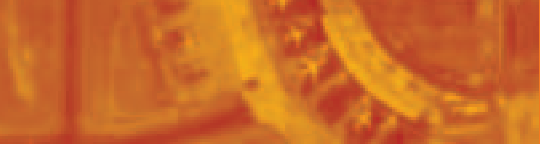


The Challenge

The Millennium Development Goals have brought into sharp focus the scale and nature of the challenges that need to be overcome in order to achieve basic levels of human dignity for all. Currently, close to 900 million people live in urban slums, an estimated 1 billion lack access to adequate water supply, 2 billion do not have access to adequate sanitation, and 4 billion live without adequate wastewater disposal. The scale of the problem is such that the imprecision of the figures is largely irrelevant.

The financing required by cities to address this challenge is daunting. For example, the UN Millennium Project's Task Force on Improving the Lives of Slum Dwellers has estimated that the investment required to upgrade slums and provide alternatives to new slum formation between 2005 and 2020 will be of the order of US$20 billion per annum.

While most of the international debate has focused on the role of increased development assistance and debt relief, insufficient attention has been paid to the much larger and growing need for local sources of investment for infrastructure in the cities where the urban poor live. These cities are in the midst of coping with the impact of three major historical trends: globalisation, requiring the creation of competitive infrastructure to attract investments; decentralisation of responsibilities, often not matched by the delegation of authority or resources; and rapid population growth, mostly poor people whose contribution to the economy is rarely matched by their access to basic infrastructure and services.

It is a paradox that the lowest level of government increasingly has to provide the most comprehensive response to the most complex developmental challenges. Yet the policy making process and institutional arrangements are often deeply flawed. Just as local governments are often ignored in the process of designing the very policy frameworks they are often required to implement, so too are slum dwellers and even the private sector often excluded in the design of vital local policies, notwithstanding their respective contributions to economic growth and tax revenues.

To meet these challenges, cities need to be transformed from passive service providers to more proactive facilitators of infrastructure and services. But this transformation cannot occur without imparting real authority, responsibility and resources to local government through a process of empowerment. A vital component of this is strengthening the city's ability to raise resources, create and maintain infrastructure and pay for these costs over time.

Most cities in the developing world have been pursuing traditional methods of financing, usually based on *ad hoc* grants and government guarantees. However, since the 1990s the widespread need for far-reaching urban reform has led some countries to provide an enabling framework for their cities to mobilise domestic capital, create infrastructure and take responsibility for repayments. Experience worldwide is now clearly demonstrating that urban infrastructure can be financed by cities accessing private capital markets, as long as supportive policy, legal and regulatory frameworks are in place. Moreover, this experience is also demonstrating that appropriate decentralisation can facilitate local initiatives by rewarding performance and punishing mismanagement through local democratic processes. Indeed, financing infrastructure in this manner provides significant incentives for improved urban governance, since enhancing accountability for service provision encourages the consent of the governed for sound pricing policies, and creates stable revenue streams directly impacting on a city's creditworthiness and providing confidence to financial markets.

Cities Alliance members are sharpening their focus on the challenge of sustainable financing strategies for cities, in particular, on how long-term domestic private financing can be mobilised for urban infrastructure and services. This strategic focus is predicated on two fundamental points of departure: i) only private capital can satisfy the sheer size of the financing requirements for urban infrastructure; and, ii) since external finance generates additional exchange risks, a long-term strategy for cities in the developing world requires linking city financing needs with domestic sources.

In summary, the prospects of sustainable financing are enhanced when domestic finance perceives cities as empowered entities rather than as feeble and pliant administrative arms of central government.

