

# Local Governments and the Financial Crisis: An Analysis

Thierry Paulais



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Cities Without Slums

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## FINANCIAL CRISIS: AN ANALYSIS

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*States has finally impacted all urban communities and investment financing systems around the world. The landscape of this financing sector is currently one of devastation. Policies have to be reformed and tools and mechanisms, restructured or overhauled. While the magnitude of these problems varies from one regional grouping to another, it seems that post-crisis recovery will be a lengthy process, perhaps more so in the least developed countries.*

Local governments grappling with the crisis face a number of constraints which, though disparate in nature, have a cumulative effect. This phenomenon has created a number of extremely difficult situations. In general terms, the consequences of the crisis can be felt on four levels: (1) Revenue—either generated by local governments or derived from State transfers—which may be subject to sharp declines; (2) Expenditures, which are rising because of the slowdown in economic activity and the corresponding increases in unemployment and social welfare needs; (3) Financing capacities, which are shrinking owing to the difficulty in obtaining loans and the increase in the cost of money; and (4) Foreign investment, which has declined; operations underway, which have been put on hold in many instances; and projects, which have either been cancelled or delayed.

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<sup>1</sup> The views expressed in this paper are those of the author and do not necessarily reflect the views of Cities Alliance.

The two major financing systems, bond issues and banks whether specialised or not, have been heavily impacted. Governments have adopted different measures depending on political and institutional environment. However, the common feature of these measures, whether they entail the bailout of financial institutions, stimulus packages, or recovery plans, is that they are more geared toward central or deconcentrated governments than toward local governments. Their impact in tangible terms, run the risk of being relatively minor or, in the case of investment programs for example, delayed, inasmuch as they require time for implementation. Regardless of what happens, beyond these short-term measures, in-depth reforms will be needed to improve the situation facing local governments. In many countries, the very nature of the relationship between the State and local governments hangs in the balance. The architecture of financial systems everywhere has been greatly undermined. The same is true of the housing sector, the starting point of the crisis.

## A CRISIS IN HOUSING AND DEVELOPMENT POLICIES

**Housing policy in the United States.** The mechanisms, particularly securitisation, by which the United States housing sector contaminated all financial systems, are currently well documented. However, relatively insufficient emphasis seems to be placed on the fact that the genesis of the crisis can, to some extent, be traced back to public housing policy. This point is however, important for a thorough understanding of the process that led to the crisis.

Historically, the Department of Housing and Urban Development (HUD) relied on two large government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, to promote access to homeownership for the middle classes. For the poor, responsibility for facilitating access to homeownership was vested in the Federal Housing Authority (FHA), which role was to provide specific loans with no down payment. In the mid-1990s, in order to implement government guidelines favoring construction and homeownership, HUD steered Fannie Mae and Freddie Mac toward financing aimed at greater access for the very poor not covered by FHA, then gradually expanded the objectives assigned to these GSEs.

To achieve these government objectives, the GSEs launched ambitious programs with catchy names—“American Dream Commitment” and “Catch the Dream,” respectively—designed to facilitate homeownership for some of the most underprivileged households. Later on, private banks entered this market and commercial transactions were, for the most part, subcontracted to independent





agents, some of whom turned out to be unscrupulous (Kelly, 2009). Programs were essentially based on new financial products: a very small down payment or none at all, a thirty-year term, a teaser rate for the first few years (loans referred to as 2/28, 3/27, etc.), and even the possibility of repaying a monthly amount below the interest rate, with the balance to be repaid when due along with the principal (known as “negative amortisation”).

The architecture of these mechanisms was in fact based on the possibility of refinancing with a new, larger loan after a few years (called a cash-out) or a home equity line of credit, which uses the updated price of the asset to replenish the buyer’s loan, thus allowing the buyer to pay the interest due. The two mechanisms fall within the realm of the equity loan, which works as long as prices are rising, and as such, fuel the increase and inflate the bubble. Attractive cash-out provisions (no penalties; tax exemption on interest) encouraged systematic refinancing activity by borrowers involving large sums of money.

