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African Cities: Unlocking Financing for Urbanisation

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The nexus between urbanisation and industrialisation provides the foundation for a structural transformation process that increases economic growth and incomes. However, in Africa, unlike most other regions of the world, urbanisation has not been associated with greater industrialisation: Africa is urbanising at extremely low incomes per capita, with most cities struggling to raise financing for investing in infrastructure and public services. The resulting deficit, combined with the lack of institutional structures and human resource capacity required to manage this urban transition, is substantial in all cities, and even deeper in secondary cities, which are amongst the fastest growing ones. Accommodating Africa's urban growth between now and 2050, along with current retrofitting needs, requires an estimated USD 20-25 billion investment in basic infrastructure and another USD 20 billion for housing.[1] This policy brief explores three areas that can support this: helping cities improve their creditworthiness, strengthening subnational financial intermediaries and pipelines of transformative investments that can help African cities unlock some of the financing needed for their urban transition.

As the populations grow, and with them the need for more local public infrastructure and basic services, it is becoming more urgent to address Africa's financing gap in order to effectively manage urbanisation. Limited financial resources cause inadequate maintenance of existing infrastructure and, over time, higher rehabilitation and reconstruction costs, which further deepens the financing gap. In addition, Africa's climate constraints mean that it cannot pursue the same urbanisation and industrialisation trajectory as other continents that were able to rely on carbon-intensive industries as part of their structural transformations. Rather, Africa's infrastructure must limit emissions and support adaptation to the current and impending effects of climate change. Although the costs of doing so may be initially more expensive, the subsequent benefits are likely to be immense and thus far outweigh these costs. For example, estimates from Kenya, Ethiopia and South Africa suggest that by 2050, climate-resilient urban infrastructure could generate benefits amounting to between 150 and 250 per cent of annual GDP.[2]

[1] C40 Cities and World Resources Institute. 2021. *Financing Africa's Urban Opportunities: The 'Why, What and How' of Financing Africa's Green Cities.* London/Washington DC: Coalition for Urban Transitions.
[2] Ibid., 1.

It is estimated that two-thirds of African urbanisation[3] – both in terms of population growth and expansion of the built environment – will come in the next 20-30 years. The Addis Ababa Action Agenda[4] for financing the Sustainable Development Goals emphasises that strengthening municipal and local finance systems is critical for unlocking the growth dividends of urbanisation. Therefore, despite the short time frame, Africa's urbanisation trajectory can still be shifted to create a more positive outcome – by unlocking financing for cities.

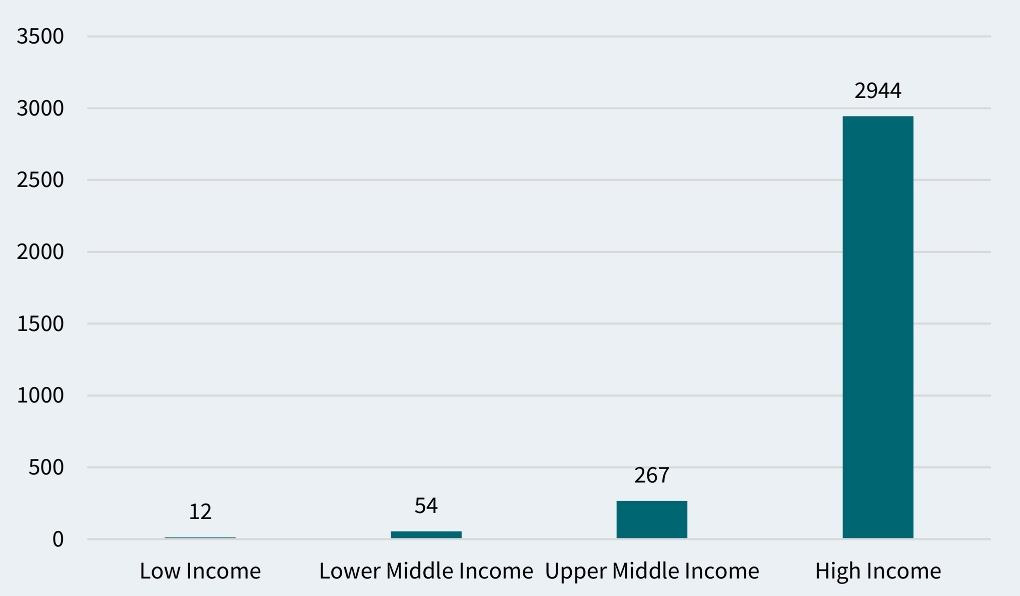

Figure 1: Average annual per capita OSR for cities by country income category (in USD).