Empowering Cities to Take the Lead

The following review of experience across continents reflects not only the diverse historical contexts of urbanisation but also the common challenges cities and countries face in accessing domestic capital:

- Larger cities with medium-term investment plans have been able to repeatedly access local capital markets and establish a credit relationship with the private sector. Examples include Johannesburg, Shanghai, Ahmedabad, and Ho Chi Minh City.
- Smaller and medium cities have found ways to access the capital market through intermediaries. Examples include Financiera de De-sarrollo Territorial (FINDETER) in Colombia, Infrastructure Finance Corporation Limited (INCA) in South Africa, Michaocan in Mexico, and Tamil Nadu Urban Development Fund (TNUDF) in India.
- There are a number of other serious efforts to develop local capital markets via the use of specialised financial intermedaries. Examples include CAIXA Econômica Federal in Brazil, Municipal Development Fund Office (MDFO) in the Philippines, and Fonds d'Equipement Communal (FEC) in Morocco.

While most of the international debate has focused on the role of increased development assistance and debt relief, insufficient attention has been paid to the much larger and growing needs for local sources of investment for infrastructure in the cities where the urban poor live.

- Partnerships between national and city governments in which duties and responsibilities are specified through legislation or contracts energise the prospects for mobilising domestic capital. Examples include Douala, Cameroon, and Cheboksary, the Russian Federation.
- Macro adjustments which cramp fiscal space for infrastructure have hurt cities, especially in the late 1990s. Examples include Brazil, India, and the Russian Federation.

South Asia

Trends toward political decentralisation in South Asia are leading to a change from *ad hoc* grants to more rational devolution, and to debt financing of city infrastructure.

In Bangladesh, the Bangladesh Municipal Fund has established a debt culture, with cities now financing at least 15 per cent of their infrastructure needs. These loans are also tied to improved financial management, including enhanced tax collection and modern accounting systems.

In Pakistan, the Decentralisation Law of 2003 has encouraged provincial governments such as Punjab to devise a performance-based grant system for financing urban infrastructure.

Women construction workers in Pune, India

In India, despite constitutional changes that provide for significant city empowerment, core issues pertaining to both the demand and supply sides remain unresolved. There is also a great variety in implementation across states. The functional and geographical fragmentation of key infrastructure sectors such as water and sanitation continues, requiring state-level actions to demarcate boundaries between state level parastatals and cities. Yet, despite this weak decentralisation framework, some cities and states have managed to innovate. For example, in the 1990s, several large cities began mobilising local market finance through bond issues for water and sanitation investments. Ahmedabad, as a pioneer, established strong links with local markets and has now accessed the capital markets on a number of occasions—improving its terms on each occassion. In the south Indian states of Tamil Nadu and Karnataka, small and medium-sized cities have accessed local capital markets on favourable terms through pooled financing mechanisms. A devolution framework based on rational formulae has greatly facilitated their access to capital markets.

East Asia

East Asia has made good progress, although some countries need to work more closely with supply-side institutions.

In the Philippines, the Local Government Code of 1991 assigned increased responsibilities and resources to municipalities with about 40 per cent of national government revenues being distributed on a formula basis. Enhanced powers to set tax rates were also granted to municipalities, although there has been very little subsequent leveraging of these resources for infrastructure financing. Since the mid-1990s only four municipal bonds have been issued—in small amounts, usually less than US$1.25 million, for short terms of two to three years, and mostly for housing. Other institutions in the Philippines such as the Local Government Unit Guarantee Corporation provide guarantees on a limited basis.

It seems clear that if private capital could be provided with the same security mechanism as those enjoyed by state institutions, the financing options for cities would increase. Although multilaterals have been lending to different state-level financial intermediaries, there has been little breakthrough in market orientation.

Institutional change is also evident in Vietnam. Despite the near absence of conventional domestic debt markets, both cities and the national government have focused on establishing a new municipal market. For example, the city of Ho Chi Minh has a five year development strategy in place with a strong local economic development component. Given its investment needs of D12,000 billion (US$750 million) and annual budget of around D5,000 (US$315 million), the city has put in place an annual borrowing programme. The city issued its first bond issue of D2,000 billion (US$125 million) in 2003; with a second bond of D1,400 billion (US$89 million) in 2004, with the term increasing from two to five years. The issuance of bonds in Ho Chi Minh is clearly linked to a city development strategy (CDS) and is based on a blend of budget and market sources. Encouraged by this success and with a strong devolution framework in place, Vietnam plans to launch a market-oriented infrastructure fund to target small and medium cities.

