reduce opportunities for pilferage without changing the underlying control mechanisms. The failure of the mobile money system,

which was introduced alongside the POS devices, is indicative of how implementation challenges arose from insufficient incentives mechanisms rather than deficient technical solutions. The M-Pesa system only lasted for a few months before it was found to be prone to abuse and abandoned.³⁴ Tax collectors were unable to differentiate between the original M-Pesa receipts which taxpayers received upon payment from the mobile operator and those that had been forwarded and edited by taxpayers. This type of M-Pesa receipt fraud is common in Kenya and can be exposed by looking at the sender address. M-Pesa's failure

was therefore likely not as a result of taxpayer fraud, but rather insufficient incentives for tax collectors to make it work.

Increasing the likelihood of automation success

Properly phasing in a new digital system is key to introducing automation, and new systems must be tested and processes adjusted before a total digitalisation can be carried out. This will also reveal possible drawbacks and allow for careful development of contingency plans. Furthermore, when introducing changes to a complex tax collection environment, it is important to be mindful of the different interest groups and the various potential leakages. A tax collection system is only as strong as its weakest link. Changes in collection need to be accompanied by improvements in audit, sanction and tax collector management mechanisms, especially when these are not well developed to begin with.³⁵ The fewer control mechanisms in place incipiently, the greater the likely extent of 'capture', and the more challenging the implementation of reforms can be. Overcoming these challenges requires acknowledging the political realities around the collection process, adopting comprehensive reforms, or careful negotiation and cooperation with effected stakeholders.³⁶ Where the political dynamics of reform are not considered and the focus remains on technical solutions, reform is unlikely to succeed.^{xiii}

Capacity building and strategising

There are numerous examples of local governments in low-income countries

xiii See McCluskey, Franzsen, Kabinga and Kasese, 2018, for an example of technical reform getting derailed by politics in Kenya's Kiambu County

that lack the capacity to optimally leverage their own tax authority.³⁷ Local governments, being smaller administrative units, often do not have access to the same capacity building programmes and/or qualified staff as their national-level counterparts. Given that fiscal decentralisation is relatively recent in many parts of the developing world, these local governments also often lack the institutional knowledge and processes to optimally tax their citizens for services provided.

County governments in Kenya are no different. A majority of its revenue officers were retained from the Local Authorities and received minimal training. A study found that only 40 per cent of revenue staff was reported as 'qualified' and only 50 per cent of counties had OSR procedures and/or a training manual in place.³⁸ The Strathmore Gap Analysis carried out in 2017 (prior to automation) found similar conditions in Kisumu.³⁹ Revenue officials lacked formal education, and more importantly, the technological equipment and processes to properly collect and analyse revenue data. Despite this apparent need for capacity building, external support to the KCG did not bring about a change in the overall OSR approach and thus was insufficient to overcome political interests in the status-quo.

In April 2019, UN-Habitat worked with KCG to facilitate the optimisation of OSR via capacity building. The idea behind this intervention was to carry out an analysis of the key issues around OSR optimisation in Kisumu alongside the Revenue Department and determine the most strategic areas of improvement. Strategic prioritisation was deemed as essential to ensure the optimal usage of the Revenue Department's limited

time and resources. The intervention adopted UN-Habitat's ROSRA (Rapid Own Source Revenue Analysis) methodology, which consolidated international 'best practices' on OSR systems and linked these to a problem diagnosis. The first part of this intervention consisted of a revenue gap analysis per revenue stream. The gap analysis was complemented by a profitability analysis and a more granular problem deconstruction. Lastly, it explored the dependencies between root causes to determine useful reform entry points.

Based on this analysis, UN-Habitat recommended that the KCG build up its own analytical and management capacity and streamline the analysis of the ROSRA into its internal accounting and reporting systems. These changes were needed to create a more transparent and evidence-based OSR policy. It also recommended the simplification of the overall revenue system and a shift of its strategic focus from unstructured revenue streams towards land rates (and other high-potential revenue sources). The need to shift tax collection efforts away from 'unstructured revenue' was based on the findings that^{xiv}

- a. The KCG only collected around 19 per cent of its total OSR potential in FY18/19 (confirming earlier estimates carried out by the National Treasury and Adam Smith International)⁴⁰
- b. Land rates constituted nearly 40 per cent of the overall revenue gap (See Figure 14)
- c. Land rates received a fraction of the overall tax collection resources

while exhibiting some of the highest profitability estimates (see Figure 15, 16),

- d. Unstructured revenue streams are generally difficult to collect in a controlled manner due to their daily – as opposed to yearly – payments collection frequency
- e. The overall tax system was highly regressive (see Figure 17) due to its focus on user fees (unstructured revenues) and low compliance of high-income groups (see Figure 21).

Despite being applauded by the city for its level of detail and accuracy, the UN-Habitat's recommendations proved difficult to implement, with the system defaulting to business as usual. Rather than shifting resources towards the collection and enforcement of land rates and other structured revenue streams, the focus remained on unstructured revenues. In 2020, the Revenue Department acquired 300 more POS devices for unstructured revenue streams as well as hired around 300 new tax collectors and enforcers, the vast majority of which (270) were intended for unstructured revenue streams.⁴¹ Similarly, rather than focusing collection efforts on fewer, more high potential revenue streams that are easy to collect from and have strong policy rationales, the Revenue Department introduced a new license fee on Boda Bodas (motorcycle taxis) which was regressive, prone to pilferage and economically distortionary. There also were very few reforms, if any, that sought to build and improve the analytical, accounting and reporting practices within the Revenue Department. As such, it continues to be difficult for senior managers in the KCG to accu-

^{xiv} This analysis is based on UN-Habitat's estimates from the application of the ROSRA tool

Figure 14: KCG OSR potential and gap analysis by revenue stream for FY18/19

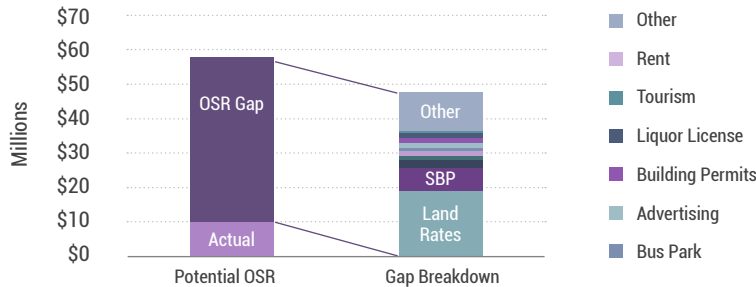
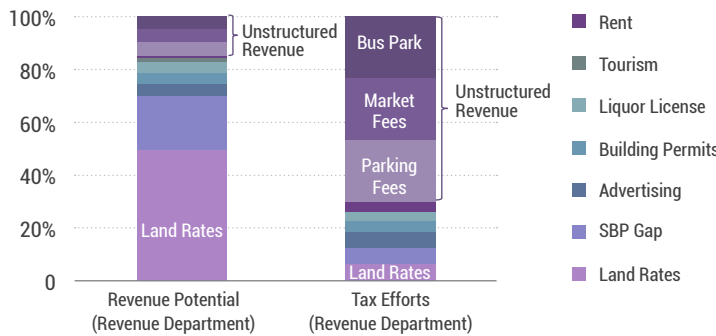


Figure 15: KCG revenue potential vs tax effort by revenue stream for FY 18/19^{xv}



^{xv} The costs of the different revenue streams were calculated in going through the budget of the Revenue department and breaking down the line-budget step by step, allocating costs to specific revenue streams in conversations with the staff of the Revenue Department. Each revenue stream was broken down into key cost drivers, personnel costs, capital costs, etc. with the remaining overhead being spread out equally across all revenue streams.

Figure 16: Profitability of revenue stream for FY 18/19 (in thousands of US\$)

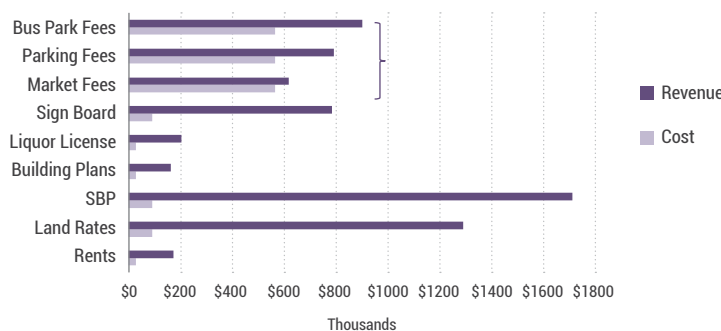
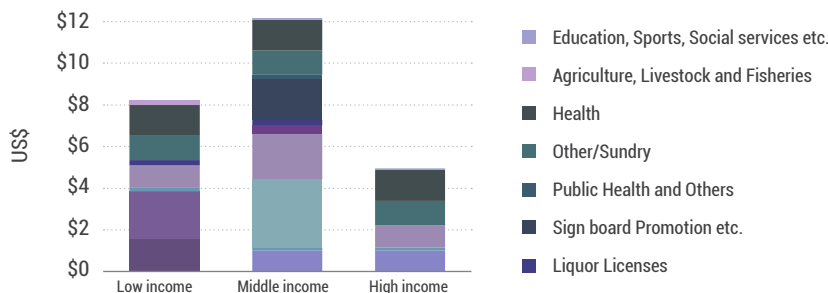


Figure 17: Tax incidence in Kisumu by revenue stream (estimates)



rately track performance of the OSR system, monitor revenue fluctuations, or identify reform entry points.

The challenges of reforming OSR strategy

Along with any potential technical Public Finance reservations, the proposed reform also struggled to gather large-scale interest. Due to the funds they have the potential to generate, OSR systems are often the object of considerable political controversy.⁴² Any proposed change to such a system is thus politically delicate and will create new winners and losers. A shift away from unstructured revenues will likely be opposed by tax collectors who may fear losing their jobs as a result of more automated, structured tax collection processes. A shift towards property taxes in Kisumu as in the rest of the world would also face resistance from large landowning elites.⁴³ Simplifying the tax system and imposing regulations on revenue streams may also face opposition by parties that benefit from complicating the system to hinder transparency and maintain pilferage opportunities.⁴⁴ Different interest groups thus may hold onto the status quo and decelerate the ambitions of the most avid political visionaries. The fire that broke out in the Finance Department in February 2020 with the alleged aim of wiping out existing records is a solemn reminder of these vested interests.⁴⁵ The OSR system in Kisumu has therefore been known as being “too messy” to change.⁴⁶

Accelerating OSR reform

As discussed above, meaningful OSR strategy pivots require serious political capital and/or fortuitous political windows of opportunity.⁴⁷ Escaping

from such 'dysfunctional' but 'stable equilibria'⁴⁸ requires first and foremost a greater appreciation for the importance of political realities in sustaining the status-quo. Technical solutions provided by external experts and/or development partners are typically hardly new or unknown to technical staff in Revenue Departments. The challenge instead is ensuring that technical insights, which commonly exist at lower technical levels, are communicated to senior management – and ultimately implemented.

Lower-level staff may sometimes withhold information to strengthen their own value within the organisation and prevent senior staff from effectively monitoring individual and departmental

performance.⁴⁹ Therefore, a fundamental first step for senior officials thus is to establish control over necessary information processes and key metrics such as revenue potential per revenue stream, profitability per revenue stream, tax incidence, and tax collector performance without over-burdening the relevant Revenue Departments. While implementing these types of information processes may face political resistance, it is less directly threatening to established interest groups than actual reforms to the OSR systems.

Increasing accessibility of information will also help strengthen incentives for responsible political officials to align OSR strategy with technical realities. It may also clarify to senior man-

agers the extent of the system's problems and motivate change. Further, the more publicly this information is available, the greater the public pressure that officials will face to address existing weaknesses.

Once the political leadership is well informed about the OSR system, it needs to charter a realistic reform path that balances the appetite for technical change with a realistic understanding of the existing political constraints and legitimacy requirements.⁵⁰ Mastering this journey requires leadership that is willing to take advantage of crises to construct narratives around the need for reform, as well as build reform alliances and secure quick wins to maintain reform legitimacy.⁵¹



Vehicle washing at the shores of Lake Victoria, Kisumu, Kenya © Shutterstock

Capturing land value and unlocking dead capital

Optimising property taxes

Property taxation – or ‘land rates’ as it is called in Kenya and Kisumu – has for some time been considered as the most under-used revenue stream for county governments.⁵² Land rates are worthy of focus as they are generally also more progressive than most other user fees and license-based charges. They are also largely non-distortionary and thus better suited to funding the provision of public goods and recurrent expenditure more broadly – unlike user fees, the revenues of which should generally be linked to the recovery of distinct services.⁵³

Since land value is not a function of the actions of landowners themselves, but rather the developments/investments in surrounding areas, it is fair to capture some of the increases in land values for public good. The traditional and most common way of doing so is, of course, via land rates.

Kisumu, as many of its peers, has not managed to fully leverage its revenue potential from land (see Figure 18).

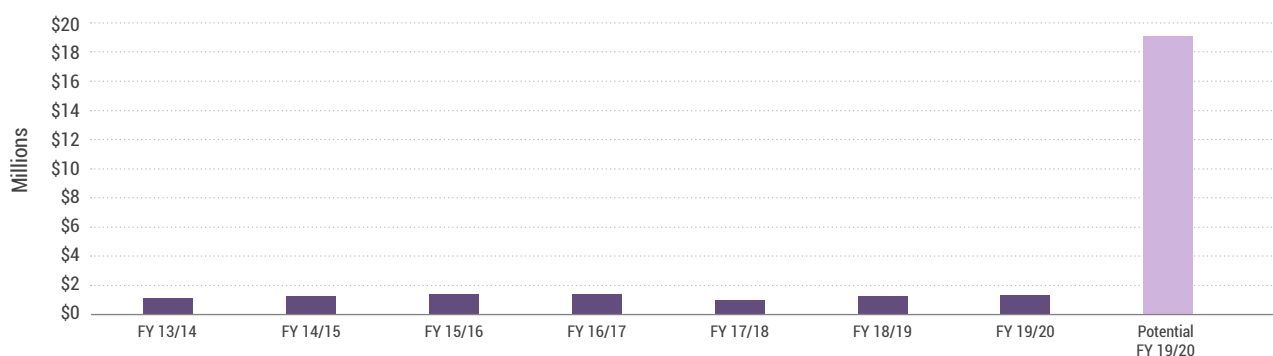
In fact, revenue from land rates has largely stagnated since devolution (see Figure 18), only increasing by 20 per cent in six years. The lack of progress is partially explained by the inability of the county to enforce compliance of land rates of landowners⁵⁴. Nearly 70 per cent of landowners have outstanding arrears.⁵⁵ Another important reason for the low revenue from land rates is the outdated nature of the valuation roll. The current valuation roll from 2008 does not cover all existing land parcels and also does not value them at their current market value, given the rapid population growth in Kisumu and the overall increase in serviced land, among other things. To overcome the coverage/assessment gap, in 2016, the KCG decided to update the valuation roll. This initiative has stalled to some extent and has not yet succeeded in updating property values. The analysis detailed below suggests that political interests may have, once again, stood in the way of a seemingly sensible reform initiative.

Updating the valuation roll

In February 2016, the KCG launched a tender process and by March 2017, awarded Syalar Consortium US\$1.2

million to come up with a new valuation roll. The process took around three years and by April 2019, the new roll was completed. As per the new roll, the value of the land in Kisumu jumped from US\$127 million (based on the 2008 roll) to just over US\$1 billion – an eightfold increase in land value. It also increased the number of registered parcels from 25,284 to 55,000. This meant that in an ideal scenario with 100 per cent compliance, the county would be able to increase its annual land rate revenue almost 15-fold (See Figure 19). This would, however, be unlikely given the low compliance and the significant increase in the average tax liability per landowner (increasing from US\$75 to US\$278 per year). Nonetheless, even if the compliance rate were to decrease to only 18 per cent (such that all current landowners would pay US\$51 per annum as before) the overall revenue would still more than double. With these figures, the investment in updating the valuation roll was likely pay for itself in less than a year. However, despite the immense potential of the valuation roll to increase land rate revenue, by July 2020, it had still not been officially approved/enacted by the County Assembly.

Figure 18: Actual KCG land rate revenue from 2013 to 2019 vs potential revenue^{xvi}



^{xvi} The overall revenue potential is based on changes in land values alone, as per the new valuation roll, which is awaiting final approval

Figure 19: Kisumu Land Rate Revenue Estimations based on New Valuation Roll (in US\$)^{xvii}

	Status-quo	New Valuation Roll	Likely Scenario
Registered Parcels	25284	55000	55000
Total Land Value	\$127M	\$1.020M	\$1'020M
Average Parcel Value	\$5K	\$18K	\$18K
Tax Rate	1.5%	1.5%	1.5%
Average Tax Liability per Landowner	\$75	\$278	\$278
Compliance Rate	68%	100%	18%
Tax Paid Per Landowner	\$51	\$278	\$51
Total Revenue	\$1.2M	\$15.3M	\$2.8M

xvii The compliance rate of the status-quo was estimated based on the data provided by CAL, the other two scenarios provide hypothetical compliance rates (scenarios). Average parcel value was calculated by dividing the total land value by the number of registered parcels; Tax liability was calculated by multiplying the tax rate by the average parcel value; tax paid per landowner was calculated by multiplying the tax liability by the compliance rate. The Likely Scenario was calculated by assuming that landowners would on average continue to pay the same tax liability that they had paid prior to the new valuation roll (\$51). This assumption is based on the lack of enforcement mechanisms and already low compliance in the status-quo. In the new scenario, new landowners who previously paid nothing, would too start paying land rates. This is a hypothetical scenario used to underscore the point that it is unlikely that the new valuation roll will solicit taxpayers to pay tax liabilities that are three times as high as before (US\$78 to US\$278)

Difficulties in getting the new valuation roll approved

There are several reasons for the delay in approving the valuation roll: financial, legal and political. On the financial side, the valuation roll could not be approved since the KCG has not been able to fully pay Syalar for its services. Following repeated delays in instalment payments to Syalar, the third party decided to withhold the GIS components of the valuation roll until it received the final outstanding payment of around 30 per cent of the overall contractual fee. Without this GIS data of the mapped-out land parcels, the valuation roll remains incomplete and thus cannot be approved. However, this payment has not been prioritised: the KCG paid around 50 per cent of its nearly US\$2 million accounts payable in April/May 2020, in which the payment to Syalar was not included.⁵⁶

The delays in these payment obligations and the passing of the new valuation roll are also due to concerns over its overall legality. Indeed, creating a legal basis for a new valuation roll requires the KCG to pass a Local

Rating Act, which spells out the valuation methodology and implementation process. However, a Local Rating Act has been ready for approval since October 2014 without being passed (see section on Rating Act below). Further, since the valuation roll was launched prior to the passing of a Local Rating Act, the valuation roll can only be retroactively validated. This type of retroactive validation was undertaken by Kiambu County, which passed a new valuation roll in 2014 but only passed the corresponding regulation in 2017.⁵⁷ While retroactive validation of the valuation roll may be legally contestable, it would nonetheless strengthen the legal enforceability of land rates. The current valuation roll was carried out in 2008 and has close to no legal validity since it is required by law to be updated every ten years.

From a political perspective, large landowners in Kisumu may be opposed to the valuation roll as it would significantly increase their tax obligations. Naturally, these landowners will seek a reduction in the land rate, as well as the cancellation of existing land arrears when moving from the old to the new

valuation roll. Decision makers might have been disincentivised to push the valuation roll forward because of the political ties of much of the land-owning elite. As has been exemplified the world over, political survival and success can often hinge on courting elite favour.

Overcoming the challenges of passing new valuation rolls

Financial shortcomings can derail valuation rolls as these tend to be costly exercises. Local governments are well advised to finalise valuation rolls within one administrative term and avoid passing payment responsibilities over to new administrations. Even with a carefully crafted and executed procurement practise, powerful interest groups can find ways to influence the process. One potentially useful way of curtailing outside influence is by addressing information asymmetries.^{xviii} Lawmakers and lower-level bureaucrats may often withhold necessary information from top officials, obscuring causes and over-complicating potential solutions. At a minimum, high-level decision makers need to develop accurate and distilled understandings of the actual bottle-

necks. In the case of Kisumu, financial and legal complications may distract from the real challenge of building the necessary political momentum for reform. Where incentives at high-levels are insufficiently strong to push through new valuation rolls, national and external actors are advised to rethink incentive mechanisms before advocating for complex technical reform. This may also entail removing potential obstacles in the process, for example, passing national legislation to replace the need for a 'Local Rating Act' – a process which has actually already been launched in Kenya.

Collecting property tax arrears

Another important aspect in enhancing property tax (land rate) revenue is compliance. As much as a new valuation roll will help to increase tax liabilities, if it is not supported by improved enforcement and compliance, it may merely further increase arrears.

In Kisumu, land rate arrears in FY18/19 already amounted to over US\$100 million.^{xix} In other words, the KCG was owed over 10 times its total annual OSR in land rate arrears. Over the years, it has attempted different measures to collect this accrued revenue, including temporary tax arrears waivers on accrued interests for citizens who paid their overdue tax obligations. The KCG also tried brief campaigns utilising social pressure, publishing names of individuals with large arrears in the local press. After this resulted in a significant political backlash, the Revenue Department abandoned the approach and instead hired a private debt collection firm. Collection Africa Limited (CAL) won the tendering process and launched efforts to collect tax arrears in March 2019. CAL was experienced in helping banks recover debt. It was well-equipped and quickly ramped

up operations in Kisumu. Within the space of a few weeks, it had around 100 staff on the ground as well as call-centre support. CAL's approach was to retrieve tax arrears data in the form of demand notices from the KCG's Local Authority Integrated Financial Operations and Management System (LAIFOMS) system, and to then physically locate individuals, ascertain contact details of debtors, generate payment plans, as well as Promise to Pay (PTP) documents with corresponding dates of payment. This information would then be logged into a CAL database and used by the CAL call-centre to carry out targeted follow-up calls.

In its first month of operation, CAL was able to deliver close to 1,440 demand notices.⁵⁸ This constituted nearly a 15-fold increase in taxpayer sensitisation from KCG's own approach. After the first few months, nearly 40 per cent of the taxpayers who had been contacted ended up paying a part of their arrears. This constituted a near 4,000 per cent increase in payment from the KCG's

past arrear collection efforts. Within the first month (March 2019), land rate revenues increased to US\$948,810 or nearly three times the land rate revenue that the KCG had earned in the March of preceding years.⁵⁹ However, this initial success was not sustained. Over time, CAL's monthly collections decreased and by October 2019, CAL stepped down operations. Collections picked up again somewhat in 2020, but remained at a low overall level, collecting under 0.02 per cent of overall debt per month. At this rate, CAL would take around 50 years to collect all the arrears, assuming these would not keep growing.

Challenges with outsourcing arrear collection

CAL faced several operational bottlenecks that limited its ability to collect arrears. One of these had to do with the receipt of demand notices. The KCG, as well as responsible officials within the City of Kisumu, were not printing demand notices as quickly

Figure 20: CAL monthly land rate arrears collections (CAL estimates) for 2019 and 2020^{xx}

Month / Year	Collections in US\$(in 000s) ^{xxi}	Month / Year	Collections in US\$(in 000s) ^{xxii}
March 2019	949	November 2019	35
April 2019	380	December 2019	-
May 2019	422	January 2020	145
June 2019	234	February 2020	171
July 2019	115	March 2020	171
August 2019	100	April 2020	180
September 2019	99	May 2020	N/A
October 2019	60	Total	2360

xx These estimates were provided by CAL and do not fully correspond to the land rate revenue figures which are featured in the KCG budgets. On average the CAL estimates of the land revenues which they helped collect far exceed those of the KCG. These discrepancies are due to the fact that not all land rate payments were accounted for as land rate revenue. In FY19/20 the revenue category in the KCG budget featuring 'unasserted revenues' greatly increased. It is thus difficult to know exactly what the effect of CAL was, the overall trend nonetheless remains valid.

xxi March 2019 exchange rate of 100 KSh to 1 US\$

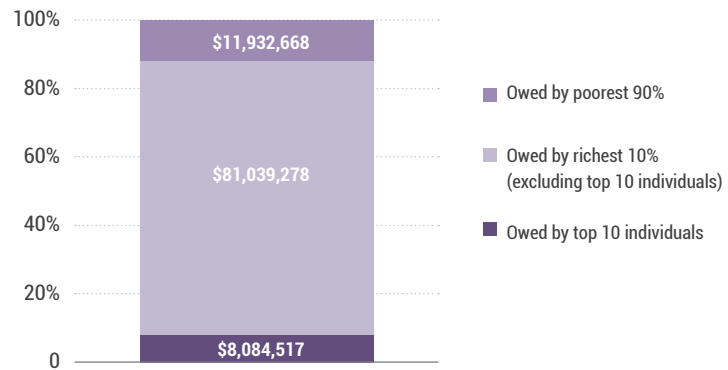
xxii March 2019 exchange rate of 100 KSh to 1 US\$

as CAL was processing them. By July 2020, CAL had received around 10,000 demand notices of a total of 17,000. While the act of printing demand notices required little more than a mouse click in the system, the reluctance to provide CAL with the notices could perhaps have been in an effort to protect specific debtors/landowners from having to pay arrears. It has been said that some debtors provided payments to government officials instead of making formal payments in return for not being issued with official demand notices.

Another challenge encountered by CAL was that the demand notices frequently did not accurately reflect real property ownership or the debt data in the system. Land-related payment data had not been maintained properly over the past years; there also was no log or record of changes made to the LAIFOMS portal, and no way to trace instances where data on arrears and defaulters was fraudulently changed within the system.

Thirdly, CAL encountered problems around the legal enforcement of arrear payments. Some taxpayers refused to pay on the premise that the KCG would not be able to take legal action against them – a line of argument particularly prominent among wealthy landowners.⁶⁰ CAL found a strong correlation between size of arrears, parcel value and the likelihood of payment. CAL found that landowners who had connections among county officials did not make payments.⁶¹ These findings are corroborated by the overall make-up of arrears by income group. Indeed, UN-Habitat estimated that nearly 90 per cent of the arrears or US\$90 million was owed by the top 10 per cent of the largest landowners in the county (see Figure 21).

Figure 21: KCG land arrears by income group (UN-Habitat estimates)



A fourth and final reason for the inability of CAL to maintain its initial revenue collection rate was due to non-payment by the KCG. By June 2020, it had only received around 20 per cent of the contractual payments that they were due. After not receiving payment for some time, CAL scaled down its operations from around 100 collectors to around 30 and also reduced call-centre activity. Rather than being paid on a monthly basis as stipulated by the contract and providing CAL with a commission on the revenue it collected, the KCG paid it in sporadic lumpsum payments, the last of which was paid in January 2020.

This violation of the CAL contract can be partially attributed to problematic accounting processes. The KCG has struggled with accounting for arrears collected, which do not feature clearly in its monthly revenue statements. Since, the CAL is contractually entitled to a percentage of the overall arrears collected, the KCG has not been able to determine its own payment obligations to CAL.^{xxiii} Additionally, a failure in the KCG revenue accounting system in April-May 2019 led to a loss of payment

receipts and further complicated the payment situation. Payment delays also occurred due to faulty processes and a lack of communication between county departments and the City of Kisumu who hold different parts of the data. There have also been claims that the payment delay could be a means to extort bribes from a service provider in return for processing payment.

Supporting third-party arrears collection

This reform initiative suggests that even where the legal context does not optimally facilitate the sanctioning of non-compliance, proactive sensitisation and follow-up can significantly increase taxpayer compliance. This may be a cost-effective and quick way to increase compliance rates while waiting for required supporting legislation. Ultimately, however, when the legal system is weak around the issue of non-compliance, arrear collection will falter, especially among parties with stronger incentives not to pay such as large landowners, who have larger tax liabilities and easier access to political networks and legal expertise. Additional measures may therefore be needed to enforce compliance and reduce the regressive potential of such an intervention.

^{xxiii} The contract between CAL and the KCG stipulated that CAL was to receive a percentage of the overall land rates collected.

Ensuring compliance and optimising the usage of third-party arrear collectors will ultimately require that the Revenue Department is fully aligned with the reform goals. In these instances, decision makers will need to invest more time and resources into ensuring that the interests of their own staff align with the reform vision. This may take the form of negotiations, salary incentives, performance incentives, and/or contractual decisions. When these underlying issues are overlooked, reforms are built onto unstable ground and doomed to eventually peter out with little lasting change. Ensuring the success of suitable technical solutions, as in the case of digitalisation, requires creating the right enabling context first before building onto it.

Improving the regulatory OSR environment

So far, this report has covered the steps the KCG has taken to improve its financial position by digitalising its tax collection, updating valuation rolls and outsourcing arrear collection. It is also important to assess the broader regulatory environment and how it affects the KCG's ability to leverage OSR. It appears that the regulatory challenge for the KCG is not expanding the existing revenue authority but rather facilitating its usage. The KCG has not however, been able to overcome existing challenges and pass necessary local legislation.

As already mentioned, the Kenyan counties do not have access to a large range of important revenue streams. Kisumu and the other counties were, as per Article 209(3) of the CoK, granted the right to levy a) Property rates; b) Entertainment taxes; c)

Charges for services they provide^{xxiv}; and, d) Any other tax or licensing fee authorised by an Act of Parliament.⁶² However, under the constitution, there is no provision for counties to charge taxes such as excise taxes, payroll taxes, or other general consumption taxes.⁶³ They also do not receive revenues from local public utility companies where significant funds are generated via electricity and water provision. This limited tax authority has been criticised by various actors, including the World Bank in its initial assessment of devolution in 2012.⁶⁴

While the devolved revenue authority certainly does not facilitate the counties' revenue self-sufficiency, it does provide enough authority to cover a sizable proportion of the budget. As per the National Treasury and Adam Smith International findings, the Kenyan counties, similarly to Kisumu, only leverage around 20 per cent of their overall OSR potential. Devolving more tax authority would possibly therefore decrease overall national revenues more than it would increase local revenue. Thus, it may make sense to ensure appropriate usage of existing tax authority before introducing regulatory changes to expand it.

Having said that, new county legislation is required to improve the accountability of the counties' existing OSR systems. Accountability is a cornerstone of effective local governance, but also directly impacts the voluntary compliance of taxpayers. Under section 120 of the County Governments Act, 2012, a Tariffs and Pricing Policy should articulate the rationale for application of tariffs, fees, levies or charges

by a county government and how these are linked with service provision.⁶⁵ Yet most counties, including Kisumu have not developed such local legislation. Instead, Kisumu uses the annual County Finance Act as omnibus laws to impose all fees and charges. This is not sufficient to provide adequate regulatory functions and collection procedures.⁶⁶ Finance Acts should be reserved for annual amendments to fiscal provisions, arising from the county annual budget while county legislation that creates a regulatory duty/obligation or imposes a licensing fee should be set out in separate county legislation.

The Local Rating Act

New legislation is also necessary to support county governments in fully leveraging their existing tax authority. The 2010 constitution was not accompanied by a comprehensive legal revision of existing OSR laws. This meant that the former legislation, which regulated how subnational government structures (preceding the counties) handle OSR, was re-framed as being valid for transitional purposes until the new county governments passed their own legislation. One of the revenue streams for which this transitional authority of counties is most questionable is land rates.^{xxv} In fact, there is no overarching law at the national level that guides counties in their imposition of land rates. The existing law used by the former local authorities (Rating Act Cap.267) was passed in 1963 and is supported by the Rating for Valuation Act Cap.266 of 1956. The counties have continued to use these Acts on the basis of the provisions set out in the interim/transitional legislative protections pro-

^{xxiv} In Kenya, the services of water and electricity are offered by incorporated companies and not the County Governments

^{xxv} The most legally contentious revenue streams besides land rates are agricultural produce cess, outdoor advertising fees, liquor licensing, entertainment taxes, and tourist taxes.

vided under Section 8(2) of the County Governments Act, 2012. However, the ability for counties to use these old acts is legally questionable. Since Kiambu County was required to come up with its own local legislation to enact its valuation roll in 2017, other counties are likely to have to do the same.⁶⁷

Enacting a Local Rating Act of its own thus appears to be the only real option for Kisumu while waiting on the potential national revision of existing laws, to create legal enforceability for their land rates and land rate arrears. Given the extensive potential of land rates and the huge land rate arrears, the KCG should feel some urgency to pass corresponding local rating legislation. To facilitate the development of this local legislation at the county level, the Commission on Revenue Allocation (CRA) in conjunction with the Kenya Law Reform Commission (KLRC) and the Council of Governors (CoG) developed a County Model Revenue Legislation Handbook containing model laws on land rates and other local taxes.⁶⁸ With this support, a Local Rating Act was prepared and forwarded to the KCG County Assembly for approval in October 2014. The Act was not accepted, which led to further iterations and another submission to the County Assembly in 2017. To this day, the Act has not been passed.

Challenges with passing the Local Rating Act

The lack of customisation to the context of Kisumu has been cited as one of the barriers to the passing of the Act. However, Kisumu is not alone in struggling to produce necessary local legislation. Indeed, by February 2019, less than 10 of the 47 counties in Kenya had passed a Local Rating Act.⁶⁹ This gap has prompted the national

government to plan national legislation to overcome the challenges that counties are facing in passing land rate-related legislation. However, while this is a sensible decision, it may also result in weakening the counties' incentive to close this legislative gap in the interim. Pressure from landowning elites may have further acted to disincentive the passing of this Act in Kisumu as in other counties. Since a new Ratings Act can strengthen the legal enforceability of sanctions for non-compliance with land rates and arrears, such landowners have a strong financial interest in opposing the Act's passing.

Realising the potential of investment in improving infrastructure

To improve its financial position, the KCG has not restricted itself to working on OSR and has also attempted to increase its access to credit, and attract private investment. Meeting the county's development targets as outlined in its 2018-2020 County Integrated Development Plan II, will require capital expenditures and upfront investment that cannot be met by OSR alone. Accessing capital markets can make particular sense when the returns on investment surpass its financing costs. It could also help address issues of inter-generational equity.⁷⁰ Despite the benefits of accessing external funding, the KCG's success in this endeavour have been limited largely due to the challenges it faces in enhancing OSR and implementing solid PFM processes.

Access to credit

The Kenyan fiscal decentralisation framework is generally supportive of subnational borrowing. The Kenyan

constitution allows county governments to take on long-term debt for capital expenditure with the approval of their respective County Assemblies, a recommendation from the Inter-governmental Budget and Economic Council (a body consisting of all the County Executive Committee members for Finance) and a guarantee from the National Cabinet Secretary. Overall, counties may borrow an amount of long-term debt equivalent to 20 per cent of total county budgets (with no more than 15 per cent of budget going towards debt servicing).⁷¹ Counties may also take up short-term debt to overcome cash flow issues. Although, borrowing for this purpose is not allowed for longer than one year and may not exceed 5 per cent of the county's last audited financial accounts.

Despite these legal options, Kisumu and other counties have struggled to access capital markets. This has less to do with regulatory restrictions and more with foreign exchange risk, competition from the national government for credit and low creditworthiness. In fact, most counties have never had an official credit rating. This might also deter private investors who rely on credit ratings to gauge the riskiness of lending to local governments. Some of these impediments to accessing capital markets are difficult to resolve and are outside the control of the county governments. Creditworthiness, on the other hand, is largely within their control.

Consequently, Kisumu county eagerly participated in the Kenya County Creditworthiness Initiative (CCI) in early 2019, which included Kisumu as one of the 10 participating pilot counties. This could potentially help shore up investor confidence and allow counties to better gauge opportunities that

capital markets had to offer, as well as help diagnose areas of improvement to enhance future credit ratings. Kisumu County worked to facilitate the creation of its first credit rating alongside the National Treasury, the Commission on Revenue Allocation (CRA), and the Capital Markets Authority (CMA), the World Bank (WB), and the Global Credit Rating Agency (GCR).

The credit ratings from this initiative were revealed to the public in March 2020. Kisumu was ranked third among pilot counties after Makueni County and

Bungoma County, with a score of BB for its long-term debt (“Low credit quality levels of obligor/obligation creditworthiness”) and B for its short-term debt (“Low to vulnerable certainty of timely payment of Short term obligations relative to other issuers or obligations in the same country”). According to GCR’s national rating scale, this meant that Kisumu was below average in regard to other issuers in the same country, for both long- and short-term debt.

As per the GCR final report,⁷² Kisumu’s rating was positively influenced by

relatively stable government transfers, its diverse economy, its low reliance on agriculture, and its above country average Gross County Product (GCP) per capita. Less favourable was the fact that the county’s economic growth had fallen behind the national average. The report made particular mention of its inability to maintain industrial infrastructure, revive agro-processing industries and/or exploit the potential of Lake Victoria. More concerning still was GCR’s assessment of the county’s overall financial position and its operating performance. It pointed to the county’s deterioration in OSR in FY17/18, its sizable unpaid trade creditors (33 per cent of FY17/18 revenue), its challenges in executing the development budget, its large recurrent expenditure and rising staff costs. GCR also pointed out concerns over the KCG’s audit outcomes, which highlighted extensive misuse of public funds and flouting of PFM regulations.

Whether the credit rating will facilitate KCG’s access to credit markets remains to be seen. For now, its key value addition has been providing data to the KCG to better prioritise further Municipal Finance reforms. Given the Municipal Finance difficulties highlighted by the GCR report, Kisumu might continue to struggle to issue debt at favourable interest rates. The overall macro-economic context and the COVID-19 pandemic might add to these challenges. Eventually, the KCG must address the core underlying Municipal Finance issues highlighted by the GCR report to access credit markets under favourable conditions.