To do this, cities must focus on several aspects of creditworthiness. One is improving their own-source revenues (OSR), which are revenues a city is authorised to collect and spend. Figure 1[5] shows that African cities can still substantially raise their revenues because current average per-capita OSR are extremely low compared to other cities and local governments across the world. Furthermore, all things being equal, collecting more OSR not only improves creditworthiness, but also increases the amount of money a city has to spend.

Low levels of OSR generation have numerous economic, political and institutional roots. Diagnosing the main cause is an important first step towards reforms that can enhance potential revenue. One major factor is the overall low per-capita income in these cities, which makes it difficult to raise large amounts of revenue from the population. Other reasons include the fact that in many African cities, most businesses are small and thus have low turnovers. This further restricts the tax base.[6] Another challenge is that a lack of financing inhibits service and infrastructure provision, which in turn limits voluntary tax payments. A series of administrative and institutional factors, such as low institutional capacities to collect taxes and the fact that greater tax enforcement tends to be politically unpopular, exacerbate these challenges.

[3] Collier, Paul. 2017. "African urbanisation: An analytical policy guide." *Oxford Review of Economic Policy* 33, no. 3: 405-37.
[4] United Nations. 2015. *Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda).*
[5] Fleck, Lennart. 2022. "Chapter 5: Towards a Framework for Own Source Revenue Optimization." In *Local government finance is development finance,* edited by David Jackson. New York: UNCDF.
[6] Lall, Somick, Vernon Henderson, and Tony Venables. 2019. *African Cities: Opening Doors to the World.* Washington, DC, World Bank.

The exact mechanisms that cities can employ to improve their OSR are context- and challenge-specific and generally fall within two overarching areas,[7] namely:

- *Administrative reforms to improve revenue management*, including updating billing and collection procedures, enhancing revenue staff capacity and identifying the underperforming revenue streams.
- *Policy reforms that alter revenue structures*, including identifying new revenue sources, changing rates or tax bases, and issuing new regulations and laws. Such laws could, for example, expand the taxpayer base or, in the case of property tax, change the valuation methodologies. In most countries, it may be easier to reform policy through regulations and byelaws rather than by changing the law itself.

For most cities, it may be more beneficial to start with administrative reforms than by attempting to make policy changes. This is because cities usually need approval from higher levels of government and the legislature to alter legal and regulatory structures and navigating national governments can be a lengthy and politically complex process. Often, national governments are reluctant to grant local governments and cities more financial autonomy. This is especially true where urban areas oppose the ruling parties, which happens frequently – and not just in Africa.

That said, city governments are usually authorised to make administrative reforms to enhance the efficiency of the revenue collection as part of their own mandates. Such reforms are not only likely to reap significant efficiency gains for many African cities, but they are usually both financially and politically less costly than more substantial policy reforms. They can usually be introduced more quickly and are therefore likely to demonstrate results in the shorter term, helping generate support for future reforms.

Infobox 1[8] presents the case of Uganda's Kampala Capital City Authority (KCCA), which raised its OSR by over 100 per cent in four years through a variety of concurrent administrative reforms. The KCCA experience – that significant financial gains can be attained by making the administration more efficient – is also relevant for other cities, including smaller secondary ones. However, Kampala's case shows that strong political will and leadership are often still needed to initiate administrative reforms. This is especially the case if endemic corruption incentivises keeping systems dysfunctional and opaque so that even if the solutions to improving OSR are obvious, it may still be difficult to implement them.
In the case of the KCCA, political support was achieved through changing the institutional structure, which the President of Uganda initiated.

Technology is increasingly part of administrative reforms, particularly automation to improve tax collection and billing. Yet technology will not automatically improve OSR because the efficacy of technological inputs still depends on the underlying revenue systems as well as the will to implement reforms.[9] A further critical consideration, especially when technological changes increase efficiency, is their impact on jobs. For instance, switching from manual revenue collection to online payment systems might make tax collectors redundant and they may block reforms. Understanding those likely to lose out from reforms and how their concerns can be addressed must be considered from the outset when looking to change administrative systems.