In China, the pace of income and urban growth has encouraged private financing, even though government legislation currently prohibits the issuance of municipal debt. With a strong fiscal decentralisation framework and a focused city-region strategy in place, the city of Shanghai plans to establish a district financing vehicle with the assistance of the World Bank, to raise debt for its neighbouring municipalities. In the long run, China's policy challenges will be more institutional in nature, pertaining to the integration of municipal debt with the rest of the financial system, and the specification of accounting standards and provisioning norms.

Latin America

Colombia provides an outstanding example of decentralising both responsibilities and resources. Since the 1991 constitution, transfers of central govern-

It seems clear that if private capital could be provided with the same security mechanism as those enjoyed by state institutions, the financing options for cities would increase.

Community construction in Yogyakarta, Indonesia

ment revenues to municipalities and urban regions increased from an already substantial 36.5 per cent of current revenues to 46.5 per cent in 2003. FINDETER, a second-level financial intermediary, helped commercial banks take part in municipal lending and now accounts for some 15 per cent of municipal lending. Prudent legal requirements set out in 1997 legislation–known as the 'traffic light' system (Table 1), have managed to keep defaults low.

TABLE 1
Colombia: Traffic Light System for Regulating Sub-national Borrowing

Rating	Indicator	Borrowing Restrictions
Green	Interest as % of operational savings less than 40% & debt stock as % of current revenues less than 80%	No Restrictions
Yellow	Interest as % of operational savings 40–60% & debt stock as % of current revenues less than 80%	Loans with Ministry of Finance approval
Red	Interest as % of operational expenses greater than 60% or debt stock as % of current revenues greater than 80%	No lending without adjustment plan

Source: Chew, Matsukawa and Peterson, Local Financing for Sub-Sovereign Infrastructure in Developing Countries. World Bank Discussion Paper, No. 1, IEF Department.

Despite this strong financial performance, FINDETER's domestic sources are short-term while it lends long term, reflecting a lack of long-term capital in the domestic market. Since the 1990s, the World Bank has helped address this constraint by extending maturities up to 12 years for municipal loans compared to the average loan maturities of three to five years. Currently, there is a World Bank initiative supported by the Public-Private Infrastructure Advisory Facility (PPIAF) and the Cities Alliance to better integrate the sources of FINDETER funds with domestic capital market options.

In Brazil, macro instability has been the major factor inhibiting the flow of long-term domestic capital for urban infrastructure.

Brazil has a history of municipal borrowing but its domestic institutions lack long-term finance. National deficits and borrowings have led to high short-term interest rates, reaching as high as 20 per cent in the late 1990s. As a result, cities have not been able to meet their demands for urban infrastructure financing, constraining their prospects for economic growth. Ceilings on borrowings have meant that even multilateral investments, which normally should be anti-cyclical, have also become fair-weather friends for infrastructure investments. Currently, the International Finance Corporation's (IFC) Municipal Fund is working with major financial institutions to improve the supply of domestic capital. However, these efforts will need to be complemented by the creation of fiscal space for infrastructure which to date has been limited by national law.

In Mexico, major reforms on both the demand and supply sides have provided the framework for states and municipalities to access domestic capital markets on a sustainable basis. On the demand side, these reforms have included the decentralisation laws of the 1990s, the elimination of automatic bailouts using federal intercepts to repay debt, and the widespread use of ratings to better establish commercial credit for cities. On the supply side, legislation has opened the door for the issuing of sub-national bonds, coupled with pension reforms and a period of relative macro stability, making long-term finance for cities more readily available.