Private investment and PPPs

Another significant potential means of attracting external funding for larger capital expenditures are Public Private



Kisumu, Kenya © UN-Habitat/Lennart Fleck

Figure 22: Propriety issues of KCG expenditure; Auditor General Reports (in US\$) (2013-2018)^{xxvii}

Year	Total Expenditure with Propriety Issues	Total KCG Revenue	% of Total KCG Expenditure with Propriety Issues
FY 2013/14	\$22,066,943	\$54,946,286	40%
FY 2014/15	\$34,157,274	\$70,507,973	48%
FY 2015/16	\$5,471,933	\$70,541,504	8%
FY 2016/17	\$45,102,654	\$76,136,282	59%
FY 2017/18	\$5,037,513	\$78,260,577	6%

^{xxvii} Note that for the year 2018 the figure is lower as the Audit Report for the County Executive is not available, only that of the County Assembly. Propriety issues in regard to expenditure here take note of all amounts in the Auditor General Reports whose propriety cannot be verified as per the respective reports.

Partnerships (PPPs). PPPs bear the potential for KCG to limit investor risk, attract funding, and possibly circumvent existing Municipal Finance bottlenecks by ring-fencing cash flows within specific projects. As per Kisumu's 2018-2020 County Integrated Development Plan II, around US\$75 million to finance the County's ambitious development is to come from PPPs. While this may seem like a relatively small amount, it is equivalent to around 75 per cent of the KCG's annual budget. It is also a considerable amount given that the KCG has historically not managed to share the financial burden of infrastructure provision via PPPs.⁷³

There have been several PPPs in Kisumu, but these do not feature the KCG as the contracting authority. For instance, the Kisumu Sea Port worth US\$80 million that was completed in 2019 was managed via the Kenya Ports Authority, the Magwagwa Multi-purpose Dam Development amounting to US\$835.6 million is managed by the Lake Basin Development Authority, and the Transmission Grid Expansion programme worth US\$434 million is similarly managed by the Kenya Electricity Transmission Co. Ltd. (KETRACO).⁷⁴

Pursuant to the powers, functions and responsibilities delegated to the county governments under the County

Governments Act, 2012, they can enter into partnerships with any private organisation in accordance with the Kenyan Public Private Partnerships Act 2013. According to the 2013 PPP Act, however, counties are required to involve the national PPP Unit under the National Treasury. This PPP Unit has extensive information requests that counties can struggle to comply with. In most instances, the PPP preparation period tends to extend beyond a single administrative cycle, thus undermining the desire of newly elected officials to show results. Thus, the KCG and other Kenyan County government officials have reported the complexity of the PPP process as one of the bottlenecks to creating these partnerships, and KCG officials have joined critics in calling for a simpler PPP process.

While the PPP process is indeed comprehensive, a World Bank report found that it was not overly complex.^{xxvi} A certain level of complexity is necessary due to the far-reaching consequences of badly designed PPPs, particularly the risk of placing perilous contingent liabilities on subnational balance

sheets that eventually require national bailouts. In fact, it could be argued that the PPP Act of 2013 was not explicit enough in regard to the development of PPPs at the county level. As a consequence, counties spent resources in launching PPP processes that ultimately never materialised, including a US\$560 million Agricity in Homa Bay or a Blue Sea Energy Project in Meru County. For this reason, the national PPP Amendment Bill of 2018, awaiting parliamentary approval, aims to entrench the need for all PPP projects valued above US\$500,000 to pass through even more direct oversight of the Public Private Partnership Unit (PPPU) within the National Treasury of the Kenya government before being presented to the national PPP Committee for approval.

Given the Kisumu county's struggles with abiding by overall PFM regulations and managing expenditure and normal procurement, it could potentially be risky to ease regulatory requirements for enacting PPPs. The Auditor General Reports of KCG Financial Operations provide some insight into the extent of malpractice in the county, which covers the range of financial accounting malpractices, including excess expenditure, un-surrendered imprest, unsupported expenditure, unexplained bank balances, unexplained variance in bank

^{xxvi} The report by the World Bank investigates the national level mechanisms not specifically those at county level see: World Bank (2017) *Benchmarking PPP Procurement: Assessing Government Capability to Prepare, Procure and Manage PPPs*. Available at: https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/Benchmarking_PPPs_2017_ENpdf.pdf

statements, missing assets and liabilities from the county's financial statements, among other things. The Auditor General concludes that year on year, public money has not been applied lawfully or in an effective manner, and that the Financial Statements do not accurately reflect the Financial Position, or cash flow of the county (see Figure 22 for a summary).

The challenge with putting in place PPPs can therefore not be addressed by easing PPP regulations alone. While there is certainly room for improvement in the PPP regulation, the key bottleneck is arguably elsewhere. The current lack of county-level PPPs needs to be tackled by addressing the inability of county governments to create conducive investment environments, adhere with existing PFM regulations, and increase OSR. By developing these foundations of Municipal Finance, the KCG can create a more appealing environment for investment and build up sufficient internal capacity to prepare bankable projects and PPPs more quickly.

Facilitating access to external funding

The analysis above suggests that both in regard to access to credit markets as well as PPPs, the KCG must strengthen its OSR performance as well as its overall PFM. However, ensuring the proper functioning of the Municipal Finance foundations can be less politically appealing as it requires long-term dedication and substantial political capital, without offering many quick wins. Thus, strengthening incentives for KCG and other local governments to build Municipal Foundations should be a priority for national governments and development partners. OSR performance can also function as a useful indicator of how prepared local govern-

Figure 23: Kenyan County revenue breakdown from 2013 to 2019⁷⁶



ments are for accessing other high-potential external revenue sources.

National transfers in particular offer a promising means of strengthening these Municipal Finance foundations. Kenya's intergovernmental transfer formula allocates 2 per cent of the overall funds to counties based on their OSR performance. Given the overall importance of enhancing OSR for the overall financial position of the KCG and other counties, transfers should be more heavily contingent

on OSR performance. The third and latest transfer formula revealed by CRA in June 2020 does not provision a change to the OSR variable (also referred to as "fiscal effort"). It does, however, introduce an additional 2 per cent variable for compliance with PFM standards ("fiscal prudence").⁷⁵ This new formula does not prioritise the unsustainable dependence of counties on national transfers (see Figure 23), access to external finance or the efficiency of county expenditure, as issues that require urgent attention.



Lake side fish market in Dunga Beach, Kisumu, Kenya © Shutterstock

Lessons, success factors and priorities for future reform

On paper, it looks as though the KCG did many of the ‘right’ things to optimise its financial position, especially in regard to OSR. It digitalised tax payments for the key user charges (‘unstructured revenue streams’), engaged in capacity building to revise its OSR strategy, and hired firms to update the valuation role, and drive in property tax arrears. It also worked on improving local legislation and acquired the county’s first credit rating. In fact, nearly all of these reforms are commonly found among the best practices for enhancing the financial position of local governments, and yet, none of them *really* worked.

Several factors contributed to the dilution and deceleration of these reforms. Arguably, the most important of these was political resistance to reform. Ultimately, the KCG struggled with overcoming vested interests in the status quo ranging from lower-level government officials, tax collectors and/or powerful landowning elites. Decision makers have been unable or unwilling to confront and overcome these

vested interests without the support of powerful information and control mechanisms or strong reform incentives. Consequently, OSR reforms lost momentum, which in turn made it difficult for the KCG to use other revenue sources more optimally, particularly credit and private investment.

Lessons and success factors

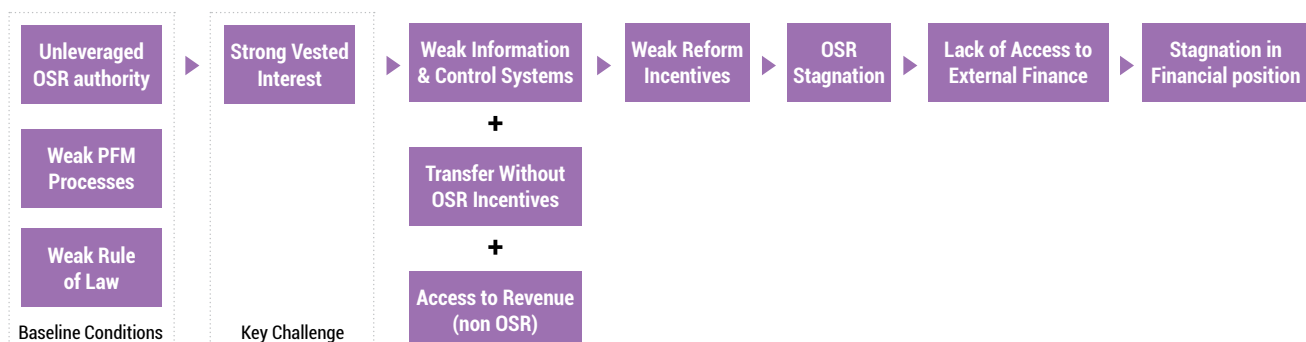
Overcoming reform hurdles

This case study analysis offers some lessons on chartering a successful reform path. For this, a decision maker needs to balance their desire to change the functionality of the system with the political legitimacy requirements of the local context. Ultimately, the exact form and sequence of reform steps must be determined through a process of problem-solving: attempting reform initiatives, closely monitoring progress and flexibly adjusting course to match outcomes.⁷⁷

Some of the lessons summarised below may also apply to other local governments. While there is always some degree of vested interest in the status-quo, it is particularly pronounced in contexts with weak adherence to the rule of law. For instance, weak compliance with PFM standards have exacerbated opportunities for public officials to benefit from dysfunctional municipal finance systems. Where tax collectors can openly accept bribes and make little effort to conceal pilferage, technical collection reforms are likely to meet steep internal resistance. In such a context, a local government ability to leverage its OSR can indicate the extent of vested interests. The lower the ratio of actual-to-potential OSR, the greater this resistance is likely to be.

A failure to overcome vested interests is likely to promote reforms that look promising on paper and provide short-term legitimacy gains to the government, but ultimately do not significantly alter the functionality

Figure 24: A simplified visualisation of KCG’s reform challenges



of the Municipal Finance system. Most of the KCG's OSR reforms fall into this category of isomorphic mimicry.⁷⁸ Sustaining reform initiatives and bringing about real change in these contexts, as in Kisumu, thus requires overcoming vested interests. Doing so will also require the strengthening of reform incentives to nourish a sense of urgency and foster political will.

Strengthening information and control systems

Adequate data management, reporting and control systems are critical for overcoming vested interests. Inadequate information systems make it difficult for government decision makers as well as the public to hold government officials accountable. Lack of information also makes it difficult to understand the status-quo, identify culprits, and uncover financial malpractice. In such an environment, decision makers will find it difficult to defend the need for reform initiatives as they lack the evidence to describe the gravity of the need for reform. They also lack the tools to understand why reforms are not meeting their intended targets and to adjust the course of reform. In such an environment, decision makers will struggle to identify the key reform entry points to quickly elicit results and support reform initiatives with needed legitimacy.

To overcome these challenges, Revenue Departments should avoid functioning as black boxes of information, but rather be as transparent and conducive to analysis as possible. Analysis of leakages should not be carried out as a one-off strategic capacity building initiative, but rather streamlined into monthly reporting

systems to expose malpractice and strategic weaknesses continuously. Data should be made as publicly accessible as possible and records must be cleaned to facilitate analysis. To better understand patterns of tax evasion, taxpayer information that is usually stored in separate records should be integrated on digital platforms. Reforms aimed at increasing compliance by sanctioning non-payment can particularly benefit from such integrated taxpayer records.

In a similar vein, internal information systems must be strengthened. Technical reforms will be insufficient if not accompanied by management reform among tax collectors. As evidenced by this case study, irrespective of the quality of the digital system or the number of devices used for revenue collection, additional management reform is needed to ensure successful implementation. Introducing POS devices without changing the method of monitoring collectors leaves them free to choose when to use POS devices and when to 'pocket' revenue. Payment automation also needs to be embedded in management systems that estimate daily revenue targets based on realistic potential of revenue stream and hold collectors accountable to achieving pre-defined targets. For this, historic revenue figures should not be used to define revenue targets, as these are unlikely to provide trustworthy baselines. Instead, Revenue Departments should use proven methodologies, such as top-down approaches (see UN-Habitat ROSRA), bottom-up revenue mapping (literal counting/surveying of the tax base) or manual testing. Manual testing would entail engaging new and reliable tax collectors for a short period to define targets based on the amounts they collect.

Unlike other reform initiatives that directly challenge vested interest groups, creating information systems is an indirect or a more covert way of limiting the power of vested interest groups. It is thus less likely to face the same level of political resistance, also because it might be more difficult for vested interest groups to conjure up legitimate reasons for resisting such reforms. Where this type of reform is not possible, the national government and outside actors can help to create the right incentives. The national government, in particular, can put in place standardised data management and reporting systems for local governments without increasing their control over subnational authorities.

Facilitating organisational change

When such reform options do not bear fruit, decision makers may have to opt for more drastic approaches. The Municipal Finance literature is replete with examples of how organisational reform and human resource reshuffling has been successfully used to overcome internal opposition to reform and create new functional OSR systems. Undertaking such measures requires significant political capital in the presence of strong reform incentives, which are often only possible once the right management and control mechanisms have been installed, or when there is a change in senior leadership. Newly appointed decision makers usually have less interest in defending past approaches and find it easier to expose past malpractice. Significant strategic pivots, as the one recommended by UN-Habitat may only be possible following a change in senior leadership as well as additional organisational change within the Revenue Department.

Introducing change in small and well-defined spurts

When political opposition is steep, decision-makers are well advised to advance the reform agenda in small and self-contained steps. When larger leaps of long duration are needed, the decision points should be pre-defined as much as possible and contained within one administrative

cycle. The valuation roll in Kisumu lost momentum as it dragged on for years, and extended to a new administration. It also struggled from a lack of clear and predefined processes for carrying over arrears. When change is introduced in small increments, realities change on the ground and slowly start to erode the basis of resistance of vested interest groups – before they can notice it.

Strengthening OSR incentives of governmental transfer formulas

The external environment can also play an important role in strengthening OSR reform incentives. One effective way of doing so simultaneously without restricting the autonomy of local governments is to refine inter-governmental transfer formulas.⁷⁹ When local governments violate PFM



Vegetable market in Kisumu, Kenya © Shutterstock

regulations, fail to provide crucial OSR related data, and – more broadly – underperform on OSR objectives, they should experience transfer reductions. Given the importance of OSR in enhancing counties' financial position, it would be a loss not to use this powerful resource lever to incentivise more serious optimisation of OSR reform and concomitant solidification of the rule of law, the social contract and government accountability.

Focusing on OSR as a precondition to accessing other sources of finance

This case study underscores the foundational importance of OSR for the financial position of local governments. Enhancing investments by skipping OSR is difficult and will greatly increase the costs associated with gaining access to external finance. Credit ratings can be a useful means of better understanding key OSR challenges, but

are unlikely to facilitate access to credit when the OSR system is not functional. As much as local governments and their national/development partners attempt to circumvent OSR-related problems and scale up government investment by accelerating access to other sources of finance, it is unlikely to facilitate the building of a solid finance foundation. In fact, it might lead local governments into a development trap and diverge attention away from an OSR system that needs to be fixed to meaningfully attract other funding. Thus, there is a need to consider framing OSR as a *pre-requisite* to unlocking other financing options, as opposed to just being a *stepping stone*.

Priorities for current and future reform

According to the KCG, OSR reform continues to be a key priority. However, its plans for overcoming existing bot-

tlenecks are still unclear. Given that OSR reform has been slow and that it only is a small percentage of the overall budget, the KCG is particularly keen to find ways of attracting private investment. In this, the successes of Mombasa and Meru County in creating Special Purpose Vehicles (SPVs) and Joint Ventures have served as an inspiration. The Lakefront Development of Kisumu, which is still in its preliminary stages, is the first project in Kisumu to be realised via an SPV. While there are currently very few investment opportunities that can offer sufficient revenue from user payments, the KCG can offer its public land to attract private investment. However, whether significant investments will materialise in this way in the near future remains to be seen. This case study suggests that if left unaddressed, the very roadblocks the KCG faces in addressing its Municipal Finance and OSR challenges might potentially also undermine its ability to attract other private investment.

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Enhancing the financial position of cities: evidence from Kampala

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Summary

The city of Kampala in Uganda provides an illustrative example of how institutional and administrative reform, without widespread policy change, can generate substantial increases in municipal revenues. Through the implementation of more efficient digitalised systems, attracting higher capacity staff, and a focus on the 'citizen as a client', the city has managed to increase own-source revenues three-fold from UGX 30 billion (US\$8.2 million) in 2010/11 to UGX 90 billion (US\$25 million) in 2018/19, as well as crowd in more central government and donor funds. These reforms were made possible by strong leadership, a political window to act, and

strong support from development partners. What was striking was the administration's reflection that its most significant success was not in doing something new, but rather in doing its job as it is meant to be done.

Furthermore, the reforms contributed to achieving an investment-grade credit rating in 2015, creating the potential for increased funding opportunities for large-scale investments in the future. This, coupled with recent regulatory change to remove the previously restrictive 10 per cent cap on borrowing, provides promising new avenues for attracting investments. However, a number of stakeholders

noted concerns that, despite overcoming regulatory hurdles, the city is still not equipped with the capacity to develop bankable plans and projects.

For development partners, the example of Kampala highlights the need for collaboration to build capacity, both in reforming systems and in designing implementable strategies and bankable projects worthy of external finance. However, concerns around the way development finance skews prioritisation of projects, as well as the difficulties in providing for ongoing maintenance which are often not accounted for in development partner investments, were also highlighted.

Key messages:

- Strong leadership and a commitment to building internal capacity are key ingredients underpinning organisation-wide and long-term success of reforms.
- The organisational structure matters: splitting the revenue and expenditure departments has enabled the authority to focus on each one as a priority in its own right, as well as better track receipts and communicate their financial position transparently.
- Simply understanding what the city owns (through an up-to-date asset register) results not only in an instant increase in the value of assets, but also in the potential revenue derived from those assets.
- Implementing a City Address Model (CAM) and using GIS to expand property registers has spill over benefits beyond that of revenue collection.
- Digitisation will not yield results unless part of broader reforms. For example, treating the 'citizen as a client' and business process mapping are important steps in building the social contract with communities and associated compliance benefits.
- Even without regulatory limitations, the ability to define and design bankable projects is critical for unlocking additional infrastructure finance in the future.

Urbanisation trends, challenges and financial needs

Uganda has, in recent years, managed to transform itself from a country with a turbulent past to one of relative stability and prosperity. The economy remains heavily reliant on agriculture and processing of agricultural products. Uganda has been experiencing consistent economic growth of around 4 to 5 per cent, with promising discoveries of crude oil and natural gas showing potential to enhance growth in the future. Despite its growth, the country continues to suffer from unemployment, poverty, and ineffective public spending. Uganda's GDP per capita is around US\$710, with 20 per cent of the country living in poverty. It also has a relatively low Human Development Index (HDI) of around 0.516 and a life expectancy of around 55 years.

In terms of domestic revenue mobilisation, Uganda has a relatively low tax-to-GDP ratio at around 14.5 per cent. While lower than the regional average of around 17.2 per cent, it is promising to have increased from only 11 per cent in recent years. Uganda was also the first country in the world to benefit from the Heavily Indebted Poor Countries (HIPC) initiative of the IMF and the World Bank, requiring US\$700 million in debt relief in 1998. This lack in ability of the national government to raise domestic revenues to finance the infrastructure needs of the country is felt at the local level too, which relies heavily on transfers from the centre.

The majority of the population continue to live in rural areas; only 16 per cent of the total population of 39 million live in urban areas. Kampala being the

only major urban centre, is therefore integral to the Ugandan economy. The city accounts for 80 per cent of the country's industrial and commercial activity, and contributes between 55 per cent and 65 per cent to national GDP.² There are five urban divisions in the city, namely Central, Kawempe, Makindye, Rubaga and Nakawa, with roughly 1.8 million residents overall. Only 23 per cent of Kampala is characterised as fully urbanised (with associated access to a full range of municipal services), while 60 per cent is semi-urbanised, comprising of 62 informal slums; the rest is considered rural.³

Considerable urban population growth in recent years has seen the city of Kampala sprawling to the surrounding districts. This has led to the formation of the Greater Kampala Metropolitan Area (GKMA), incorporating the districts of Mpigi, Mukono, and Wakiso. Each of these districts has its own mayor and local government. However, only the city of Kampala is managed by the Kampala Capital City Authority (KCCA). Significant levels of coordi-

nation are therefore required to plan and implement large projects which expand spatially across these different administrations. However, to date, there is no formal metropolitan governance structure, which is often the reason projects become too administratively complex to proceed with.

Daily commutes to Kampala from the surrounding districts for work increase the population in the KCCA's administrative boundaries from 1.8 million at night to around 4 million during the day. This daily jump puts incredible strain on the taxpayer-to-services ratio, as taxes are paid to the municipality one lives in, while citizens utilise services elsewhere. This is particularly noticeable in the high levels of congestion that Kampala faces, with significant need for investments in roads, parking, and public transit. It is expected that the ensuing pressure on service delivery will only continue to increase, with Uganda having an urbanisation rate of 5.2 per cent per annum, making Kampala one of the fastest growing cities on the continent.



Heavy traffic in the center of Kampala, Uganda © Shutterstock

Municipal finance and urban governance structure

Urban governance structure and mandate

In 2010, an Act of Parliament was passed that replaced the Kampala City Council (KCC), which had been suffering from years of maladministration, with the Kampala Capital City Authority (KCCA). The Act, termed the KCCA Act, included several stipulations that improved the enabling environment for reform – most notably, the separation of the political arm of the city from management functions, and converting the city authority into a central government entity. The latter required the creation of the Ministry of Kampala and Metropolitan Affairs, which is the ministry responsible for the KCCA.

The political arm, ‘Kampala City’, is led by the Lord Mayor and consists of the five divisional mayors, 34 elected councillors representing specific divisions and associated special interest groups. The core mandate of the political arm is to maintain contact with the residents to understand their challenges and needs, as well as monitor the impact of various projects, making recommendations that feed into the KCCA’s strategic development plans. In contrast, the management and operations of the city fall under the remit of the KCCA, an organisation led by the President-appointed Executive Director (ED). The latter is the arm responsible for implementing development projects and raising development funds.

Although these reforms have streamlined certain city functions and made

it easier to align with national priorities, until late 2019, there had been no clear delineation of the relationship between the various authorities that govern Kampala. The Minister of Kampala and Metropolitan Affairs, the Lord Mayor, and the ED of the KCCA, all hold important and influential positions, but there was uncertainty as to who makes the final decisions. Disagreements between different parties have therefore left many projects on pause.

Although disputes over certain aspects of the 2010 KCCA Act left progress in the city gridlocked for a long time, the KCCA Act amendment was finally authenticated in November 2019 and gazetted in January 2020. It now attempts to clarify the hierarchy of decision-making between the various Kampala authorities – strengthening the Lord Mayor’s office and streamlining roles and responsibilities. In addition, it removes the cap on borrowing explored below, opening possibilities for new sources of funding for much-needed future infrastructure. The final aspect of the amendment was in dealing with the broader metropolitan governance of the GKMA. While authority for planning across districts has been given to the Ministry of Kampala, it is still unclear how the fiscal relationship between authorities and the burden of revenue to service delivery will change.

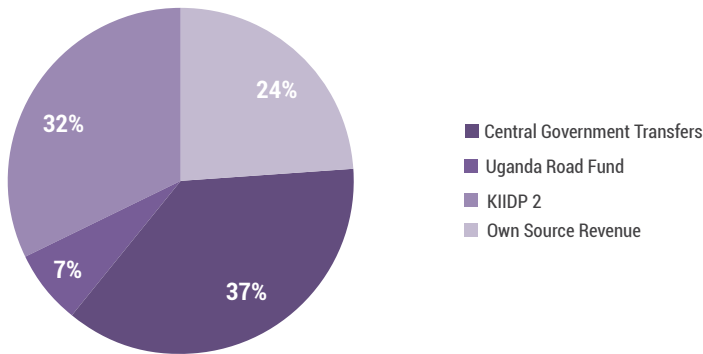
Despite the KCCA effectively becoming a central government entity, it must still abide by the Local Governments Act. In particular, it is still responsible for the same functionalities and can

leverage the same revenue sources. The KCCA consists of 10 directorates, each responsible for a different aspect of the city’s operations. These include the construction and maintenance of smaller roads, storm drainage, streetlights, and other local transport infrastructure. In addition, they support public schools, hospitals, libraries, museums and public parks, as well as promote and regulate economic activity such as slaughterhouses, markets, street vendors, transport operators, bars, clubs, and lodgings.

Municipal finance overview

The KCCA’s total revenues have increased substantially over the last few years, from under UGX 100 billion (US\$27 million) in 2011/12, to around UGX 480 billion (US\$125 million) in 2018/19.⁴ This jump is largely the result of a three-fold increase in own-source revenues, which were matched by increased contributions from the central government and development partners, reflecting their improved trust and confidence in the financial management competency of the KCCA.

Kampala’s revenue sources are comprised of central government transfers, own-source revenues, and grants from third-party providers. The split of revenues for 2018/19 is shown in Figure 1 below, with around UGX 170 billion (US\$45.6 million) coming from central government grants, an additional UGX 34 billion (US\$9.1 million) from the national Uganda Road Fund, and UGX 117 billion (US\$31.4 million) from own sources.⁵ Moreover, UGX 157 billion

Figure 1: 2018/2019 KCCA budget sources

Source: Nywomoya, A (2018)

(US\$42.1 million) came from the World Bank's second Kampala Institutional and Infrastructure Development Project (KIIDP 2), the most prominent source of development finance in the city.

Central government transfers are the single most significant contributor to the budget at around 37 per cent of the total when accounting for KIIDP 2, or 54 per cent without it. These grants are all conditional and therefore allocated to pre-identified purposes such as schools and healthcare centres, as well as salaries for KCCA staff. The Uganda Road Fund also contributes a further 7 per cent to total revenues. The Ministry of Finance, Planning and Economic Development (MoFPED) does not provide physical cash directly to the KCCA, but instead provides a platform through which KCCA can access their funding to make payments to suppliers and employees. The intention is to reduce the number of transactions and maintain close oversight on all public sector financial flows. However, it also means that the KCCA is reliant on the national treasury's financial strength and processes.

The KCCA has been advocating for a

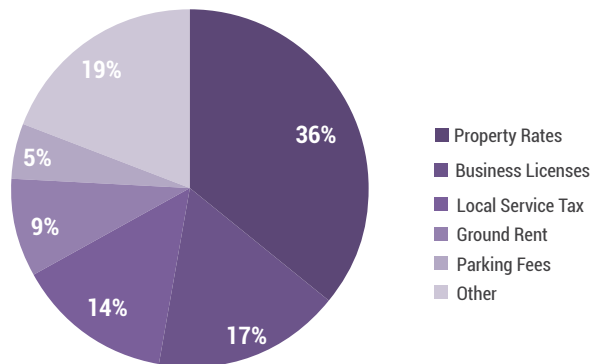
more substantial portion of funding from the national government on the basis that they are responsible for the majority of the country's GDP, as well as the rapid rate of population growth and daily in-migration of workers. Furthermore, the city of Kampala is where the Uganda Revenue Authority collects 72 per cent of their total revenue. However, given national constraints, and priorities to uplift and equalise rural districts, MoFPED does not envisage further increases in its transfers to the city. Instead, it has actually *decreased* its contributions to Kampala's budget for the financial year ahead. This reduction puts more pressure on the KCCA to find alternative sources of funding.

In terms of **own-source revenues**, the KCCA has a total of 24 revenue sources available for collection.⁶ These include, amongst others: property rates, parking fees (bundled with taxi licences for the 'matatu's', a 14-seater privately owned minibus), ground rents, business licences, local service tax, local hotel tax, land fees, building plan fees, markets fees, refuse collection charges, fines, advertising and billboards, and inspection fees. Water and electricity service providers

are not under the authority of the local government, but the KCCA is currently in negotiations with the national water and sewerage corporation on whether they can recover a nominal fee for either each connection or on each bill.

A unique and beneficial change instituted during the inception of the KCCA was the splitting of the revenue and expenditure departments. This split enabled the authority to focus on each one as a priority in its own right, as well as better track receipts and communicate their financial position transparently. However, there are trade-offs associated with such a split, with strong coordination being an essential requirement.

During the fiscal year 2018/19, own-source revenues made up 40 per cent of total revenues when compared with only 44 per cent central government transfers and the Uganda Road Fund, and 24 per cent when including development partner contributions. The key contributors were property rates at 36 per cent, business licenses at 17.5 per cent, local service tax at 14 per cent, ground rent at 9 per cent, parking fees at 4.5 per cent, with all the rest accounting for 19 per cent together as shown in Figure 2 below.⁷ The majority of own-source revenues have grown steadily, altogether increasing three-fold from UGX 30 billion (US\$8.2 million) in 2010/11 to UGX 90 billion (US\$25 million) in 2018/19, primarily due to improved identification of taxpayers, as well as automation of internal operations and municipal finance systems.⁸ The objective is that as own-source revenues continue to increase, more and more central government grant funding can be used for investing in capital projects, rather than on meeting ongoing maintenance expenses.

Figure 2: 2018/19 KCCA own-source revenues

Source: Data from KCCA revenue department

However, these local revenue sources are still subject to national politics. For example, in 2005 (before the 2006 election), the Graduation Tax, a form of head tax levied on all men and working women over the age of 18, was simply removed with a presidential letter to the MoFPED overnight. The Graduation Tax was one of the largest sources of revenue for local governments, and unlike most taxes in Uganda, covered a large base at a nominal amount per person.⁹ The removal was on the grounds of it being 'backwards' as well as complaints about the 'dehumanising' manner in which it was collected.¹⁰ Although a hotel tax and local service tax were introduced in its place, they did not generate the same amount of revenue.

At the same time, a revision of the Local Government Ratings Act of 2005 exempted owner-occupied properties (which make up almost 40 per cent of the total¹¹) from paying property taxes. Estimates show that these exemptions resulted in a loss of 45 per cent of property tax revenues and are causing undesirable distortions in the property market.¹² Furthermore, it complicated the administration of property taxes, as owner-occupied and rental properties are often hard to discern from one

another. Similar to the Graduation Tax, the intention was possibly to garner political support from influential property owners in the city.

More recently, another directive delivered by the president in October 2018 removed the revenue from fees on Passenger Service Vehicles (PSVs – i.e. taxis and buses). The operators used to pay UGX120,000 (US\$33) monthly. These fees made a substantial contribution to 'parking fees' in the budget, constituting the second most significant source of own-source revenue, at around UGX 20 billion (US\$5.4 million) per year.¹³ Given this enormous loss to city revenues, the government has since reinstated the fees to commence in 2021. However, in order to streamline taxes and payments and limit the disruption, unrest and inefficiencies that multiple payments were causing, daily or monthly fees were replaced with an annual fee of UGX 720,000 to UGX 840,000 (US\$190 – US\$225) for taxis and UGX 2.4 million (US\$640) for buses, paid directly to the Ugandan Revenue Authority (URA).¹⁴ This is roughly half of what the previous fees were bringing in. The new arrangement would allow PSVs to operate anywhere, and the revenue generated would then be split between local

authorities in agreed-upon ratios. Considering these losses, the own-source revenue achievements of the KCCA becomes even more impressive.

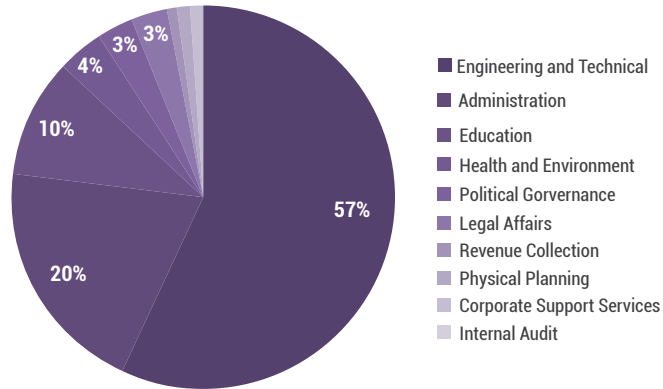
In terms of **debt financing**, the KCCA has made significant progress in terms of creditworthiness. However, until very recently, it has been unable to borrow in its own right from local and international markets. This was due to limiting legislation, with the Local Government Act capping borrowing at just 10 per cent of own-source revenues. In late 2019, the Kampala Capital City Act was amended, and the cap removed. However, stakeholders expect that even with the cap's removal, the KCCA continues to lack the capacity to develop the bankable projects necessary to attract debt financing.

Development institutions, on the other hand, continue to play a substantial role in funding Kampala's operational reforms, as well as large infrastructure projects. Most notably, the World Bank has provided extensive funding through two phases of the Kampala Institutional and Infrastructure Development Project (KIIDP). The first phase that ran from 2007 to 2013, focused primarily on improving the institutional efficiency of the KCC through the implementation of the Strategic Framework for Reform. The total value of the project was US\$37.1 million, with US\$3.5 million provided by the Government of Uganda.¹⁵ KIIDP 2 then started in May 2015 and contributed around US\$183.7 million by 2020.¹⁶ This second phase is focusing on city-wide infrastructure and institutional systems support. The infrastructure focus has been mainly on transport: the construction of roads, drainage, and associated infrastructure. Meanwhile, the institutional reform is focusing on creating an automated

register of all properties and roads in the city, constructing a traffic control centre, and streamlining revenue management systems.

As shown in the figure above, in 2018/19 KIIDP 2's contribution made up 32 per cent of the overall budget – however this and other donor contributions are liable to vary widely from year to year. While the money is provided as a loan to the Ministry of Finance with a low interest rate of 2.11 per cent¹⁷, it is passed through to KCCA to manage and implement.

Figure 3: KCCA 2018/19 budgeted expenditure



Source: Nywomoya, A (2018)

While revenues have been increasing in the city, there has been a commensurate increase in **expenditure**. Figure 3 below shows the breakdown of the budget by directorate, with the engineering and technical services directorate accounting for more than half of the budget. The department is currently focussing on catching up on much-needed repairs and maintenance, as well as designing studies

and plans for future investment – particularly on road and drainage infrastructure. Most recently, the focus is on traffic signalisation at junctions as opposed to roundabouts – which research has shown to be very effective in enhancing city connectivity.¹⁸

Administration is the next largest, which includes civil servant salaries. The staff bill has increased substan-

tially since KCCA's establishment, due both to an increase in the number of staff, and their levels of skill and experience. It is interesting to note that physical planning, which is responsible for surveying and securing all public land and assets, managing and processing building plans, and implementing city addressing, takes up such a small share of the budget as no central government funding can be used for this purpose.



Kikuubo Market, a hub for the trade of whole sale goods, Kampala, Uganda © Shutterstock

Reforms undertaken to enhance the city's financial position

Enhancing the capacity of city financial management

Two critical elements have underpinned the KCCA's approach to enhancing its capacity in financial management. The first stage of reform was around people, both in leadership and the capacity of the workforce. The second stage was then on process, streamlining and digitising systems to maximise efficiency, while keeping the citizens' interests and experience at the heart of all change.

Human capacity

The Executive Director (ED) was appointed directly by the President and was therefore empowered to make decisions. At the time, the person appointed was Jennifer Musisi, whose technocratic approach and zero tolerance for corruption created quick credibility and trust in the institution from external partners. Furthermore, she arrived from the URA, which had already undergone substantial digitisation, integration and capacity reforms to achieve well-running systems for revenue generation and collection. This meant she had existing knowledge of the systems the KCCA needed to improve.

The ED recognised that at the core of strong performance, was a highly capable and motivated team that can deliver results. She brought a group of highly skilled technical staff along with her from the URA, who could instil a new set of skills and work ethic amongst the remaining employees

transferred over from the KCC. In order to attract these highly skilled people, the KCCA has much better-paid staff than other local governments and national ministries in Uganda. In fact, the staff expense to income ratio is above the acceptable benchmark of 35 per cent.¹⁹ However, in recent years the ratio has shown a sharp downward trend, indicating that the new people hired (although more expensive) have had a positive economic impact on the KCCA's overall financial position.

To maintain this level of capacity and motivation, the KCCA has created a culture of ongoing learning. For example, organisation-wide training was made available through the Local Economic Acceleration through Partnerships (LEAP) programme, a two-month leadership programme for managers. Another example was, where relevant, making staff training a mandatory component of service provider and consultancy projects and contracts. The aim being to enable similar projects or services to be provided in-house in the future. The consultancy agreement for the automation of various revenue systems was a case in point and is described in more detail below.

However, although the results demonstrate a positive impact of these reforms, the removal of many of KCC's existing employees was highly controversial at the time and resulted in costly lawsuits. In 2018, The Ugandan High Court ordered that KCCA should pay UGX 91 billion (US\$24 million) to compensate 679 former KCC employees

who were determined as wrongfully dismissed, given that there was no provision for them to be absorbed into other public service sectors.²⁰ This total is close to a year's worth of own-source revenue collection. This illustrates that financial and political costs of these reforms need to be weighed against long-term efficiency gains of a high-capacity workforce.