This practice became widely used as a means of purchasing homes that were bigger than necessary, with tax-free lines of credit being used to finance consumer credit and current expenditures (Wallison, 2009). When the real estate market reversed course and prices fell, it ensnared not only these homeowners who were artificially able to afford homeownership and speculators riding the bubble but also solvent borrowers, who may ultimately turn out to be the main

victims. Although they made the customary down payments and assumed loans in keeping with their financial situation, these borrowers, like the others, may find themselves in a situation of negative equity, where the amount of the remaining debt exceeds the value of the asset.

Currently, a total of 12 million households face this situation.<sup>2</sup> Because of the tax system and legal provisions in most states of the union, the best solution available to homeowners to extricate themselves from this negative equity situation, in practical terms, is to stop making mortgage payments (Wallison, 2009). Such homes are foreclosed upon and the snowball effect on prices takes hold. Some homeowners who are not in a negative equity situation are choosing to keep their homes that have depreciated in value while awaiting a hypothetical or gradual uptick in prices. Consequently, they lose all mobility, at least temporarily, a situation that seems to exacerbate the employment situation in some parts of the country where a correlation exists between the unemployment rate and the homeownership rate.

**Housing and development policy in Spain.** Spain is facing one of the most severe recessions in Europe. The 1997–2006 expansionary cycle ended abruptly with the bursting of the real estate bubble, which was fueling it and driving up all indicators. Some of the factors responsible for this bubble are similar to those in the United States, while some are specific to Spain's socioeconomic and institutional context as well as its development policy. The period of expansion started with strong demand for housing linked to demographic growth and a reduction in the average size of households. This demand was thus exclusively oriented toward homeownership, owing to factors which, historically, have been unfavorable to the rental market, namely, the taxation system which was very clearly tilted in favor of homeownership, and government legislation that discouraged the creation of private rental stock.

Most underprivileged households and young people are encouraged to become homeowners at all costs. Over a ten-year period, the number of homes doubled: with 568 homes per 1,000 residents, this rate is currently the highest in Europe (Vorms, 2009). To sustain this growth, banks had to offer increasingly attractive financial products to homeowners who faced relentless price increases. Mortgages were extended to forty or fifty years and initial down payments were constantly being reduced, to the point where they became optional. These measures and the general situation were also conducive to a sharp increase in the construc-

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<sup>2</sup> Source: Equifax, Moody's Economy.com

tion of second and vacation homes and, in general, to investments that were speculative in nature. Toward the end of the expansionary cycle, real estate prices were climbing by more than 17 percent per year (Vorms, 2009).

When the real estate bubble burst, a large number of developers and builders were forced into bankruptcy, a situation that greatly heightened the effects of the global recession on the country and also created serious problems for local governments. These governments in fact rely heavily on revenue from construction, building permits, and appreciation in land values. These factors, coupled with the almost complete absence of a framework and rules governing development in autonomous regions, which theoretically have responsibility in this area, largely explain why the real estate bubble eventually burst. Communes were forced to seek development activity to boost their current revenue. This tendency grew given the fact that each private operation entailed the transfer of a portion of the land developed to the local authorities for public infrastructure purposes. In reality, it seems that many local governments sold this land, channeling the revenue toward current expenditures (Vorms, 2009). These different factors fueled the real estate bubble by increasing the speed of land development, a situation that spawned a predatory and chaotic form of urbanisation and urban sprawl.

**Unsustainable policies.** The examples of Spain and the US highlight a number of bedrock principles. On one hand, no financial engineering miracle can be worked to overcome borrower insolvency. In the absence of social provisions to make homeowners more secure the provision of individual assistance, a policy of homeownership for all is unsustainable. Furthermore, having the private or semipublic financial sector finance a policy of this nature at no cost to the State budget is not viable in the long term. On the other hand, housing policies based exclusively on homeownership for all are rooted more in cultural schemes than in economic reality. There is no correlation between a high percentage of homeowners and the wealth of a country or population. In the case of Europe, for example, the countries where homeownership rates are high (Greece, Bulgaria, Romania, the Baltic States) also have high poverty indices; conversely, the countries with a low percentage of homeowners (Sweden, Germany, Switzerland, Netherlands) are among the world's wealthiest and have some of the world's lowest levels of poverty and exclusion.