Africa

In the continent where the developmental challenges are perceived as the most intractable, significant innovations and national and city partnerships are nonetheless underway. On the demand side, efforts are being made to design rule-based decentralisation systems and improve revenue collection; while on the supply side, ongoing reforms in a number of countries are helping domestic financial institutions become more market-oriented.[1]

The contract-based links created between the state and municipalities in Cameroon are an ongoing example of these efforts. The municipal financ-

[1] Some of the materials in this section have been reproduced from the six case studies in AFD's, "Etudes sur le Marche du financement des Municipalités Africaines," Paris, February 2004.

ing system is characterised by uncertain resource transfers, inflexible business tax legislation and limited local taxes. In response to these challenges, the national and city governments have entered into contracts aimed at sharing responsibilities and planning city investments. The city contracts signed in 2003-2004 should provide a systemic basis for urban investment. This process has the backing of: (i) the Agence Française de Développement (AfD) and, more recently, the World Bank, for Douala and Yaoundé, (ii) the European Union (EU) for the five urban communities in the western inland and northern parts of the country; and (iii) Fonds Français d'Aide et de Coopération (FAC) for Limbé. These contracts have facilitated the provision of credits to Douala and Yaoundé and should eventually flow to other smaller cities through intermediaries, including Fonds Spécial d'Equipement et d'Intervention Intercommunale (FEICOM).

City-national government partnerships are also underway in Uganda and Tanzania through the use of performance grants, improving financial performance of cities and, to some extent, infrastructure and service delivery as well.

GOOD FINANCIAL MANAGEMENT IN LOCAL GOVERNMENT:
The Examples of Tanzania and Uganda

The Local Government Development Programme in Uganda and the Local Government Capital Development Grant system in Tanzania are both designed to reward good management at the local level. Both countries have intergovernmental transfers enabling local government to build capital infrastructure, based on needs determined through a participatory planning process. These programmes have been designed based on the premise that setting capital investment priorities at the local level will prove more efficient and responsive than nationally-driven sectoral investment strategies.

Each year, local authorities in both countries are assessed to determine whether they meet certain minimum conditions and are evaluated against specific criteria known as performance measures.

For a local authority to access a non-sectoral capital development grant, it must meet the minimum conditions. Eventually, these conditions will apply to all transfers to local governments, regardless of sector. These minimum conditions are derived from laws, regulations and government guidelines. They are objective, capable of rapid assessment and include the following:

- Timely annual accounts submitted
- Timely quarterly financial management reports
- Duly adopted development plans and budgets
- Absence of adverse audit reports and mismanagement of funds

The performance measures are somewhat more qualitative, and can increase the capital grant by 20 per cent in the case of very good performance, or reduce it by 20 per cent in the case of poor performance. Compared to the pass/fail minimum conditions, these measures seek to evaluate performance in key functional areas such as financial management, development planning, procurement, project implementation, and human resource development. Additionally, these measures evaluate performance against broad policy guidelines on governance issues such as transparency and accountability, participatory planning, and pro-poor budgeting.

To help local authorities build the capacity to access capital development grants, and to earn bonuses for good management, capacity building grants are part of the intergovernmental fiscal system. Capacity building grants can be used to address weaknesses identified in the annual assessment.

The results to date have been impressive. In the three years since the programme has been in effect in Uganda, 42 local governments now qualify, compared with 19 initially, and 16 have received performance bonuses in the most recent fiscal year. Of the participating local governments, 89 per cent now have functional planning committees and long-term development plans, compared with 30 per cent initially. Compliance with the Local Government Act and with accounting regulations has improved dramatically, and residents report improvements in both services and transparency.

The Tanzania programme is just beginning (FY05), and time will be required to judge its success.

Source: Matthew Glasser, World Bank, 2005

Coordinated actions by cities and national governments clearly facilitate greater flow of private financing. In Burkina Faso, the 1992-93 decentralisation law has facilitated collaboration between cities and chambers of commerce, with investments structured through a public–private partnership format. Burkina Faso also enjoys support from a number of bilateral lenders via a 'lending cooperative' that encourages decentralisation. Several investment funds have been set up and credits extended, such as: Fonds de Démarrage des Communes (FODECOM), Service d'Appui à la Gestion et au Développement des Communes (SAGEDECOM), and Fonds d'Investissement des Communes (FICOM).