System reform

Before 2010, KIIDP 1 had laid some of the groundwork for this by putting the Financial Recovery Action Plan (FRAP) in place, which had the ultimate goal of reducing the level of indebtedness and achieving clean audit reports. In the mid-2000s, overdue liabilities in the form of outstanding payments for goods and services accounted for about 30 per cent of the annual budget.²¹ The FRAP stabilised the budget by increasing property tax collection and working out a payment schedule for overdue liabilities over a 5-year period.²² At the same time, the plan focussed on changing citizen perceptions and creating community buy-in, ensuring that two-thirds of property tax revenue was used in improving services in the same collection zone.

The progress made during the FRAP was then augmented with the inception of the KCCA. The first major reform was to split the revenue and expenditure departments, with the former linked to a commercial bank and the latter to the central bank. Splitting the departments allowed each element of the budget to be focused

on exclusively, while also improving financial management and oversight in the city. In addition, previously outsourced revenue collection was brought back within the remit of the Authority. In doing so, the number of bank accounts used for revenue collection could be collapsed from 151 accounts to 8 in 2011.²³ This reduction enabled more efficient and transparent tracking of revenues coming in.

When the new technical staff arrived in the KCCA, there were very few systems in place: limited phones and computers, and no intranet or website. The priority was to create a digitised revenue management system, with the intention of locating payments in real-time, using a system with similar foundations to those in the URA. The digitisation and automation of revenue sources was done in stages and took two years to become fully operational. Public transport and business licenses were targeted first due to their frequent collection, and therefore, substantial potential gains from automation. Following this was the local service tax, local hotel tax, and market fees.

The 'eCitie portal' was then launched in 2014 as Kampala's electronic revenue management system, allowing for online registration and payment of local taxes and fees, as well as automatic billing, payment reminders, and generation of receipts. Instead of travelling to designated banks to make payments, residents could pay via mobile money, reducing the cost both in time and expenses incurred to make the payment. The overall result was that revenue reconciliation dropped from one month to one day, vastly increasing taxpayer satisfaction. The platform also encourages citizens' feedback – to date, there have been around 9 million

message exchanges. Figure 4 shows the vision, mission, and core values of the KCCA and the eCitie project.

There were two fundamental elements to the success of the new systems. The first was the initiative to undertake business process mapping. Many city governments implement new systems in the hope of enhancing their efficiency and effectiveness. However, few designers of those systems have taken the time to properly understand the protocols or interactions at each stage. In Kampala, each person involved in the design and running of the new system spent significant time with the user to fully understand their experience and adapted the design accordingly. This was complemented with widespread stakeholder engagement to understand what *could* or *should* be done and analysing the gap between the two to come up with a workplan. The idea was that prior-

itising user experience would increase compliance.

The second was developing in-house capacity to build the software for these systems. While the upfront capital cost of procuring the system was high at about UGX 9.9 billion (US\$2.75 million)²⁴, the contract required the service provider to train the KCCA staff in the methodologies used, as well as leave them with the source code. External consultants were therefore only hired to automate the first, and most complicated system – public transport. The KCCA staff then adapted the code to automate other systems such as business licenses, market fees, local services tax, and the hotel tax. Having in-house programmers ensured that all the different aspects of automation were able to speak to one another, resulting in the consistency and coordination of both the intra-city and inter-city systems.

Figure 4: Coordinated vision, mission, and values of KCCA



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Capturing land value and unlocking dead capital

Alongside the capacity and operational reforms, Kampala's efforts to identify city-owned land and property assets, update the city property register, as well as implement a more efficient and fit-for-purpose property valuation system have contributed greatly to own source revenue enhancement. Furthermore, activities undertaken in this process including the City Address Model (CAM), improved use of GIS, and widespread data gathering, have improved city planning and created opportunities far beyond that of revenue collection.

Management of land and property assets

One of the first major revenue reforms undertaken after the establishment of the KCCA was the compilation of an accurate asset register. In 2011, KPMG were contracted to conduct the physical verification of the assets and their locations. These assets included school land, public spaces, and productive income-generating assets such as land for infrastructure development and markets.²⁵ Importantly, it also included reclaiming the numerous lands and properties that belonged to the city but were being used by private entities with no compensation paid to the city. This process of documenting assets that were previously not reported resulted in a tenfold increase in the book value of KCCA's fixed assets from UGX 41.5 billion (US\$ 11 million) to UGX 421 billion (US\$113 million) the following year.²⁶ Fixed asset values continued to increase as new properties were identified and more development took place, reaching UGX 550 billion (US\$150 million) in 2018. Understanding this position allows the city

to better leverage their assets to maximise the income that they generate, as providing collateral for investment.

Property tax reform

Property taxes are the most crucial source of revenue in the city; however, until recently, its collection has been far below potential due to outdated valuation rolls and widespread exemptions. Property taxes are levied on all commercial, institutional, and rented residential properties. The rate is calculated as a percentage of the actual or estimated annual rental value, and adjusted for various factors depending on the property type.²⁷ The current rate applied is 6 per cent, which is within the margins set out by the Local Government Ratings Act.

In Uganda, the law requires local governments to update property valuation rolls every five years. However, the last valuation in Kampala (before the current one) was done in 2005, with one supplementary valuation conducted in 2009. This hiatus meant that the KCCA property tax revenues did not capture the increase in property values of over 300 per cent during that period, nor did it capture all new properties built from 2009 onwards.²⁸ The delay was partly because property valuations are expensive, particularly when they are done manually – as was the case in Kampala. This resulted in a negative spiral, where a lack of revenue collections meant the city could not afford an updated valuation, and therefore could not gather property taxes, resulting in even lower revenues.

In order to break this cycle, in 2016, the KCCA, with assistance through KIIDP 2, undertook a rigorous process of addressing and valuing all properties in Kampala, with the aim of dig-

itising and automating certain processes. These projects were known as the City Address Model (CAM) and Computer Aided Mass Valuation (CAMV). They included all five divisions in Kampala with over 300,000 properties, starting with the Central division of about 15,000 properties where there was potential to gain most revenue. The other divisions followed in phases. The updated roll has seen the potential collection just from the Central and Nakawa divisions, rising from UGX 14 billion (US\$3.8 million) in 2013/14 to 38 billion (US\$10.3 million) in 2018/19.²⁹ The steps undertaken for this reform are outlined below.

Sensitisation of the public: Local leaders were included in the property addressing and valuation process to help with consultation of property owners or tenants. The consultations usually took place during regular community meetings, and ensured residents were adequately informed at each stage of the process, including data collection, value publication, and billing. While the involvement of local leaders significantly reduced the number of formally lodged disputes, in some cases residents still refused access to their properties when it came to data collection. In a smaller few, it was alleged that some local leaders encouraged people to avoid these taxes altogether. In these cases, higher levels of leadership, such as mayors, had to be brought in.

Fieldwork: The fieldwork for the street addressing system as well as to update the valuation role were undertaken concurrently. Research assistants collected more than one hundred data points, including information on ownership, location, neighbourhood, and property attributes. While not everything was necessary for the

valuation exercise, the KCCA used the opportunity to collect additional information that could be potentially beneficial for future activities as well. The survey form was designed by looking at similar surveys conducted in other countries, as well as meeting with all directorates to determine what relevant information they might need.

Addressing: The City Address Model (CAM) provided all roads with road names, and all the properties with unique property numbers, which were different from the existing plot numbers. Figure 3 shows both numbers. A key feature was the incorporation of GIS mapping to ease identification of properties and to integrate spatial information into digital platforms. There were some challenges faced in terms of the agreement on road names, often due to people having named roads informally and not wanting them to be changed. Theft and damage of signage for scrap metal also caused delays and increased project costs.

Valuation: Instead of contracting a private firm, the valuation was done in-house, which made the valuation much more affordable. The approach also resulted in a change from focusing on large commercial properties which contributed relatively high tax revenues, to looking at each and every property, regardless of whether it was currently taxable. This was done to ensure that the data was ready and available in case of status change. Once the property values are calculated, they are published and available for 30 days so that the public can raise any queries. They are then officially gazetted as part of the valuation roll.

Billing and payment: Bills are issued both via the old system of physical paper-based bills, as well as the new option to register on the online eCite portal. Payments can also be made through a multitude of methods, including the new mobile money platform, reducing the burden on taxpayers who would earlier have to queue at the bank and waste 2-3 hours of their day just to pay.

Integration with other systems: Land management in Kampala is split between numerous different departments and government agencies. For example, the Ministry of Lands, Housing and Urban Development (MLHUD) processes all land registration. However, the KCCA is responsible for issuing development and demolition permits through the Directorate of Planning, and valuing properties and setting relevant taxes through the Revenue Directorate. The data that each of these separate entities hold is incredibly useful and informative for the work of the others. Therefore, creating an integrated system that can trigger rates billing when households are issued an occupancy certificate, or cancel rates payments when a demolition permit is issued, will significantly enhance the efficiency of all operations. Two developments show progress in this regard:

- Discussions with MLHUD and the URA are already underway on information sharing; the way forward depends on resolving the technical challenge of integrating the two systems.
- There is currently a pilot in some of the GKMA municipalities funded by the World Bank, called the Integrated Revenue System (IRS). It aims to integrate all property information in the region into one system, including the revenue management, land information, and physical planning systems.

Computer Aided Mass Valuation: Computer Aided Mass Valuation (CAMV) is currently being explored with the aim of making property valuation more efficient and cost-effective in the future. The data points on select property characteristics collected during the

Figure 5: Updating the street addresses in KCCA



fieldwork process described above are used as a basis for predicting or extrapolating property values. This replaces the need for market data on each individual property in the future. The International Growth Centre (IGC) has supported the KCCA by analysing different regression-based models of mass valuation.

Although the initial investment to set up a system like this is large (mostly due to the data collection described above), there are minimal ongoing costs once implemented. International experience suggests that it may cost between US\$3-6 million and would see recuperation within 3 to 4 years of gradual implementation.³⁰ In addition to dramatically decreasing the cost of future valuations, it also enables policymakers to cover both formal and informal areas.³¹

Interestingly, Uganda is one of the few African countries with Mass Valuation already provided for in the Local Government (Ratings) Act. However, to apply it city-wide would require a change in

the city by-laws to stipulate the practicalities of its implementation as well as substantial sensitisation. There has already been some resistance to the pilot, with stakeholders arguing that the estimated valuation, although cheaper, is not nuanced enough and has the potential to be regressive. Furthermore, it is likely to increase the number of people querying their valuations, given that they are not specific to the individual property.

Ongoing challenges in capturing land value and dead capital

Multiple tenure systems: One of the primary challenges in levying property taxes, and the fundamental reason as to why land taxes in Kampala do not exist, is the complexity of the different tenure systems in the city. In total, there are four tenure systems, each with their own rules of governance and management, resulting in incomplete land registries and widespread confusion over land rights. Property rates and ground rents depend on the tenure system a parcel of land is under, and

there are also different forms of proof associated with each one. In some cases, there is no legal document, and the onus is on the local leader to certify ownership. Although this is a long-term issue under the jurisdiction of the national government, it is important to note as a key area for reform to enhance the financial position of Kampala. Figure 4 shows an informal display of ownership.

Informal land transfers: In addition to the complexity surrounding the tenure system, around 75 per cent of land in Kampala is not formally registered and therefore cannot be taxed. As previously mentioned, for unregistered land, there is no formal documentation showing its value, and is therefore likely to be misrepresented by the owner. This distorted market is particularly difficult in informal settlements, where high levels of density, multiple owners, and high rates of property exchange compound the other issues experienced. In an attempt to remedy this, the MLHUD is looking into how blockchain could be used in the management of land transactions. This is primarily to ensure that in the future, transactions of properties are at the market rate. It also helps with reporting since people cannot under or over-report these figures. However, tackling land governance challenges should be a prerequisite to implementing blockchain solutions.³²

Flat, standardised property rates: While the central government sets the ceiling for how much local governments are allowed to charge for property taxes, local governments can decide within that where to set it with Council approval. Currently, local governments are allowed to charge up to 12 per cent of net income from the property, and Kampala has set

Figure 6: Land right issues in Kampala



their property rate at 6 per cent. This rate is mirrored in the fellow Ugandan municipality of Tororo, although it is 5 per cent in Gulu, and was recently reduced from 6 per cent to 4 per cent in Kabale.³³ These ceilings need revisions, and might also benefit from being made more progressive.

Tax exemptions: Even though Kampala has made substantial progress in increasing revenues generated from property taxes, the actual collection continues to be far below its potential. While this is primarily due to issues with compliance as discussed below, it is also a result of the numerous property tax exemptions legislated in the Local Government (Ratings) Act. For example, while taxes can be levied on rental and commercial properties, owner-occupied properties, which make up 40 per cent of the total, have been exempt from paying property taxes since 2005.

Enhancing tax compliance

Compliance is one of the most significant barriers to increasing all local revenue; many people do not see why they should pay, while others do not have the necessary information. Often enforcement can become very politically and financially challenging. For example, even though the property tax base has been expanded and tax potential has increased, actual collection has not increased as anticipated as property tax compliance remains low. In the 2019/20 financial year, only 12 per cent of properties paid their taxes on time, and only 34 per cent of potential revenues have been raised.³⁴ While this may be particularly affected because of COVID-19, it remains a chronic challenge due to weak means of enforcement and low tax morale.

The KCCA have made increasing the social contract with residents one of their top priorities – including the ‘Citizen as a Client’ campaign, matching service delivery to tax payments, and widening the tax base to reduce the burden on existing taxpayers.

‘Citizen as a Client’: This approach has transformed the way the KCCA deals with tax collection and service delivery. The city is trying to build their relationship with communities around a shared understanding of their respective responsibilities; i.e. the city tasked with delivering high-quality services, and citizens for their part, paying their taxes. The goal is to provide citizens more information and make applications and payments much more convenient in the hope that this will better incentivise taxpayers to comply. Given the high enforcement costs, encouraging voluntary compliance is a far more sustainable solution, and has been enshrined in the development of the KCCA citizen charter.³⁵

Some of the strategies used include:

- Decentralising revenue collection centres to make payment more accessible;
- Automation and diversification of payment methods and making services available online through the e-Citie portal;
- Creating a ‘one-stop-shop’ where people can get all their required services attended to and processed in one visit;
- As highlighted above, involving the people responsible for providing citizens with information in the design and implementation of new systems and processes, so that they can provide advice from first-hand experience;
- Establishing a Large Taxpayer Office for the people responsible for the majority of fees and taxes, providing special services to encourage compliance.

Figure 7: Citizen as a Client in KCCA and Building the social contract



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However, there is still much progress that needs to be made, particularly on the two fundamental challenges of meeting residents' expectations in the delivery of public services, as well as widening the tax base to limit feelings of injustice by those who pay.

Matching service delivery to tax payments

One of the major impediments to increasing compliance is that citizens do not yet see the link between the taxes they pay, and services received. While generally better communication on what the city is doing with taxpayer money is essential to enhancing buy-in, the practical demonstration of projects sends a far more impactful message. However, some of the negative perceptions around service delivery is also the result of failure to provide from other jurisdictions or at the national level. Residents are mostly not discerning about which services each government entity is responsible for delivering, nor where the taxes they are paying are going. Government is seen as a single entity, and therefore what the national government does affects the social contract with KCCA and vice versa.

One of the primary ways in which the KCCA aims to tackle this is through investing in highly visible projects such as small-scale waste removal in dense residential areas. While investment in large city-wide infrastructure, such as water processing plants, may have a significant impact on the city overall, it is not visible or personalised to the average citizen. Investing in social infrastructure at the micro level empowers citizens and disrupts the negative cycle of people refusing to pay their taxes based on lack of service delivery. The KCCA sees investment in visible city-branded service delivery projects as an

essential way that development partners can help contribute to increasing compliance in the future.

In addition, as mentioned above, the Large Taxpayer Office is currently making good inroads in the prioritisation of service delivery to taxpayers who are responsible for paying a larger share of taxes. Although this does not have the same pro-poor benefits of the strategy above, it does increase compliance of the most important contributors to the revenue base, allowing for higher service provision overall. In fact, property tax compliance of the highest valued properties are four times higher than the lowest valued ones.³⁶

Building the tax base to reduce pressure on taxpayers

Both the KCCA and the URA face the challenge of a very narrow tax base, often choosing to increase revenue by putting more pressure on the larger taxpayers, rather than taking on the challenge of expanding the base. As a short-term strategy, the KCCA is ensuring that all potential taxpayers are captured on their registers by sharing and exchanging taxpayer databases with the URA and the National Social Security Fund (NSSF) to identify those who are missing. However, in the long run, high levels of informality, low incomes and unemployment, as well as the numerous tax exemptions, make it both ethically and politically challenging to tax large portions of the population.

To combat this, the KCCA is employing initiatives that focus on *building* the tax base and creating an enabling environment for businesses to thrive. They are currently looking to do more research on why and where firms are emerging and why others are dropping off the register and closing. As

a senior member of the KCCA put it, "we cannot continue to milk the cow without feeding it".

Improving the regulatory environment for access to finance

Since the KCCA's establishment, it has not used any form of direct borrowing to finance its projects or operations. Instead, all borrowing (such as the KIIDP loan) is done through the MoFPED and is provided to the KCCA as a grant. However, much of the focus around the revenue system and administration reforms, as well as targeted increases in specific own-source revenues, was centred on achieving the goal of the KCCA being creditworthy in its own right. A major breakthrough was the recent removal of legislation requiring borrowing to be capped at 10 per cent of own-source revenues, which has opened up the possibilities for multiple new financing mechanisms. However, despite this, concerns remain over the ability of the KCCA to develop bankable projects that meet investor requirements.

Creditworthiness initiatives

Active creditworthiness reforms started in 2012, building on the progress made through FRAP with support from the World Bank's PPIAF's Sub-National Technical Assistance (SNTA) programme. In line with the KIIDP programme, they have been working with the KCCA on enhancing own-source revenues, along with improving financial management, accounting policies and procedures, and debt management practices. In 2012, the Auditor General gave the first unqualified audit opinion, which KCCA has now maintained over several consecutive years.

In 2015/16, the KCCA undertook its first official credit rating assessment. It achieved a national scale rating of A- in the short term, and A in the long term, by The Global Credit Rating Co.³⁷ However, the fact that this is a national scale rating means it only represents the position of Kampala relative to other borrowing entities in the region. Putting the rating in context, Uganda's international credit rating has consistently stood at around B+ (Fitch), B2 (Moody's), and B (Standard & Poor's), which are all below investment grade.³⁸ This tempers the extent to which people see the KCCA as investment-worthy on an international scale. However, it does bode well for the KCCA's progress within its given context.

The ultimate goal of establishing creditworthiness was to increase overall investment confidence in Kampala, as well as to take concrete steps towards issuing a sub-national bond. Following the establishment of creditworthiness, the procedure for floating a municipal bond in Kampala would include: packaging a bankable project, going through the relevant national government reviews and approvals with MoFPED (who are ultimately the liable party if KCCA were to default), doing a roadshow to attract investors, and then working with the Bank of Uganda to issue the bonds on behalf of MoFPED. However, legal obstacles to borrowing, as well as limited capacity to develop bankable projects made issuing a bond, or taking sub-national loans more broadly, an unlikely prospect.

Legal obstacles to borrowing

The Local Government Act of 1997 stipulates that local governments can only borrow up to 10 per cent of the previous year's own-source revenues. At current collection rates, this would be

about UGX 900 million (US\$240,000). By comparison, this would cover just 14 metres of a Bus Rapid Transit (BRT) line in the city according to a recent feasibility study.³⁹ The inclusion of the clause was a way to ensure that local governments could not over-burden themselves (and thereby MoFPED) with debt. In Uganda, caution over debt is particularly prevalent, given their history of being the first country to be declared a 'Heavily Indebted Poor Country' (HIPC), requiring US\$700 million in debt relief in 1998.⁴⁰

While well-intended as a measure for protection, the cap on municipal borrowing has inhibited the use of this mechanism as an alternative source of financing entirely. The KCCA is not willing to expend the effort of taking a loan when they can instead focus on increasing own-source revenues by the same 10 per cent. Stakeholders felt that even if the cap was a higher percentage of own-source revenue, it would not be sufficient. Instead, the base requirement to float a municipal bond should be on the ability of the project to recover its costs from user fees and other revenues.

After numerous cabinet discussions, there was agreement that the KCCA should be exempt from the borrowing restriction clause in The Local Government Act. The fact that the KCCA is a central government agency, and that Kampala is the hub of economic activity in the country with extensive revenue generation potential, were strong arguments in their favour. However, legislating the KCCA's exemption required an amendment to the KCCA Act, which was stalled for several years, with numerous other contentious amendments required. Finally, early 2020 saw the Kampala Capital City (Amendment) Act

gazetted, removing (amongst other issues as highlighted above) this legal obstacle to borrowing.

An additional legal challenge is that there is currently no single law that governs how to account for and manage municipal bonds. The Companies Act and Capital Markets Act, which would have oversight on this, have conflicting approaches. The Credit Markets Authority (CMA) is in charge of the regulation and promotion of capital markets in Uganda, and therefore municipal bonds would fall under its domain. The CMA is therefore currently developing a set of 'bond issuance guidelines' to fill the gap in the legal framework. These guidelines are following both acts as closely as possible to ensure that the guidelines are enforceable.

Limited ability to develop bankable projects

Even more than the legislative challenges, the KCCA does not have the capacity to develop bankable projects and the associated documentation, a sentiment held with many stakeholders. Therefore, even with the removal of the 10 per cent cap, they would still not be ready to launch a successful municipal bond. The capacity gaps highlighted include a lack of continuity and foresight in strategic plans, inability to develop (trustworthy) feasibility studies, lack of expertise and experience in preparing financial models, and immaturity of internal controls and financial management systems.

There is, therefore, substantial scope for other government entities and development partners to assist in preparing bankable projects. MoFPED has a whole unit dedicated to assisting

with bankable projects. This 'Integrated Bank of Projects' (IBP) acts as a tool for registration, tracking, and most critically, strengthening project preparation, implementation, and evaluation.⁴¹ The IBP hopes to improve capacity in designing these projects, with an aim of doubling the investment absorption rate from its current level of US\$0.8 per dollar.⁴²

Although it is not directly part of their remit, the CMA also offers guidance in developing bankable projects in line with their requirements. The CMA focus on the contingent liability side, which involves looking at the financials and assessing whether it aligns with the public interest and the national development plan. In addition, as part of making the assessments easier to comply with, the CMA is moving from a merit-based method to a disclosure-based method of assessment. Disclosure-based ensures all information is available to investors, instead of the regulator making a judgement-based decision on the merits of the investment in an attempt to shield public investors. The hope is that this will result in a reduction of differences in information available and confidence in the investment.

Finally, development partners are well placed to assist with structuring and developing feasibility studies underpinning bankability. In fact, it was the area most highlighted by the KCCA for development partner assistance. However, as is the case of all external assistance to the KCCA, stakeholders believe that the key to this assistance being successful long term is in taking a collaborative approach. This is to ensure that the capacity to do it going forward is developed internally. Furthermore, a key ongoing debate across all development organisations

is how to define what makes a project bankable, and whether we should be looking at projects in isolation or investing in broader city systems that generate value and productivity as a whole. The definition adopted will have far-reaching implications for how investments are targeted in the future.

Realising the potential of investment in improving infrastructure

Given the progress made to date, the KCCA is in a good position to start exploring different options for infrastructure investment in the city. Key focus areas need to be identifying measures to further reduce the risk of investment, tightening up guidelines and processes with relevant authorities, and building capacity to develop and manage bankable projects. In the meantime, continuing to leverage the strong relationships built with development partners will be vital.

Investor demand for municipal bonds

Whether municipal bonds in particular, or other vehicles, investors in Uganda highlighted that there is more capital than there is supply of credible assets to invest in, along with an appetite to leverage this capital. The Ugandan pension market is mostly in government bonds, sitting in banks and not being fully utilised for productive assets. However, project returns on investment underpin a fundamental restriction in realising this demand. Ugandan treasury bills are relatively low risk and offer a one-year return of 13.5 per cent.⁴³ Therefore, relatively riskier projects at the KCCA level must provide a higher return on investment than government bonds. Over the last

10 years, the average bank lending rate in Uganda has exceeded 20 per cent which are high in both nominal and real terms when compared with regional peers and had a high rate of spread.⁴⁴ Borrowing at this rate is simply too expensive to maintain bankability of infrastructure projects. Prudent macro policy, improving competition and regulation in the banking sector, as well as other measures to reduce the risk of these investments at the local level, will be important in creating an investment environment conducive to all stakeholders.

Designing future municipal bonds

The type of bond a city undertakes can directly determine its level of risk as well as its probability for success. Going forward, the KCCA is not interested in taking on a general-purpose bond, as this puts out a fast call for repayment, requiring a level of stability in revenues not yet present in Kampala. The KCCA cannot risk draining existing revenue sources and tying them all up in large infrastructure projects, as there is still a need for those revenues to cover ongoing expenses such as road maintenance and waste collection.

Instead, the KCCA should favour a project-specific bond, in which the management of borrowed funds occurs in a separate account, and income-flows from that investment (user fees) would be used to repay the bond. In this way, short-term revenues match short-term expenditures and vice versa. Achieving this repayment could occur using a Special Purpose Vehicle (SPV) that is self-financing and lifts the accountability from KCCA. However, this would also require further legislative reform, as at present there is no law governing SPVs. As an interim solution, the CMA bond issuance guidelines will include

a section on SPVs and how to account for them. Another concern is that user fees might exclude certain parts of the population who cannot afford to pay them. There is also a need for extensive sensitisation and behaviour change, given the resistance towards payment of user fees from communities.

Partnering with development institutions

The creditworthiness of a city also determines the extent to which development partners and international finance institutions are willing to get involved in providing the capital for

infrastructure investment. In Kampala, the human capacity and administrative reforms undertaken have renewed the trust of development partners, and a number of projects were either initiated or expanded. Key development partners working with the city include, amongst others, the World Bank



Farmer's market in Kampala, Uganda © Shutterstock

(through KIIDP 2), the UK's Department for International Development (DfID) (through their Cities, Infrastructure and Growth programme), the Netherlands Embassy, the European Union delegation, Japan International Cooperation Agency (JICA), United Nations Capital Development Fund (UNCDF), African Development Bank (AfDB) and the French Agence française de Développement (AFD).

There are three primary ways in which development partners assist with finance: grants, loans, or some combination of the two – otherwise known as blended finance. Finance from development partners and IFI's usually has far more favourable terms when compared to what can be provided by local banks or bonds – their model being making low margins on a large number of projects, and raising money at low rates on the international market. For the most part, grants and loans are arranged at the national level, as the fiduciary risk at the sub-national level is too high. In Uganda, the counterpart is usually MoFPED.

External guarantees and blended finance mechanisms are proposed as a solution to offset the risk involved with municipal bonds, as it reduces the burden on the central government. While this was indicated by most stakeholders as a promising way forward, some asserted that the involvement of development partners could make processes more bureaucratic – enhancing accountability but slowing down delivery. Development partners at the national level also means that they have neither the incentives to ensure that projects are designed with the city's priorities in mind, nor that the KCCA will have the revenue to repay the bond and cover ongoing operations and maintenance costs.

Public private partnerships

The Public Private Partnerships (PPP) Act was recently passed in 2015, opening up new opportunities to leverage private sector investment. However, lack of experience on the part of contracting authorities, weak inter-governmental cooperation, and little

knowledge of best practices continue to impede implementation.⁴⁵ Currently, no projects in Uganda have gone through the process outlined in the act, but were rather negotiated and concluded under prior guidelines and frameworks.⁴⁶ To remedy this, the national government set up a specific PPP unit, which helps build capacity, particularly in structuring partnerships and contracts.

However, sound project development is still a preliminary issue that needs to be overcome before PPP mechanisms are explored. PPPs require a strong authorising environment with the ability to coordinate, and research shows that they are typically only feasible for large-value projects over US\$50 million, given the high transaction costs incurred in structuring the deal.⁴⁷ Similar to other investment structures, they require capacity to build bankable projects, as well as face issues surrounding the affordability of user fees and resistance from the community to pay these.

Lessons, success factors, and priorities for future reform

The reforms achieved by the KCCA since its inception in 2012 illustrate how institutional and administrative reform, without widespread policy change, can generate substantial increases in municipal revenues, even within economically constrained contexts. Striking was the administration's reflection that their most significant success was not in doing something new, but rather, doing their job as it is meant to be done. Furthermore, efforts to reform regulation and expand opportunities for enhancing the city's financial position have been passed, including the removal of the cap on borrowing, and clarity on the hierarchy of decision-making in the city's governance structure. We are yet to see whether this will bring the catalytic change envisioned. Development partners now have an important role to play in building capacity and de-risking municipal investments. However, caution also needs to be taken to ensure development funding does not skew strategic prioritisation of projects, and adequately accounts for operation and maintenance costs.

Lessons and success factors

Strong leadership: When asking about the most fundamental factor behind Kampala's recent success in financial reform, there was resounding agreement across multiple stakeholders that it all boiled down to leadership. Jennifer Musisi, appointed as the first Executive Director of the KCCA, had a dynamic and technocratic approach

to getting the job done. This created credibility and trust in the institution from external partners, which has carried forward in the leadership that followed.

Window of opportunity for streamlined decision-making: In addition to the ED being a strong leader with vision, the new governance structure of the KCCA along with a window of political alignment, also enabled the team to enact this vision. Although the hierarchy of decision-making between the Minister, the ED, and the Lord Mayor was unclear, shortly after Jennifer Musisi started her term as ED, the Lord Mayor (from an opposition party to the president) was impeached and only came back to office after the 2016 election. This meant that together with Ministerial and Presidential support, there was a window of fast and effective decision-making, with little political opposition.

Following a successful national model: The fact that many of the key decision-makers in the KCCA came from the URA meant they had a collective understanding and model for the necessary financial reforms. Being able to draw on the experience of a more established institution in a similar context that had successfully implemented similar systems was very helpful in circumnavigating potential challenges and transferring best practice.

Motivated and high-capacity employees: One of the most notable challenges in conducting these

reforms was managing change. The replacement of the KCC with the KCCA meant a substantial turnover in staff, bringing in new and highly qualified people, and integrating them with the pre-existing staff. Continuous organisation-wide training programmes, including capacity building as part of projects and contracts, was one way in which to steer this shift in organisational culture to that of motivated problem-solving teams. The relatively higher salaries paid by the KCCA to attract and retain talented people also aided this cultural shift. However, this shift was ultimately very costly to the KCCA, given the court order to compensate ex-employees whose dismissal was deemed unconstitutional.

Focussing on improved administration: As has been mentioned previously, the KCCA achieved many of these reforms within their existing mandate and legal framework simply by improving administration. This included digitisation and automation of various systems, as well as improving the governance structure; for example, by splitting the revenue and expenditure departments. Although in the long run, several policy changes need to be unlocked to make further progress, ensuring that the current reforms were strictly within legal limits was very important for maintaining compliance and enforceability. It also built trust with external parties. This approach limited resistance from other government entities as well as from the citizens themselves.

Business process mapping: For each new system implemented in the KCCA, staff were required to spend time understanding how the citizen experienced existing systems. This mapping was conducted for each and every aspect of the improved service. It allowed them to fully understand all the protocols, interactions, steps and procedures that citizens and officials had to go through to complete a task. At the same time, KCCA engaged with a variety of stakeholders to understand what could or should be done to improve the service, enabling targets to be set. Analysing the gap between the existing process, and future potential, enabled a detailed plan of action to be drawn up and executed. The goal was to make the user experience as convenient as possible, with the hope that by enhancing convenience, they would increase compliance.

Development partner support: Large and consistent development partner support has been integral to the progress that the KCCA has made. In particular, the World Bank's KIIPD programmes have increased revenues by almost a third. However, this has been a two-way street, with efforts of the KCCA to improve their operational capacity and fully partake in all aspects of project design, implementation, and monitoring. This collaborative and pro-active approach has given international financial institutions and development partners greater confidence to invest and partner with the city. The example of Kampala has highlighted the importance of a true partnership (a give-and-take relationship) between development partners and local governments, rather than a donor-recipient relationship.

Priorities for current and future reform

Computer-Aided Mass Valuation (CAMV): The CAMV project was piloted with the aim of introducing it throughout the city as a more efficient and cost-effective way to value properties in the future. Values can be attributed using data on select characteristics and running regression models, rather than needing detailed market data for each individual property. These values are then accessibly stored in KCCAs digital eCitie platform. While the initial investment to set up a system like this is costly, there are minimal ongoing costs once implemented, and it dramatically decreases the cost of future valuations. Interestingly, Uganda is one of the few African countries with mass valuation already provided for in the Local Government (Ratings) Act. However, to apply it city-wide would require a change in the current by-laws, such as the phases of the rollout, time validity of changes, and regulations on implementation.⁴⁸

Several future opportunities for **enhancing own-source revenues** in Kampala were also highlighted, including:

- **Advertising fees:** Many individuals in the KCCA Directorate of Revenue saw advertising as a critical future opportunity for enhancing Kampala's financial position. In order to mainstream this as one of the key revenues, a robust database of all advertising locations would need to be developed and automated.
- **Parking fees:** Currently, parking management is outsourced to a private company which pays the KCCA a nominal fee for the right. However, it has been estimated that

this would be much more lucrative to do in-house and will be one of the key areas that the KCCA pursues after the existing contract expires. Furthermore, the assertion was that the KCCA currently has some land that could be used to develop larger parking terminals to ease the burden of on-street parking in the city and associated traffic congestion.

- **Trading licences:** Updating the levying of trading licences in a way that works with the informal sector rather than against it is a priority for enhancing the city's financial position. However, this is challenging, as those in the informal sector do not usually have one permanent place of work. Additionally, many do not want to formalise their businesses to avoid accountability for additional fees.
- **Compliance with property rates:** Compliance with property tax is relatively low. Building voluntary compliance with property rates through better service delivery and communication with communities is a considerable opportunity to achieve higher revenues without legislative change. However, enabling punitive mechanisms for enforcement will also be essential.
- **Urban oil and gas taxes:** Recent oil and gas discovery in Uganda has caused KCCA to pursue the potential of increasing fees on petrol stations, with the aim of ensuring that the city also benefits from the discovery. In addition, the current Local Government (Rating) Act does allow for oil pipelines to be rateable; however, parties are lobbying for an exemption to improve industry competitiveness, thereby removing a potentially lucrative revenue source.

- **Water and electricity rates:** Water and electricity service provision are not under the authority of the local government, but are instead run by the national water and sewerage corporation. Given the potential of revenue generation from these sources, the KCCA is currently negotiating with the national water and sewerage corporation to collect a nominal fee for either each connection or on each bill.
- **Vacant land tax:** 8-10 per cent of Kampala's land could be classified as 'vacant', and is not subject to property tax under the Local Government (Ratings) Act. A study has shown that between UGX 245 million and UGX 1.8 billion (US\$65,000 to US\$478,000) could be generated in revenue, depending on the model applied, in addition to the benefits of reduced speculation and improved land-use planning.⁴⁹

Investment in visible service delivery:

Currently, local tax compliance is estimated by KCCA as slightly above 50 per cent. Although higher than many other developing cities, this still represents significant lost revenue and subsequent expenditure. One of the primary ways to increase compliance in Kampala is by explicitly demonstrating the connection between fees or taxes and increased service provision. However, this is a reinforcing cycle, as local governments need revenue to fund service delivery, while citizens will not pay until they see the services being delivered. The KCCA therefore sees investments in visible city-branded service delivery projects as an essential way that development partners can help increase compliance in the future.

Legislation surrounding SPVs and bonds: Currently, there is no single law governing how to account for and manage municipal bonds or SPVs. The Companies Act and Capital Markets Act, which would have oversight on this, have conflicting approaches. The CMA is therefore currently developing a set of 'bond issuance guidelines', which includes a section on SPVs to fill the gap in the legal framework. These guidelines are following both acts as closely as possible to ensure that the guidelines are enforceable. However, the laws need to be amended for long-term clarity.

Building capacity to define and develop bankable projects:

Even more than the legislative challenges, there was a sentiment amongst many stakeholders that the KCCA does not have the capacity to develop bankable projects and the associated documentation. The capacity gaps highlighted include a lack of continuity and foresight in strategic plans, inability to develop (trustworthy) feasibility studies, lack of expertise and experience in preparing financial models, and immaturity of internal controls and financial management systems. In addition to government efforts, this was highlighted as a key area for development partner support.

Urban land rights: Although this is a long-term issue under the jurisdiction of the national government, it is important to note as a key area for reform to enhance the financial position of Kampala. Kampala's highly complex land tenure systems and high degrees of informality have resulted in incomplete land registers and associated widespread confusion over land rights. This creates room for multiple claims on land, and by extension, multiple claims for compensation. Not only

does this become incredibly costly, but it also causes severe delays to project implementation. To date, this has made levying any pure land taxes impossible, causing the KCCA to lose a significant source of revenue. In addition, acquiring the necessary land for large-scale infrastructure investment projects is incredibly difficult.

Clarifying roles in the GKMA: As a result of rapid urbanisation, the city of Kampala has outgrown its administrative boundary, spilling over into neighbouring districts. This has caused great difficulty in cohesive decision-making, project implementation, and a geographical imbalance between the source of revenue generation and where services eventually need to be delivered. Although much progress has been made in overcoming other legislative obstacles, the challenge of revenue sharing and project implementation in the GKMA remains. While the 2010 KCCA Act allows for a Metropolitan Physical Planning Authority, the idea was still meeting resistance from authorities neighbouring KCCA in late 2018.⁵⁰ New legislative amendments see authority in this regard resting with the Minister of Kampala.⁵¹ However, it is still unclear how the fiscal relationship between authorities and the burden of revenue to service delivery will change.