Finally, improving a city's OSR is just one aspect of improving its creditworthiness. For cities and local governments to obtain an investment grade credit rating, they must adopt,

[7] Haas, Astrid, with Paul Collier. 2017. *Financing Fast-Growing Cities.* London: International Growth Centre.
[8] Andema, Fred, and Astrid Haas. 2017. *Efficient and Effective Municipal Tax Administration: A Case Study of Kampala Capital City Authority.* London: International Growth Centre.
[9] Fleck, Lennart. 2022. *Enhancing the Financial Position of Cities: Evidence from Kisumu County Government.* Nairobi: UN-Habitat.

and adhere to, more comprehensive financial reforms. These include improving budget administration and assets and liabilities management and strengthening accounting and auditing procedures.[10]

Infobox 1: Kampala Capital City Authority Administrative Reforms

In 2010, an Act of Parliament created the Kampala Capital City Authority (KCCA) to replace the Kampala City Council. The next year, Ugandan President Yoweri Museveni appointed Dr. Jennifer Musisi, a former director in the Uganda Revenue Authority, as the KCCA's first Executive Director. Initially, she had the president's support and thus the political freedom to undertake wide-ranging reforms, including that of the revenue administration.

Key to these reforms was improving the KCCA's revenue collection through several administrative changes, including:

- *Internal staffing and skills:* Dr. Musisi split the Treasury Directory into the Treasury and Revenue Directorates, with the latter focused solely on increasing revenues. She ensured that the new directorate was not only adequately staffed by appointing more than 100 contract and permanent staff, but also had them attend relevant training courses.
- *Digitising databases:* Until 2011 most of the KCCA's revenue processes were manual, making them prone to major errors, delays in account reconciliations and overall poor tax services, amongst other problems. For that reason, greater effort was put into digitisation. That culminated in the roll-out of the 'e-Citie' system, which was developed in-house and not only digitised databases but also allowed taxpayers to digitally access their own records.
- *Treating taxpayers as clients:* Tax morale and voluntary compliance was very low in Kampala. To encourage greater compliance, the KCCA shifted their organisational focus to viewing the taxpayer as a client to whom they provided services. This led to reforms that were easier for taxpayers to comply with, including streamlining tax brackets and instituting online payment.

Through these administrative reforms and others, the KCCA was able to increase their OSR by over 100 per cent in four years (2011-2015).

The Role of Subnational Financial Intermediaries

Cities may succeed at generating additional resources and boosting their creditworthiness but still not be able to access finance from capital markets. Take Kampala: It instituted extensive financial management reforms beyond improving OSR administration and applied for and received an 'A' long-term local rating in 2015.[11] Yet it still could not raise capital because of Uganda's legal restrictions on local government borrowing. This is true for many other jurisdictions across Africa and elsewhere because city governments are prohibited

[10] Gorelick, Jeremy. 2018. "Supporting the Future of Municipal Bonds in sub-Saharan Africa: The Centrality of Enabling Environments and Regulatory Frameworks." *Environment and Urbanization* 30, no. 1: 103-22.
[11] Global Credit Rating Co. 2015. "Kampala Capital City Authority." Uganda Local Authority Analysis.

from borrowing from capital markets. This is often related to concerns about the substantial fiscal risks that national governments could sustain.[12] However, restrictions on subnational borrowing tend to be stronger in Africa than in other developing regions, including Latin America and Asia (Figure 2[13]).