In Senegal, the Municipal Aid Programme started in 1997-98, and recognition of the need for self-financing and prompt repayment has contributed to an initial restructuring of financial transfers from the state. The increase in loan collection rates and local resources, especially since 2001, indicates the beginnings of a sustainable financing structure.

In other countries, high urban growth rates have necessitated improved regulatory frameworks. In Ghana, for example, since 1992, the district assemblies have enjoyed extremely stable transfers from the state through the District Assembly Common Fund of around US$100 million each year. Furthermore, in 2003 the government formalised a political movement to promote the decentralisation of powers to the district level via the National Decentralisation Action Plan (NDAP). The short-term goal of the NDAP is to loosen the financial authority of the state and make transfers to the District Assemblies more secure. These actions have facilitated a greater access to financing.

Financial databases specifically designed for the Africa region are also being developed. These databases seek to provide private domestic capital sources with the credit history of various cities in order to make prudent investment decisions. For example, during the past several years, the Municipal Development Partnership (PDM) in Cotonou has been working on a financial database for municipalities in the West African Economic and Monetary Union.

South Africa's transition to democracy and constitution-making process included an extensive examination of policy frameworks and intergovernmental fiscal relationships. During this period, the government introduced comprehensive reforms of the fragmented local government system involving regulatory and financial changes in the framework governing relationships between the central government and cities. These initiatives have contributed to the ongoing urban transformation by providing a basis for cities to actively engage in sustainable infrastructure development.

Sustainable Urban Financing: Lessons from Successful Cities

The experiences described in the previous section allow us to derive some essential lessons from those cities and countries that have demonstrated viable financing models. These highlight the importance of:

- Rational, predictable revenue transfers that are usually formula based, such those found in South Africa, India and Mexico;
- Legal frameworks for borrowing such as the Municipal Finance Management Act in South Africa, the Common Urban Local Bodies bill in Tamil Nadu, and the Master Trust Structure in Mexico;
- Macro stability with affordable long-term interest rates, conducive for financing infrastructure;
- Financial intermediaries working with cities, such as the Development Bank of Southern Africa in South Africa, TNUDF in India, and Dexia and the World Bank/IFC Municipal Fund in Mexico.

These experiences suggest that successful domestic financing of city infrastructure depends on coordinated actions by cities and national governments and requires partnerships. Uncoordinated actions are at best futile and at worst harmful. For example, if national governments pre-empt the pool of domestic savings, as had happened in Brazil, the chances of cities finding long-term finance are weakened. This is despite a relatively

A SOUTH AFRICAN SUCCESS STORY

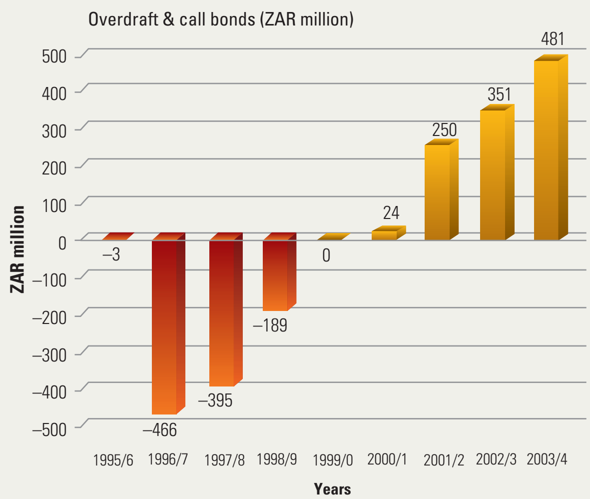
South Africa's efforts at strengthening relationships between national and city governments deserve special mention, as they offer a good example of a national government working in tandem with city governments and the financial market on municipal finance.

Enabling policies and actions by the national government:

- Legal framework for local government reform through the Municipal Structures Act, 1998, Municipal Systems Act, 2000;
- Financial framework for municipal budgeting, accounting and borrowing provided by the Municipal Finance Management Act, 2003, National Treasury Rules, 1998;
- Definitive intergovernmental finance framework ensuring the stable flow of financial resources to city governments from higher tiers as well as a three-year indicative allocation of such transfers.