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Enhancing the financial position of cities: evidence from Dakar

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Summary

The city of Dakar is one of the only cities in Africa to come close to taking a municipal bond to market. The US\$40 million bond, set to launch in 2014, was designed to fund a new market hall for informal traders in the city. The market would relocate more than 4,000 street vendors, with the aim of moving them from side streets into a safe and central place to sell their goods, with access to credit agencies and other market services. Development partners, including the Bill and Melinda Gates Foundation, the World Bank's Public-Private Infrastructure Advisory Facility (PPIAF), Cities Alliance, and USAID, played a crucial role in making the bond terms viable – both in shouldering the financial burden of developing internal creditworthiness, and in providing expertise and guarantees to reduce the risk.

Although the bond's launch was ultimately stopped by national government decree, the process of preparing for the bond has greatly improved the

financial management capabilities and creditworthiness of the city. As a result, Dakar's bond journey is still paying dividends to the city today, with a number of successful concessional and commercial loans. The process also deepened the city's connection with its residents – with small bond denominations, informal traders were one of the key investors.

The motivation for the bond was in part due to the city's lack of control over its financial resources. While the most recent decentralisation law amendment, Acte III de la Décentralisation of 2013, has seen many responsibilities devolved to the local level, finances to deliver on this new mandate have not followed. In fact, all revenue and expenditure for local governments in Senegal are processed at the national level, leaving little room or incentive for financial reform. Surprisingly, despite this, the law gives local governments relative independence

in taking on debt. This meant that when Mayor Sall came into office with a vision for change, the only viable financing opportunity within the city of Dakar's control was via the latter. This legislated independence is also the reason why the halting of the bond was so heavily contested.

The city of Dakar provides an example of the importance of the political landscape in effecting any innovative reforms, as well as the need for the national government to buy-in to the fact that successful cities are in their interest as well. This is particularly critical in Dakar's case, given the city's finances are managed at the national level. Fortunately, the national government is now beginning to focus on improving local revenues, primarily through property taxes, as well as better coordination amongst different stakeholders through a dedicated department and the 'Local Fiscality Commissions' described below.

Key messages:

- Decentralisation of responsibilities needs to be accompanied with the commensurate decentralisation of finances in order for it to be effective.
- Strong leadership and an empowered and capable workforce are essential for reform.
- Development partners can play a critical role in de-risking municipal bonds and ensuring the terms are viable – both for investors, and for the city.
- When thinking about floating a municipal bond, ensuring the denominations are low enough that citizens can buy in is important for strengthening the social contract.
- Designing 'bankable' projects requires a broader definition, given there is a trade-off between pro-poor and pro-return investments, and the additional benefits associated with public goods.
- Regardless of the bond, the financial management reforms to achieve creditworthiness can bring additional opportunity in concessional and commercial loans.

Urbanisation trends, challenges and financial needs

Dakar, Senegal's capital, is one of the chief seaports on the West African coast. Growth rates in the country have been high at over six per cent since 2014, with positive future projections, particularly with oil and gas production expected to start in 2022.¹ However, its development indicators are still relatively low compared to other cities in sub-Saharan Africa. Senegal has a human development index (HDI) of 0.505, placing it 164th out of 189 countries, and a GDP per capita of approximately US\$1,500.² This figure compares to a sub-Saharan Africa average of 0.537 and approximately US\$1,600 respectively. The country's debt-to-GDP is also around 65 per cent, partially due to a Eurobond issuance of around US\$2.2 billion in 2018.³

With more than 45 per cent of Senegal's population living in cities, the country is more highly urbanised than its sub-Saharan African neighbours.⁴ Projections estimate that this will grow to 60 per cent by 2050, with over a quarter of this proportion residing in Dakar.⁵ Home to around 1.15 million people, the city of Dakar currently has over 3

million people in the greater metropolitan area. It also boasts of being one of the only cities that has been able to lift these new inhabitants out of poverty through economic growth. Dakar produces over 55 per cent of the country's GDP itself, with the city being home to more than 80% of the country's registered firms and 52 per cent of its jobs.⁶ Outside of Dakar, urbanisation across Senegal has not been wholly positive, with many of the other cities failing to deliver urban infrastructure and public services.⁷ For example, only 37 per cent of urban households have access to basic sanitation, and less than 20 per cent of cities have urban plans, most of which are obsolete or not enforced.⁸

Senegal has been continuously giving local governments more power to improve the lives of citizens since its independence in 1960. The most recent phase, the 2013 Acte III de la Décentralisation (Third Decentralisation Act), which is described in more detail below, saw an even greater push towards redefining the importance of local governance in the country. The Act increased the number of municipi-

palities from 172 to 557 and empowered them with the transfer of new responsibilities as a way of increasing connection with citizens and equalising the distribution of resources. This empowerment, together with the current president's 'Plan Senegal Emergent' (Emerging Senegal Plan 2014 – 2035), aims to enable and guide the structural transformation of Senegal's economy to more productive 'urban poles'. As part of this, one of the objectives is to strengthen domestic revenue mobilisation, with the ambitious goal of increasing the tax-to-GDP ratio from 15 to 20 per cent by 2023.⁹

Dakar is a city that is constrained geographically in a narrow peninsula. It is therefore, unable to expand to accommodate rapid urbanisation, resulting in high levels of congestion, overcrowding, and rising house prices. This restriction has resulted in an innovative push to create the futuristic city of Diamniadio, aimed at reducing pressure on the capital and igniting economic growth. Located 40 km from Dakar, midway to the Blaise Diagne International Airport, the aim is for the new city to be built by 2035 at a cost of over US\$2 billion (funds are expected to come mainly from Public Private Partnerships). It aims to be a modern urban centre with luxury and middle-class housing, as well as a university and industrial park.¹⁰ Progress has been slow; some see this as the only solution to the capital city's problems with serious potential for wealth creation. However, others fear that it will trap the country in unmanageable levels of debt for years to come and has been planned without inhabitants in mind.



Panoramic view of the city from the harbor, Dakar, Senegal © Shutterstock

Municipal finance and urban governance structure

Urban governance structure and mandate

Senegal is a unitary country: the state is governed as a single entity in which the central government is ultimately supreme, but with a multi-level governance framework. At the sub-national level, there are 14 regions and 45 departments, as well as 557 communes, or commune de ville (urban communes) at the municipal level. While regions and departments are both administrative boundaries with no political power, communes are democratically elected every five years. Figure 1 shows the four departments of the Dakar region, including Guediawaye, Dakar, Pikine, and Rufisque, and their associated communes.

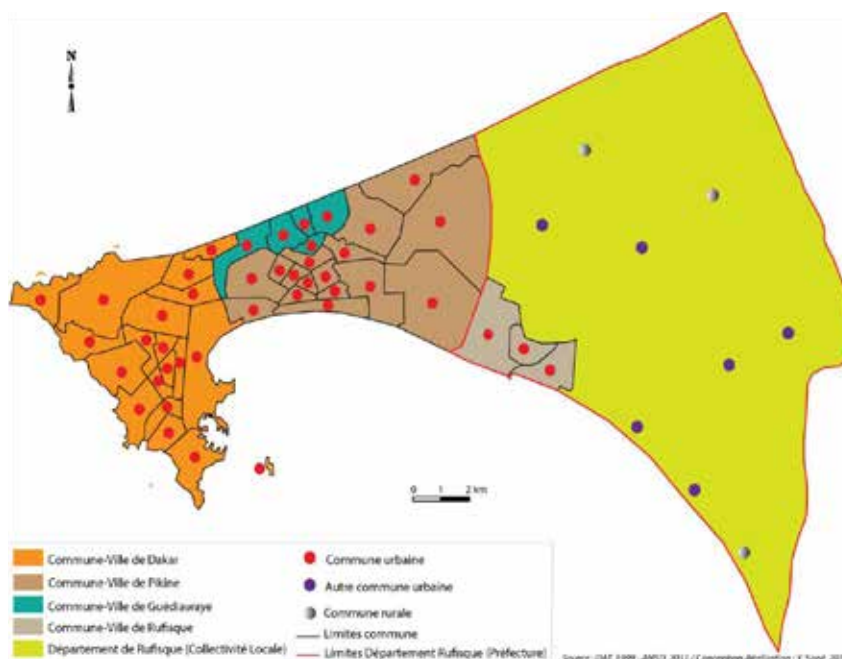
The city of Dakar is both a department and a commune – i.e. both a collection of citizens and its own administrative legal entity, with no hierarchy between the two functions. The department of Dakar is divided into the city's four arrondissements (districts) – Almadies, Grand Dakar, Parcelles Assainies, and Plateau/Goree (downtown Dakar), and the city was then further split into 19 'communes d'arrondissement' in 1996. While the commune-ville of Dakar acts as a coordinator of all activities, each commune in itself has an elected council, and since 2013's Acte III, have even higher levels of autonomy. The 'prefet' of the department and 'sous-prefet' of each arrondissement are central government figures in charge of controlling

the communes and aligning them with the state.

The 2013 General Local Government Code builds on the Decentralisation Law and Local Government Code of 1996, to outline the competencies at the municipal level.¹¹ These include administrative services such as the registry of births and marriages, police, urban planning, urban roads, public and green spaces, local tourism, construction and renovation of housing and community amenities, street lighting, primary health care and education, sports, libraries, and social protection of children and young people. The department level has similar competencies, but the specific function within each section is different and depends on the spatial scale it covers. For example, the district might cover high schools, while the commune would cover primary schooling. However, the department will assist if the commune does not have sufficient capability. The decentralisation of competencies is calculated by the coefficient of territorial equity, weighted by demography (20 per cent), rural/urban location (40 per cent), and poverty (40 per cent). In practice, this has resulted in a widespread lack of clarity between cities and departments, as well as fragmentation between an even larger number of local authorities in the greater Dakar region.

The General Code also maintains that the resources necessary to deliver on those responsibilities must be made available, and a community consultation framework for participatory governance of projects must be established. Unfortunately, in reality and as is the case in many cities, the decentrali-

Figure 1: The communes and departments of the Dakar region



Source: Sané, Y. (2016)

sation of funding has lagged behind that of functional responsibilities. Recent reforms attempt to remedy this with a dedicated national unit focused on increasing local tax revenues and working with citizens to improve the social contract. The section on 'Improving the regulatory environment for access to finance' fleshes out the current state of progress on decentralisation in more detail.

Municipal finance overview

The city's major issue regarding municipal finance is the complexity and confusion regarding fiscal decentralisation following the reallocation of services under Acte III. Dakar's revenues had grown sustainably, from CFA 40 billion (US\$68 million) in 2010 to CFA 60 billion (US\$102 million) in 2014.¹² However in 2015, after the phasing in of Acte III, the city's financial position dropped by CFA 13 billion (US\$22 million). This is because more communes meant both higher operational costs, as well as more entities to split local revenues. The budgeted revenue for the 2020 fiscal year has only now rebounded to 2014 levels at CFA 67 billion (US\$111 million).

A key element of Senegal being a unitary country is that the state has control over all finances. Therefore, another key challenge is that the state collects, manages, and spends all revenues on behalf of the municipality. Even in the few cases where there is local collection of fees (such as market fees), the city remits the funds to the national treasury, who then takes care of the accounting and distributing. Local governments are unable to hold a bank account unless co-signed by a central government authority. The Directorate General of

Taxes and Domains (DGID) under the Ministry of Finance is responsible for this financial management.

Although the national Ministry of Finance is in charge of all finances, it is important to note that all local revenues collected in a specific commune are simply held by the state on behalf of the local authority. At the beginning of the financial year, the expectation is that the central government provides an advanced transfer that represents a minimum of 25 per cent of the city's proposed budget for the year. This allows the municipality to function and deliver initial services while the DGID collects actual revenues. The rest is transferred as adjusted actuals once collected; however, this is often ad hoc, with stakeholders noting that the state often prioritises their own cash-flow management before paying the local authorities.

The issue with this type of decentralised system is the city's lack of autonomy. Although it has the power to plan its budgets and design projects to deliver on its mandate, it has no control over how much money it can raise to achieve this. This effectively usurps the decentralisation of power. Two central government actors, the 'prefet' and the 'percepteur', also have oversight over this, approving the budget and financial activities, and acting as the city's external accountant respectively.

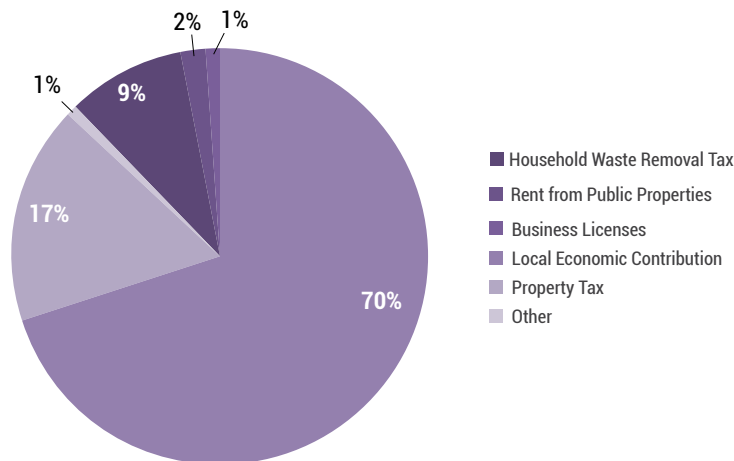
The state's collection of all finances also creates perverse incentives around payments, collection, and distribution. For example, there is no incentive for the central government to make investments in enhancing local revenue collection as they do not directly stand to benefit. Furthermore, this set up makes it tricky for the taxpayer to hold government account-

able, as there is a distinction between who is collecting the taxes and who is delivering the services, and given that they are intrinsically interconnected, it is difficult to pinpoint which one is falling short.

Locally generated revenues comprise of the property tax, local economic contribution (Contribution Economique Locale or CEL), domestic waste collection tax, business licences, rent from public properties, advertising and fuel taxes, and fees relating to water, electricity, transport, funeral services, and telecommunications. Which authority collects each tax depends on their spatial scale; for example, Dakar district collects CEL and property tax, while the individual communes collect market fees and waste collection tax. As described, these are all immediately remitted to the central government's custodianship.

The total operational revenue for Dakar as shown in the 2020 budget is CFA 42 billion (US\$70 million), with CFA 10 billion (US\$17 million) carried over as surplus from the previous year. The CEL, levied on businesses, is the most significant contributor to Dakar's operational revenues, making up 70 per cent, or CFA 23 billion (US\$38 million) of revenues collected in the 2020 budget. It is calculated using the annual rental value of the business premises, and the value-added contribution of the previous year. The CEL has only been levied since the implementation of Acte III, replacing the 'patente' or business licence to ensure that economic contributions are more closely related to spatial position. The move from the 'patente' to CEL has therefore ultimately reduced revenues for Dakar. Figure 2 below displays the breakdown of operational revenues budgeted for 2020.

Figure 2: Budgeted operational revenues for the City of Dakar, 2020



Source: Dakar Commune Budget 2020

Property taxes, while making up only 17 per cent of the total budget, are one of the more promising areas to increase local revenues. Current collection rates are much lower than potential, around 20 per cent of what could be expected with strong administrative reform.¹³

Dakar benefits from around 80 per cent of all local government tax revenues (largely driven by the fact that the city generates 68 per cent of national economic activity). However, the revenues received are still far lower than potential. As mentioned above, this is mostly due to the lack of central government incentive to increase compliance and enhance collections. In addition, central governments often provide tax rolls late, midway through the financial year, and are known to grant exceptions to third parties without consulting local governments. As of July 2019, the municipality had not yet received its funds that were due in January.

In addition to these centrally held local revenues, there are two main

instruments through which the **central government contributes** to local authorities: the Local Government Endowment Fund (FDD) and the Capital Investment Fund (FECL), which transfers 5.5 per cent of VAT.¹⁴ In the 2020 budget, the former contributes CFA 165 million (US\$270,000), and the latter CFA 850 million (US\$1.42 million). In addition, the central government allocates resources to deliver on mandates such as education and health under the transferred Consolidated Investment Budget (BCI). Local authorities also receive rebates from the annual vehicle tax, tax on oil (50 per cent), and property transfers (50 per cent of margin on profit).

Central government contributions are allocated in line with pre-determined formulas, with more being allocated to less fortunate localities in an attempt to equalise revenues given that Dakar is home to the majority of economic activity. The result is that for Dakar, these central government contributions all together make up a minuscule proportion of the budget – far less than 1 per cent. The central

government also provides assistance through the National Local Development Programme (PNDL) and the Municipal Development Agency (ADM). Both are under the Ministère des Collectivités territoriales, du développement et de l'aménagement des territoires, and were put in place to help smaller communes.

The ADM, in particular, is a vehicle for the national government to coordinate and raise funds from various donors and allocate them to specific communes. The national government manages the investment process on their behalf, saving communes from having to negotiate with private partners, especially those who do not have the power and internal structures to go to international markets. However, it does take away their autonomy, as the national government makes the decisions, and projects are simply 'placed' in the commune. Ideally, communes should be involved in these projects to build technical capacity in project management and maintenance.

Although local governments have a small amount of autonomy in the collection of local taxes such as garbage tax and market fees, the only real source of autonomy comes from external funds provided by **development partners and the private sector**. Local authorities in Senegal are allowed to borrow directly from any sources, the only restriction being that locally generated revenues should cover both the operating expenditures and outstanding debt. Big cities, such as Dakar, have the capabilities to do this, but it can reinforce inequalities with other communes.

The difficulties in the allocation of own-source revenues were a key contributing factor to the city of Dakar looking

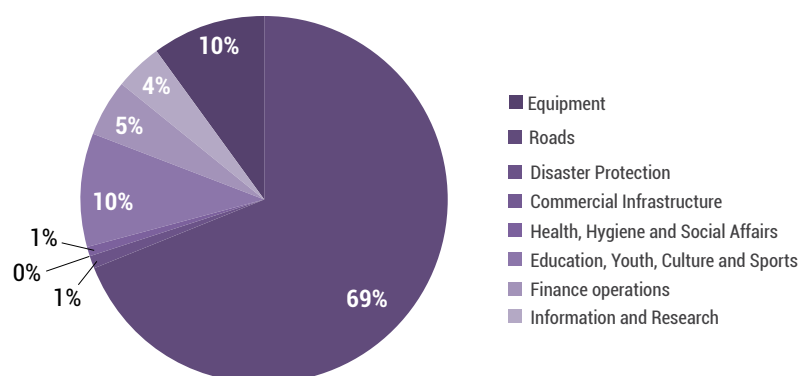
to financial intermediaries for a more secure source of funding. Although the bond did not ultimately work out, international loans, such as those from the African Development Bank, the French Development Agency (AFD), the West African Bank, and the International Finance Corporation's Cities programme have become an increasingly large part of financing the city's infrastructure. Currently, they amount to CFA 1.9 billion (US\$3.2 million), but this figure fluctuates drastically year-on-year as projects begin and come to a close. In addition, private sector partnerships, which by law are allowable up to a 33 per cent share, are becoming a popular alternative for investment in high revenue-generating activities. Since 2012, the state has also set up the Guarantee Fund to support private investment, including the Priority Investment Guarantee Fund (FONGIP) and the Sovereign Investment Support Fund (FONSIS).¹⁵

Expenditure overview

Local government spending is low compared to overall public spending, representing just over 1 per cent of GDP and less than 4 per cent of Senegal's total public spending.¹⁶ Within local expenditure generally, 75 per cent is budgeted for operating expenditure and 25 per cent for investment, with Dakar being no different. However, relatively high operating costs left an investment gap averaging CFA 3.4 billion (US\$5.7 million) each year between 2008 and 2014.¹⁷ This gap constrains the city's ability to develop. It is important to note again that the state directs all spending on behalf of the city, even though the procurement process is managed at the local level.

In terms of investment expenditure, Figure 3 below shows that the city

Figure 3: Investment expenditure for Dakar City, budget 2020



Source: Dakar Commune Budget 2020

Table 1: Operational expenditure for Dakar City, budget 2020

Operational expenses	Value	% of Total
Debts, fees and insurance	CFA 772,500,000	3.7%
Quotas and contributions	CFA 1,350,000,000	6.5%
Mayor's office & secretariat	CFA 7,175,779,1630	34.5%
Public parties and ceremonies	CFA 926,329,538	4.5%
Municipal incomes	CFA 228,892,773	1.1%
Municipal collection service	CFA 537,945,963	2.6%
Abattoirs, Halls and Markets	CFA 25,687,373	1%
Communal Properties	CFA 136,000,000	0.7%
Protection/Accidents	CFA 14,500,000	0.1%
Roadways, squares and Gardens	CFA 2,341,950,074	11.2%
Water, Cleaning and Sanitation	CFA 205,728,369	1%
Workshop and Garages	CFA 799,496,481	3.8%
Public Lighting	CFA 159,500,000	0.8%
Education, Youth, Culture and Sport	CIFA 3,280,331,497	15.8%
Health Hygiene and Social Affairs	CFA 1 397,071,523	6.7%
Other	CIFA 1,477,915,435	7.1%

Source: Dakar Commune Budget 2020

spends the vast majority (69 per cent) on roads at CFA 17 billion (US\$28 million). This allocation is followed by administrative and larger equipment at CFA 2.5 billion (US\$4.2 million), and education, youth, culture, and sports at CFA 2.4 billion (US\$4 million).

In terms of operational expenditure, the most considerable expense is the staffing cost of the Mayor's office and

Secretariat making up over a third of the total at CFA 7.2 billion (US\$12 million). This allocation is followed by spending on education, youth, culture, and sport at CFA 3.3 billion (US\$5.5 million) or 16 per cent, and then by maintaining roadways, squares, and gardens at CFA 2.3 billion (US\$4 million) or 11 per cent. Table 1 shows the operational expenditure budgeted for the 2020 financial year.

Reforms undertaken to enhance the city's financial position

Enhancing the capacity of city financial and investment management

Many of the reforms to the Dakar municipality took place after the election of Mayor Sall in 2009, a leader of the opposition party in Senegal. The Mayor had extensive plans to transform the city but was constrained due to limited resources. As described above, finances were also out of the city's control, leaving few options to increase the resources available. Therefore, out of this necessity came invention: the Mayor's team was tasked with sourcing external finance, particularly international loans and the possibility of a municipal bond. However, in order to build the long-term financial capacity and creditworthiness of the city, they first needed to ensure that sound revenue and expenditure procedures were in place. This included building a team of qualified and well-trained staff, creating a long-term vision and strategic plan, and enhancing the efficiency of financial operating systems.

Empowered and autonomous team

Initially, the city's financial and accounting team took on the task of modernising the city's financial systems. However, their limited capacity, large existing workload, and resistance to change resulted in the appointment of a specialised and highly skilled team in 2012. This team, the Dakar Municipal Finance Programme (DMFP), was separate from the rest of

the city administration and consisted of four Senegalese professionals and one external expert.¹⁸ It also operated outside of the typical bureaucratic limits, with direct accountability and access to the Mayor.

Preparing for a municipal bond and engaging with international financial institutions is a complicated endeavour, particularly with no previous experience and in an area where little precedence has been set. The international partners supporting Dakar at the time wanted to bring in external expertise. However, the Mayor would not allow external consultants to work on the project before Dakar's internal team could themselves construct a strategic plan to meet his vision as detailed below. Only once staff had the necessary foundations could external expertise be brought in to assist and further enhance internal capacity. Once the internal vision was set, the project team was then able to create a highly capable taskforce of technicians from the city as well as external experts. These individuals became a so-called observatory, a collective cross-government and cross-sector team with one desired output: to develop a tangible project worthy of external financing.

In addition to learning by doing, training was also necessary. AFD's training school in Marseille was a key platform for developing capacity in both governance and financial management. Partnerships with other cities and cross-city learning were also critical – the team undertook two

study tours, to the cities of Douala and Johannesburg, which had already issued municipal bonds. These trips provided the team with a critical background in understanding the financial market and foresee potential pitfalls that might arise.

Long term vision & strategic planning

Before 2009, the city of Dakar did not have a strategic planning document. This lack of shared vision was a significant challenge for coordinating investment. Therefore, one of the new administration's first initiatives was to set up a Department of Planning and Urban Development, tasked with creating a credible development strategy.¹⁹ This Strategic Orientation Document (DOS) specified the vision, values, commitments, roles, and responsibilities of the city of Dakar, aiming to place Dakar as the economic and cultural capital of West Africa. To do so, the DOS set specific strategic goals with defined objectives - both in the medium term (2012 - 2017), as well as long term (to 2025).

A key challenge was aligning these strategic plans with the municipality's budget, given the reliance on the central government for collection and disbursement of revenue. The city's inability to accurately forecast when revenues would be made available from the central government resulted in difficulty planning payments for investment projects, and matching expenditure outflows with revenue inflows.

Enhancing operational systems

The Public-Private Infrastructure Advisory Facility's (PPIAF's) Sub-national Technical Assistance (SNTA) programme had been present in Dakar since 2008, initially as the Public Expenditure and Financial Accountability (PEFA) programme. The programme itself provides technical assistance to develop public financial management skills, implement debt-related financial transactions, and other fundamentals to improve credit ratings. In 2019, Senegal was one of only thirteen sub-Saharan countries which had a sub-national government partake in the programme. Furthermore, Dakar was one of only nine sub-national governments to have made their audits and evaluations public, aiding investor confidence.²⁰

The DMFP also applied their training to build on this during the bond preparation process, supported by a grant from the Bill and Melinda Gates Foun-

ation. There was a coordinated effort to design and implement appropriate budgetary and financial management tools, with the aim that the city could analyse revenues, expenditures, cash flows, and assets. The team built a framework based on revenue (both base and recovery), financial management (particularly cost management), and multi-year investment planning and public procurement management, to improve the systems within which the staff were working. This is described in more detail below.

Realising the potential of investment in improving infrastructure

Accessing infrastructure funding is tricky for many developing cities. Beyond regulatory restrictions from the national level, this is primarily due to a lack of capacity in cash-flow and debt management, thin credit histories, and absence of strategic

planning and competent administration.²¹ Dakar was no different, but as described above, with strong leadership and external assistance, the city was able to build its creditworthiness to be eligible for concessionary and commercial loans.

The city had the further benefit that, according to the 1996 decentralisation law, local authorities are allowed to enter into debt agreements for investment with financial institutions without national government intervention. This also enabled the city to get close to launching one of the first municipal bonds in Africa, which was particularly pertinent given its lack of control over other revenue sources and the subsequent need to diversify.

Concessionary loans

As a result of the PEFA reforms described in the section above, in 2009 the city was able to secure its first 20-year concessional loan of US\$12



A busy street in Dakar, Senegal © Shutterstock

million from the AFD to finance the refurbishment of existing streetlights as well as invest in a further 1000 solar streetlights. The agreed-upon loan had favourable terms, with an interest rate of 2.23 per cent and a 7-year repayment grace. These terms allowed the city to go through the motions of project development, debt structuring and honouring its repayments without being in a high-stakes environment. In doing so, the city gained valuable experience in further enhancing its systems and capacity. It also had a chance to prove its creditworthiness to others.

Following the success of the AFD loan, in 2012, the city of Dakar also borrowed at a slightly higher rate from the West African Development Bank for the construction of roads and parking areas. This loan was for US\$18 million over 13 years at 5.5 per cent, with a three-year grace period.

Commercial loans

The success of the AFD loan also paved the way for the city to take on a few small commercial loans, albeit with more stringent conditions and higher interest rates. This debt included a 2011 loan from the Islamic Bank for traffic lights for US\$4 million over three years at an interest rate of 8.5 per cent. Further to this, a 2012 loan of US\$7 million was taken from the Ecobank of Senegal to rebuild a downtown market. These terms were for a five-year loan at 9 per cent interest, with a two-year repayment grace.²²

The ability to pay off a market-rate loan, even if for smaller amounts, further increased confidence in the creditworthiness of the city. However, commercial bank borrowing is restricted to CFA 10 billion (US\$17 million) with a short repayment period and several

other conditions, making it unsuitable for larger and more long-term investments.²³ A municipal bond was therefore an attractive alternative.

The municipal bond

In late 2011, the city of Dakar began exploring whether a municipal bond was an option for financing future projects in the city. The hope was that a bond would enable the city to borrow a large lump sum at a lower cost than through commercial loans, and with more flexibility than a concessional loan. It would also signal that the city was confident in its ability to manage significant revenue-generating investments. After careful review of the constitution and consultations with experts and national government representatives, it was determined that a bond issuance at the city level met all legal requirements.

The Bill and Melinda Gates Foundation were key partners in making this idea a reality. After initially hearing Mayor Sall speak at an international conference, the Foundation funded an initial US\$500,000 scoping grant to conduct a feasibility analysis. They deemed Dakar to be a city with suitable potential given the development of the DOS, a high-capacity team, and strong track record with international loans.²⁴ Their goal was to improve the quality of life for the urban poor through mobilising finance in the regional capital market, as well as test the municipal bond process in order to replicate it to solve development challenges in other African cities. Although the bond ultimately did not launch due to complications with central government approval, the process in itself ended up improving the city's financial position.

1. Building creditworthiness

The most fundamental aspect of preparing for the bond was laying the groundwork in terms of building creditworthiness. This expanded on the progress made as a result of the PEFA process, as well as the experience gained in managing both concessionary and commercial loans. However, investing in internal creditworthiness reforms year after year can become difficult for the city to justify given the returns to the public are long-term, leaving minimal potential for short-term political gain. The role of the Bill and Melinda Gates Foundation, and later Cities Alliance, was therefore crucial in investing in these processes. The Foundation extended their 'scoping grant' with a delivery grant of US\$5 million for a six-year programme (2011 – 2017) to improve financial management systems, alter the city's approach to planning, and influence investor's perception of the city's creditworthiness.

The international ratings agency, Moody's, was brought in at the outset to provide a confidential credit rating for the city. This was used as a benchmark against which to measure improvements before obtaining the official public rating, and provided a roadmap for improvements. Key areas such as 'quality of debt data recording and reporting', and 'scope and frequency of debt sustainability analysis', received low grades of D and C respectively. These became focus areas for reform. A local ratings agency, Bloomfield, was then selected to conduct the follow-up rating. In September 2013, Dakar received an A3 short-term investment grade rating and a BBB+ long-term rating.²⁵ The report showed that compared to the previous year, revenues had increased, operational costs had decreased, and loan repay-

ments were in order, resulting in an overall net budget surplus.²⁶

2. Envisioning a bankable project

The project conceptualised for the bond was a formal market for local traders. It was known as the 'Petersen commercial zone' and would cover 10 hectares in the northern extremity of the Dakar-Plateau commune.²⁷ It was designed to be affordable and safe, with facilities for over 4,000 street vendors. While the lower levels were reserved for subsidised stalls and kiosks, the upper floors would house credit agencies and other market-related services used by the traders to improve the ease of doing business and access to finance. Figure 4 below shows the conceptual design.

The market was also part of a strategy to re-organise the city centre, diverting activity from downtown Dakar where the street traders exacerbated traffic

congestions. The World Bank estimates that Dakar's traffic congestion, exacerbated by unregulated street trading, costs CFA 108 billion (US\$216 million) in lost income a year.²⁸ The inclusion of off-street parking in the design aimed to reduce associated idling traffic or unregulated parking while cars stop to purchase goods from street traders.

The project's anticipated cost was US\$40 million, with 25 per cent allocated to acquiring the land and the remaining 75 per cent to the design and construction of the marketplace.²⁹ Importantly, since market fees are one of the only revenue streams collected by the city of Dakar, they had greater oversight over this income for the purposes of repaying investors.

However, some stakeholders believed the market would not succeed as sellers would not be able to afford the relocation, and that the cen-

tralised closed-off space disrupted the very thing the street sellers thrived on: mobility and flexibility to reach their customers. This lack of demand would result in the market being unable to generate the income streams required to repay the bond. To avoid this, the city moved to ban street trading, which was highly controversial and ultimately unsuccessful due to the strong resistance.³⁰

In the design of all city investments, there is often a trade-off between pro-poor and pro-return projects. Many felt that this particular project emphasised an idealistic vision of empowering the poor, without considering how to achieve a suitable return. While the project was in keeping with the Mayor's drive to amplify the voice of the city's urban poor and the desire of the Bill and Melinda Gates Foundation to deliver a project with social impact, in the process however, it may have lost bankability.

Figure 4: Dakar's Petersen Commercial Zone



Source: Dakar Municipality

3. Designing the bond mechanism and reducing risk

Over and above achieving creditworthiness and designing a bankable project, the issuing authority, the Regional Council for Public Savings and Financial Markets (CREPMF), also had requirements that needed to be met. These largely revolved around providing investors with sufficient security and knowledge that they would see repayment. Revenues generated from the investment can easily be repurposed into the next project of political importance rather than being kept aside to repay investors. Dakar therefore took further steps to reassure investors by ring-fencing revenues.

A Special Purpose Vehicle (SPV) called 'Société de Patrimoine Immobilier de la Ville de Dakar' or SPID S.A. was created to be the custodian of the asset funded by the municipal bond. SPID S.A. was responsible for running the project, collecting the fees, and securing revenues in a private account. It was also meant to be the liaison between the city, the private sector, and the public. This vital separation and streamlining of funds from the broader city budget was a recommendation of the Minister of Finance, and assisted in increasing investor confidence as funds could not easily be used for non-project related expenses.

Although all regulatory requirements had been met, the city of Dakar went a step further to secure a 50 per cent guarantee from USAID under its Development Credit Authority (DCA). This meant USAID would repay at least half of the investor's capital if actual revenues from the project did not match expectations. Since it was a non-sovereign bond, the DCA could not provide a full guarantee, and instead required the City of Dakar to create a reserve

fund to finance the initial repayments. The city therefore placed a coupon in a private bank, amounting to one year's interest on the bond, which provided a first-loss guarantee to investors and ensured no liability for the central government. The DCA guarantee and reserve fund implementation saw the bond quality improve to an A-rating, which in turn improved the marketability of the bond by assuring investors of reduced risk.³¹

In further attempts to reduce risk, bondholders received clearly defined legislation and regulations. This included the fact that bondholders may automatically group together in defence of their interest, in a body with a legal personality. Furthermore, the regulations of West African Economic and Monetary Union (WAEMU) Regional Market and those of the Organisation for the Harmonisation of African Business Law (OHADA) would govern disputes. This system of corporate law, adopted across countries, brought more certainty to investors – particularly the knowledge that any dispute between investors and the city of Dakar unable to be settled amicably in three months would be entrusted to the Common Court of Justice and Arbitration (CCJA) of OHADA, located in Abidjan.

4. Bond repayment terms

The wide-ranging creditworthiness reforms combined with investment guarantees saw the municipal bond of US\$40 million become viable at an annual interest rate of 6.6 per cent with a seven-year maturity. This rate was below the 8.5 per cent paid on Islamic Bank of Senegal's three-year commercial loan, but more stringent than the AFD's twenty-year concessionary loan at 2.23 per cent.³² The low-risk profiles meant they did not need to be com-

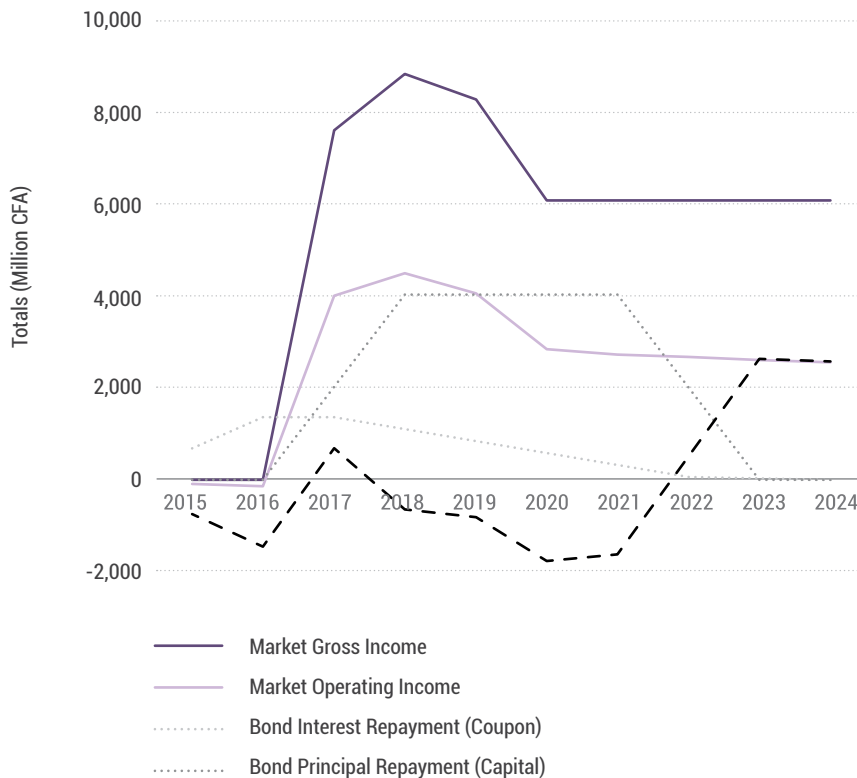
pensated considerably in the event of financial loss.

Critically, Dakar's bond also allowed for a two-year delay in principal repayments. This allowed for the proposed market to be built and expected revenues to be realised before the payments kicked in. After the grace period, Dakar would repay the principal amount and interest accrued, in ten payments over five years.³³ Without this stipulation, the city would have been required to repay investors out of other revenue sources such as property tax, putting more financial pressure on the budget, and reducing overall project viability.