In the cities of developing countries, the existence of rental stock, which may be in the private sector, and is regulated and secure for both tenant and owner, is a way to house the underprivileged and recent migrants, for example, and to ensure a degree of market fluidity and collect local savings. An organised rental sector appears to be an integral part of a balanced housing policy and thus deserves active

donor support. Lastly, these homeownership-for-all policies encourage the building of mainly single-family homes, land use, and urban sprawl. They foster urbanisation models that are costly in terms of infrastructure given that operations entail recurrent costs, particularly in the case of transportation, energy, and social services.

## THE IMPACT OF THE CRISIS ON LOCAL GOVERNMENTS

**Sharp decline in revenue.** The situation differs greatly from one country to another. In some institutional contexts, local governments are relatively sheltered while in others, they are exposed. In terms of assets, local governments that can invest their funds in the market have been directly affected by losses in capital. In the United States, the cities that made the most prudent investments have lost between 20 and 25 percent of their funds, while others that invested in hedge funds have posted much greater losses. In the United Kingdom, local governments are thought to have lost €1 billion capital in the collapse of Iceland's banking system, in addition to future discounted revenue. Elsewhere, such as in several east European countries, for example, variable rate debt or foreign currency denominated debt may take a severe toll on local government budgets.

In the case of tax revenue, local governments everywhere are feeling the effects of lower revenue from buildings, construction, or real estate activity. In the United States property taxes constitute the main source of revenue for urban local

Commuters in city train of Western Railways, Mumbai, India



governments, and some have posted declines of more than 45 percent relative to the previous fiscal year. Furthermore, this situation transcends cities, given that state governments themselves are facing major budgetary shortfalls. Most cannot balance their budgets for the next two fiscal years, with the shortfall exceeding US\$350 billion (McNicols & Iris, 2009).

In general terms, the slowdown in global economic activity is also impacting local budgets in both the emerging and the most developed countries. In the case of the latter category, this is particularly true in regions where industries have been decimated; Detroit, the American motor city, is perhaps emblematic of this situation. Lastly, many local budgets have been adversely affected by the decline or delay in state-level transfers, given that states are also facing budgetary constraints. This is the case in particular in a number of east European countries or some of the least developed countries that are facing plummeting commodity export revenue, a significant decline in foreign remittances, and a paucity of own resources at the local government level.

**Higher operating costs.** In some instances, higher expenditures are also the result of smaller State subsidies for public services. Local budgets generally cover these expenditures, which often remain fairly constant. In the most developed countries and, among them, those most heavily impacted by the crisis, local governments are facing skyrocketing social budgets as they struggle with the twin effects of higher unemployment and a spike in the number of families that have lost their homes, and homeless persons. Even in countries that provide some of the most limited social services such as emerging countries, local governments are facing higher expenditures in this area. Trapped between declining revenue and increasing expenditure, particularly in the social sphere, local governments are being forced to resort to drastic measures to reduce their operating expenses. Required by law to submit balanced budgets, some US cities have been forced to close their most costly facilities for a few days each month and furlough their employees. In many instances, particularly in the least developed countries, reductions in operating costs have targeted such non-market services as sanitation and waste collection and treatment.

**Difficulty gaining access to borrowing.** The deterioration in local government accounts is often one of the factors constraining the ability of these governments to borrow. The lack of liquidity of the financial system, the precarious situation facing many financial or banking institutions, the general lack of appetite for investment, and the increased cost of money are the other factors affecting local governments, to varying degrees, depending on their borrowing philosophy and

the structure of their local financial systems. Clearly, in a number of emerging countries where local governments are not allowed to borrow directly, or in the least developed countries where local governments have never had access to borrowing (as is the case in the majority of Sub-Saharan African countries), the situation has not changed drastically.

In countries that have specialised semipublic financial institutions, credit restrictions have been limited or even non-existent in some situations where the State has used these institutions as a vehicle for local stimulus plans. However, in most developed countries, constraints in borrowing have exacerbated the problems faced by local governments. In the handful of countries such as Hungary where local governments are authorised to borrow to meet their current expenditures, the increase in the cost of money further darkens the outlook for budgets that are already under pressure. For the vast majority, borrowing is limited to investment, and restrictions result in the reduction, delay, or cancellation of operations, with the attendant negative fallout in the areas of local activity and employment. The higher cost of money therefore means that local governments that borrow are incurring higher future expenses.