As a consequence, cities have responded with internal actions to improve their financial management. For example, the city of Johannesburg:

- Developed and implemented a three year Strategic Plan, called *Igoli 2002;* improved its liquidity by enhancing billing and revenue collection procedures (see the figure);
- Changed the orientation of municipal service delivery by corporatising and converting service entities into autonomous utilities under city ownership;
- Successfully issued municipal bonds in 2004 and 2005 to finance its capital investment requirements.



Source: Roland Hunter, Presentation at the Second IADF Conference, Washington DC, October, 2004

well developed borrowing tradition and strong financial intermediaries. Similarly, the use of supply-side interventions without an adequate devolution framework, as in Bangladesh, can hamper the prospects of sustainable financing.

For policy purposes, it is useful to categorise the urban financing situation so that policies and interventions promote better coordination between demand and supply. This typology is based on two basic propositions:

First, on the demand side, the ability of cities to attract private domestic debt on a sustained basis is dependent on the stability of revenue streams over the life of the loan. This, in turn, crucially depends on the predictability of internal and external sources of revenue, requiring actions both by the city and by higher levels of government. In situations where cities are reasonably efficient in assessing and collecting their own revenues, and where the devolution framework is rational and predictable, debt financing is easier.

Second, on the supply side, the key determinant is a framework which makes available domestic savings (often generated by growth in cities) as long-term debt for urban infrastructure development. Factors that constrain supply include excessive borrowings by national government, especially for consumption which has the effect of reducing the fiscal space for cities to borrow locally and invest in infrastructure. This pre-emption of available savings would also increase the borrowing costs for cities and, in extreme cases, stimulates capital flight, thus making long term money scarce.

The urban finance situation in any given county is therefore an outcome of demand and supply factors, referred to in Table 2 as city empower-

Burst water main in Mathare, Nairobi, Kenya

done on methods for quantifying the fiscal space available for debt, although some recent work through the International Monetary Fund and World Bank has begun to define the factors involved.

The key message from this table is the need for partnerships. A good macro environment (as in cell C) with low interest rates would not help financing infrastructure, if cities are not empowered. In India, for example, despite the availability of finance, a weak decentralisation framework hampers the ability of cities to mobilise the finance for infrastructure.

The conclusion is that in those situations where demand-side actions (empowerment) are not coordinated with supply-side actions (macro environment), sub-optimal outcomes emerge, as in cells A, B and C of Table 2. Therefore, policies which attempt to reduce risks on the supply side, such as using credit guarantees, would provide little long-term credibility for private debt if the empowerment index is poor. The same holds true for lines of credit to domestic private and public entities such as municipal development funds. Similarly, in situations of fiscal stress, city-level actions alone would be of little use without complementary actions by the national government to free up the fiscal space for infrastructure—a situation which affected much of Latin America in the 1990s and some parts of East Asia.

ment and macro environment. City empowerment—the demand side—can be broken down into technical and managerial capacity, investment autonomy and financial capacity to borrow. Rating agencies routinely use indicators to assess the extent of empowerment. These indicators typically include city-level indicators of collection and coverage, efficiencies of own resources and the grant framework in place. The level of empowerment at any given point of time is an outcome of partnerships between cities and national governments.

The macro environment is a composite index of supply-side factors. These include the fiscal space which is available for cities after the borrowing needs of national governments from domestic markets have been met. Clearly, prudent fiscal policies would ensure the availability of finance for cities at reasonable costs. Little work has been

TABLE 2

Finance outcomes		**Macro environment**	
		Poor	Good
City empowerment	Poor	A	C
	Good	B	D

This crude categorisation enables us to distinguish at least three cases that are of interest from a policy perspective. The first case (the situation in cell A) is where the devolution framework continues to be *ad hoc* and the supply of savings remains weak, as in Bangladesh, the Kyrgyz Republic, Namibia and Uganda. In such a situation policy emphasis is required to strengthen cities along with supply-side interventions. The second case (the situation in cell B) is where the demand-side factors

(devolution and city actions) are relatively developed, but supply-side factors limit debt, especially longer-term debt, for example, as in Brazil, Colombia and the Philippines. The third case (the situation moving towards cell D) is where linkages between markets and cities are emerging, for example, India, Mexico and South Africa, but are not yet systemic, and the possibility of higher levels of government pre-empting the supply of debt for cities, or reversals of decentralisation cannot be ruled out.