Matching bond maturity with investment cycles is of critical importance to ensure the sustainability of finances. In Dakar's case, the bond had a seven-year maturity, similar to many other subnational loan offerings of 3 – 10 years. Meanwhile, typical infrastructure project life cycles are 20 – 30 years.³⁴ If a city has to repay large amounts of investment capital quickly, it may not be able to match relevant revenues from project user fees (in this case market rents) to make the investment viable.

Figure 6 below shows the anticipated revenue and associated debt service costs for the market. By 2023, after servicing debt, the expected revenue (gross income) was CFA 6 billion (US\$10 million) and operating income (post-operating expenses) was over CFA 2.5 billion (US\$4.2 million).³⁵ The latter figure is equivalent to about four per cent of the city's 2020 budgeted revenue. Repaying the capital throughout the bond lifecycle brings two benefits. Firstly, future administrations are not left to repay the entire principal, thereby aligning current and

Figure 5: Expected revenue of market and repayment of municipal bond, 2015 – 2024



Source: Data from Ville de Dakar (2015)

future policymaker interests. Secondly, it can smooth cashflow – paying with current revenues removes the need for a sinking fund to build up revenues to pay at the end of the bond’s cycle.

5. Domestic demand

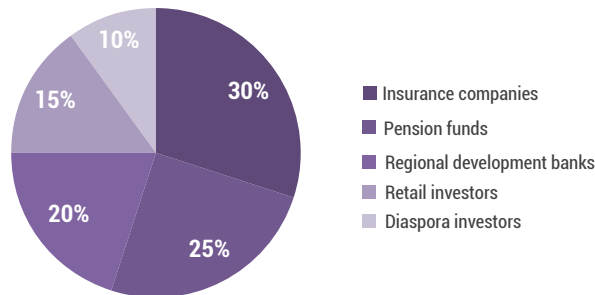
Once all the requirements for the bond had been met, it was time to begin marketing the bond and conduct an investor roadshow. A Dakar-based firm was tasked with coordinating this, including placing the bond with 18 financial intermediaries in the 8 West African Economic and Monetary Union (WAEMU) countries. Dakar benefitted from strong domestic demand for the bond for several reasons:

- Senegal’s central government had been issuing bonds on the local market since 1996 under the Regional Council for Public Savings and Financial Markets (CREPMF).³⁶ Therefore, there were specific rules, regulations and expectations that already had precedence. In addition, the macroeconomic environment was steady relative to other countries in the region.
- Dakar was aiming the launch of its bond on the Abidjan-based regional securities market, ‘Bourse Régionale des Valeurs Mobilières’ (BRVM). As a financial and regulatory hub for the 14 francophone countries of Central and West Africa, BRVM enables consistency in regulations across the

member countries. There was, therefore, a much broader base of potential investors, pension funds, and other buyers that could invest in the bond, with no currency risk. Similarly, rules, regulation, and norms around bond issuance, municipal or sovereign, were shared and had some historical precedence. These are critical for replicability of municipal bond issuance in the region.

- Dakar leveraged public participation and engagement in preparing for the bond. Internal weekly city meetings between departments ensured there was a common narrative being weaved, and the city’s communications department would then relay this to the citizens to help them understand what the city is doing for its residents.³⁷ This lengthy process of consultation with citizens culminated in a ‘public call for savings’, asking citizens to invest in the bond, and thereby invest in their city’s future.
- In order to better facilitate this, the city set the lowest denomination of investment at CFA 10,000 (US\$18) compared to CFA 1,000,000 (US\$1,400) in Douala’s bond transaction and ZAR 1,000,000 (US\$159,000) in Johannesburg.³⁸ This low requirement allowed a large section of Dakar’s population, both individual public investors and private institutional investors, to be able to buy into the bond. The demand was so high that during the investor roadshow, members of the public would approach the bond administrators with cash from their pocket to purchase a part of Dakar’s future. Figure 7 below shows that 15 per cent of primary issuance demand was expected to come from these small-scale retail investors.

Figure 6: Expected distribution of Dakar's municipal bonds in the primary issuance



Source: Adapted from Gorelick, J (2018)

6. Failure to launch

By 2015, the city had completed all regulatory steps required to issue a bond, as well as having built sufficient demand from investors. In February, the CREPMF issued the visa authorising the city to proceed. However, despite receiving pre-approval on three separate occasions, the central government withdrew its written consent on the eve of the launch. This last-minute withdrawal was based on constitutionality and concerns about the municipal debt's impact on overall country indebtedness. They were also cautious that the bond was too innovative, and that the national government was not in a position at that time to support the engagement with the risks involved.

However, it was also deemed by some to be purely a political move. The threat of an opposition-led commune, with a recently re-elected Mayor gaining such financial independence, did not bode well for the ruling party. The lack of clarity over the legal basis for the central government withdrawing consent resulted in the city of Dakar filing a lawsuit against the central government. Although this was unsuccessful in overturning the state's opposition, there has been no blanket ruling

against municipal bonds in general, leaving their overall future in Senegal very unclear.

Despite the municipal bond ultimately not being launched, its preparation still brought substantial benefits. Improved financial management contributed to increasing the city's revenues by almost 40 per cent between 2008 and 2012.³⁹ As a result of the city's ability to enhance and directly prove its creditworthiness, borrowing became an indispensable tool for financing local development for the city of Dakar. Furthermore, for many large infrastructure projects, longer-term concessionary loans such as the one from AFD over 20 years, and the West African Development Bank over 13 years, were in many ways, found to represent a better-aligned funding and investment model.

Capturing land value and unlocking dead capital

Since the failure to launch the municipal bond, a number of other (more basic) municipal finance reforms have been piloted by national government stakeholders in partnership with various communes; in particular, a new process for administering land and property taxes. Dakar is unusual in pursuing innovative

infrastructure investment mechanisms before capturing land value, largely due to the latter being outside the remit of the city government. However, just as in other cities, rapid urbanisation and considerable investments in real estate, both in Dakar and Senegal more broadly, offer large, mostly untapped, revenue potential.⁴⁰ Efforts to leverage the city's land value are explored in more detail below.

Land and property tax

While property taxes offer massive potential for local revenue, they continue to be an immensely underutilised mechanism in Senegal. Property taxes currently amount to 0.4 per cent of GDP, which, although up from 0.1 per cent of GDP 2016, remain far below their 2 per cent potential, as calculated by the IMF.⁴¹ By comparison, this is equal to the prospective estimated revenues from the Senegalese oil sector.⁴² Similarly, property taxes make up only 2 per cent of all tax revenues in Senegal, compared to an average of 9 per cent in OECD countries.⁴³ The assertion during stakeholder engagements was that this results from the fact that only 60,000 out of the 1.8 million properties in Senegal are paying property taxes.

Cadastral and fiscal data from 2018 shows that of the roughly 110,000 plots registered in the commune of Dakar (not the entire city), less than a third have registered properties. Other Dakar communes, such as Rufisque, have closer to 25 per cent of their properties on the Contributions Foncières roll. Places of worship, schools, public buildings, and owner-occupied residences with annual rental values below CFA1.5 million (US\$2,700) are exempt. This loss of potential revenue is compounded by low levels of compliance of around 12 per cent, with

many people stating that either they were not aware they had to pay property tax, or did not receive any notices. While there are some penalties provided for in the law, including interest on arrears, or seizure and auction after demands and warning procedures have been exhausted, in practice these are not enacted.⁴⁴ As a result, only 20 per cent of the potential revenue from property taxes in Dakar are collected.⁴⁵

Property, its valuation, and tax assessment are under the remit of the Directorate General of Taxes and Domains (DGID - the national tax administra-

tion), with the National Treasury being in charge of billing and payment collection. Municipalities assist through the sensitisation of taxpayers and identification of property owners, thereby helping to maintain the valuation roll.

The taxes are levied on improved and unimproved property, along with a surtax on unimproved land. Central government legislation has fixed the rate of the first two at 5 per cent of rental value, and 5 per cent of market value, respectively. The surtax on land has different rates depending on market value tiers – in Dakar's com-

munes, these vary between 1 per cent and 3 per cent.⁴⁶ The central government's control over setting property tax rates and their collection leaves no room for local government discretion to progressively charge wealthier areas, or those areas receiving more public services, higher rates.

The historically used system relies on property owners to annually declare their address and its rental value to DGID. Where these declarations are not updated, previous declarations simply rollover from preceding years with no update in valuation.⁴⁷ There



Retba salt lake near Dakar, Senegal © Shutterstock

are not enough resources to enforce this system, both in terms of detecting undeclared properties, as well as in verifying values. Furthermore, not all houses are formally captured within the addressing system, and even when they are, it is often not used. This weak data foundation makes accurate billing extremely difficult. While administrators do undertake infrequent fiscal census's, there is no standardised protocol, the information is manually collected and imprecise, and there is no link to cadastral plot identifiers.⁴⁸ Furthermore, recorded values are often bargained by agents and taxpayers rather than using a certified methodology.

In response, researchers are piloting a modernised property tax management system. It is being implemented and rolled out as part of a Randomised Controlled Trial (RCT) throughout the region of Dakar. The programme includes a comprehensive survey of all households on their tax affair, as well as the digitalisation of the cadastral and addresses information. It then uses a new application to automate the data analysis process, compute tax liabilities, and produce tax notifications. A semi-automated method to value properties on a mass basis is also under analysis. This method is similar to the one used in Kampala – using observable characteristics of the households to predict a relative valuation.⁴⁹

In order to fully realise the potential of property taxes, communication and sensitisation of residents is critical for compliance. They need to understand how to comply with processes, and more importantly, what the city is spending their tax money on. The Bureau des Collectivités Locales and the Local Fiscal Commissions are integral players in this regard. The

approach used is described in the section on 'improving the regulatory environment for access to finance' below.

Although the trial is still in progress, the results from the baseline data confirm the undervaluation of properties currently in the Dakar register. In addition to the direct benefits, digitalisation of the system has resulted in better coordination between the different government entities, reduced information losses, and increased institutional memory.⁵⁰ The data collected also creates a repository of information to draw upon, for example, by the authorities in charge of urban planning and housing. The trial is currently taking place in three communes but will extend to other areas of the region after the experimentation phase. The ultimate goal is to have full automation integrated with other land systems, such as building plan authorisation, so that when residents register to build new properties, their details are immediately recorded on the tax register as well.

Leveraging public land for commercial activities

The National Domain Law of 1964 declared about 97 per cent of all land in Senegal as state-owned, with its classification varying between urban, agriculture, pioneer or non-disclosed zones.⁵¹ Much of the governance of this land is decentralised to municipalities.⁵² As a result, the city hopes to increase revenues going forward by leveraging its land assets – partnering with the private sector to build commercial entities on public land that generate income for the city. There are currently three big commercial centres in Dakar, an example being the Dakar business centre, although it was envi-

sioned that this could be extended to hotels and apartments as well. As with the bond, SPID S.A. would be the financial vehicle used to invest in those projects, in order to isolate the financial risk and allow for financial partnership with the private sector.

Improving the regulatory environment for access to finance

A number of local administrators felt that the central government undertook and enacted significant legislative reforms without their inclusion. Most notably, the 'Acte III de la Décentralisation' of 2013, which increased local government responsibilities while decreasing the available financial and human resources. This created adverse incentives for the local governments who were tasked with delivering change. They were either knowledgeable of the requirement and not motivated to deliver, or were unknowledgeable of the requirement and therefore unable to deliver. Both represent challenges for decentralisation and enhancing financial positions of cities.

Perhaps the height of misalignment between the city of Dakar and the central government was in March 2017, when Mayor Sall was arrested for allegedly embezzling public funds worth CFA 1.8 billion (US\$3 million). This was met with much resistance in the city, resulting in him being finally pardoned by presidential decree in September 2019. However, in recent years, a number of initiatives have been undertaken to improve vertical coordination in government, most notably the Bureau des Collectivités Locales and their Local Fiscal Commissions. The ongoing issues with the Decentralisation Act and the recent

initiatives to improve coordination are elaborated upon below.

The Decentralisation Act

The most recent phase of decentralisation, 'Acte III de la Décentralisation' of 2013, has been marred with difficulties. A 2015 evaluation of the first phase of implementation highlighted complications around the limited tax base of many small local governments throughout Senegal, the lack of clarity over the division of responsibilities between cities and departments, and the difficulty caused by fragmentation of local governments in the greater Dakar area. In 2019, the following issues were still identified as critical problems:

Structure of public services: Acte III saw nine areas of competence either totally or partially transferred from central departments to local government, depending on capability. These included environment and management of natural resources, health, population and social action, youth, sports and leisure, culture, education, investment planning, land-use planning, and housing and urban development. Building its technical capacity was vital for the local government to adequately deliver these services. However, as was the case in Dakar, if the function of public service delivery is decentralised without matching fiscal decentralisation, then local governments will struggle in building their capacity. At the same time, when local governments then show weak capacity in service delivery, the central government will be hesitant to devolve these responsibilities, leading to a vicious cycle.

Revenue capacity: As described in the municipal finance overview, Dakar's

revenues have noticeably declined since the implementation of specific changes associated with Acte III. Acte III's Phase 1 saw the delivery of changing legislation; however, the implementation of these changes in Phase 2 was more fraught with difficulty. In particular, the creation of more communes in an attempt to achieve increased regional equity saw revenues being split in a greater number of directions, reducing the amount going to the commune of Dakar. Furthermore, given the high proportion of economic activity (and the attendant revenue) generated in Dakar, tax redistribution mechanisms were put in place such that new communes and other cities could receive some of this revenue for their development as well. With almost all local taxation collected at the central government level, this reallocation and redistribution could straightforwardly happen.

Human capacity: With the increase in the number of municipalities from 172 to 557, the city of Dakar's staff also had to be divided and shared. Pre-Acte III, the city's workforce was 3,324 employees, which reduced to 1,688 as administrative boundaries declined and the department was further divided into more communes. However, this transfer of staff coincided with increased service delivery responsibility leading to additional pressures.

In short, despite decentralisation first occurring in Senegal in 1872 with the country's first commune, no sufficient fiscal decentralisation has taken place. This means that although local governments have increased responsibility, they continue to have little autonomy in enacting that responsibility due to fiscal constraints. Subsequently, in order to enhance the financial position

of cities, a focus on capacity building as well as support for adequate fiscal decentralisation is needed. This requirement should be part of a comprehensive process of acknowledging and strengthening the role of local governments as core political and institutional players in national development.

Coordination initiatives

Despite these ongoing issues, some attempt at progress has been made.

The Bureau des Collectivités Locales (BCL) is an initiative of the DGID, created in 2016 as a way for the central government to more directly engage with local governments in order to enhance future revenue streams and local collection. They are taking steps to align the Acte III decentralised responsibilities with the required finances to deliver them. The unit is working to enhance the collection of all taxes that will eventually find their way to the Municipality, with a current focus on property taxes as described above.

One initiative of the BCL is the **Local Fiscal Commissions (LFC)**, the creation of which was intended to improve connections between central government, local government and their taxpayers, thereby overcoming the barriers of information sharing. They are small groups made up of civil society, neighbourhood representatives, and political councillors who together are involved in local-level sensitisation campaigns to enhance tax buy-in and compliance. Members are trained by the national tax administration (DGID) on the technical aspects of tax collection. With this knowledge, they can correctly identify taxpayers and their properties, essentially becoming fiscal representatives on the ground.

The construction of these LFCs also results in considerable reform for participatory processes within government, creating more substantial buy-in from citizens in public sector activities. Simply changing technical systems or using technology to automate processes, while creating substantial efficiency gains, does not account for the human element of tax payment. The LFC will feedback into the systems with citizens' perspec-

tives, as well as communicate how the city is spending their taxes. Particularly, how this spending positively affects the value of resident's land and property assets. Therefore, while the LFCs are still finalising direct incentive mechanisms, they have great potential to be a significant part of own-source revenue reform in Dakar.

However, since their establishment, the LFCs have only been set up in

three communes in Dakar, where the political alignment is with the central government. Many of the other fifteen which are aligned with the opposition, had not yet heard of the initiative. However, it is slowly being expanded: Dakar commune (one of the 19 communes within the Dakar district), mentioned in February 2020 that its first engagement with the BCL would be in March 2020.



Aerial view of Dakar, Senegal © Shutterstock

Lessons, success factors and priorities for future reform

The city of Dakar, although failing to ultimately launch one of the first African municipal bonds, has made significant progress in achieving creditworthiness. This has been essential in unlocking potential in terms of both commercial and concessional loans. The city's relative independence in taking on debt is surprising, given that all own-source revenues are administered at the national level, as are all municipal expenditures. Overall, the city of Dakar provides an important example of the need for buy-in at the national level, and the importance of the political landscape in effecting any innovative reforms. Fortunately, the national government is now focussing on improved land-based revenues and coordination with the municipalities. Some of the key lessons and success factors, as well as the aims for future reform, are detailed below.

Lessons and success factors

Visionary leadership: As with most of the case studies in this series, the reforms for enhancing the financial position of Dakar were predicated on strong leadership. The Mayor's ability to convince external partners to invest, as well as his commitment to building capacity to internally transform the city, were significant drivers of change. Even more important was the emphasis placed on building relationships with the city's residents. However, he simultaneously also had many critics, and as a reformist opposition leader, was a potential threat to

the national government. The Mayor was controversially arrested in 2017 for allegedly embezzling public funds, and then pardoned by Presidential decree in September 2019.⁵³

Highly skilled, autonomous team: A specialised team, the Dakar Municipal Finance Programme (DMFP), was appointed in 2012 to deliver on the Mayor's vision for a financially autonomous and prosperous city. The team had direct accountability and access to the Mayor, and operated outside of typical bureaucratic limits. Once internal capacity had been built, a task-force of technicians as well as external experts came together to form an observatory – a collective cross-government and cross-sector team with one desired output: to develop a tangible project worthy of external financing. In addition to on-the-job learning, staff were given access to training in Marseille and city visits to Douala and Johannesburg, which had already issued municipal bonds.

Building creditworthiness: Although the bond did not ultimately go ahead, the groundwork that led up to it was a significant success factor in achieving both increased revenues and greater diversity of finance mechanisms over the 2008 to 2015 period. This increase is particularly noteworthy in Dakar's case, given the limited control the city has over the management of own-source revenues. From an overhaul of systems and capacity through the PEFA programme, to gaining experience through concessionary and commercial loans, and undergoing credit rating

assessments and recommendations, the city has drastically strengthened its financial management capabilities.

Development partner support: From the outset, the World Bank-administered PPIAF was crucial in assisting with the groundwork to increase the city's creditworthiness to an investment-grade level. The Bill and Melinda Gates Foundation, and later Cities Alliance, were also instrumental in supporting Dakar's journey to launch the municipal bond. The foundation offered an initial US\$500,000 scoping grant to analyse the feasibility of launching the municipal bond, and subsequently added another US\$5 million delivery grant for a six-year programme to improve financial management systems and city planning. USAID's Development Credit Authority also supported by acting as a guarantor for 50 per cent of the bond, which was critical in lowering the bond's risk profile and ensuring the interest rate was feasible, both to local investors as well as for the city's repayment.

Development partner support also extends to the concessionary loans given at preferential rates by AFD and the West African Development Bank. These were not only crucial to investing in the necessary infrastructure for improving liveability and productivity in the city, but were also integral in embedding financial management operations in the city and improving investor confidence.

Enabling regulatory environment for sub-national debt: Overall, the regula-

tory environment in Dakar is severely limiting, given the lack of control the city has over its financial resources. However, compared to its peers, it is unusually free to take on sub-national debt with relatively few restrictions from the national level. While politics continues to be a factor that influences the options available, and processes still need to be clarified and tested with more 'innovative' financial tools such as the municipal bond, the city has successfully been able to enter into agreements with both concessionary and commercial lenders without national government involvement.

International exchange: The Abidjan-based regional securities market where the bond was set to launch – 'Bourse Régionale des Valeurs Mobilières' (BRVM) – was critical in designing a viable bond. As a financial and regulatory hub for the 14 francophone countries of Central and West Africa, BRVM provides a much broader base of potential investors, pension funds, and other buyers that could invest in the bond, with no currency risk. Furthermore, rules, regulations, and norms around bond issuance were shared and had some historical precedence at the national level. This would also have been beneficial for replicating the municipal bond in the region.

Strong domestic market: The central government has been issuing bonds on the local market since 1996 under the Regional Council for Public Savings and Financial Markets (CREPMF), and so precedence had been set. Specific rules, regulations, and expectations were therefore already in place. The macroeconomic environment was also relatively steady. Furthermore, due to widespread communication and public

participation efforts, there was strong demand from small retailers and individuals too, who wanted to share in this vision of the city's future.

Priorities for current and future reform

Clarity over decentralisation: As noted throughout this case study, the latest Decentralisation Act has left a gap between the devolution of responsibilities and the devolution of finances. It has also resulted in a lack of clarity over the specific roles of various stakeholders. Enhancing Dakar's financials required incentives to be aligned. Currently, the national government has no urgent need to increase the efficiency of revenue collection, as it is not responsible for the services that need to be delivered – its reputation and social contract with residents are not on the line. Given the existing regulatory environment, encouraging the central government to optimise revenue collection for local governments is an area highlighted for development partner support. This optimisation should be considered as part of a comprehensive process of acknowledging and strengthening the role of local governments as core political and institutional players in national development.

Vertical government coordination: Noting the above, the national government is currently making attempts to improve coordination through the Bureau des Collectivités Locales (BCL). The BCL is an initiative of the DGID, created in 2016 to better engage with local governments, as well as to enhance future revenue streams and local collection. An initiative to connect the national government to both local governments and residents has been

the setting up of LFCs. However, these need to be more widely leveraged, as many communes were not yet aware of these initiatives in 2019.

Better-leveraged land assets: A current project of the BCL is to reform how property tax is administered and perceived within the city. An experiment underway to modernise and automate property tax-related systems and better integrate them between different actors has shown successful results, and should therefore be expanded to more communes. Furthermore, partnerships with the private sector to use public land for income-generating commercial centres was also highlighted as a key focus area. While the city of Dakar owns a large amount of property and land to enact this, the true extent of these assets is not yet known. This means that Dakar might be under-leveraging, under-coordinating, and under-capitalising these land assets.

Clarity on debt legislation: Clarity on different debt mechanisms allowable and the necessary debt guarantees is a major regulatory challenge for future access to finance. Often, laws in sub-Saharan Africa regarding local government finance were drafted before capital markets were fully functioning and accessible. Furthermore, markets, norms, regulations, and expectations have not had time to develop through 'learning by doing'. In Dakar's case, understanding where the line is drawn in terms of the city's autonomy in debt financing, as well as how this differs between loans, municipal bonds, and other future mechanisms, is essential for investors to know where they stand.

Building capacity for bankable projects and plans: Some stakeholders in Dakar believed that the lack of

financing is not the penultimate restriction for utilising investments to enhance its financial position. Instead, a more fundamental challenge is that the plans and projects proposed for financing are not bankable. This issue is a global one: 'The Business 20' (B20), a global business community contributing to international policy discussions, stated that the investment gap in infrastructure is not the result of a shortage in capital.⁵⁴ Developing such plans and projects requires

strong technical capacity and experience. Thus, while blending finance and capital guarantees are important future financing elements, assistance in producing detailed bankable urban plans and projects should take precedence.

Continued loan and bond potential: The benefits of building creditworthiness did not stop with the failed launch of a municipal bond. Since 2009, the incrementally higher capacity of

systems and staff have marked Dakar as a city that can pay back its debt. Therefore, both concessionary and commercial loans, exemplified through the successful non-defaulting loans with AFD and Islamic Bank, represent considerable opportunities for the city. A future bond is also still in the pipeline, but the city is not actively looking into it until the political and legislative environment is clearer.

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Enhancing the financial position of cities: evidence from Hargeisa

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Summary

The City of Hargeisa, despite being in the very early stages of enhancing its financial position, has achieved significant reform in just a few years since its democratic establishment in 2002. The successes achieved are even more remarkable, considering the fragile context of Somaliland after 30 years of civil war within Somalia, which left widespread destruction and devastation in the city. This is compounded by Somaliland's lack of recognition as a sovereign state by the international community. The case provides an illustrative example of leveraging urbanisation to raise municipal revenues for public service delivery, and in building local government legitimacy to better deliver to the populace.

Given the context, the reforms are those that are easy to implement and effective, including the application of a

simple digitised accounting and billing system, and a fit-for-purpose area-based property tax system. Where other cities have struggled to service more people with a stagnant revenue base, Hargeisa's reforms have meant that population growth has resulted in increased revenues from property taxes and daily vendor collections. At the same time, private contributions of land on the peri-urban fringes offer an opportunity for in-kind land value capture and planned development in the future. Their successes are reinforced by the legitimacy built through participatory governance, which demonstrates what is achievable when communities, local government and the private sector work together.

While Hargeisa has made progress on the basics of own-source revenue, much more is yet to be done to finance

future development. Local government capital expenditure, for instance, is often far below what is budgeted. This is influenced by public demand for current and visible service delivery over and above less visible long-term investments. Furthermore, due to Somaliland's internationally unrecognised status as an independent country, Hargeisa received limited development assistance when compared to other cities in similar contexts. However, a small coordinated effort through a coalition of UN agencies has fundamentally shaped some of the city's reforms. As the country begins to formalise its financial sector, opening up to commercial banking and international investment, development support will be needed to ensure local governments and the private sector are able to capitalise on the opportunities this presents.

Key messages:

- Simple, fit-for-purpose property tax systems ensure revenue can be collected without incurring large expenses and navigating complex procedures.
- Administrative reforms, such as digitising systems and streamlining the number of taxes collected, can have a significant impact on tax efficiency and accountability.
- Planning for future expansion is not only useful for capturing the gains from rapid urbanisation through exaction, but also improves future urban investment.
- Building and maintaining the social contract through participatory planning and visible service delivery is essential in increasing collection rates.
- International opportunities for finance may be severely limited both by an under-developed finance sector, as well as a reliance solely on Islamic banking.
- Well-coordinated development partners provide a strong enabling environment and an anchor for reform.

Urbanisation trends, challenges and financial needs

Somaliland, a self-declared autonomous state since 1991, is one of the poorest countries in the world, with Gross Domestic Product (GDP) per capita in 2017 estimated at US\$ 675. The economy is heavily reliant on agricultural products – livestock in particular – which made up 28 per cent of GDP in 2012.

As such, growth, output and exports in the country are closely tied to weather conditions. There is limited foreign direct investment in Somaliland, given its lack of recognition as an official state and the fragility of the war-torn context in which it resides.

This limitation also extends to investment from development partners and NGOs. In addition, government taxation and spending are amongst the lowest in sub-Saharan Africa; the former at 7.2 per cent of GDP and the latter at ten per cent of GDP.

The government, therefore, has relatively little control over the country's economic resources to ignite investment and consumption.

Estimates of Somaliland's total population stand at around 3.9 million people, with over half of this population living in urban areas.

The urbanisation rate has been incredibly rapid over recent years, primarily driven by climate change and the resultant displacement from farming activities, as well as high birth rates. Citizens are seeking public services and social safety nets through proximity to the city and urban clan networks. Although one in four urban households still do not have enough to meet their daily basic needs, for many, it is an improvement to precarious and unpredictable rural poverty.

Hargeisa, as the capital city of Somaliland, is an epicentre of this urban growth, with the total population roughly tripling over the last ten years. In 2005, the city was estimated to contain 300,000 inhabitants, while current estimates put the city's population at around 1.2 million. While the city has subsequently undergone rapid reconstruction and expansion to accommodate this surge, some difficulties remain. Visitors describe Hargeisa as one of the lowest-rise capitals in the world, with wealthier diaspora investors accredited with the few notable exceptions. This low density, exacerbated by poor road infrastructure, results in considerable difficulties in both congestion and connectivity.

The city is also characterised by high levels of unemployment and informality. Although information at the sub-national level is hard to come by, the World Bank Doing Business in Hargeisa 2012 report provides an indication.

According to the estimates provided, the informal economy accounts for about 77 per cent of total employment in the city. One of the critical drivers

of this informality is the lack of development in the formal financial sector, which constrains the ability of businesses to access finance. Of the firms surveyed in Somaliland, 48.8 per cent indicated that access to finance is the number one constraint to doing business as opposed to the global average of 16.9 per cent. This is because the majority of financial services are provided by informal Islamic banking systems that offer short-term deposit schemes and no interest on payments.

Another driver of informality is the crippling cost of business licences. In 2012, Hargeisa was one of the top 15 most expensive cities in the world to start a business, with 50 per cent of the expense coming from the local business license cost.

Reforms in the financial sector and large-scale investment are desperately needed to address these challenges, ensuring the city's infrastructure is planned and built to accommodate increased populations in a productive and liveable manner, rather than having a sprawling site of crowding, contagion, and congestion.



Aerial view to Hargeisa, biggest city of Somaliland, Somalia © Shutterstock

Municipal finance and urban governance structure

Urban governance structure and mandate

The legal basis for local governance in the country, including the structures and functions of local governments, is set out in the Regions and Districts Law (Law 23). The Law was created in 2002 but revised extensively in 2007, and aims for extensive decentralisation of power to the local districts. It outlines the division of Somaliland into six regions, with each containing several districts, one being the capital. There is a rank assigned (A-D) to each district after assessing its production, economy, total population, and land area which determines the level of responsibility that can be decentralised.

Hargeisa represents the most advanced grade (A), and is the capital of the Maroodi Jeeh region.

While the six regional councils are not elected, the 23 district councils with ranks A through C are, and the expectation is that elections will be at five-year intervals. Grade D districts still require border demarcations to become electoral districts and therefore remain under the Ministry of Interior, which appoints the Mayor and Councillors.

Although initially there were only 19 Grade D districts prescribed in the law, there have been a growing number of districts appointed by subsequent presidents, now totalling 59. These have largely been politically motivated along tribal lines.

Although the Somaliland Constitution has recognised the importance of district councils for some time, the first direct elections were only held in December 2002. Since then,

municipal elections have only been held again in 2012, skipping 2007, and the 2017 mandated election is now more than 2 years overdue.

There are 25 elected councillors in Hargeisa, with the Mayor being elected from within this group.

Article 11(2) of Law 23 outlines each district's responsibility in providing social and economic services to its citizens. This includes health and education provision up to intermediate schooling level, livestock husbandry, security, water, electricity and communications, amongst others. Although Somaliland is striving for a fully decentralised system under Law 23, local government's ability to deliver the service determines the level of responsibility allocated. In practice, therefore, only some elements have been devolved in larger cities such as Borama, Berbera, Buroa, and Hargeisa; however, even in these, the majority of health and education functions remain centralised or fall between the cracks. Hargeisa's budget reflects this with only 5 per cent of the total spent on healthcare and education services.

This approach has resulted in a severe lack of clarity on which level of government has the responsibility to deliver specific mandates. In some cases, the private sector and diaspora have even stepped in to fill the resulting gap in providing public infrastructure and services such as garbage collection, water, electricity, and telecommunications. The lack of clarity has also led to loopholes in overall tax collection, as well as issues of double taxation. To overcome this, the Joint Programme

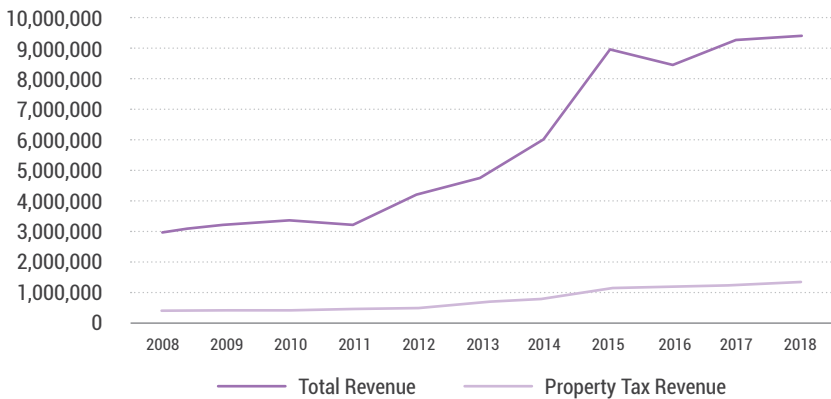
for Local Governance (JPLG), a multi-donor initiative including UN-Habitat, UNICEF, UNCDF, ILO and UNDP, has actively tried to support local governments in achieving the capacity for decentralisation since 2008.

Despite the lack of clarity over roles and responsibilities, the central government is actively engaged in supporting and enabling local governments. The Ministry of Interior helps with the coordination of revenue reform activities, harmonising budgets for development partner projects as well as overall government budgets. They also raise awareness of the importance of adequate central government funding for local governments. This engagement is crucial not just for coordinating Hargeisa, but also consolidating approaches and communication between the other city districts as well. The Ministry of Planning helps by acting as the first point of contact and coordination mechanism for development partner support – channelling partners to the relevant ministry, department or district.

Municipal finance overview

As a result of recent reforms in administrative systems, and capturing the gains of rapid urbanisation, Hargeisa's own-source revenue grew from US\$3 million in 2008 to US\$9.4 million by 2018, translating to roughly US\$7 per capita, depending on population estimates. This represents a tripling of revenues in ten years with over 12 per cent growth per annum, as shown in Figure 1 below. It was asserted that a large

Figure 1: Total own-source revenue and property tax revenue in Hargeisa, 2008-2018 (US\$)



Source: Hargeisa City Council data

portion of these revenue increases can be attributed to compliance. According to the budget, since 2016, total property tax compliance has been hovering between 70 per cent and 75 per cent, however, the revenue generated is significantly limited by the informality of the population – both because of the lack of formal systems to collect it, but also the inability for people to pay.

The municipality has a considerable number of local taxes (46), but the top eight make up over 50 per cent of revenues. Figure 2 shows these key own sources of revenue for 2016 below.

Of these, the three of critical importance for the municipality to enable the creation of urban wealth and deliver public services appear to be those taxes relating to land: property tax, property transfer duties, and vacant land tax. Looking at property tax specifically, the increases in this crucial source of revenue were 17 per cent per annum, quadrupling in ten years to US\$1.34million in 2018, as shown in Figure 1 above. Overall, between 2008 and 2018, own-source revenues increased by a staggering 233 per cent.

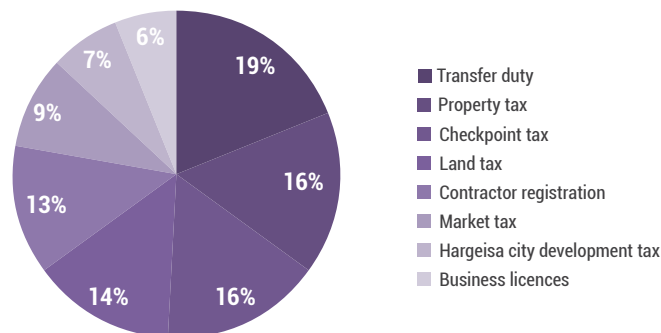
Daily collections are collected predominantly from market vendors and outer city checkpoint taxes. The former is collected largely from informal street sellers, while the latter applies to goods sold in the city coming from outside the city limits. These daily collections should increase in line with the city’s growth. Although market taxes halved between 2014 and 2016, from US\$800,000 to US\$400,000, this was likely due to an increased focus on checkpoint taxes for goods coming into the city, which alone contributed US\$700,000.

Business licences are also a key source of income, but add significantly to the cost of doing business in Hargeisa and therefore deter investment and keep businesses operating informally. Their exorbitant rates, as explored in a following section, may actually reduce overall revenue that this tax can generate.

The city of Hargeisa also obtains funds from the central government. There are two types of central government transfers: the Ministry of Finance’s ‘Municipal Tax’ in the form of a ten per cent share in customs revenues at local customs entry points, and the Ministry of Interior’s ‘Municipal Subsidy’, an equalisation fund based on 12.5 per cent of cumulative customs tax throughout the state. While Hargeisa received 23 per cent of its budget from the central government in 2008, central government transfers made up only 11 per cent, around US\$1.1 million, by the end of 2018.

The Municipal Subsidy from the Ministry of Interior (locally known as ‘Kabka’) aims to cover the shortfall for development expenditure that remains after taking into account revenues. It is enshrined in law, which states

Figure 2: Top 8 own-source revenues in Hargeisa, 2016



Source: Haas, A. (2017)

that 12.5 per cent of customs duties should be allocated to the 42 districts, with six per cent being shared among grade A districts, including Hargeisa.

However, there are ongoing concerns surrounding the delays and unpredictability in the payment size, which make it challenging for the city to plan for its use.

Furthermore, although it is stipulated in the National Decentralisation Policy that the determination of payments should be based on objective and transparent criteria, there are no known factors driving the distribution till date.

The ratios for the division of the total amount between various local districts skews in favour of Hargeisa, given that it contributes

85 per cent of economic activity.

These ratios, however, do not strictly adhere to the law and are often amended by presiding Ministers. For example, Hargeisa is currently allocated around 30 per cent of the total nationwide transfer, as opposed to the legally prescribed 51 per cent.

The 'Municipal Tax' is a more direct form of customs revenue sharing, specific to the customs entry point in that district over and above the Municipal Subsidy. On average, each Grade A district gets about ten per cent of revenues collected at a customs post, transferred by the Ministry of Finance. This tax is a more reliable source of revenue as it is remitted directly to the local government's bank account.

Those districts with major customs entry points, such as Berbera, Gebilay, and Zeila, benefit far more from this tax, and therefore from Central government transfers in general. In Berbera, for example, 68 per cent of revenue came from central government transfers in 2018 due to its location as a port city, far higher than the 11 per cent for Hargeisa as mentioned above.