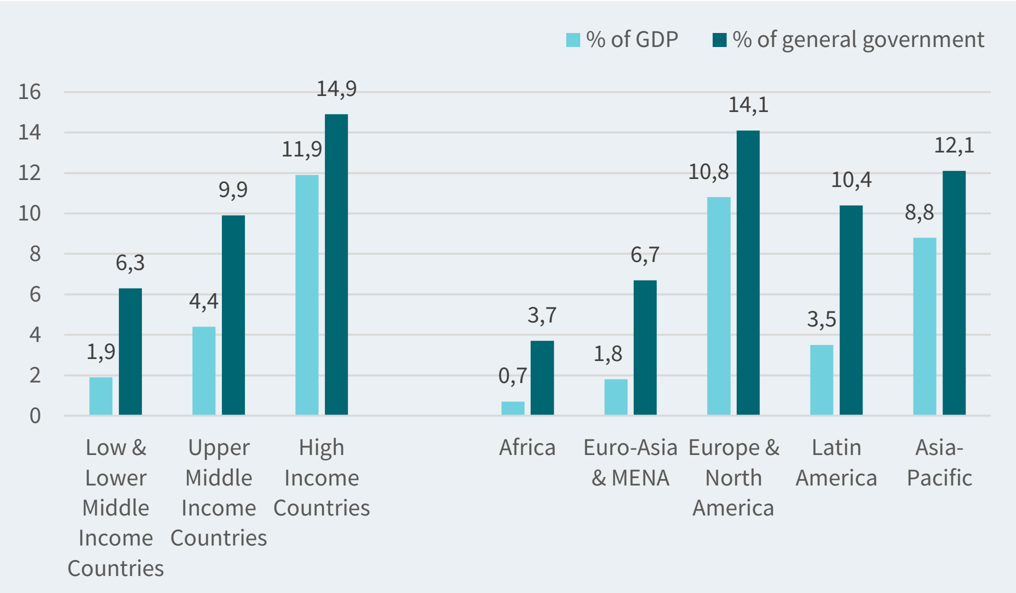

Figure 2: Average borrowing by subnational governments, by country income category (in USD).

To overcome this, the Addis Ababa Action Agenda proposes strengthening the municipal bond market. In some parts of the world, most notably the United States, municipal bonds are a key financing instrument for cities. However, in many developing countries, particularly in sub-Saharan Africa, only a few cities – primarily in South Africa – have been authorised to float bonds. Aside from the aforementioned legal and regulatory challenges, there are also political challenges in floating bonds, as highlighted in the case of Dakar, Senegal (see Infobox 2).[14]

Furthermore, although a well-functioning municipal bond market could unlock many benefits for cities, it is not a short-term solution to the financing challenge because it requires numerous other political, institutional and financial reforms – particularly at the national level – that are beyond the city's control. These reforms include, for example, deepening the country's domestic capital market, stabilizing the overall macroeconomic conditions and many others.

Therefore, providing cities access to finance through subnational financial intermediaries may be a possibility for the short term. It should expand municipal and local governments' access to capital, especially where they could otherwise be legally constrained from directly accessing financial capital markets. The exact structure of the intermediaries varies, but usually they have some form of public ownership and can raise resources from the public or private sector and then on-lend or on-grant them to cities. These financial intermediaries may also be able to pool projects, which can be beneficial for smaller cities. With respect to the finance, they can also, for example, blend capital grants with loans and on-lend or grant

[12] Saxena, Sandeep. 2022. *How to manage fiscal risks from Subnational Governments.* Note 22/03. Washington, DC: International Monetary Fund.
[13] UCLG, and OECD. *2019 Report World Observatory on Subnational Government Finance and Investment.* Paris: OECD.
[14] Delbridge, Victoria, Khady Dia Sarr, Oliver Harmann, Astrid Haas, and Tony Venables. 2022. *Enhancing the Financial Position of Cities: Evidence from Dakar.* Nairobi: UN-Habitat.

these to municipalities and local governments. Some intermediaries also operate as revolving funds or through international financial institutions, which may have local lending options.[15] Irrespective of the institutional structure, when it comes to financing infrastructure, specialised subnational financial intermediaries can have greater impact if they can provide longer-term loans in the local currency.

These types of intermediaries have been used around the world to improve financial lending to cities: the *Kommuninvest* in Sweden, the Local Government Funding Association in New Zealand and the *Financiera de Desarrollo Territorial S.A.* (Findeter) in Colombia.

Infobox 2: Dakar's (Failed) Municipal Bond

In 2015, the city of Dakar, Senegal was supposed to become one of the first cities in Africa, outside of South Africa, to float a municipal bond worth USD 40 million. Preparation work, including improving Dakar's creditworthiness, had started in 2008 with support from a wide variety of partners. City reforms led to Dakar getting a BBB+ (regional scale) institutional credit rating from Bloomfield Investment Corporation in 2013. The day before the bond was supposed to be issued, despite having completed all the regulatory steps and obtained all the necessary approvals outlined in Senegal's laws, as well as having generated sufficient demand from investors, Senegalese President Macky Sall intervened and the central government withdrew its support. The bond was never issued.

Although the official reason for government intervention was concerns about its impact on overall national debt, many observers believed it was politically motivated. The Mayor of Dakar at that time was a popular leader in opposition to the president's party and having Dakar achieve this form of financial independence was deemed politically risky for Sall's re-election prospects.

