LOCAL GOVERNMENT INVESTMENT IN THE LEAST DEVELOPED COUNTRIES: A CASE FOR A NEW GENERATION FINANCIAL PRODUCT

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This note makes a case for a new generation financial product to fund local government investment in the least developed countries (LDCs). Current financial products are either inadequate or ill-suited to the needs of these local governments, particularly those most mired in problems. The current menu of financial products makes no provisions for opportunities to finance urban development in a sustainable manner, in particular by attracting savings and using these savings to promote private investment and employment. Developments in international aid architecture and the financial crisis are creating an opening for the modernization of current practices and tools.

Local governments in LDCs are finally being impacted by the crisis, which has taken a heavy toll on local governments in developed countries

The 2008 economic and financial crisis dealt a severe blow to all local government financing systems around the world. In the United States, the municipal bond market has contracted, credit enhancers (also known as monolines) are facing serious problems, and local governments are finding it difficult to fund their operations. In Europe, several specialized institutions, such as *Kommunalkredit* in Austria, have had to be bailed out by their governments. Perhaps the most dramatic incident was the collapse of the worldwide leader in loans on the local government market, *Dexia*, which escaped bankruptcy when it was recapitalized by the Belgian and French Governments.

The problems faced by local governments in the most developed countries, which are grappling with a decline in their resources, higher social expenditures, and the dearth of financing, have finally spread to local governments in developing countries. In addition, the latter have been particularly hard hit by the slowdown in public-private partnership activity. Many projects have been suspended or even cancelled. Some sectors, such as telephone services or energy, have been less affected than others. Those most affected are municipal governments (water and transport), where the decline in the volume or number of projects is on the order of 40 to 50 percent.

In addition to these cyclical problems, local governments in LDCs are facing growing structural problems

The impact of the crisis on local governments in the least developed countries is uneven and depends on national situations, the degree of integration of national financial systems into the global financial system, and the types of aid that these governments have managed to secure from central governments. However, overlaying crisis-related problems, regardless of their severity, are structural problems that are becoming increasingly acute.

On one hand, official development assistance (ODA) is either stagnant or declining.

On the other, general aid architecture has changed significantly over the past decade. It has become diversified, fragmented, and specialized. It comes with new types of financing that are unrelated to official aid in the strict sense of the term, but account for or are required to account for an increasingly bigger share of total financing available. The most noteworthy changes include:

- The emergence of what are known as vertical funds (AIDS, vaccinations, etc.), with each having its own financing structure;
- The ascendancy of major foundations, with the biggest having financing capacities that far exceed the capacities of a number of bilateral donors;
- The increase in the volume of remittances (although total amounts have also been impacted by the crisis) which, in many countries, surpass official aid amounts; and
- The emergence of new sources of financing related to global warming, adaptation funds, and carbon financing.

While urban local governments are very much affected by the stagnation in aid, they receive very little, if any, of the increase in other resources that are not (or not really) available to sub-sovereign borrowers, are not intended for them (such as vertical funds), or simply escape their grasp owing to the lack of *ad hoc* collection mechanisms (as is the case with remittances). This situation is compounded by the fact that for a very long time, urban development has too often been confused by most donors with major infrastructure works, which are rarely managed by local governments.

At the same time, the investment needs of these urban local governments are constantly growing as a result of demographic growth and migration. Over the next three decades, 300 million persons will have to be settled in urban areas in Sub-Saharan Africa. Local governments will have to assume an increasing share of responsibilities and investments, owing in particular to the fact that state budgets are being tapped for state-related expenditures, the relative amounts of which are increasing, and the international community is rallying behind issues which, for good reason, are being considered priorities (the food crisis, major pandemics, global warming, etc.).

What are the options available in the face of this worrying situation?

Given this gap between investment needs and capacities, the reaction of states and the international community has been, since the 1970s, to focus on decentralization and good governance. The thinking is that boosting the amounts, along with the regularity and predictability of state transfers to local governments, improving local tax systems, and increasing local governments' own resources - in conjunction with better administration and management - will gradually place African cities on the path to sustainable growth.

However, it must be acknowledged that after several decades, this approach, which in and of itself is eminently laudable, has in general terms fallen short, despite the undeniable progress made in certain areas and in some countries.

In fact, nowhere in the world, either in the past or at present, have local resources alone been adequate to fund the development of rapidly growing cities. Land-based financing has always been used in parallel to achieve this goal. There is no need to hark back to the Haussmann era; recent examples include the glorious thirty years in France or the People's Republic of China. Over the course of two decades, China succeeded in urbanizing close to 300 million people while containing slum creation, using mainly this approach to financing where, literally, the city finances itself.

Local governments in LDCs currently have no access whatsoever to this method of financing. In Sub-Saharan Africa, even when a few experiences in some countries are taken into account, it can be said that overall, the juxtaposition of land rights, cultural habits, and the lack of suitable financial products, taken together, have thus far thwarted establishment of this system to fund urban expansion.