The city has limited means of accessing municipal **debt financing**. This is not surprising given the underdeveloped formal financial sector at the national level, with Islamic banking limiting any interest-bearing options. Law 23 also imposes a strict limit on local government borrowing, currently allowing only short-term loans from commer-



Roadside trade in Hargeisa, Somaliland © Shutterstock



Food Market, Hargeisa, Somaliland © Shutterstock

cial banks for cash-flow management.

For capital investment, local governments do not meet the credit-worthiness requirements, and are therefore unable to undertake longer-term borrowing at affordable rates.

UN-Habitat is currently supporting a Local Government Finance Policy, which aims to provide clear guidance on borrowing and debt management.

As is the case with the country as a whole, Somaliland’s lack of international recognition prevents the city from accessing responsive **bilateral or multilateral development partner support**, apart from significant support from a few dedicated partnerships such as the Joint Programme for Local Governance (JPLG). The JPLG initiated the Service Decentralisation Model (SDM) and the Local Development Fund (LDF). The SDM aims to support the transfer of minimum education and health functions, and between the relevant Ministries, the JPLG contributed US\$567,622 to education and US\$246,000 to health in 2018. The LDF aims to coordinate development spending and incentivise local governments to institutionalise

and develop financial management capabilities, as they must meet a set of minimum conditions in order to be able to access the funds. In 2018/19, the fund reached US\$2.3 million.

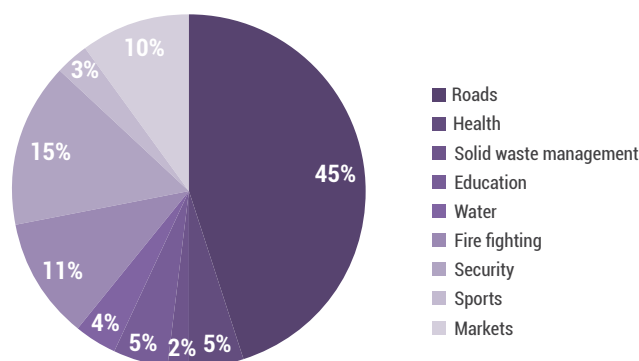
In terms of expenditure, according to the data from 2016, most of the city’s budget (44 per cent) goes towards salaries, followed by operations and maintenance (32 per cent), and then investment in capital stock (23 per cent). While the city’s budgeted revenue and expenditure were equal at just under US\$9.8 million, in reality, total

expenditure was only US\$6.7 million, leaving a budget surplus of around US\$1.58 million when compared to actual revenue of US\$8.28 million. This difference was mostly due to lower investments in the capital stock by around 34 per cent. There was also overspending on salaries by around 20 per cent. The spending on operations and management was roughly similar to what was budgeted.

Although these kinds of discrepancies are common, the low capital expenditure is of concern as this is what ensures a sustainable urban future. Long-term strategic vision and quality of investment appear to be one of the weakest areas in terms of capacity in Hargeisa. The high salary expenditure is also of concern given the very disproportionate breakup: as much as a third of it appears to go to the 25 elected councillors, while two-thirds goes to the remaining 1,200 staff members.

Total budgeted expenditure in 2019 was US\$12.4 million. Figure 3 below shows the breakdown of this expenditure by service, exemplifying that roads make up the lion’s share with 45 per cent, followed by security and markets at 15 per cent and ten per cent respectively.

Figure 3: Breakdown of service delivery expenditure, Hargeisa, 2019



Source: Hargeisa City Council data

Reforms undertaken to enhance the city's financial position

Enhancing the capacity of city financial management

Before 2008, Hargeisa municipality had relatively low capacity in financial and investment management. Compared to current standards, there was little appreciation of the importance of raising local revenues. Many systems were out-dated with records requiring manual processing, leading to a lack of transparency and accountability, as well as enormous difficulty in conducting any analysis. Furthermore, tracking money from its neighbourhood source to its spending destination was difficult. There were also several instances where money meant for capital expenditure was spent on operations instead.

Introducing digital accounting, billing and financial management systems

In order to remedy this, new digital systems known as the Accounting Information Management System (AIMS) and Billing Information Management System (BIMS), both funded by UN-Habitat and UNDP, were introduced. Although the implementation of AIMS took place in 2008 and BIMS in 2010, there was a long period of learning and adopting the systems, and therefore substantive revenue changes were only seen in 2014. Once taxpayers had been registered in the system after their first payment, it became much easier to target them for future payments.

AIMS records all revenues and expenditures in the Chart of Accounts (CoA) and produces the financial reports for the districts. It was designed to capture revenues and expenditure in new ways. For example, on the revenue side, the digitised revenue management system enables the city to accurately record annual revenues and allocate these to specific expenditure funds. On the expenditure side, the AIMS system limited the amount of spending according to budgetary allocations to ensure transparency and accountability. Both revenues and expenditures became identifiable as either capital or current, which significantly reduced the opportunity for capital development expenditure to be usurped by current salary or operational expenditure, as was the case in previous years.

BIMS, on the other hand, deals with billing for property tax and business licences. It provided a critical first electronic link from the central accounting department to individual and neighbourhood-level billing. Not only has this enabled the city to see who has or has not paid, it also allows decision-makers to understand the collection performance of districts and if necessary, have targeted follow-ups. Another key positive outcome of the system is improved efficiency in service delivery, such as business licences. As a result of the new easy-to-use system which enables licences to be provided in decentralised government offices, licence application times

have decreased to just one day. The city is now issuing over 6,000 licences per annum, up from 3,000 in 2010. However, this has not yet translated in a reduction in license cost, which is another critical inhibiting factor, discussed in the section on regulatory reform below.

The AIMS & BIMS systems have improved analysis capabilities and transparency in the city, underpinning much of Hargeisa's financial improvement. However, despite this, there are still ongoing challenges with these systems. The lack of automation in the system primarily drives this difficulty, resulting in a disconnect between AIMS, BIMS and broader government departments. Although AIMS and BIMS are inter-connected, they are functioning under two different departments – the former under the Finance and Administration Department, and the latter under the Revenue collection department. Any change in BIMS requires a manual transfer to AIMS representing a challenge in coordination. Recent 2019 amendments to the Law 23/2007, which specified roles and responsibilities of departments, have provided greater clarity and coordination between the departments. However, this does not negate the resulting limited functionality with understanding municipality assets and cash flows, or in forecasting total or project-specific revenues.

Figure 4: Neighbourhood level billing, ready for input into BIMS

Source: Priya Manwaring

The introduction of the Financial Management Information System (FMIS), which is currently being supported by UN-Habitat, is expected to alleviate the aforementioned issues. The FMIS is an automated and integrated accounting system linked with all arms of government with unified CoA and budget codes. This system will allow Somaliland's audit general to get information on the municipality's accounts instantly. Currently, FMIS is fully operational at the central level, with plans underway to decentralise it to the district level. Hargeisa will be targeted as the first district to facilitate a unified accounting system for Somaliland, which will significantly aid the overall process of decentralisation in the country.

Further digitisation and automation reforms are also underway to connect various elements of city operations through an integrated dashboard. This is already leading to considerable efficiency gains felt by citizens – both in paying for services and in tracking their

progress. Services that previously took two months now take four to seven days, with text messages and electronic billboards at the Mayor's office keeping citizens informed of relevant progress. Mobile money payments have also come online, allowing citizens to pay at their convenience. The hope is that this will further increase compliance and trust in government accountability.

Reducing the number of taxes administered

In many cities, including Hargeisa, a common strategy to increase revenues is simply to increase the number of tax types. Between 2014 and 2016, the number of unique local taxes being levied increased from 42 to 67, which is extremely high by world standards.

However, this strategy does not account for the cost of collecting and administering those taxes, which is often similar to or even exceeds the revenues they bring in. It also contributes to high staff costs and tax fatigue

of residents, as many of these relatively 'expensive' taxes are collected frequently and in-person. With so many payments to keep track of, residents are more likely to be unaware, forget or avoid the nuisance of these payments. Therefore, enhancing the efficiency of the most important taxes and eliminating others could result in higher revenues overall.

While there has been a slight reduction in the number of taxes to 46 since 2017, there is still significant further progress that can be made. This could help in unlocking existing capacity that would otherwise have been taken up in processing a large variety of different taxes, and would enable the city to focus on implementing more in-depth financial reform.

Building human capacity and skills

Alongside enhancing the system's capacity in Hargeisa, several training initiatives have also been underway

to improve human capacity and skills development, particularly given the challenge of high employee turnover in local governments across Somaliland. The city administration in Hargeisa has also been growing – while there were 900 people employed in 2012, there were more than 1,200 by 2015 – and all new employees need to learn and develop the requisite skills.

The key stakeholders driving this forward have been the Local Government Institute (a department within the Civil Service Institute), supported by JPLG. This Institute is linked with Hargeisa University (pictured in Figure 5 below) and is essentially a training school for government officials and citizens. Although initially funded by UNDP, it is now fully funded by the Somaliland government.

Local Leadership Management training is one of the key courses offered, intended as an induction for new local councillors, providing them with an overview of local council functions and the resources at their disposal. It covers issues such as decision-making, policy-setting, institutional development, conflict management, negotiation skills, financial management and community empowerment, amongst others. In addition, at the start of every electoral cycle, councillors undergo capacity building to understand their legislative mandates and restrictions. While the intention is for this to happen every five years, in reality, it has happened every ten years.

More frequent capacity building takes place for administrative staff who are on the frontlines of policy change. While this also covers a range of skills and capabilities, the most notable was training in finance and project cycle management.

Capturing land value and unlocking dead capital

Capturing land value is where the city has achieved relative success, implementing systems that are simple and easy to administer and keep updated. Land-based revenues are captured through the property tax, annual land tax, and the property transfer tax, made more efficient with the use of GIS technology. There are also regulations in place for exaction of land on the outskirts of the city – a provision to finance infrastructure and services as the city grows. However, more can be done to ensure these revenues accurately reflect changes in land value, and to clearly connect them to services delivered.

Simply administered property tax

The City of Hargeisa uses an area-based property tax system, designed to match the available capacity and realities of the context. This was employed following the development of a basic cadastre using satellite imagery and surveys conducted between 2004 and 2005 and supported by UN-Habitat.

Rather than using the standard value-based property tax system driven by market characteristics requiring complex valuations done by personnel of considerable expertise, Hargeisa's system only requires multiplying the area of the building by a location factor. This relative simplicity makes it far easier to maintain and update the register on a more frequent basis and allows the city to enhance its financial position at low cost. However, the simplicity also means it is likely to be more regressive and insensitive to actual changes in value.

Hargeisa's property tax system only requires information on the building's

width and depth, the number of floors, and the location. The tax on each additional floor decreases at a rate relative to the ground floor. The first floor is taxed at 80 per cent of the ground floor, then the second floor at 60 per cent, and so on. In terms of the location bands, while there are 16 locations available in legislation, in practice however, the municipality uses only five. The highest band levies a fee of US\$2 per square metre. The five location bands used are:

1. PTAXCENTER – a tax on property located in the city's centre (mainly commercial buildings);
2. PTAXOPEN – a tax on property that is vacant land (open space or unimproved land);
3. PTAXOUT/OP – a tax on property that is partially used land (partial building and partial unimproved land);
4. PTAXOUTER – a tax on property located outside the city centre (mainly villages);
5. PTAXWALL – a tax on property within a walled compound.

While this approach simplifies administration, it is vital to ensure that there is enough of a range to accurately reflect different location characteristics.

Since the primary purpose of the property tax is revenue generation, tax collection and enforcement are the most critical components of the property tax system. On the whole, citizens seem willing to pay these taxes, and although compliance seems to vary between 50 per cent and 70 per cent, the city states that they have regularly collected up to 90 per cent of budgeted property tax

revenues since 2013. However, enforcement of those who do not comply is relatively weak due to a combination of a lack of political will, data collection and enforcement mechanisms, and in some cases, a lack of taxpayer confidence or an understanding of how the tax is levied, collected, enforced, and used.

There is also a mis-incentive for late payments as the municipality gives discounts for long-term pending payments.

In addition to the property rates, there are also **taxes on property transfers**. The tax applies a four per cent levy on the sale price when a property is sold, with the Ministry of Finance and City of Hargeisa splitting collection, each getting two per cent of the total amount. This is one of the primary sources of confusion between the roles and responsibilities of different tiers of government, subsequently leading to high levels of double taxation. This discourages citizens from transferring their properties and inhibits efficient functioning of the property market.

There is also an **annual land tax** based solely on the area of undeveloped land, collected by the city of Hargeisa. While land with property on it attracts the highest rate of US\$2 per square metre, undeveloped land attracts a much lower value of US\$0.20 per square metre. There are vast swathes of undeveloped land in the city, and with land speculation rife along with estimations of the diaspora owning around 60 per cent of the city, this undertaxed asset could be a key area for reform. Not only would increasing the vacant land tax bring in revenues, as recurrent property tax, but depending on why it is vacant, it could prompt owners to re-allocate to more efficient use. For example, in Kampala, vacant land constitutes just 8-ten per cent of land in the city, and the estimated revenue loss based on

just two of Kampala's 74 parishes was between US\$65,000 and US\$478,000.

Expanding the land and property tax registers

In order to capture the city's growth, Hargeisa municipality has been expanding its registered properties through Geographical Information Systems (GIS) mapping. This entails geolocating each property in an area of space and outlining it on the city map. It was first done in 2005 and then again in 2017, at both points showing considerable increase in the tax roll. In 2005, the number of properties increased from 15,850 to 59,000, resulting in an increase in revenue of over 250 per cent. In 2019, nearly 200,000 plots were registered in the GIS system, including commercial and vacant land. Of these, only 80,000 were built upon.

The property tax revenue increases shown in Figure 1 above are largely a result of expanding registers and improving administration systems. However, this data provides even greater benefits, including improved urban spatial planning in the District Development Plans.

Challenges and opportunities in land value capture

Despite these land and property taxes, the municipality continues to struggle in capturing a fair portion of the substantial increases in land values that result from public investment, rapid urbanisation, and speculative investment. As public services are delivered (sanitation, water, improved roads, drainage), land values are expected to increase, and, ideally, so would land and property taxes to recoup some of the costs and encourage land to be transferred to its highest value use.

In some cities, adequate water supply to plots sees land prices increase by ten times the cost of that investment.

However, the property tax value comes primarily from the location factor, and with limited bands used, capturing the land value increase is unlikely to be fully appreciated.

While the rates allocated per location band can be updated with Council approval every year by law, in practice this is tricky. Land taxes are also solely area-based and are therefore entirely uninfluenced by the value of their surrounding location.

To improve valuation methods and address enforcement issues, UN-Habitat through JPLG, has commissioned a study on Better Management of Property Taxation, the recommendations of which are expected to be implemented in 2020.

The limited data required for area-based property and land tax is therefore both its advantage and its drawback. True land price increases are only really captured through the property transfer tax, relying on the building or land to be sold. However, as discussed earlier, the tax's cost likely impedes sales, and the city therefore derives less revenue from it than desired. Failure of the government to accurately capture land value actually reduces the efficiency of the market, which is perhaps the reason why Hargeisa is such a flat capital city.

Having said this, the city government has been very progressive in implementing a system of 'in-kind' land value capture. This land capture is a form of exaction, whereby the development of land comes with specific conditions for the benefit of the municipalities. In this case, landowners on the outskirts of the city applying to convert their land from

rural to urban use, must provide the city government with 30 per cent of their land if their application is approved. In this way, the city can access land for needed public infrastructure to service a growing city. At the same time, rent from this land can offer the city a valuable source of additional income to pay for the required infrastructure. Figure 5 shows an example of the municipality's 30 per cent land allocation demarcated for future services on the peri-urban fringe of Hargeisa.

Improving the regulatory environment for access to finance

The most fundamental issue that Hargeisa faces in accessing to finance is the lack of international recognition of Somaliland as an independent state. While this is not a regulatory issue per-se, it has implications on the governance of the country. Since the country is not recognised, most donors work with Somalia through the government in Mogadishu. Funding to Somaliland therefore has to pass through Somalia's government, even though in practice they are separate. Most international investors are also not willing to take on the risk of this political instability.

Despite the state's fragility and limited international assistance, the local government has been able to develop what the city describes as relatively high levels of legitimacy amongst its citizens over time. This citizen buy-in has been developed largely through a strong focus on participatory governance, communication, and visible service delivery. They have also started to conduct regular internal audits and prioritise a 'free and fair' election process in order to boost confidence in the local government's transparency

Figure 5: Land demarcation on the fringe of Hargeisa



© Oliver Harman, IGC

and accountability. Building this legitimacy is essential to ongoing compliance in own-source revenue collection.

Building legitimacy through participatory governance

The most important aspect of participatory governance in Hargeisa is the process of strategic participatory planning. The establishment of local government planning departments has encouraged municipalities to think strategically about the long-term trajectory of issues through five-year 'bottom-up' district development plans. According to the City Council, the strong participation of communities in developing these plans, as well as the budgetary framework, makes the citizens feel the government is working for them. The deep engage-

ment with the community in terms of what they want to spend municipal revenues on, enables citizens to understand what should be delivered and hold the local government accountable, thereby raising motivation to 'invest'. This virtuous circle can help to improve legitimacy with citizens in the short run, as well as in the longer-term if local governments are able to deliver.

In Hargeisa, this appears to have been done very well in some areas, but less so in others. The relatively high levels of tax compliance described by the city, suggests that citizens value their tax payments and are receiving the requisite services in return. However, this short-term delivery has come at the expense of capital expenditure, resulting in little and poor-quality

investment. This is starting to affect both voluntary compliance and trust in government, and will increase over time as the gaps in long-term planning increasingly start to show. During community planning sessions, a significant emphasis is placed on current issues rather than focussing on future ones. There is challenge in balancing participatory planning with less visible, long-term planning for investments.

Other efforts to improve transparency in revenue collection and expenditure further build legitimacy. As mentioned previously, the municipality regularly undertakes internal audits to ensure that the system is transparent throughout and provides a check on financial activities. This unqualified opinion, if successful, increases citizens' trust in the local government. Digital systems such as the AIMS and BIMS, the public dashboard display of city activity, and automated text messages of progress on City Council requests, are also important elements in communication and accountability. The intention to introduce mobile money payment systems to reduce pilferage of daily collections will also further support this.

In some ways, the knowledge that external assistance may not be readily forthcoming may inspire the local council to be more accountable out of necessity. Policymakers are able to construct a social narrative around the collective difficulty and achieving a common purpose – that citizens must come together and assist in tax provision and development. This is further supported through free and fair elections at the local level, which incentivises city officials to deliver their campaign promises and generate revenue separate from national transfers, while also creating a sense of local agency for the citizens.

Developing the commercial financial sector

In Somaliland, access to finance is limited with formal banking (Islamic or conventional) still largely undeveloped, underpinned by a lack of the requisite legal and regulatory structures. Instead, the majority of financial services are provided by remittance companies and informal Islamic banking systems that offer short-term deposit schemes and no interest on payments.¹ The supply of investments in the country is therefore severely restricted, hindering the development of both the public and private sectors.

Although regulatory progress has been made, implementation continues to be held up by resources and capacity challenges. The Bank of Somaliland (BoS) Act was passed in 2012, and provides the legal basis for the Bank to act as the supervisor and regulator of the financial system. The Islamic Banking Law was also passed in 2012, and the BoS internal 'Guidelines for the licencing of Banks and Financial Institutions' was passed in 2013. However, a number of critical legal provisions remain unclear, making certain elements difficult to enforce – resulting in unpredictable and incoherent decision-making.

Currently, remittance companies are still the leading providers of financial services. In addition to connecting Somaliland residents with money from the Diaspora, they also facilitate the transfer of funds within Somaliland and provide deposit accounts – essentially acting as quasi-banking institutions. The other financial services more recently available include 'murabaha' used for financing domestic and foreign trade, and 'musharaka', used for longer-term investment financing, and both have grown significantly over time.²

Mobile payments, or 'Zaad', have also gained traction as a way to move away from the entirely cash-based system. Mobile payments are accepted by a large group of merchants, including restaurants, hotels, petrol stations and universities, and are even connecting to international providers for cross-border transfers. Currently, 26 per cent of the population have reported using mobiles to pay their bills, one of the highest rates in the world.³ However, regulations overseeing these transactions are lacking, presenting a possible future risk.

Islamic finance is based on Sharia Law, underpinned by two key principles: the sharing of profit and loss, and the prohibition on the collection and payment of interest⁴. It directs funding to the real economy by promoting risk-sharing, while avoiding excessive speculation, and limits debt to the value of the assets themselves. There are several different Islamic financing 'tools', including *Sukuk* – the Islamic equivalent of bonds. However, instead of conferring debt ownership, *Sukuk* confers a share of an asset, along with the commensurate cash flows and risks. Although still a niche instrument, the use of *Sukuk* to finance infrastructure projects of governments and corporations is growing exponentially. Islamic finance is a US\$2.2 trillion industry in over 60 countries⁵, and thus enabling the formal Islamic banking sector to thrive could bring enormous benefit in itself.

Having said that, Somaliland is in the minority in having Islamic finance as the only option. Many other Muslim-dominated countries have both commercial and Islamic banking options, with the variety of options offering greater choice and potential for financial inclusion. This regulatory environment currently puts Somaliland at a global disadvantage. The Commercial Banking Act, allowing

for non-Sharia compliant loans, has been drafted, but has been sitting with the House of Representatives since 2012 and remains unpassed.⁶

Clarifying responsibilities and reducing complexity

Beyond the two overarching issues of government legitimacy and enabling the financial sector, there are also a number of more specific governance stipulations that need to be addressed. These include the lack of clarity on coordination between the district or city and central level government taxes, including reducing the overly stringent and complex business licence requirements.

Through the process of decentralisation, there has been frequent confusion around collection responsibilities, resulting in loopholes in addition to double taxation. As mentioned previously, one key example is the tax on property transfers, which is meant to be split equally between central and local governments but has proved difficult to execute in practice. Three actions are necessary. First is to further streamline the number of taxes being levied to avoid duplication, focussing on enhancing the efficiency of those with the highest potential. Second is to amend Law 23 to clearly stipulate who collects what, regardless of responsibility transfers. Third is to improve the payment process and coordinate with national revenue collection so that residents are not overwhelmed by having to navigate payment of multiple taxes to multiple different agencies at different points in time.

In some cases, requirements can be excessive, stifling growth and economic opportunity in the city. A clear example of this is the business licence requirement, which has contributed

significantly to the substantial cost of formally doing business in Hargeisa described above. Furthermore, between 2016 and 2017, the cost of business licences increased from US\$124 to US\$274, with 121 different classifications of businesses to navigate.⁷

This expense and complexity keeps people in informality and reduces the benefits of scale and specialisation that a formal, organised, and conducive business environment can bring. Furthermore, setting exorbitant tax rates can reduce tax revenues overall, as economic growth remains stagnant. There is a need to find a balance between deriving justified revenues and making formal economic activity too costly to partake in. There is also a need to plan for the informal sector properly, finding ways to provide for and capture some of the real benefits that this sector brings.

Realising the potential of investment in improving infrastructure

Hargeisa, like many cities, has struggled with infrastructure delivery due to financing limitations. This is largely a result of the underdeveloped commercial financial sector described above. In addition to the constrained financial environment at the national level, Hargeisa municipality has further legislative restrictions on its ability to take on debt. There are prompt repayment requirements (liabilities must be less than two years), and any debt requires central government sign off. Until regulatory reform, current options therefore revolve around leveraging investments from the community and the diaspora, collaborating with the private sector, and coordinating investment from development partners.

Leveraging the local community and diaspora

One of the primary ways that the city has been able to deliver large infrastructure projects is by leveraging the private sector and the community (both locally and the diaspora). As described above, the district development plans have been a critical reform in leveraging both financial and human resources. This buy-in, combined with an understanding that due to Somaliland's lack of international recognition, outside assistance may not be forthcoming, results in citizens, the diaspora, and firms themselves investing in projects. A key example has been the Hargeisa Bridge over the Marodijeh River – community finance, private sector delivery, and local government vision and coordination provided an essential city connection.

Diaspora have also typically contributed to medical practices and higher education, sharing their skills as well as medicine, equipment and books. Investments are also made into buildings and roads where required, although this has tapered off as development assistance has increased. The University of Hargeisa, founded in 1999, was almost completely organised, managed, supplied and funded by the diaspora, leaning on the local government to help in clearing the land, and commit ongoing revenue for security of the new building.⁸

Research has found that many of the contributions are made along clan lines, and is rarely well coordinated, with consequences for the distributional impacts of the investments made.⁹ However, there are also cases of collective formal and informal associations that mimic aid agencies – identifying the needs, selecting pro-

jects, and assisting local authorities in overseeing implementation.¹⁰ The relationships built between the local government, NGOs and the diaspora are vital in facilitating and maintaining these investments.

Private sector concessions

Public Private Partnerships (PPPs) are one (often complex) way in which municipalities can overcome financing constraints in delivering services to their citizens. The private sector concessionaire finances some or all of the up-front capital cost, recouping their investment through user fees or scheduled payments from the public sector partner.¹¹ A form of PPP, or private sector concession, has been used by Hargeisa municipality in solid waste management (SWM). Before this, for 20 years, the city had specific areas or 'nodes' for collection, as they were unable to afford the needed waste vehicles. Individuals dumped their waste at these nodes, but limited resources and poor scheduling for collection meant that garbage was often left there for a while between collections.

With the aim of relieving waste pressure, the municipality entered into a partnership with the private sector through a concession. The concession started small with collection at a few critical sub-streets. After this, feasibility studies were undertaken, and tenders were put out for further collection areas. The city now has five companies covering different neighbourhoods, both at the household and commercial levels. The municipality provides a subsidy to the private sector for its service, and households pay between US\$2 and US\$5 per month. For many, this is three times the amount they pay in property tax. In addition to overcoming short-term

financing constraints, this private concession has provided jobs for around 1,000 citizens who work for these companies.

However, PPP's are often not the fix-all solution they are touted to be and are typically only feasible for large-value projects over US\$50 million, given the high transaction costs incurred in structuring the deal.¹² In addition, they require a very strong authorising environment. In undertaking a PPP, the city is also giving up foregone revenues from fees as well as the subsidy provided to private firms. Together, these outweigh the costs of current provision, otherwise it would not be profitable for private firms to undertake. It is essential to consider whether the cost efficiencies of private sector provision outweigh this foregone revenue. If not, efforts to alleviate short-term credit constraints through borrowing might be better for long-term service provision and financial health of the city.

Coordination with development partners

Despite the city having limited recognition from international development partners relative to other cities at similar stages of development, it has had significant assistance from the few involved. Coordinating the input of these development partners to both align with the city's objectives, and with one another, can be a significant challenge, particularly in the future as interaction with them increases. The Ministry of Planning is the first point of contact and coordinator for development partners. A necessary delivery vehicle upon which this coordination takes place is the Somaliland Development Fund (SDF), established in 2012. This single fund ensures two important outcomes:

1. External development partners can support the country's development goals;
2. All development partner projects delivered are aligned with Somaliland's National Development Plan, a five-year plan covering the period 2017-2021 focusing on rapid economic growth, sustainable development, and poverty reduction.

One useful associated reform already underway by the SDF through JPLG is the construction of markets for informal traders. These markets provide three benefits:

1. Traders can coordinate in one place; they have proper amenities and can benefit from proximity to one another;
2. The administration of taxation is more efficient;
3. Rather than daily collection, businesses licenses and bi-annual market fees could be levied and collected alongside rental payments. This decreases the opportunities for pilferage, reduces administration costs, and improves voluntary compliance of easily identifiable traders who need to pay for rent to stay in the market.

However, to be successful and ensure they are used, it is important that these markets are located where informal traders have access to customers with necessary amenities. As outlined above, the JPLG also contributes to the SDM which aims to support the transfer of minimum education and health functions to the districts and cities.

Lessons, success factors and priorities for future reform

Hargeisa has made a number of leaps forward in enhancing its financial position, despite the fragilities of the state. The key lessons revolve around implementing basic systems that are fit-for-context, as well as the city's ability to coordinate various stakeholders to work towards a common objective.

However, Hargeisa still has a long road ahead in enhancing its financial position. With annual revenue totalling around US\$7 per capita, and a vastly under-developed financial sector in the country, there is little scope to take on debt to finance the city's development. Unlocking the supply of investment for long-term financial sustainability will require significant effort from the national government to improve the regulatory environment for finance, both in providing clarity on the existing Islamic Banking Act and working to ensure the Commercial Banking Act is passed.

Within these constraints, the city is continuing to focus on improving the efficiency of financial management processes, with strong development partner support. This will both increase own-source revenue collection, as well as the city's creditworthiness, attracting further concessionary and community or diaspora-based investment.

Lessons and success factors

Digitising and automating operational systems: The AIMS and BIMS systems have improved analysis capabilities and transparency in the city, under-

pinning much of Hargeisa's financial improvement. AIMS records all revenues and expenditures and produces the financial reports for the districts. BIMS deals with billing for property tax and business licences, as well as property matrices with tariff and location categories. It also provides a critical first electronic link from central Hargeisa accounting to individual/neighbourhood-level billing. It enhances accountability as it allows decision-makers to understand the collection performance of a district and if necessary, have targeted follow-ups. In addition, the new easy-to-use system has enabled licence application times to decrease to just one day.

Simple and fit-for-context property tax system: Rather than using the standard market value-based property tax system requiring complex calculations, expensive evaluators, and personnel of considerable expertise, Hargeisa instead uses a simple and low-cost area-based system. Specifically, it entails calculating the building's size multiplied by a rate based on location, thereby only requiring information on the building's width and depth, the number of floors, and the location band as set by the City Council. JPLG also enabled successful expansion of the property register through the use of GIS, increasing the land and property registered from under 20,000 in 2005 to over 200,000 currently. This simplicity of the system, combined with GIS technology, makes it far easier to frequently maintain and update the register, with revenues having increased by a factor of 4 since 2008.

Pre-planning for future urban development: The city government has also been able to implement a system of 'in-kind' land value capture. Landowners on the outskirts of the city applying to convert their land from rural to urban use, must provide the city government with 30 per cent of their land if their application is approved. This system is a form of exaction, whereby the development of land comes with certain conditions for the benefit of the municipalities. In this way, the city can access land for needed public infrastructure to service a growing city. At the same time, rent from this land can offer the city a valuable source of additional income to pay for the required infrastructure.

Strong focus on the social contract and local government legitimacy: The ability to raise municipal revenues has been underpinned both by a commitment to visible service delivery, such as roads and waste management, as well as the clear focus on participatory planning. The city authorities stated that citizens have a strong say in local government planning and projects through the district development plans and have thus, 'bought-in' to the process. However, this is highly dependent on meeting service delivery expectations, and in some areas, limited and poor-quality capital investment threatens the social contract, risking a reduction in compliance and future legitimacy.

Relative self-sufficiency: Rather than be inhibited by Somaliland's lack of international recognition and support,

the City of Hargeisa has fostered an environment of self-sufficiency with regard to public service delivery. This sufficiency has both positive and negative consequences and is useful to leverage for future reforms. While the city may take longer to build up public services without the variety of development partner programmes that other cities have available, it is simultaneously enhancing self-reliance. That local Councillors are locally elected, without reliance on central government funding, further aligns incentives to help stimulate the need for own-source revenue reform.

Leveraging the local community and diaspora: The diaspora has contributed significantly to the development of the city and the region as a whole, working with local firms, government and individuals to achieve community goals and objectives. This has largely been facilitated and encouraged through the above-mentioned focus on participatory planning. However, as with all other forms of investment in Somaliland, it relies on personal relationships and trust, given the risks attached to the underdeveloped financial sector.

Coordinated and targeted international development partner support: Although limited when compared to other cities at a similar stage of development, those development partners who have worked with Hargeisa were very well coordinated. Often highlighted as an anchor to much change was the JPLG, which was instrumental in a number of reforms, most notably in setting up the AIMS, BIMS, and in capacity building. It has provided a number of enabling conditions in terms of driving change, fronting initial capital, and providing expertise when the municipality lacked capacity, all in a highly collaborative way.

Central government support: In line with Somaliland's decentralisation policy, the central government is actively engaged in supporting and shaping local government. The Ministry of Interior coordinates revenue reform activities and advocates for adequate central government funding for local governments as the country pushes for decentralisation. The Ministry of Planning acts as a coordination mechanism for international development partner support through the SDF.

Priorities for current and future reform

Integrated financial management system: The outstanding challenges since the implementation of the AIMS and BIMS systems, such as the system's automation and coordination with other local government departments as well as the national government, are currently being alleviated through the introduction of the Financial Management Information System (FMIS). The FMIS is an automated and integrated accounting system linked with all arms of government with unified Chart of Accounts (CoA) and budget codes. UN-Habitat is supporting the implementation, and Hargeisa will be targeted as the first district to facilitate a unified accounting system for Somaliland, which will greatly aid the country's overall decentralisation process. Further digitisation and automation reforms are also underway to connect various elements of city operations through an integrated dashboard, with text messages keeping citizens informed of progress. The hope is that this will further increase compliance and trust in government accountability.

Mobile money payment systems: Collecting relatively small fees from many vendors every day is a well-known inefficiency in tax collection. UN-Habitat is currently supporting the government of Somaliland with the introduction of a mobile money payment system, wherein citizens will be able to pay tax via mobile phones, a reform that will hopefully facilitate higher revenue collection, accountability, and transparency. It is promising that currently, 26 per cent of the population use mobiles to pay other bills – the highest in the world.¹³ Further down the line, leveraging the mobile money market as a vehicle for financial investments could also be a useful way of widening the base of investors at the community level.

Capturing the value of land appreciation in land and property tax: With urban expansion, land value increases due to a combination of factors. These include the connectivity to infrastructure, proximity to local services, and expectations associated with future use. Currently, Hargeisa's property tax system does not and cannot fully account for these increases in land value, only differentiating between land in the city centre and outside it. This means that if the municipality delivered similar infrastructure to a specific area of the city, the property owner would fully gain from the increase in associated land value. Using more detailed property location bands to capture land value increases would be a beneficial future aim of reform, as would adding these location factors to the vacant land tax. This undertaxed asset could be a key area for reform. Not only would increasing the tax on vacant land bring in revenues, but depending on why it is vacant, it could prompt owners to invest and develop the land or re-allocate it to a more efficient use.

Clarity over decentralisation of taxes:

The lack of clarity around taxation results in both loopholes and double taxation. Stakeholders mentioned the examples of income tax and business licenses, and in particular, the property transfer tax which is designed to be split. Legislative and institutional clarity on who should be collecting and maintaining these areas of revenue is critical to ensuring there is no further revenue loss or double taxation.

Evaluating the efficiency of local taxes:

Although some progress has been made, there is still an urgent need to critically evaluate the cost-effectiveness of the city levying such a high number of individual taxes. For many of the low revenue taxes, costs for collection may be close to or even higher than the revenues that these taxes bring in, not to mention the tax fatigue experienced by citizens. Instead, focusing efforts on increasing the efficiency of taxes with high potential such as land and property taxes, is likely to be a far more effective way of reaching revenue goals.

Reducing barriers to business formalisation:

Given the enormous size of Hargeisa's informal economy, incorporating it into formal planning is necessary. Even though they are not large businesses, they contribute significantly to economic stabilisation. Nationally, the informal sector is not planned as a key driver of the economy, being absent from Somaliland's National Development Plan. One way to encourage formalisation could be through lowering the cost and complexity of the business licences. In 2012, Hargeisa had the highest minimum capital requirement in the world to begin formal enterprise, with 50 per cent of business start-up costs attributed to the required licence.



Trading on the streets of Hargeisa, Somaliland © Shutterstock

Improved investment expenditure:

Capacity in revenue spending continues to be a challenge in Hargeisa. Limited capital expenditure and poor-quality investment in visible areas are starting to affect both voluntary compliance and trust in government. To combat this, there is a need to focus on longer-term investments, specifically incorporating long-term issues into community plans, as these often focus disproportionately on the issues of the day. Furthermore, if these investments can be connected to increases

in land value, some of the investment could be recouped through land and property taxes.

Local government creditworthiness:

Most of Somaliland's local governments are not creditworthy¹⁴; however, Hargeisa is the most financially buoyant. Creditworthiness is critical in order to engage with the growing options for financing. The city has relatively low revenues at US\$9 million, and therefore the size of loans may initially be small. However, in order

to undertake longer-term borrowing at affordable rates in the future, significant improvements in creditworthiness, particularly revenue and cash flow forecasting, would be necessary. Stakeholders cited cross-city learning and study visits to take stock of successful investment management practices taking place elsewhere, as an area of need. A particular interest was how best to leverage and manage PPPs, given that they are one of the few options currently available.

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Enhancing the financial position of cities: evidence from Mzuzu

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Summary

The case of Mzuzu illustrates how secondary cities, where revenues are often incredibly low and capacity is minimal, can innovate and lead the way on municipal finance reform. Mzuzu is Malawi's third largest city. The focus of this case study is a simple and fit-for-capacity property valuation system that increased realised revenues seven-fold between 2013 and 2018:¹ The Revenue Mobilisation Programme (REMOP).

Although the programme was initially seen to be a success, several serious misgivings continue to inhibit further progress. These centre on legal barriers in the current property valuation process in Malawi. More broadly, issues such as revenue pilferage, lack of capacity for financial management, land ownership disputes between

spheres of government, and national rural bias continue to prevent Mzuzu from achieving a sustainable financial position.