In developing countries, these financial intermediaries have often been created with the support from international financial institutions such as the World Bank.

Particularly for cities in developing countries, where several major impediments prevent local governments and municipalities accessing capital markets, these intermediaries can play an important role in unlocking finance, particularly for longer-term infrastructure projects. Intermediaries can help municipalities and local governments gain borrowing experience, build their credit histories and help them to gradually start accessing the capital markets directly. A relevant example of tailoring an intermediary to a local context is the Development Fund for Local Authorities (DFLA) in Malawi (Infobox 3[16]).

To date, subnational intermediaries in developing countries have a mixed record.[17] One of their challenges is capacity constraints, particularly when it comes to how they raise resources, especially if they are not creditworthy. Hence, many are undercapitalised. Another challenge is government interference: When they are not independent institutions, they cannot always make economically and financially sound choices, which can skew their portfolios and subsequent lending. Furthermore, some intermediaries established with the support of external development partners have had difficulties becoming self-financing.

[15] Smoke, Paul. 2022. "Chapter 8: Reimagining the Role of Special Financial Intermediaries in Subnational Development Finance." In *Local government finance is development finance,* edited by David Jackson. New York: UNCDF

[16] Delbridge, Victoria, Khady Dia Sarr, Oliver Harmann, Astrid Haas, and Tony Venables. 2022. *Enhancing the Financial Position of Cities: Evidence from Mzuzu.* Nairobi: UN-Habitat.

[17] Ibid., 14.

Infobox 3: Development Fund for Local Authorities

In 1993, Malawi's national government established the Development Fund for Local Authorities (DFLA) to support improvements in local government financing. Initially, DFLA was capitalised with about USD 12 million from the World Bank: 50 per cent as a grant and 50 per cent as a loan. In 2017, the DFLA was transferred from the World Bank to local management. It is now managed by a CEO appointed by Malawi's Ministry of Finance. The DFLA on-lends the financing it raises in the form of short-term commercial loans to revenue-generating projects or longer-term infrastructure loans at competitive rates.

Local governments and city projects include purchasing refuse collection vehicles, updating property valuation rolls and constructing guesthouses, as well as investing in other types of machinery and equipment. DFLA repayment rates are high, with minimal delinquency or arrears and positive overall impacts.

As a revolving fund, DFLA loans are issued on a first-come, first-served basis, with the interest paid on current loans covering fund management costs and future loans. Borrowing from the DFLA has allowed local governments to start establishing credit histories. However, the DFLA is struggling to recapitalise and the absolute value of its lending and project numbers are low and much smaller than what Malawian cities need.

However, if well-structured, using intermediaries may be the important first step to introducing cities to borrowing and opening new sources of finance.

From Bankable Projects to Transformative Investments

In addition to strengthening the supply of finance, cities must also be able to build their demand for it. The conventional narrative of many development partners is that the financing is there, but not the projects. This indicates that cities have difficulties transforming their visions and ideas into concrete proposals. This has led many development partners to turn to helping cities develop "bankable projects." These are investment-grade projects that are structured to attract public or private finance or a combination of both. To underpin this effort, several financing institutions have set up project preparation facilities, such as the European Union's African Investment Facility, to provide grants for the early stages of project preparation and identification.

Infobox 4: Components of a Productive and Sustainable Infrastructure Agenda

- Strengthening employment and the labour market
- Concentric value chains that cluster related economic activities
- Circular economy – from waste to energy
- Catalytic sectors and specialisation in a unique context
- Rural-urban linkage and a territorial approach
- Connectivity – people, goods, services and information diffusion

This approach to developing individual bankable projects can create problems by not focusing on a city's overall systemic dynamics which, in turn, can cause fragmentation in the system and lead to unintended adverse outcomes. It also focuses on commercially viable projects, which results in an investment bias towards projects in sectors such as energy, banking and mining, and neglect of the social sectors, including health, education, water and sanitation.[18] Even if projects in social sectors are selected and packaged as bankable, they may exclude vulnerable populations because the user fees charged to generate a revenue stream to repay investors are too high. In this context, it is also important to emphasise that not all projects are bankable: Every city has local public services that must be financed from its own public revenues.