Furthermore, many African cities, rather than being on a sound path toward progress, are caught in a spiral of degradation. Revenues are stagnant and are becoming increasingly expensive to collect while collection resources can no longer be increased. Maintenance is not taking place, land policy is being neglected, site planning activities have been abandoned, and makeshift housing is on the rise. The formal sector is losing ground to the informal sector. Consequently, business and real estate tax revenues are also trending downward. It is becoming increasingly difficult to finance basic services. Cities are becoming less attractive to investors, their external financing capacity is disappearing, financial costs are increasing, and expenditures need to be slashed further. A downward spiral of this nature could be triggered rather abruptly following a fairly long period of slow decline. It is very difficult to break such cycles – the term "trapped cities" can be used – without foreign aid.

At the moment, it can be argued that the financial crisis and downturn in private investment are creating an opportunity to establish a land-based financing, to implement the institutional reforms necessary, establish suitable financial products, and optimize their economic effects.

Optimizing the economic effects of the land-based financing

The land-based financing is the indispensable solution for cities experiencing rapid growth. It also offers additional economic advantages that may prove valuable in an LDC context, particularly in Africa.

It is known that the growth rate of African economies has been relatively high over the past decade, a situation which, *inter alia*, has to some extent paved the way for the emergence of a middle class. While this group currently has savings, there are few, if any, opportunities for local investment. Investment in real estate, usually a preferred vector, is difficult owing to the shortage of land development. It is also fairly risky precisely because of the absence of laws, regulations, and protection governing investment in land development.

If laws and security governing land development were in place, all indications are that the housing sector would serve as the preferred pillar of local investment, offering the dual advantage of providing urban development resources in local currency for urban development and sustaining the housing and construction sector, a major source of job creation.

The same is true of remittances. Surveys have shown that many immigrants, after sometimes living for decades in cities in their host countries, would like to invest in a house in their countries of origin, also located in the city. They experience problems doing so for the same reasons mentioned above, with their feelings of insecurity and fears of being swindled being intensified by distance. Here again, the loss to local economies and governments in terms of employment and investment capacity is considerable.

What type of financial product?

The main feature of a financial product suited to land development is the term and, above all, the grace period. Indeed, the time period for carrying out land development operations is long. An operation typically takes place over twelve to fifteen years, with initial earnings being received only after five to seven years.

A grace period of five to seven years, depending on the case, is therefore crucial for maintaining the balance of operations, given that such a period facilitates the alignment of initial capital repayment with initial earnings. This is true for all land development operations, but even more so for those that target price floors at least for one portion of production, in the context of what are known as cross-subsidies (earnings generated by one portion of the stock targeting the middle class subsidize, to some extent, the portion targeting the poorest).

These features are very far removed from what can be obtained on markets, particularly in Africa where rates are high and terms short (seven years is viewed as the long term on markets or local banks). Pursuing land development by obtaining market financing therefore implies the need to refinance several times, an approach that in no way addresses the issue of the grace period.

At the moment, only donor financing meets this dual imperative of the term and the grace period. However, in practical terms, a large number of limitations are associated with this financing: (1) donors are involved in little if any land development, given that most focus on investments that are less problematic to finance (typically, revenue-generating infrastructure); (2) funding is rarely provided in local currency, hence the need for operators to assume risk; and (3) for the most part, this funding is extended to the State (sovereign loans).

While exceptions do exist (loans in local currency, direct sub-sovereign loans), they are rare and create their own disadvantages: by issuing on the market to obtain local currency, donors exhaust the liquidity needed by the private sector; by providing sub-sovereign loans, donors reinforce the routine practices of the local banking system and a lack of awareness with respect to the local market, and in so doing, delay even further the emergence of a local government market (these factors have fueled criticism of donors who finance *ad hoc* operations instead of focusing on comprehensive activities.

Hybridization and leveraging

In summary, the features and qualities of this new generation product should meet the following objectives:

- Be long (15 or more years), and have a significant grace period (5 or more years) ;
- Be inexpensive, in order to optimize the yield on cross-subsidy operations and the production of lots for very low-cost housing;
- Be in local currency;
- Contribute to the collection of local savings and the local investment of these savings by using market resources and promoting the gradual involvement of banks in local government markets and land development;
- Encourage local direct investment in rental real estate;
- Provide securitized investment support for remittances; and
- Facilitate the mobilization of a number of vertical funds to be used for social welfare purposes and funds from foundations for social welfare activities.

A product of this nature therefore requires fairly sophisticated production within specific vehicles (such as revolving funds) to be established at the national or local level. Several types of resources will have to be combined: (a) local capital markets: (b) State transfers; (c) remittances (direct or via specific bonds); and (d) funds from foundations or vertical funds.

Against such a backdrop, the activities of donors could focus on the following comprehensive actions: guarantees, in particular to foster the involvement of local banks, as well as the extension of bond terms and institutional support for the product as a whole and for specialized vehicles.

In summary therefore, resources of different kinds will have to be combined to create a product with suitable features (rate, term, and grace period), using the leverage of donors.

The justification for the participation of donors and foundations lies in the expected effects – the collection of local savings, the collection of remittances, the promotion of local investment, support for a highly employment generating activity, and the creation of a regulated private housing stock to provide low and very low-cost housing, and social challenges in poorest neighborhoods.