For development partners, the example of Mzuzu provides a stark reminder of the vital importance of widespread stakeholder engagement and caution for legal obstacles in order to achieve sustainable project success. It also illustrates the potential of using smaller cities, with more flexibility and somewhat strong incentives for reform, as a useful starting point to trial new revenue enhancement innovations. The Development Fund for Local Authorities (DFLA), a special entity set up for small and low-cost loans to local governments in Malawi, also presents an interesting model for

further exploration. By helping local authorities through the process of lending, they are building local government creditworthiness and enabling them to develop systems for future debt finance.

Malawi's cities, being some of the poorest in the world and in a country with relatively low level of urbanisation, are still at the beginning of the development curve. This early stage brings numerous challenges that are yet to be faced as well as an enormous opportunity to learn from the mistakes and successes of other cities in similar contexts. The cities are still at the critical juncture where they can invest in the urban infrastructure essential for livability and productivity before mass settlement takes place.

Key messages:

- Secondary cities, with more flexibility and strong incentive for reform, can be useful places for innovation and experimentation of new revenue models.
- Automated points-based property valuation works well as a low-cost, and fit-for capacity way to increase property tax revenues and keep valuation rolls up to date.
- However, widespread stakeholder engagement and co-generation is essential to ensure buy-in, understand vested interests and achieve long term success.
- The use of Geographical Information Systems (GIS) has far reaching benefits beyond improving property tax, including the identification of informal properties, as well as improved urban planning and management.
- Development partners tend to work through the national government, reinforcing the national rural bias in policy-making and investment.
- The DFLA can be a useful model for local governments to smooth cashflow and demonstrate creditworthiness for additional debt financing.

Urbanisation trends, challenges and financial needs

Malawi, the ‘warm heart of Africa’, is one of the poorest countries in the world, with a gross domestic product (GDP) per capita of around US\$290 and 51 per cent of the population living in poverty.² Furthermore, it has a Human Development Index (HDI) of 0.418, ranking 170 out of 187 countries measured. The country also has a low life expectancy of 55 years. Apart from the unrest surrounding the recent elections, Malawi has been predominantly peaceful, with mostly stable governments since gaining independence in 1964. However, many of Malawi’s indicators are similar to those of fragile states or war-torn countries.

The land-locked economy is heavily dependent on agriculture, which employs almost 80 per cent of the population, contributes almost 30 per cent to GDP, and is highly vulnerable to climatic shocks.³ Manufacturing, such as food processing, construction, and cigarette production, contribute around 11 per cent to GDP; while the services sector, such as tourism, transport, health services, and banking, dominates the economy at 52 per cent. Despite its fragile economic state, Malawi has a real GDP growth rate of around 5 per cent and an unemployment rate of just six per cent (this is mostly due to subsistence farming). Given the challenging context, the national tax to GDP ratio is also reasonable, at 17 per cent in 2018.⁴

Malawi’s population of 17.5 million is primarily rural, with only 17 per cent of people currently living in urban areas. However, estimates show Malawi as one of the most rapidly urbanising countries in the world, at over 5 per cent

per annum.⁵ The National Urbanisation Policy was published in response to this. It highlights that “past national development strategies have viewed urbanisation as a constraint to development rather than an opportunity that needs to be harnessed”. Malawi’s early stage of urbanisation gives it a unique opportunity to learn from the mistakes of cities further along the development trajectory. In particular, to actively plan ahead of urban settlement, investing in the necessary infrastructure required to ensure the maximum benefits of urban agglomeration.

The four urban centres in Malawi are Lilongwe, Blantyre, Mzuzu, and Zomba. Lilongwe was declared the capital city in 1975, and is the largest city in terms of population, at 989,318 people in 2018. Blantyre is the second largest city and is still the commercial and industrial centre of Malawi. It is located near to Zomba, the fourth largest city and the former political capital of Malawi, as established during the colonial era. Mzuzu, the focus of our case study, is the third largest city in Malawi, with

a population of only around 221,272 residents in 2018, and with a further 1.7 million living on its outskirts. Although a small city, recent reforms have substantially increased its revenue collections, accountability and transparency – in some cases beyond that of the larger cities in the country.

Mzuzu’s key urban challenge is its under-developed economy. There is much potential to leverage, with the city serving as a key gateway to the Tanzanian border, being home to well-known coffee production, and offering room for further processing of other agricultural products, such as fish, rice, and tobacco. Mzuzu is also home to one of the best universities in the country. As a secondary city run by an opposition party, it is often not prioritised for critical infrastructure investment and has gaps in terms of major roads as well as vital water, sanitation, and electricity infrastructure. However, the small city at preliminary stages of expansion is still able to make these investments before mass settlement takes place.



Stadium in Lilongwe, Malawi © Oliver Harman, IGC

Municipal finance and urban governance structure

Urban governance structure and mandate

Malawi has two spheres of government: National and local. While the classification of local governments can be as a city, town, municipality, or district, there is no stipulated institutional hierarchy between them. Together, the National Decentralisation Policy and Local Government Act of 1998, provide the legal framework for decentralisation in the country. The Act has been continuously reviewed and amended (most recently in 2017) to ensure that local governments are empowered to promote infrastructure and economic development within their area. The National Decentralisation Policy aims to eliminate dual administrations, as well as to promote accountability and participatory governance at the local level.

In urban areas, governance takes the form of a city council, made up of two parts: A political arm composed of elected councillors and led by a Mayor; and an administrative arm called the Council Secretariat, led by the Chief Executive Officer (CEO).⁶ The Ministry of Local Government and Rural Development has oversight and responsibility for all local governments. For city councils, the Ministry of Lands, Housing and Urban Development also assists with strategic planning and urban policy.

The mandate of Malawi's local governments as stipulated by law includes the provision and maintenance of refuse and sewage disposal, city and feeder roads, water supplies, public amenities, as well as licencing and inspection of small and medium businesses. They are also assigned with managing

healthcare centres, education, transport, agriculture, and the administration of land within their localities.

The law does not discern between urban and rural councils, but councils may request an exemption from functions that do not relate to their location. In reality, local governments often lack the resources to deliver on this mandate, requiring assistance from national government and development partners. Consequently, full devolution of powers, including land administration and fiscal decentralisation, is still not complete.

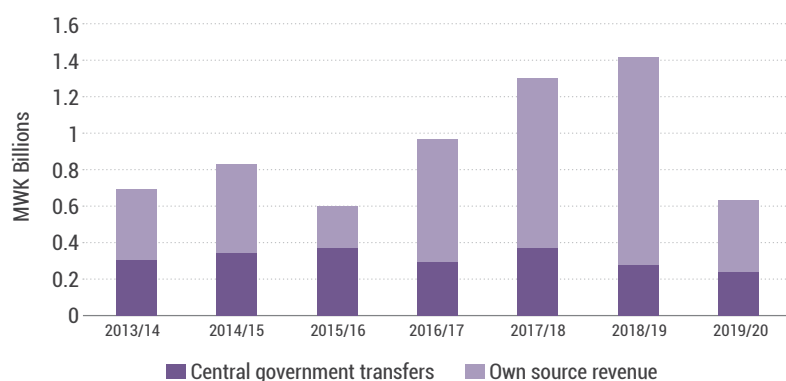
Municipal finance overview

Cities in Malawi struggle with a very narrow tax base, and low levels of collection. Because most of the Malawian population is rural, national government efforts focus primarily on uplifting the rural districts. This is reflected in the allocation of funds. For cities, central government transfers should make up less than 20 per cent of the total budget, given they have potential to raise revenues

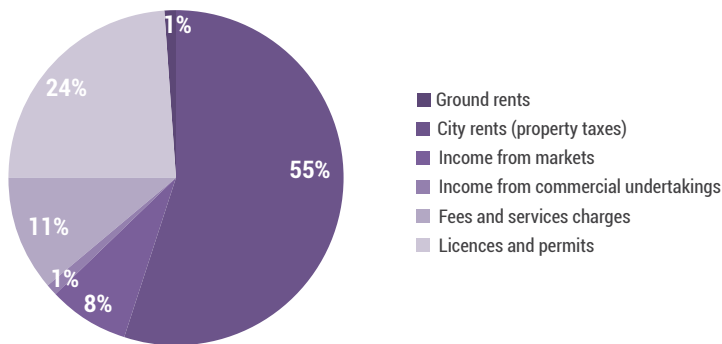
of their own. For rural local authorities this figure is 80 per cent. Development partners have provided some initial investments in necessary projects in an attempt to ameliorate particular urban challenges. However, there are often not enough resources in place to support the ongoing maintenance of these projects.

In Mzuzu, the 2019/20 budget is a total of Malawian kwacha (MWK) 2.4 billion (US\$ 3.3 million), up 15 per cent from the previous year. Of this, MWK 414 million (US\$ 563,000) or 17 per cent is due to come from central government, while own source revenues are due to account for MWK 2 billion (US\$ 2.7million) or 83 per cent. However, the actual revenues are often much lower than predicted. Therefore, central governments typically end up contributing a far higher proportion of total revenue. The central transfers and own source revenue split over the last seven years is illustrated for Mzuzu in Figure 1 below. As the figure shows, there is wide variability and inconsistency of own source revenue collection.

Figure 1: Mzuzu total revenue breakdown by own source and central transfers from 2013 to 2020



Source: Data from the Mzuzu City Council.

Figure 2: Breakdown of own source revenues in Mzuzu for the year 2019/20

Source: Data from the Mzuzu City Council.

Section 68 of the Local Government Act empowers local governments to collect **own source revenues**. The principal sources of own source revenues include property rates (known as city rents in Malawi) and ground rents (a flat fee for rent of public land), business licences and market fees, service charges such as fumigation, and commercial entities such as city-owned guest houses and stadiums. The breakdown of actual own source revenues received in Mzuzu for the year 2019/20 is detailed in Figure 2, together making up a total of MWK 397 million (US\$ 544,000).

The largest source of revenue for all local governments is property rates, as evidenced in Figure 2, at 55 per cent of all revenues. Cities in Malawi levy these property rates on the value of both land and improvements. According to the law, every property is rateable, but the cost of updating property registers as well as low levels of compliance means that achieving potential collection rarely occurs. Fees and service charges are the second most important revenue source, making up 24 per cent of revenues in Mzuzu, largely due to market fees.

Some of the significant challenges faced in own source revenue collection are:

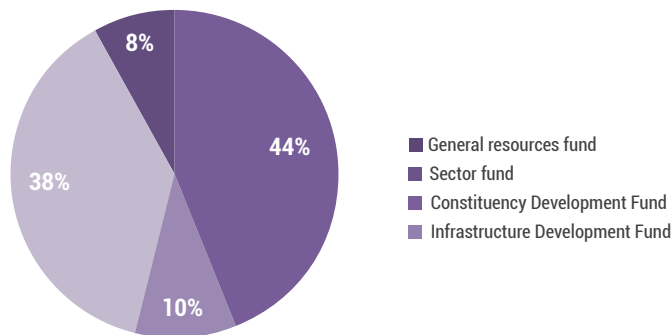
- City-owned property and infrastructure often require investment and maintenance before they can become revenue-generating, and the city councils do not have enough upfront capital to invest in this.
- Illegal vending prevents the city from collecting the required market fees. Also, the operational costs of many markets are much higher than the money coming in from them. Business licenses are better as the costs of collection are lower.
- Compliance with numerous fees and taxes is low. Most cities are severely lacking in by-laws to enforce this given the cost and technical expertise it requires.
- The tax base is constrained by the fact that 60-70 per cent of the urban population in Malawi live in low-income or informal settlements.⁷

Central government contribution and transfers come in several forms, both for capital investment and to cover

operation costs. As is the case in many developing cities, the calculation of the amount transferred uses a formula based on population size and specific development indicators. However, it was asserted that it is also largely influenced by politics. Staff salaries, apart from those seconded to the council, are not covered by this transfer at the city level, while they are in their rural counterparts. In the cities, salaries must be paid from local revenues, which has resulted in a number of periods where city council workers have gone unpaid, in some cases for up to four months.⁸

The central government contribution to urban councils is often lower per-capita than for rural councils. A UNICEF report highlights that Blantyre and Lilongwe City Councils get the lowest per capita allocations⁹, partly due to the majority of the population still being rural, and partly due to the presumption that urban councils have the means to raise sufficient own source revenues. The National Local Government Financing Committee (NLGFC) makes transfers and is mandated to disperse and manage operational and development resources for Local Councils in Malawi. It helps with improving financial management, budgeting, accounting, and auditing of local government finances. In Mzuzu, the relative allocation of all central government funding for the 2019/20 financial year is shown in Figure 3. The total amount transferred was MWK 241 million (US\$ 328,000).

Figure 3: Breakdown of central government transfers to Mzuzu for the year 2019/20



Source: Data from the Mzuzu City Council.

Central government funds relevant to cities:

- The General Resource Fund (GRF)** provides an unconditional grant that central government transfers to local governments every month, with an expectation that a minimum of a quarter will be used for service delivery. It is relatively small and usually used for operational expenditure. The Constitution stipulates that the central government should be contributing at least 5 per cent of national revenues to the local councils. However, councils profess that even though the national government collects significant revenues, they rarely end up transferring the legislated amount – currently averaging only 1.5 per cent.
- The Infrastructure Development Fund (IDF)** helps to finance various infrastructure projects, such as the development of markets. It is only made available to the cities, and is the equivalent of the District Development Fund (DDF) for rural councils. The fund forms part of the National development budget but the choice of projects is discretionary to the councils based on their local

development plans. Usually these are community projects chosen by the communities themselves in a participatory manner. Donor funds can be filtered through this fund, however, because the projects cannot be earmarked for specific activities they tend to prefer the LDF.

- The Constituency Development Fund (CDF)** was introduced in 2006 with the intention to help develop small-scale projects that respond to immediate and short-term development needs. It comes from the same pot of funds as the IDF and is for the same purpose, but projects are selected by councillors rather than by the community in a participatory manner. The assertion is that this fund has not been used efficiently due to political interference and several irregularities have been found in the management of the fund.¹⁰
- City roads allocations are made to the **Road Fund Authority** by the **Road Fund Administration** to assist city councils with their mandate to maintain and construct new road infrastructure. The Road Fund Authority is a quasi government institution

established by an act of parliament in 2006 and reports to the Ministry of Transport and Public Works.¹¹ The Road Fund Administration are mandated to collect and account for funds intended for road works in Malawi. These funds come from the fuel levy, parliamentary appropriations, donors and development partners. It does not show up in the budget of the local councils and is usually the most significant form of contribution to local governments.

- The Local Development Fund (LDF)** was created in 2008 as a vehicle to pool resources from multiple development partners and national government to achieve local development initiatives. The LDF operates on a performance-based system, whereby more grants are provided to those who do well. Its size fluctuates over time, depending on development partner interest and central government investments.

For the 2018/19 financial year, the LDF allocation was only 1.7 per cent of the total national budget, or MWK 20 billion (US\$ 27 million). It also has funds of US\$ 107 million from the World Bank, US\$ 25.7million from the African Development Bank (AfDB), and US\$ 15 million from the German Development Group (KfW).¹² Donors prefer this fund as it allows funding to be ring-fenced for specific projects or types of projects.

In 2018, the LDF merged with the NLGFC, to further improve coordination of central government funding dispersed to local authorities. Policymakers acknowledge that the LDF and NLGFC are still trying to establish the legal structures to make it a coherent and coordinated

institution for efficient financial management and local government development financing.

In addition to these funds, the government makes transfers of conditional grants to specific sectors, such as health and education. In theory, these should make up 9 per cent of national revenues to health and 15 per cent of national revenues to education. Together with the GRF, this means that a minimum of 29 per cent of national revenues should be transferred to local governments. While transfers of the national budget to local government have increased from only 5 per cent in 2015/16 to 17 per cent in 2018/19, this is still far below what the Constitution promises.

Other sources of revenues include:

Ceded revenues: Non-tax revenues that are collected for central government and then redistributed to local governments using a formula. Although legally allowed, Malawi is yet to operationalise many of these. As per the Decentralisation Policy, these include toll fees, fuel levies, vehicle registration fees, and industrial registration fees.

Borrowing and partnerships: These are somewhat unexplored sources of finance given the under-developed financial management capacity of cities in Malawi. The Local Government Act states that councils can borrow money from commercial banks and other lending institutions, as well as enter into partnerships with the private sector, provided the national Ministry of Finance approves these interactions. However, operationalisation of this legislative provision is problem-

atic due to the Ministry's hesitation to guarantee such loans in fear of abuse and bloating the domestic debt burden of government. The Development Fund for Local Authorities (DFLA) is one exception that is explored in more detail below, but this has also been underutilised.

Development partner contributions: Although not always consistent, these contributions form a fundamental part of the financing of development and social protection in Malawi's local authorities. However, their provision is generally to the national level before it is transferred to the local governments.¹³ In particular, both health and education allocations receive funding from the sector support budgets.

Development partners also contribute through the LDF. For example, the World Bank's Fourth Social Action Fund for Malawi (MASAF IV) implements public work programmes and social cash transfers, and develops local government capacity and administrations to take this forward.¹⁴

In terms of **expenditure**, cities in Malawi are forced to make difficult trade-offs - given both the financial and personnel capacity constraints - to deliver on their mandates. As detailed in the section above, many core 'development expenditures' are allocated by central government funds, leaving only personnel emoluments and other recurrent transactions as responsibilities for the city councils. The split between capital investment and recurrent operational expenditure averages around 50 per cent. Strong capital investment is a result of the IDF and CDF being earmarked allocations, which means they cannot be diverted towards operational expenditure.

Since the 2017/18 financial year, all city councils started rolling out **programme-based budgeting (PBB)**.¹⁵ This approach is designed to ensure budgets are comprehensive and comply with international practices, classifying expenditure by programme, as well as economic, functional, and administration impacts. It also improves monitoring of individual budget lines.

For the 2019/20 financial year, Mzuzu prioritised infrastructure development, improved waste management, the establishment of the metropolitan police, and the improvement of Council employees' wellbeing, amongst other impacts.¹⁶ More specifically, they focussed on the maintenance of the markets, cold rooms, and clock tower, as well as capacity building for waste management staff. They are planning the construction of a 10 km road running from the M5, connecting to Matete, then Mzuzu Technical College, and onto Luwinda, via the Botanical Gardens. The road will act as a by-pass for traffic passing through the city. Other city roads will also be improved from earth to formal gravel roads.

Comparing this to actual expenditure, however, the majority of funding still goes towards the Council, internal travel, and maintenance of city vehicles. Furthermore, there have been multiple incidents over the years where the city council has been unable to afford their staff wage bill - forcing them to sell land and property assets to make up the shortfall in revenue collection.¹⁷ Given that actual expenditure was less than half what was budgeted - MWK 661 million (US\$ 899,000) as opposed to MWK 2.4 billion (US\$ 3.3 million) - it is unlikely that Mzuzu was able to meet its targets for the year.

Reforms undertaken to enhance the city's financial position

Capturing land value and unlocking dead capital

As mentioned before, property taxes, or city rates, make up the most substantial portion of all local governments own source revenues in Malawi. However, before 2013, property tax collection in Mzuzu was meagre, with several limiting factors:¹⁸

- The registration roll had only been updated once in the past 20 years and consisted of only 10,000 properties. This represented a quarter of the Council's estimated 40,000 properties in the city. This was due to the formidable valuation fees required to update the roll - the level of which was purported to outstrip current revenue generation - as well as the lack of market data, which was often unavailable or in poor condition.
- Where completed valuations occurred, the value of assessments was often incorrect, due to conflict or collusion between the property owners and valuers.
- The absence of formal addressing systems made the delivery of bills and follow-up for non-payments extremely challenging. Defaulters often managed to get away with not paying.
- Informal settlements, which make up 60 per cent of the city's taxable base, were not included. While this is not a legal prescription, the absence of market data in these areas

made the valuation of land and improvements incredibly challenging.

- There was a lack of awareness and sensitisation of the community to the purpose and process of the property tax. This, combined with a lack of trust in the Mzuzu City Council to deliver services, reduced incentives for citizens to comply.

The lack of own source revenues generated in Mzuzu became particularly challenging when development partners made considerable investments in critical infrastructure, but left the city with no way to fund the ongoing maintenance and operations costs. The Council was in need of reforms to help capture land value and unlock dead capital.

In 2013, given the difficulties in own source revenue collection, the German Development Corporation (GIZ) were looking for a way to maintain a recent investment in waste management facilities in Mzuzu. They contacted the Revenue Development Foundation (RDF), a non-profit consultancy that supports governments to increase domestic revenues, to implement their Revenue Mobilisation Programme (REMOP) on a pilot basis. The programme was funded by GIZ, as well as the German Federal Ministry for Economic Cooperation and Development (BMZ), and cost between US\$ 300,000 and US\$ 400,000 in 2013. The REMOP was deployed over the duration of a full fiscal year to ensure that all procedures would be tested under conditions exactly similar to reality.

Mzuzu lent itself well to the REMOP test because of the dynamism of its leaders, their desire for reform and the fact that, being a secondary town, it remained at some distance from the political influences of the capital.

The Revenue Mobilisation Programme (REMOP)

REMOP is an Urban Tax Administration System that automates the entire process of property taxation, from registration to billing and payments.¹⁹ It employs a six-step methodology, which follows the tax year. The six stages of reform, as conducted in Mzuzu, are outlined below:²⁰

1. **Discovery:** All properties were registered and given a unique number and index. The process included the identification of surrounding roads and buildings, as well as data collection on property attributes and location. Satellite imaging and GIS software were incorporated to improve property identification. The number of properties on the roll increased four-fold, from 10,000 to 40,000, at the same time enabling the Mzuzu City Council to introduce housing numbers and street names.
2. **Assessment:** A points-based Computer Aided Mass Valuation (CAMV) method was introduced to replace the more complex and expensive market valuation method currently in use. With the points-based method, additional points are added to a property for

positive features, such as having a paved road, a tiled roof, and security features. Similarly, points are deducted for negative features, such as no access to electricity. A more detailed explanation is provided in Box 1.

A comparison study found that, although producing no absolute values, the points system mimics market valuation very closely, as shown in Figure 4, below. A vital benefit of this method was that properties in informal settlements, where there is no market data available, could be included in the assessment, dramatically widening the tax base.

3. Billing: The REMOP software automates the updating of outstanding bills, including the systematic delivery of Rate Demand Notices, to all taxpayers, as well as notification upon receipt. The billing period was changed from quarterly to annually, which also helped to ease the administrative burden. To enhance transparency, the demand notices sent out detailed all the

characteristics that influenced the value of the property.

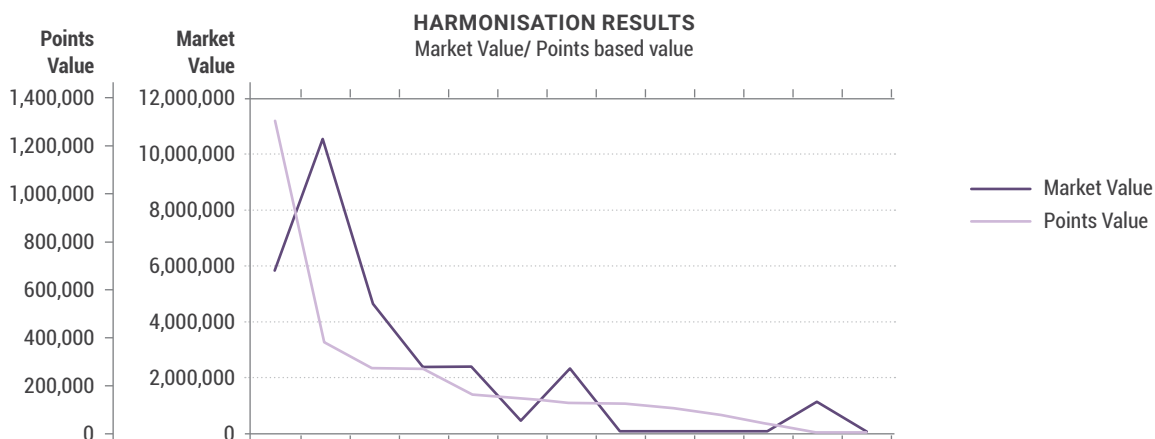
4. Sensitisation: Implementing the new system required a strong sensitisation strategy. A campaign titled, 'My City, My Responsibility' was rolled out to inform Mzuzu residents of the new system, as well as their rights and obligations. The campaign took care to explain the link between taxes and public services to be delivered to encourage buy-in. It achieved this via weekly radio announcements, posters, billboards, newspaper articles, and updates at ward meetings. Special information meetings were also held with various community business leaders and the elite, given they are responsible for most of the property tax. In Mzuzu, the top 100 of these taxpayers shoulder 30 per cent of potential revenue.

5. Collection: The process was restructured from door-to-door collection to payments via banks. This change was a way to reduce pilferage, increase the taxpayer's trust, make payments more con-

venient, and allow the recording of transactions. The 60 per cent collection rate described by Council staff is relatively high in comparison to other cities. A branch of the bank was encouraged to set up at the Civic Centre to leverage the time of change. This financial hub started the process of creating a 'one-stop-shop' for all citizens' services.

6. Compliance: Defaulters were issued with a summons to court. Again, wealthy business people were targeted, as they were liable for a substantial portion of the city rents. The introduction of the court summons yielded initially positive results, as people preferred to pay to avoid the embarrassment. In addition to the social pressure, the prompt sending of bills and follow up letters meant that the Mzuzu City Council could go ahead with legal proceedings, having followed all due protocol. In the past, delays in sending invoices and following up often meant missing the period in which taking legal action was allowed.

Figure 4: Market valuation versus points-based valuation in Mzuzu



Source: Chirambo and McCluskey, 2019.

Box 1: Points-based property valuation

Researchers from the International Centre for Tax and Development (ICTD) have studied and piloted a methodology that uses both surface area and easily observable characteristics to arrive at an estimated market value. Points are added to a property for positive features, such as having a paved road, a high quality roof type, and security features, meanwhile, points are deducted for negative features, such as no electricity. The system is more nuanced than a basic area-based valuation but is more straightforward to administer than a comprehensive market-based system. Therefore, area is still a fundamental determining factor, but with the addition of other housing elements to get a more accurate reading. The application of adjustment factors to each element depends on how the improvement changed the market value. Different methods can be applied depending on the property's classification, either as residential, commercial, or industrial.

Some of the key features of this method include:

- **Simplicity:** Although there is a trade-off between simplicity and precision, the system is adaptable to the requirement.
- **Breadth:** It allows the city to assess properties in informal settlements where market data is unavailable.
- **Effectiveness:** The use of computer-aided mass appraisal also reduces the cost and makes valuation easier to conduct and monitor.
- **Accuracy:** It allows for a more detailed breakdown of what elements add to the value of a property, rather than having a total figure for land and one for the value of improvements, as in the market-based system. While the value is likely to be more aligned to the services the house receives, it may be less likely to match the market value.
- **Progressivity:** Accounting for property characteristics sees the more financially able paying more, but is still less progressive than market valuation.

All of the above are suggested to have strong potential to improve transparency and accountability, curb revenue leakages, and enhance voluntary taxpayer compliance.²¹ However, face difficulties in the progressivity of the tax and legal barriers to formal adoption in many countries. The system has been piloted in more than 12 local authorities in Sub-Saharan Africa over the last 10 years, with Mzuzu being among the first.

Source: Fish, P. (2018)

The result of REMOP was a seven-fold increase in property tax revenues, from MWK 50 million (US\$ 68,000) in 2013 to over MWK 350 million (US\$ 478,000) in 2018. This increase allowed the city to noticeably improve service delivery in garbage collection, street lighting, and road grading, as well as pay off liabilities. For example, Figure 5 shows a waste management vehicle financed with income derived from REMOP.

Figure 5: Waste management vehicles financed with REMOP revenues



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It also proved to be a more straightforward, transparent, and lower-cost way of valuing properties. The project cost between US\$ 300,000 and US\$ 400,000 in 2013. As a comparison, the current Quinquennial Valuation Roll (QVR) - the standard valuation process in Malawi - is costing the Blantyre City Council US\$ 1.9 million, six years later.

Despite the initial successes of REMOP, a number of challenges were highlighted - both general challenges with the implementation process, as well as more fundamental challenges with the use of this methodology within Malawi's legal framework. Figure 6 (above) outlines this, with substantial growth in revenues somewhat tapering off in recent years. The more fundamental issues have halted any further progress in entrenching the new valuation system in Mzuzu, as well as inhibited its expansion to other cities in Malawi.

Challenges with implementation

- **Poor quality data:** During the discovery phase, fieldworkers were given targets for the number of houses they had to collect data on and register each day. This incentivised the fieldworkers to rush the process,

leading to compromised data that did not always accurately reflect the properties characteristics or location. For example, recording properties with incorrect amenities, such as additional outbuildings or different building materials. Incorrect locations meant invoices were sometimes sent to the wrong people.

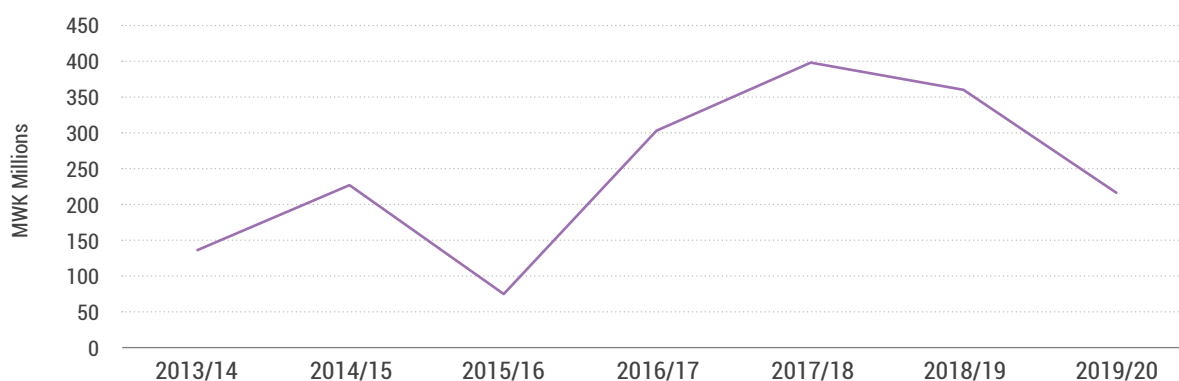
- These issues led to a large number of appeals. However, 80 per cent were associated with incorrect names associated with plots, a consequence of poor land tenure security. The remaining 20 per cent required return field-visits to collect better quality information. Technicians noted that in future rounds of registration, fieldworkers should be given more realistic targets and have a detailed and precise checklist of information they are required to gather.

- **Confusion over the points-based valuation methodology:** Despite the extensive sensitisation campaigns, the community was not sufficiently educated on the point-based methodology. Many citizens, on receipt of their bills, were confused as to why certain elements, such as their

'view' or 'roofing type', affected what they pay for public services. To handle appeals, senior people in the Mzuzu City Council, including the Directors of Finance, Planning and Administration, as well as the Chief Executive Officer (CEO), held open days to listen to people's hesitations and objections. In some cases adjustments were made, but usually the approach was to explain to people how the points-based system worked. It was noted that in future, there should be fewer factors included, and the city council needs to be able to account for how these factors relate to the services households receive from the council.

- **Lacking legal framework to enforce penalties:** It became clear through the systematic implementation of REMOP, that the legal framework and penalties available to local governments to enforce compliance with taxes are lacking for all cities in Malawi. For example, the city councils have to wait three years before they can seize a property to recover rates. Additionally, if a tax payer defaults on a payment, they are not cut off from services, thereby reducing the incentive to comply.

Figure 6: Mzuzu revenue generated from property rates, 2013 to 2020



Source: Data from the Mzuzu City Council

Figure 7: Building the social contract in Mzuzu



© Oliver Harman, IGC

Weak social contract: There is strong mistrust between the people and local governments in Malawi due to pilferage, inefficiency, and the general mismanagement of public finances. People will contribute if they know the local government will spend the money on services, however, the perception is that this will not be the case. There are also too many separate departments collecting taxes from individuals and businesses at both the national and local level, which is very time consuming and confusing for citizens. They are often not able to discern between which government entities they have paid, and what services this payment should bring them. Communication campaigns, such as the one pictured in Figure 8, are being used in an attempt to strengthen the social contract.

Fundamental challenges with the new system

- **The Local Government Act stipulates valuers should use market valuation:** One of the main challeng-
- **The Act stipulates that Valuers registered with the Surveyors Institute of Malawi (SIM) must complete the**

es following the implementation of REMOP in Mzuzu, was the lack of legal provision for the points-based valuation method under section 68 of the Local Government Act (1998). Instead, the Act calls explicitly for market valuation, such as assessment using rental or capital values of the properties. While the use of the points-based method for the pilot in Mzuzu was authorised by the Chief Valuation Officer, applying it to the whole city was not. Despite this, the programme went ahead, but left the current rates without legal grounding, held up only by voluntary compliance. Figure 6 suggests that this voluntary compliance has been waning as people have begun to realise that they cannot be held legally accountable. The negotiations for sign-off with the Department of Lands, Housing and Urban Development are still ongoing.

valuation: However, REMOP in Mzuzu was undertaken by an external expert from the RDF. As mentioned above, although there was a registered surveyor from Mzuzu University involved in the pilot project, they pulled out when the project was expanded city-wide due to legal and ethical conflicts. The Mzuzu City Council has argued that although they are willing to work with SIM to find ways to incorporate them into REMOP in the future, the current fees charged by the valuers are exorbitant. One of the key benefits of REMOP was its low cost, and the cost charged by valuers for market valuations prevents the city councils from keeping their registers up to date. The fee, as prescribed by law, is a maximum of 1 per cent of the properties valued.

The surveyors refuted this claim, stating that they had always been open to negotiating their fees depending on the economic climate and ability to pay. They were also willing to negotiate depending on the number of houses undergoing valuation. For example, rather than the 1 per cent charged for individual houses, they could charge closer to 0.5 per cent per household when undertaking an entire QVR process. There is the option of conducting annual supplementary valuations, so that each year the system updates with the inclusion of newly built properties, meaning the QVR is not so expensive at the end of the five years.

The case of Blantyre's new QVR provides an example of this approach. In Blantyre, there are around 80,000 properties set to be valued. Updating the QVR through market valuation has been procured for MWK

1.4 billion (US\$ 1.9 million), an average of MWK 17,500 (US\$ 24) per household. By way of comparison, it was estimated that revenue from property rates equal approximately MWK 3-4 billion (US\$ 4-5.4 million) over the year, with the potential to rise to around MWK 7 billion (US\$ 9.5 million) per year with the updated roll. If accurate, it thus costs - at most - half of the yearly revenue from property rates to update the QVR every five years. However, this still exceeds the cost of the REMOP system.

▪ **Points-based system results in higher rates than market valuation:**

Some of the stakeholders asserted that the REMOP points-based valuation system was not scientific enough. It was stressed that, given it is more rudimentary than market valuation, it frequently categorises properties into higher rates brackets than the market valuation would, making it inconsistent with the local economy and people's ability to pay. Figure 4 shows that while mirroring market values broadly, it does tend to flatten the distribution, potentially making the tax more regressive. This reinforces another fundamental challenge: residents simply cannot afford to pay.

▪ **There was already an existing QVR running:**

As was mentioned above, the Local Government Act specifies that the QVR should be updated once every five years. However, the assertion was that the Mzuzu City Council implemented REMOP at the same time as an existing QVR was running, and hence rendered the REMOP valuation legally invalid.

▪ **REMOP does not solve the challenge of lacking political will:** A number of stakeholders stated that

the real reason behind the outdated property register is the fact that it takes a lot of time and resources. Therefore, rather than the cost of the valuation, it is the lack of capacity and political will of the city councils that is the main impediment. It was stated that if the city councils were proactive in following up and collecting from all the houses registered on the QVR, the cost of valuation would not be so large, and the valuation method would not make a long-term difference in the maintenance of the register. The assertion was that without constant support from external partners, the city council will not maintain it - even with the points-based valuation - as it still requires input and effort.

The way forward for property taxes

Although the REMOP system was a success in generating increased revenues, the political economy of the valuation method it employed has left it at a standstill. The line between professional protectionism and merited concerns is blurred. Although the Mzuzu City Council is confident that a resolution will be found and that they will be able to continue with the new method, others are not convinced. As it stands, the property tax system operating in Mzuzu is not legally compliant and is relying on the voluntary compliance of its residents. Furthermore, the city have been unable to register any new properties developed using this valuation method, which has meant the proportion of city properties registered has declined to 60 per cent.

This lack of legal clarity has been a significant barrier in expanding the system to other cities in Malawi. The CEO's of all three other city councils

have actively requested support to implement the same system as Mzuzu. One of the fundamental reasons in preferring the points-based system to the market-based one is that informal properties, which do not provide formal market data, could be incorporated into the valuation process. Another key element is the use of GIS identification and the automation of their systems.

Until acquiring more clarity on the legality of the use of the points-based method, Blantyre recently initiated an adapted version of the REMOP process to create an updated QVR that complies with current regulations. They are using market valuation with certified valuers for all formal properties, while incorporating informal properties into their register as 'special rating areas' and charging flat rates.

They are also focussing on improved use of GIS, explaining that GIS is the key component that improves the billing and identification of properties, particularly infill properties or properties that have undergone renovation and are otherwise hard to spot. The GIS system also helps in the collection of other revenues, such as fees from markets and trading centres. In addition, digitisation and geographical data have spillover benefits to other areas of city management, such as the identification of flood zones and properties on fragile land.