Obvious exceptions to this typology are the transition economies, including the Russian Federation, China, Vietnam and Eastern Europe, where the macro situation and city devolution are relatively strong, but institutional frameworks for financing and intermediation are still developing.

These arguments are subject to an important caveat. Debt financing is not possible in cases where cities are unviable because of structural factors that could persist over the medium term. These cities or regions, are typically those where growth has faltered for a long time, and a sensible policy framework for this category of cities would favour grants rather than impose a financial burden that the city cannot afford. Obviously, private or public debt cannot solve a basic insolvency problem; and *ad hoc* financial structures, unconnected to domestic capital, more often than not, stifle local initiative and eventually become unsustainable. It would be sensible to consider differentiated policies and to look at urban finance from the city point of view, hence the emphasis on empowerment and coordinated policy through partnerships.

Partnerships and Collective Action

The foregoing brief survey of international experience underscores the need for collective action by cities, national governments and their development partners to address demand- and supply-side imbalances. Recent initiatives towards partnerships include actions at the global, country and city levels.

The Cities Alliance has recently launched a major new municipal finance partnership to help cities become proactive developers of urban infrastructure by mobilising domestic long-term capital. The Municipal Finance Task Force (MFTF), includes experts and practitioners from rating agencies, private sector financial institutions, and bilateral and multilateral banks and development agencies. The MFTF will help to analyse and share the knowledge and experience of cities which have successfully mobilised long-term private capital and the frameworks which need to be in place at all levels of government to facilitate this process. In parallel, the Alliance is also supporting an initiative of United Cities and Local Governments (UCLG) to establish both a global and regional commissions of mayors on municipal finance that will both interact with the MFTF and help broaden and deepen the engagement of cities in improving these instruments and their application.

Private finance is comfortable with public entities which have an inclusive and broadly based investment strategy, as both characteristics substantially reduce cyclical political risks. Therefore, using the CDS framework as an entry point for a city to undertake a financial stocktaking, and identify the steps it needs to take to build bridges with local markets for financing its development strategy, would be a logical policy step. Cities Alliance members, national governments and cities are developing CDS frameworks in countries as diverse

Aerial view of Mathare slum, Nairobi, Kenya

THE MUNICIPAL FUND

The Municipal Fund, an initiative of the World Bank Group, provides financing and credit enhancement to local governments and other sub-national public sector entities for development projects, without requiring central government guarantees.

Scope

The Municipal Fund is building an investment portfolio in all emerging regions, with projects already approved in Mexico and South Africa, and a dozen more under preparation. It will consider projects in a wide range of sectors, including water, wastewater, transport, electricity, solid waste, district heating, and other essential public services, and with a wide range of sub-national entities, including municipal, provincial or state governments, public enterprises, special purpose vehicles, and financial intermediaries. Local governments can manage the investments directly, or in the context of public-private partnerships. The Municipal Fund will typically look at investments in the range of US$5 million to US$50 million. Larger or smaller investments may be considered for select projects with a significant development impact.