There are several reasons for a bias towards focusing on individual projects compared to developing longer-term, more integrated pipelines. Firstly, developing a more transformative pipeline is a multi-year process, yet the support of most development partners is usually structured around much shorter-term project cycles that require accountable final outputs. It is also a resource-intensive process that usually exceeds an individual development partner's investment capability. Furthermore, the city may not have the capacity to sufficiently engage in investment planning for multiple projects at any one point in time, which is partly why in many cases, it has not been possible to establish project pipelines. For all these reasons, investing in the preparation of a single infrastructure project rather than a full project pipeline is often preferred.

Merely identifying and developing individual bankable projects is unlikely to have the transformative effect required to revolutionise Africa's urbanisation. However, even when developing individual projects, special regard needs to be given to how each project fits into and underpins a sustainable and productive infrastructure agenda and coordinate with other efforts to unlock the sustainability of cities across several dimensions (see Infobox 4[19]).

Recommendations for Unlocking Financing for African Cities

African governments are struggling to manage existing cities, let alone plan for cities to be built in the future. As such, across the continent, cities are associated with congestion, crime and contagion, and perhaps of even more concern, increasing poverty and inequality. One of the most important causes is the lack of the immense financing needed to manage

[18] Ibid., 11.
[19] Jackson, David. 2022. "Chapter 1: Analysis and Investment Agenda for a Liveable Healthy Planet." In *Local government finance is development finance,* edited by David Jackson. New York: UNCDF.

the urbanisation process. This brief has focused on only three of the many areas that need to be urgently addressed to be able to unlock financing for urbanisation, which are also three areas currently receiving too little attention from the development community:

1. Building cities' administrative capacities to help generate OSR and improve their creditworthiness.

Although administrative reforms may appear unremarkable, they are key to unlocking finance. Many African cities' revenue efficiency levels are still extremely low so supporting administrative reforms can yield the greatest returns in the least amount of time. These types of reforms can often be carried out at less cost than other types of development assistance, thus they can also reflect good value for the money. In this context, multiple and diverse types of interventions can be undertaken, depending on what is needed. Examples include updating taxpayer and property databases, digitising systems and processes, establishing modes of cashless payment, designing communication and taxpayer education campaigns and training revenue staff.

However, before any reform programme is begun, the context, systems, processes and capacities should be analysed. This should not only include the technical aspects, but also a political economy analysis to reveal challenges that could arise from different reforms and allow mitigation mechanisms to be integrated from the outset.

Finally, it is important to emphasise that this policy brief only looks at one specific subcomponent of improving creditworthiness: reforms to increase OSR. Similar work also needs to be done on expenditure, asset management and overall budget planning to strengthen cities' financial systems.

2. Strengthening subnational financial intermediaries, including recapitalisation.

Most African cities have not been able to access financing from capital markets. Yet given the large volume of investments needed *now*, this is critical for both retrofitting existing cities and planning for future cities. Besides the challenges mentioned here, many cities have no credit history because they have never had the opportunity to borrow. Therefore, it is important to start helping cities establish credit histories and better understand the mechanisms and procedures related to borrowing and to strengthen the role of subnational financial intermediaries. The type of institution will vary according to the national context and local needs, but development partners should consider collaborating closely with cities, including offering technical assistance, capacity building and other programmes to ensure that the intermediaries provide the most appropriate services to the cities they serve.

Furthermore, many intermediaries urgently need to be recapitalised so they can open new opportunities for financing, particularly for smaller cities. Development partners can also explore how to do this and opportunities to strategically use their financial assistance, so that it has a catalytic effect and helps intermediaries unlock further financing. This is a key tenet of the Addis Ababa Action Agenda.

3. Supporting the design of pipelines of transformative projects in cooperation with other development partners.

Improving demands for finance must be included in a comprehensive approach to unlocking financing for cities by helping cities translate their visions into investment projects. Development partners have already set up a variety of project preparation facilities to support these endeavours but more needs to be done in this regard, particularly at the project identification stage to ensure that cities can develop infrastructure projects that respond to their citizens' preferences and also attract financing.

More broadly, however, the focus needs to shift from supporting individual bankable projects to establishing and investing in pipelines of transformative ones. This will help ensure that non-commercially viable projects that provide significant social benefits and positive externalities receive adequate consideration. Development partners will have to deepen their cooperation to leverage their expertise and work together with cities – firstly by developing pipelines and then ensuring their implementation.

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