Box 2: The political economy of surveyors in Malawi

A large component of the resistance to the REMOP system comes from the surveyors and SIM. Together, they have managed to stop the REMOP system in Mzuzu from being legally signed off and have halted the progression of the system to other cities in Malawi, despite significant interest. While citing many legitimate reasons, others stated they were merely trying to protect a well-guarded profession for their benefit, at the cost of the public good. Programmes like REMOP have the potential to reduce their source of livelihood, and they are condemning it to protect their income.

There are strict rules around becoming a qualified surveyor/property valuer in Malawi - one needs to have a relevant qualification in land management, work under a professional valuer for two years and submit a diary of experience, and then pass a final exam. This is costly, and because of the strict requirements, there are only 24 qualified valuers in the entire country.

The profession is also highly privatised, with little interaction and influence from government employees. As a result, the surveyors feel that the methodology they employ is necessarily more sophisticated than simplified indicators predicted using machine automation. They believe the new methodology will fall short of internationally prescribed standards that are not worth sacrificing.

However, others have noted that with only 24 registered surveyors, it is very difficult to conduct market valuations for every building in each district every five years. Some automation is always going to be necessary, is more cost efficient, and provides a more efficient service to the public overall.

Optimising other land-based revenues

Many stakeholders asserted that better management of urban land was a crucial factor in enhancing their financial positions. Apart from the city rents, urban land can provide revenue in the form of:

- **Ground rents:** These are an annual levy on public land, charged at a flat rate payable to the owners of the land (either a Ministry, housing corporation, or local government authority). The current collection is almost negligible across all local and national governments in Malawi, because the rates were last reviewed in 2005 and are extremely low, and because the systems to operationalise, monitor, and enforce them are lacking.
- **Returns on land-based investments:** Significant revenue could

be generated by investing in city-owned land and generating an ongoing return. For example, guesthouses, shopping malls, and stadiums. Although some of these investments have already been implemented and running for many years, the norm is to sell the land at low prices to provide immediate income, spending this on consumable goods rather than long-term capital gain. Contributing city-owned land to large commercial ventures in exchange for a share of revenues was also posited as a way to better leverage city assets.

- **Sale of serviced plots:** Currently, the supply of serviced land for housing, industrial, and commercial uses is statutorily placed in the hands of the Department of Lands, the Malawi Housing Corporation, and the Local Authorities. They each have their respective target groups of high, medium, and low-income pop-

ulations. However, the supply of serviced plots has always fallen short of demand, increasing the cost of land and resulting in wide-spread informality encroaching on peri-urban land that is typically managed by traditional chiefs.

There is potential for the undeveloped land that is undergoing severe encroachment to be serviced and allocated to developers, with the associated development charges generating a source of revenue for the councils. This would also have a multiplier effect of increasing the property stock and hence increasing property rates and ground rent. Cross-subsidisation of plots for low income residents by plots for high-income developers can also reduce informal settlement development. The significant challenge to enact this is the limited portfolio of land administered by the city councils and lack of clarity over ownership.

Realising the potential of investment in improving infrastructure

Although the Local Government Act decentralises most responsibilities, the Public Financial Management Act stipulates that local governments cannot take loans without prior approval from the National Government Financial Committee. The Ministry of Finance assesses projects that require loans based on their bankability and potential to generate revenue. The Ministry of Finance is then the official custodian of the loan, taking on all liability if anything goes wrong. Given this onus, the national government is hesitant to encourage borrowing for local councils. One exception to this is the DFLA, which is a special unit designed to assist local governments with inexpensive loans to maintain municipal services and invest in infrastructure. PPPs are another option being explored to leverage private investment, but difficulties mean that grants and loans from development partners are still the mainstay for infrastructure investment.

The Development Fund for Local Authorities (DFLA)

The DFLA is a special unit designed to assist local governments with inexpensive loans to maintain municipal services and invest in infrastructure. It was initiated in 1993 by the World Bank funded Local Government Development Project, but was recently brought under the national government for ongoing management. This change has reignited interest in it as a source of infrastructure financing. However, it desperately needs recapitalisation to finance larger infrastructure projects to be of use to urban local authorities in Malawi. One of the key goals and benefits of the

Box 3: The Development Fund for Local Authorities (DFLA)

The DFLA was founded in 1993 with the primary purpose of increasing the capacity for revenue generation in Malawi's local governments. It is a revolving fund, with seed capital of MWK 8.7 billion (around US\$ 12 million). Initially, the World Bank provided this sum as 50 per cent grant and 50 per cent loan, and the fund survived by giving out good loans at a competitive rate, with minimal delinquency and arrears. They offer two products, the first is a commercial loan, covering projects that will generate income in a short amount of time, and the second is a longer-term infrastructure loan. In 2017, the fund was transferred from management by World Bank consultants, to management by a local CEO and team, which has reignited interest in it as a viable 'lender of first resort' for local authorities.

Since its inception, the DFLA has had a steady loan recovery rate, with interest paid covering future loans. This is because the repayment terms are very favourable, with a repayment period of up to 10 years, and an interest rate of 14.5 per cent (the same rate as the Reserve Bank of Malawi). By comparison, commercial bank rates are around 26 per cent. Compliance is also encouraged by engaging the entire city council in the loan process rather than just liaising with one representative, to ensure full knowledge and buy-in. In the rare cases that loans see a default, the DFLA tries to assist the councils in rescheduling payments, or as a last resort recoups their losses through the pledged collateral. One of the critical goals of the DFLA is to motivate the council to think commercially and generate revenues.

The fund operates on a first come first served basis, with the caveat that the DFLA do try to distribute money evenly among all 35 councils. Common projects funded include refuse collection vehicles, updating the valuation roll, the construction of guesthouses, and machinery or equipment. There is no cap on how much they can apply for (other than total funds available in the portfolio). However, the loan size granted will depend on the capacity of the council, the project bankability, and the availability of funds.

For the sake of accountability, the loan is not given directly to the council, but rather the council receives the go-ahead to follow the standard procurement process. Once selecting the service provider, the DFLA pays the money directly to the supplier. The low capacity for developing viable projects and proposals and poor financial management in city councils are some of the main challenges faced in issuing new loans. Assisting the local councils with this so that they can verify the loans requires significant input, assistance, and follow up.

The DFLA is now actively looking to recapitalise, as there has been no injection of funds since its 1993 inception. So far, they have only managed to secure a small contribution from the central government of MWK 400 million (US\$ 545,000), for utilisation on Blantyre's QVR. Development partners are not willing to invest until the modernisation of the Funds' systems so that they are better able to monitor the money's use. However, the DFLA's financial model has no provision for excess income to invest in a system update, and the interest charged covers only a few administrative employees' salaries, marketing, and overheads. As a first step, therefore, they are currently looking for funds to invest in an automated operating system so that they can expand their portfolio.

DFLA is allowing local governments to build creditworthiness through these smaller inexpensive loans.

Apart from the DFLA, it is unlikely that municipalities will achieve autonomy to take on debt financing themselves any time soon. One of the main obstacles is the inability to have a history of transparent and certified financial accounts, which until very recently has not been a widespread phenomenon in Malawian cities. For example, when the new CEO of Lilongwe City Council came into office in 2018, there had been no financial reports for the last seven years. The new Director of Accounts has had to complete this retrospectively. Without better financial management and modernised administration systems in place, the risk of investment will remain too high to be feasible.

Public Private Partnerships (PPPs)

Instead of taking loans that they might not be able to pay back, the National Government is trying to encourage the cities to make use of Public Private Partnerships (PPPs) to achieve their investment and service delivery goals. There was a sentiment that this would also enable the city councils to focus on their core business, i.e. to create a conducive environment for the private sector, rather than taking loans to operate all services themselves.

However, it was asserted that most private entities do not see how they can recover their investments in the current economic climate. Furthermore, PPP's have a high rate of failure in similar contexts. To overcome the extraordinary coordination costs, successful PPP projects tend to be very high in value, around US\$ 50 million.²² An additional hurdle is the feasibility of

recovering investments through user fees – which currently only make up 11 per cent of revenue.

Even if such PPP arrangements were to become feasible, the processes by the Private Partnership Commission (PPC) in Malawi are lengthy and rigorous. This lack of timeliness can end up frustrating the private partner. There is a need for the PPC to devise simple PPP processes befitting local councils. Additionally, councils need contracting and assessment capacity building to analyse projects that bring real public value.

Grants and loans from development partners

Grants and loans from development partners, therefore, continue to be the preferred source of infrastructure financing for city councils. Although they are tied to particular projects, they incur very little cost. However, all financial partnerships with external parties still need to go through the national level. For example, while the LDF comprises of both loans and grants from development partners, the loan liability sits with the central government, and the local government receives it as though it were a grant. The requirement for national partnership means that development partners often align their support to national priorities, which in this case means that the focus is often on the rural districts. For urban councils, more direct funding aligning with municipal and local authority priorities would be far better suited to assisting them with their elected mandates.

The Government of Malawi and several development partners are trying to build a partnership-oriented approach to development assistance, rather than the old model of grants.

This cooperation has culminated in a strategy to align national systems with new financing arrangements.²³ Blended finance is one example, where grants are used to de-risk and incentivise private investment. The Organisation for Economic Co-operation and Development's (OECD) 2019 report on blended finance in the Least Developed Countries (LDC's) states that Malawi attracts 12 per cent of all blended finance in LDC's, with an average deal size of US\$ 194 million.²⁴ However, these partnerships are still largely focussed at the national level.

Improving the regulatory environment for access to finance

A strong regulatory environment underpins the ability of local governments both to generate own source revenues, as well as define the options available for financing larger infrastructure projects over time. The most pertinent areas for regulatory reform are refocussing Malawi's rural bias, reforming land administration and the legal requirements for valuations and building the social contract for citizen buy-in.

Refocussing Malawi's rural bias

There is a strong rural bias from the national level, which filters into development partner relations who invest in projects according to national priorities. The fact that the Ministry of Local Government and Rural Development is the Ministry responsible for oversight and project approval of all local councils (including cities) reinforces this bias. Furthermore, the Department of Lands, Housing and Urban Development can provide input to urban development strategies, but it has no official say over the activities of the city coun-

cils. As a result, there is often conflict and confusion between the two parties as to who takes the lead in certain areas, resulting in duplication in some areas and neglect by both in others. As the country becomes more urbanised, there will be increasing pressure to restructure these departments to give equal weighting to both rural and urban development.

Reforming land administration

As per the updated Land Act of 2016, Malawi's land is designated as public, private, or customary ownership.²⁵ In terms of public land, the central government is always the principal landlord by law. However, the legislation also states that where the President declares a city, the central government requirement is to transfer all land within the city's jurisdiction to the custodianship of the city council. The city council then has control over the management of that land, as well as the financial benefits that accrue from investments in it.

However, the full transfer of land to cities is not currently happening in practice. Instead, the administration of land is done by a combination of the city councils, the Malawi Housing Corporation (MHC), and the National Department of Lands.²⁶ In addition, the national government continues to charge city councils to rent the land at the same rate as a private developer - even when the land is used to provide public infrastructure.

Moreover, where adequate compensations are not paid by the national authorities to relocate communities out of the city boundary, traditional authorities still maintain rights to large tracts of land in the city centres.

Private organisations also own parts of the cities land, which intensified during the International Monetary Fund (IMF) structural adjustment programmes, with some transfers to private ownership not following due protocol.

In addition to inhibiting a critical source of incomes for the cities, policymakers have attested that the multitude of landlords and unclear land rights also makes any spatially expansive infrastructure development projects very difficult to implement. Decentralising land administration and development control to the city councils would therefore streamline investment, as there would be one entity that investors need to deal with when trying to lease land in the city. It also makes it simpler to service, and provides more clarity in terms of which government entity citizens should pay their ground rents to, encouraging compliance.

Currently, a cabinet paper is being prepared to push forward the ideal that all land in each city should be transferred to the relevant city council. This proposal includes dealing with the improper transfers of land to the private sector, as well as providing the necessary compensations to buy urban land from traditional authorities. This legislation could have dramatic benefit in aligning incentives for urban development if passed, subject to the capacity and will of local governments to invoke change.

Also relating to land and property regulation are the legal requirements for valuations. As explained above, the REMOP system has been stilted by the fact that the valuation conducted does not align with the Local Government Act. Instead, the Act specifies that to calculate city rents, councils must use (i) market valuation, and

(ii) that a certified surveyor from SIM must provide sign-off. This restricts the use of simpler and potentially more fit-for-purpose systems. Negotiations and discussions are ongoing, but until achieving a resolution, Mzuzu's revenues from property taxes rely on the voluntary compliance of the citizens.

Building the social contract

Tax compliance in Malawi is low, partially due to the lacking legal framework to enforce penalties, as well as mistrust of people towards the local government. The mistrust is due to perceived corruption, pilferage, and general mismanagement of public finances. Introducing electronic payment systems, reducing the number of agencies collecting taxes, visible service delivery, and communication campaigns were all highlighted by the City of Mzuzu as ways of strengthening citizens' trust in the regulatory environment. This would build on the 'My City, My Responsibility' campaign that was rolled out to inform Mzuzu residents during the implementation of the new property tax system. Figure 7 below shows some current initiatives in this regard.

To complement the Council's development efforts, some residents of Mzuzu devised the Mayor's Development initiative. The initiative is a people centered movement that seeks to solicit resources and ensure prudent management of resources for the development of Mzuzu. Members of the initiative have diverse educational backgrounds and expertise in professional private sectors, academia, and public sector colleagues. The initiative works in collaboration with the Mzuzu City Council Secretariat to prioritise development activities.

The initiative's activities include fund-raising, for example, for medical equipment or the education sector. In parallel, the initiative solicits resources for infrastructure development in areas such as roads, markets rehabilitation, opening up of new markets, police units, bus depots and broader promotion of tourism in the city. The Mayor's development initiative further helps in the dissemination of information targeting Mzuzu residents and other clients. The main aim is that they pay city rates and other fees owed to the Council.

Enhancing the capacity of city financial management

The previous two sections highlight how low levels of capacity and limited structures for financial management continue to limit the city councils in Malawi. This is compounded by a lack of good quality data and information. However, councils are making progress, particularly in long-term planning for investments, as well as

systems and technologies investment. Both these can aid the financial health of the city. Some of these projects are highlighted below:

- **Electronic billing:** National Integrated Technology Limited (NITEL) piloted electronic billing in Zomba City Council in 2017 to enhance transparency in the collection of market fees, ground and city rates, and business licences. It works by instantly recording when a payment is made on the Council's service system, reducing the chances of fee-collectors skimming some of the revenues collected. One year later, the system had increased revenue collection by 53 per cent.²⁷ Mzuzu and other cities are now doing the same.
- **Local revenue investment plans:** The NLGFC has set up an initiative to encourage the development of detailed and implementable local revenue investment plans through the Local Authority Performance Assessment (LAPA) tool. By creat-

ing a competition between cities with the incentive of MWK 5 million (US\$ 6,700) for winning the best strategic plan as well as having results published in the newspapers, they have added an element of social pressure. Initiative officials reported the resulting improvement in the quality of submitted projects - around 20 percent in the third year and 60 percent in the fourth year.

- **Improving council capacity:** As mentioned above, one of the most critical obstacles to improving the financial position of cities in Malawi is poor financial management capacities, with cities like Lilongwe having no financial reports for the last seven years. The European Commission and the Malawi Local Governments Association (MALGA - an inter-governmental voice for local governments) are also partnering to deliver a project on developing the institutional, technical and management capacities of councils in order to improve local government performance, transparency, and accountability.²⁸ A competition between cities for fund allocations was considered as a possible way to create sustainable change in proper financial management.

- **Integrated Financial Management Information System (IFMIS):** A complementary reform is an initiative of the central government with support from the World Bank to implement an Integrated Financial Management Information System (IFMIS) to control government expenditure better and enhance transparency and accountability. There is both a new central government IFMIS and a local government IFMIS in all 35 councils, managed by the NLGFC.²⁹

Figure 8: Posters to enhance the social contract



Lessons, success factors and priorities for future reform

Although much of Malawi's urban story is still progress in the making, the example of the REMOP reform in Mzuzu sheds light on one potential way that partners can use to enhance the financial position of cities. Mzuzu, as a smaller secondary city, with little funding from central government, had to think 'outside the box' to become more self-reliant.

Current and future reforms are centred on improving the stability of own source revenues through internal systems and the regulatory environment to begin building creditworthiness. There seems to be a coherent narrative amongst many stakeholders that before looking at new avenues of raising finance, there is a need to optimise the sources they already have available. The DFLA is one example of an existing entity that could be better leveraged.

Another key element of reform as urbanisation continues to pick up pace is re-focussing the rural bias. Malawi is at a critical juncture where they can invest in the urban infrastructure essential for livability and productivity before mass settlement takes place. This will require large and targeted investment. Along with financial reform, there is a strong need to support economic growth, given that people's ability to pay is a key determining factor of compliance.

Lessons and success factors

Flexibility of small cities: Mzuzu's small size and distance from the capital meant it had more flexibility to trial new initiatives and strong incentive for reform. It also had fewer existing systems and lower levels of bureaucracy to navigate in order to facilitate change. By comparison, decision makers noted that this reform would be much harder to achieve in a capital city like Lilongwe, where political interests would play a far greater role in decisions and procedures.

Motivated and well-trained staff: In terms of capacity for reform in Mzuzu, new people had to be brought in and trained on the new systems. The understanding was that retraining of existing people rarely works, as they are averse to change and often cause disruption. Often, the new people hired were straight out of university and motivated to be a part of the change. This change needs to be expanded, with careful attention paid to how to integrate a new culture through to the rest of the administration, without causing too much disruption to existing personnel.

Immediate source of funds for reform: REMOP was born out of a need to ensure the sustainability of an existing GIZ project. GIZ was actively looking for something to invest in that would provide ongoing revenues to the Mzuzu City Council to maintain the infrastructure built. Having this funding in place for the REMOP system meant that they did not have to go through the slow and

tedious process of funding applications. The assertion was that in other contexts, this often means missing a political window of opportunity.

Systems built to fit capacity: In terms of property valuation, while market valuation is usually more accurate, it also costs a lot of money, requires specialist skills, and requires detailed land registry and sales data. In developing cities, these three things are often in limited supply. Matching the system in use to the capacity of the people and the environment, can deliver much more effective results, and can be adapted as capacity increases over time.

Automation of revenue systems and GIS: One of the critical challenges for revenue collection in all of Malawi's cities is the pilferage of local government revenues. Introducing mechanisms to automate processes and create records of transactions or reduce the number of hands that money passes through is essential to limiting this leakage of valuable public resources. Electronic billing and automating the revenue management system improves transparency, and means the council can produce and audit accurate accounts. The emergence of mobile money also provides opportunities for easing payments and hence reducing default.

GIS is the component of the automated systems that improves identification of properties, particularly infill properties, properties that have undergone a renovation that are otherwise hard to spot, as well as those in informal set-

tlements. It improves not only the collection of city rents, but also other revenues, such as fees from markets and trading centres. It also has spill-over benefits to other areas of city management, such as the identification of flood zones and properties on fragile land, enabling effective urban planning.

The importance of stakeholder consultation and working within the legal framework: The key limiting factor in the Mzuzu REMOP reform is that the new valuation has not been signed off by a registered surveyor in Malawi, a critical requirement for the valuation roll to be legally enforceable. There were many stakeholders that felt there was not adequate consultation of the necessary groups before the new valuation method was rolled out. As a result, they felt excluded and threatened by the reforms, and increased resistance to the method being legislated and adopted more broadly.

The DFLA as a tool for building creditworthiness: By providing access to small, low-cost loans solely aimed at local authorities, as well as step-by-step guidance on meeting the requirements to access the funds, the DFLA has potential to make a large contribution to smoothing cashflow and demonstrating creditworthiness for future debt financing as the city grows.

Priorities for current and future reform

Potential for expanding own source revenues:

- **Business licences:** Historically, the focus has been on market fees, however, evidence shows that the operational costs of the markets are much higher than the money

coming from them. Business licences are much better as the cost of collection is lower due to less frequent visits.

- **Investing in real estate:** The perception is that investing in hotels, shopping malls, and other real estate assets on local government owned land is a sound way of bringing in long term rents from which the city council can benefit. However, complexities in managing these assets, and diversifying away from the city councils core mandate are strong trade-offs that need to be considered.
- **Water and electricity provision:** Currently water and electricity are provided by statutory corporations. However, the Mzuzu City Council suggested that the corporations should instead be doing back supply, with distribution done by the city. This would enable them to earn the user fees, as is done in South Africa. However, the delivery of this service requires significant capacity to operate and would require considerable adjustment to the city council.
- **Other revenue sources:** Mzuzu, given their position as the central pass-way from Tanzania, is considering the use of toll gates and carbon tax for vehicles passing through as an alternative source of revenue.

Improving the social contract: People want to see value for their payments, meaning they want to see the connection between rates paid and services delivered. As one of the stakeholders at the Mzuzu City Council stated, “people are not looking for plans for roads, they are looking for roads”. The ‘My City, My Responsibility Cam-

paign’ and the Mzuzu Mayor’s Development Initiative is making inroads on building the social contract, but more needs to be done. One stated desire was that future development partners could brand and market their investments as city council initiatives in order to encourage a stronger connection between service delivery and tax collection.

Increasing the tax base: Malawi’s cities suffer from a shallow tax base, underpinned by a large portion (60-70 per cent) of each city being part of the informal economy. Incorporating the informal sector into the tax register, as a number of the cities are doing with their property rates, could make a tremendous difference. However, the more fundamental challenge is that many of these residents cannot afford to pay. MALGA is also currently engaging the Ministry of Local Government and Rural Development to expand the revenue base for local councils – transferring certain functions and human resources from the central government to local councillors. The central government currently has control over all the high potential and easy to collect revenue items, some of which may be better suited to the local level.

Enabling economic growth: There is a recognition that increasing public revenues depend on citizens having enough money to pay and therefore the city council needs to do more to focus on economic growth. The Council noted that Mzuzu’s critical economic sectors are distribution and administration. In terms of agriculture, there is also fish, rice, tobacco, and the famous Mzuzu coffee that they could be processing. They could also do better as serving as a hub for tourist activities in the north of Malawi. The Mzuzu City

Council is therefore looking to the Ministry of Trade to help boost economic activity and create special economic zones to improve infrastructure and attract investors.

Automation of revenue sources:

Stakeholders highlighted that for future property valuations, the field-work component should include a more significant number of data points related to other taxable activities, such as businesses and city assets. This expansion could enable the automation of a higher number of revenue sources, without having to pay for separate surveys to be done, and result in a more holistic and integrated revenue system.

The primary goal of this would be to improve accounting and financial management and to be able to show central government and development partners what their funds are achieving in an attempt to advocate for more resources. Accordingly, the Mzuzu City Council identifies the following

benefits from automating their property taxes: Instant audits and financial reports, bulk electronic billing, easier 'client' payment, links with mobile money or internet banking, SMS alerts for clients, mapping of compliance, and finally, transparency – leading to a virtuous cycle of trust and further revenue generation.

Improved partnerships: There was a view that there are strong synergies with other entities that are underleveraged. For example, partnerships with other cities for capacity building and exchange of best practice. Also, partnership with local universities. For example, in Mzuzu, there are urban planners, land surveyors, and GIS planners all nearby that are underutilised.

Partnership with the central government, particularly the Ministry of Trade and Industry, and the Ministry of Transport and Public Works is key. Strong local/national relationships could also begin to unravel the rural bias in Malawi, ensuring that urban investment is prioritised before mass urban migration takes place.

Furthermore, the example of Mzuzu provides a stark reminder of the vital importance of widespread stakeholder engagement and extreme caution for the law in order to achieve sustainable project success. For the REMOP reform, had stronger relationships been formed with SIM, and co-generation of projects taken place, perhaps the new system would have met far less resistance.

Reforming regulations: Ensuring that the legal requirements are met for all public land owned in a city to be transferred to the control of the local authority will bring significant additional opportunity to all the cities of Malawi. If handled correctly, this will not only increase revenues, but also allow city councils to better plan their cities, and improve the environment for investment and doing business. Another regulatory area for reform is the ability of local governments to enforce tax compliance – both in general, and more specifically, to make a final decision on the legality of the new points-based valuation method used in Mzuzu.

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Events held under this initiative

First Advisory Group Meeting, 11 November 2018 UN-House, Brussels, Belgium

13:30	Welcome Jan Olbrycht MEP, President of Urban Intergroup, European Parliament Lars Gronvald, Team Leader - Urban development and Cities, Directorate-General for International Cooperation and Development, European Commission Paulius Kulikauskas, Chief of the Office for Europe and European Institutions, UN-Habitat
13:45	Tour de table , Introductions of Advisory Group members
14:00	Agenda and Goals of the meeting Professor Sir Paul Collier, Chairperson, Advisory Group
14:10	Take stock of existing work/initiatives and discuss how can this project create value added
15:00	Debate how can we focus this exercise to make it most relevant: To whom will conclusions be targeted, and for what purpose;
16:00	Agree on a structured set of typical issues in having adequate municipal financing schemes/ financing of urban development
17:00	Guidance on selecting the reference cities
18:00	Conclusion and next steps Chairperson Paulius Kulikauskas

Second Advisory Group Meeting, 11 November 2019 UN-House, Brussels, Belgium

The Second Advisory Group Meeting consisted of presentations of the findings during the city missions; policy implications of the findings, and a discussion of the Advisory Group on the next steps: the missing elements and final city selection, and considerations of policy implications.

10:00	Welcome and Opening
10:15	Presentation of the findings of the city missions – Prof. Anthony Venables and International Growth Centre team
10:45	Policy implications and open questions – Paulius Kulikauskas, UN-Habitat
11:00	<i>Coffee break</i>
11:15	AG as round table – comments and discussions , chaired by Prof. Venables
12:30	Conclusions by Prof. Venables
12:45	depart to Parliament by bus

Policy session, 11 November 2019 European Parliament

This event served to direct further analysis towards practicable recommendations and tools in using sustainable urbanisation as driver of development. It brought together UN, EC and IFI senior staff, and prominent thought leaders in global academia.

- 14:30 **Welcome:** Jan Olbrycht MEP, Chair of the session
- 14:40 **Opening:** Mr. Felix Fernandez-Shaw, Director, Policy, Directorate-General for International Cooperation and Development, European Commission
- 14:50 **Keynote:** Why Sustainable Urbanisation is Critical for Development,
Sir Paul Professor Collier CBE Fellow of the British Academy, University of Oxford (by live videolink)
- 15:20 **The What - Round Table: State of Play** – institutions present their current practice with urban finance (EIB – Mr. Gerry Muscat, Head of Regional and Urban Development, UNCDF – Mr. David Jackson, Director, Local Development Finance, AECID – Ms. Ana Beatriz Jordao Carneiro-Monteiro, Chief of Coordination Area of Sustainable Cities, DG REGIO – Wallis Goelen Vandebroek, Senior Adviser)
Introduced and Moderated by Ms. Jennifer Musisi (Kampala, Uganda), City Leader in Residence at Bloomberg City Leadership Initiative; Harvard University
- 16:20 **The Next - Debate on Way forward:** Representatives of EU Institutions and the floor
Introduced and Moderated by Professor Anthony Venables CBE Fellow of the British Academy, University of Oxford; opportunity for MEPs and audience to contribute
- 17:20 **Way forward:** Mr. Felix Fernandez-Shaw, Director, Policy, DG DEVCO

World Urban Forum (WUF 10) Networking event, 9 February 2020

This networking event entitled “Innovative urban finance instruments – creating effective links to planning and policy” was organised by the Directorate-General for International Cooperation and Development, European Commission, and the Urban Intergroup at the European Parliament, supported by UN-Habitat

- 14:00 **Welcome:** Jan Olbrycht MEP; Paulius Kulikauskas, UN-Habitat
- 14:10 **Keynote:** Paolo Ciccarelli, Head of Unit, Cities and Infrastructures, DG DEVCO
- 14:40 **Findings of the initiative:** Supporting the Urban Dimension of Development Cooperation: Enhancing financial positions of cities in developing countries to achieve sustainable urban development – Paulius Kulikauskas, UN-Habitat and Oliver Harman, International Growth Centre
- 15:00 **Moderated panel of stakeholders: Next Steps**
Susan Goeransson, Director for the Municipal and Environmental Infrastructure team at the European Bank for Reconstruction and Development; Serge Allou, Technical Advisor, United Cities and Local Governments (UCLG); Dr. Manuel de Araujo, Mayor of Quelimane, Mozambique; Dr. Ernest Nsabimana Deputy Mayor of Kigali, Rwanda
- 15:40 **Interventions from the audience**
- 15:55 **Closing remarks** by Paulius Kulikauskas

First Cities and Experts Meeting, Friday, 28 February 2020, Dakar, Senegal

08:30	Registration at Conference Centre of Radisson Blu Hotel, Dakar Sea Plaza
09:00	Welcome – Mme Maimunah Mohd Sharif, Under-Secretary-General of the United Nations and Executive Director of UN-Habitat
09:20	Opening: Plan for the day – Oumar Sylla, Regional Representative for Africa, UN-Habitat
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Session 1	Chaired and moderated by Lars Gronvald, Directorate-General for International Cooperation and Development European Commission
09:30	Introduction of the initiative and its first findings Astrid Haas, Policy Director, the International Growth Centre – results from city missions 20 min Paulius Kulikauskas, UN-Habitat – first steps to conclusions 20 min Q&A and moderated debate – 20 min
10:30	<i>Coffee break and registration for afternoon breakaway sessions</i>
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Session 2	Moderated by Dr. Xing-Quan Zhang, Senior Adviser, UN-Habitat
10:45	Inspiring examples: (20 min each) and Q&A “The growth rate and the factors- the case of self-government in Poland” Mr. Olgierd Roman Dziekoński, fmr. State Secretary of Poland and fmr. Vice-Mayor of Warsaw “Financing Zenata Eco-city” Mrs. Ilhame Maaroufi, Finance, HR and Administrative Director, Zenata Eco-city, Morocco
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Session 3	Moderated by Ishaku Maitumbi, Senior Human Settlements Officer, UN-Habitat
11:45	Round Table of Governors/Mayors/City Directors: obstacles for investment in sustainable urban development (Moderator leads in with 5 min status on known obstacles; Mayors comment 10 min each, and the rest for debate and moderator’s conclusion) <ul style="list-style-type: none"> ▪ Yvonne AKI-SAWYERR, Mayor of Freetown, Sierra Leone ▪ Peter ANYANG’ NYONG’O, Governor of Kisumu, Kenya ▪ Abdirahman Mohamed AYIDID, Mayor of Hargeisa, Somaliland, Somalia ▪ Mourade DIEYE GUEYE, Secretary General, Dakar Municipality, Senegal ▪ Brian Kondwani NYASULU, Mayor of Mzuzu, Malawi ▪ Samuel SSERUNKUUMA, Ag. Executive Director, Kampala Capital City Authority, Uganda

Guiding questions - choose one theme A, B, or C to fit into a 10 min intervention and include references to your own experience:

A: To advance viable urban financing models, and to remove constraints for access to finance, what would be the core national and subnational responsibilities that would need to be better defined, differently structured, or reassigned to subnational level? Some examples:

- (i) Fiscal authority: decide on collecting and/or spending own revenue and government transfers?
- (ii) Dealing and negotiating with development partners (donors, international financial institutions, private investors)?
- (iii) Land use and spatial planning? Other elements?

B: Cities have to pursue a multitude of development objectives, for example:

- (i) Delivering more productivity in economy of your city and – among other – attract more firms and create employment opportunities;
- (ii) Improve the environment in the city by better public utilities and resilient infrastructure: energy, mobility/public transport, water and sanitation, waste management;
- (iii) Improve housing and real estate development; and other goals.

How can we reconcile some of these goals that sometimes look as if conflicting, for example environmental improvements versus economic growth? How can they go hand in hand?

C: What do you see as the most important obstacles for advancing urban financing models in practice, and how should cities seek to overcome them? Some examples:

- (i) Lack of Integrated urban development strategies?
- (ii) Poor collection of Own revenues and other financial management issues?
- (iii) Dealing with PPPs, procurement and other involvement and investment coordination of the private sector?
Other issues?

13:30

Lunch

Breakaway sessions

14:30

Tasks for breakaway (will be adjusted depending on the results of the Round Table)

14:35

2x2 breakaway sessions 1h each

	<p><i>Urban development policies and strategies to guide public expenditure and investment</i></p> <p>Moderated by Mathias Spaliviero, Senior Human Settlements Officer; UNHabitat</p>	<p><i>Focus on finance and investment ecosystem</i></p> <p>Moderated by David Jackson, Director; Local finance; UNCDF</p>
<p><i>Multi-level governance: Which goals are most important, and how to achieve synergies between the goals?</i></p>	<p>A. What urban development policies, goals and strategies should be provided at the national level, and what goals and strategies should be determined and managed locally?</p>	<p>C. Coordinating revenues, public expenditure and external investment – roles of national and subnational levels?</p>
<p>15:40 – 15:55</p>	<p>Coffee break</p> <p>Presentation “Urban regeneration of the centre of Dakar to support new mobility solutions” by Alioune Badiane, President, The Urban Think Tank Africa-TUTTA</p>	
<p><i>Obstacles to be overcome at local level</i></p>	<p>B. For the well-coordinated urban development at the local level, what obstacles need to be removed for the local authorities, and what long-term institutional solutions are needed?</p>	<p>D. What needs to be improved to achieve complete financial ecosystem: e.g. Government transfers, Land value capture, Own revenues collection, Procurement, PPPs and other private sector involvement; interacting with development partners?</p>

Session 4 – Moderated by EIB

17:00	Reports from breakaway sessions (breakaway moderators 10 min each session)
17:40	Closing debate, moderated by Alioune Badiane, President, The Urban Think Tank Africa-TUTTA
18:00	End

Third Advisory Group Meeting, 26 February 2021 (Online)

The third and final Advisory Group Meeting on **26 February 2021** deliberated on themes that emerged from the review and feedback on the interim draft report.

11:30 CET	Opening remarks: Jan Olbrycht, MEP Prof. Sir Paul Collier, Chair of the Advisory Group
11:50 CET	Presentation: Key messages of the working paper (Paulius Kulikauskas, UN-Habitat)
12:00 CET	Short break
12:10 CET	AG as round table, chaired by Prof. Sir Paul Collier 10-15 minutes for each AG member
13:50 CET	Conclusions by Prof. Sir Paul Collier

Second Cities and Expert Meeting, Thursday, 29 October 2020 (Online)

10:00 CET	<p>World Cities Day commemoration: Valuing Our Communities and Cities Introduction of the event - Oumar Sylla, Regional Representative for Africa, UN-Habitat; Paulius Kulikauskas, Chief, Office of Europe and European Institutions, UN-Habitat</p> <p>Contribution of the European Investment Bank (EIB): Introduction of City Climate Finance Gap Fund – Ms. Giulia Macagno, Urban Development Division, EIB Introduction of African Sustainable Cities Initiative – Ms. Kristina Eisele, Global Partners Department, EIB</p>
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10:30 CET Session 1	<p>Is there a case to be made for strengthening focus on sustainable urban development in low income countries? Two panel discussions moderated by Mr. Ishaku Maitumbi, Coordinator of Programme in Somalia, Regional Office for Africa, UN-Habitat</p>
10:30 - 11:45 CET Subnational actors view	<p>Prof. Peter Anyang' Nyong'o, Governor of Kisumu, Kenya; Dr. Manuel de Araujo, Mayor of Quelimane, Mozambique</p>
11:45 - 12:15 CET Experts view	<p>Mr. Hamdan Abdul Majeed, Managing Director, ThinkCity, Khazana Nasional Berhad, Malaysia; Matthew D. Glasser (tbc); Prof. Edgar Pieterse, Director, African Centre for Cities; Lars Grønvald, Head of Urban Team at DEVCO, European Commission</p>
12:15	<p>Break</p>
12:30	<p>Welcome from European Commission - Carla Montesi, Director, Planet and Prosperity, Directorate-General for Development and International Cooperation (DEVCO)</p>
12:45	<p>Welcome from Urban Intergroup, European Parliament (EP) - Jan Olbrycht, Member of the European Parliament</p>
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13:00 CET (08am EST) Session 2	<p>Debate in two modules: What could and should be done to strengthen urban finance?</p>
13.00-14.00 CET Debate module 1	<p>Moderated by Prof. Edward Glaeser, Harvard University Institutions: Serge Allou, Technical Advisor, United Cities and Local Governments (UCLG); Ms. Edlam Yemeru, Chief, Urbanization Section, United Nations Economic Commission for Africa (UNECA); Ms. Lisa da Silva, Global Cities Lead (International Finance Corporation); Mr. Gerry Muscat, Head of Urban Development Division (European Investment Bank)</p>
14.00 CET Debate module 2	<p>Moderated by Prof. Sir Paul Collier, University of Oxford, Chair of Advisory Group of this initiative Cities and institutions: Ms. Khady Dia Sarr, in charge of the investment projects and municipal finance advisor, Cabinet of Mayor of the City of Dakar, Senegal; Ilhame Maaroufi, CFO, Zenata Eco-City, Morocco; Mr. Maniram Singh Mahat, Nepal Town Development Fund; Samuel Sserunkuuma, Director Revenue Collection, Kampala Capital City Authority, Uganda</p>
14:50-15:00	<p>Conclusion by Prof. Sir Paul Collier</p>

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