Skills and Products

The Municipal Fund draws upon the combined sectoral, credit, and loan structuring expertise of the World Bank and the IFC. Its appraisal processes are modelled on private equity funds, thereby permitting a flexible and rapid response to clients' requests. The fund invests from the IFC's AAA-rated balance sheet and has access to the IFC's full line of financial products. Loans are issued at fixed or variable rates, in major currencies as well as in local currency in several countries. The Municipal Fund also offers loan or bond guarantees to help its clients attract new sources of financing in their currency of choice, reduce their borrowing costs, and extend maturities beyond what lenders would otherwise provide. Where appropriate, the Municipal Fund can make equity investments in project companies, financial institutions, or other entities. Quasi-equity products include convertible debentures, subordinated loans, income warrants, and other hybrid instruments. The Municipal Fund can also help its clients access technical assistance grants to build capacity and improve their creditworthiness, and works in close partnership with key development partners in the municipal sectors, such as the Cities Alliance.

To find out more, or to suggest a project idea, contact the Municipal Fund at municipalfund@ifc.org. Information is also available on the IFC's website at http://www.ifc.org/municipalfund.

as the Russian Federation, Peru and India.

These partnerships with cities should also facilitate greater use of newer market making instruments including those developed by Alliance members, including the World Bank/IFC Municipal Fund, the GuarantCo initiative, and USAID's Development Credit Authority (DCA).

A major threat to evolving sustainable financing mechanisms is the continuing use of scattered grants and traditional loans by national governments, and sometimes by multilateral and bilateral development institutions. Such interventions, while usually well intentioned, tend to distort local incentives and weaken the emerging opportunities for raising domestic resources for city infrastructure. The scale and pace of urban demands are now driving the movement towards modern financing models, and as this change involves a sharing of power, it is unlikely to be painless. The challenge for cities, national governments and their development partners is to impart momentum to this process in an organised fashion.

THE GUARANTCO INITIATIVE

In 2004, a group of bilateral donors within the Private Infrastructure Development Group (PIDG) established GuarantCo, as a local currency finance company which specialises in credit enhancement. The purpose of GuarantCo is to promote economic and social development by facilitating access to domestic financial markets for infrastructure companies that seek to borrow local currency funds for their investments.

GuarantCo provides partial credit guarantees for the benefit of local institutional investors to enable them to invest in debt (bonds, notes) issued by infrastructure companies. Local bank loans are also eligible. GuarantCo may also support refinancing in cases when foreign currency is being replaced by local currency debt. GuarantCo charges a market-based guarantee fee and customary up-front fees. In addition to risk capacity, GuarantCo also provides technical assistance grants to help prepare projects and structure local currency transactions by drawing on PIDG's Technical Assistance Facility.

Clients include private firms, municipal utilities or municipalities engaged in infrastructure projects in lower income countries. Eligible sectors are telecoms, power, water/wastewater services; transportation; and infrastructure components of industrial or agro-industrial projects. GuarantCo has targeted up to 20 per cent of its portfolio, subject to the availability of suitable opportunities, to urban regeneration projects, such as economic and social infrastructure in cities, including housing.

GuarantCo initially envisages that the average size of its risk participation in a single project will be in the range of US$5 million to US$12 million. GuarantCo's interim management has already developed an initial pipeline of transactions, and the first guarantees are under preparation.

For more information, contact Stefan Jansson, acting Managing Director, at sjansson@guarantco.com.

USAID'S DEVELOPMENT CREDIT AUTHORITY

USAID uses its Development Credit Authority (DCA) to provide guarantees for private local currency lending directed at a wide array of development activities. USAID has found the DCA to be particularly effective in encouraging private debt financing for infrastructure and has achieved significant results in the water, wastewater, and sanitation sectors. Notable successes include pooled financing facilities in India, where financing facilities in Tamil Nadu, and more recently in Karnataka, are now serving as models for creative infrastructure finance.

In South Africa, USAID is using DCA guarantees in conjunction with grant-funded technical assistance and training for infrastructure project formation through the Municipal Infrastructure Investment Unit, which was recently absorbed by the South African Ministry of Finance. Currently, USAID is focusing efforts on broadening its involvement with small- and medium-scale infrastructure projects in Africa.

To learn more about USAID's DCA, contact John Wasielewski, Director of the Office of Development Credit, at jwasielewski@usaid.gov, or visit their website at www.usaid.gov/our_work/economic_growth_and_trade/development_credit/overview.html.