**Collapse of investment and Public-Private Partnerships activity.** Direct capital investment in development, office real estate, and infrastructure activity is falling sharply everywhere. Public-private partnership (PPP) activity is declining significantly. Many projects have been delayed, suspended, or even cancelled. Some sectors, such as energy, where demand remains strong, and telecommunications, have been less affected than others. However, the sectors most heavily impacted are those that have the greatest implications for local governments, such as water, sanitation, and transportation, with declines of 40 to 50 percent in the volume and/or number of projects (Leigland & Russell, 2009). Proportionally, developing countries have been more affected by the decline in activity. A few special operations, such as telecommunications in export-oriented countries like Nigeria or the Democratic Republic of Congo, have escaped the recession owing to investor expectations of high returns. However, in general terms, the dearth of revenue and higher cost of money have prompted investors and operators alike to reduce their commitments in areas where risk is perceived to be highest.

## DAMAGED FINANCING SYSTEMS AND TOOLS

**The municipal bond market.** In the United States where bond issues are virtually the sole method of financing for local governments, this typically thriving market—



Trading hall at the New York Stock Exchange, New York City

with outstanding debt amounting to US\$2,500 billion and annual commitments to the order of US\$200 billion—owing primarily to the tax exemptions it enjoys, has severely contracted. Local governments with an average or poor financial rating are currently struggling to obtain financing. The higher costs of borrowing has forced them to scale back their investment programs. Projects for which financing was easily procured, which generate their own revenues that are used as backing for revenue bonds, have had to be discontinued. The impact of this increase in the price of money is especially severe because it comes on the heels of a buoyant period during which local governments were funding their operations by issuing bonds that yielded historically low returns. Today, local governments with an average or poor rating are effectively excluded from borrowing. They no longer benefit from the services of credit enhancers (see below), which themselves were hard hit and appear to bear, along with the rating agencies, the brunt of the responsibility for the market meltdown.

**The demise of credit enhancers.** Credit enhancement is a mechanism by which a financial company provides a guarantee to bond subscribers. Prior to 1985, this activity was limited to municipal bonds. By providing its guarantee to a bond issued by a local government with a less favorable rating, a AAA-rated company enables this local government to raise funds on the market at a more attractive rate than what it would obtain without this enhancement. Credit enhancers are also referred to as insurers (monoline insurance companies), despite the fact that, in the view of a number of observers, they are not exactly insurers in the strict sense of the term.



Shifted slum dweller at Slum, Delhi, India

Credit enhancers owe the success that they have achieved in a low-risk activity to legislative provisions that require that institutional investors, pension funds, and the like invest their funds in highly rated bonds only (investment grade, that is, equal to or higher than a BBB rating). Local governments with a lower rating thus represent an almost captive market for monolines, which enhance their rating, thereby allowing them to gain access to these resources. In a bid to boost and diversify their activity, a number of monolines focused on enhancing structured products backed by securitised assets; first mortgages, then, as securitisation techniques became progressively sophisticated, by other increasingly complex products.

Monolines played a key role in the development and distribution of these products that proved to be toxic (Schich, 2008). When the financial crisis erupted, the deterioration in the value of these products triggered a tsunami among credit enhancers. Indeed, their high rating had, in principle, been justified by the fact that they possessed adequate capital to honor their commitments. Once it became evident that this was no longer the case, rating agencies downgraded most of the monolines, thus precipitating their collapse. Of the roughly ten credit enhancers in operation, only three maintained an AA rating; Ambac, which was one of the largest, was downgraded to a C rating (junk status), while others are no longer rated, effectively sounding their death knell.

The economic justification for the credit enhancement activity, its usefulness, and its future are currently the subject of debate (Rose, 2009).



**Specialised institutions on life support.** In countries where local governments borrow from banks or specialised financial institutions instead of the market, the financial crisis led to a sharp contraction in the supply of credit, due particularly to the difficulties experienced by large general banks. As a result, rates have increased. Consequently, long-standing specialised banks in Europe, such as Kommunekreditt in Norway and Kommunalkredit in Austria, encountered difficulties in securing financing (CEMR, 2009). Kommunalkredit was ultimately taken over by the Austrian Government.

The most widely publicised case however involved Dexia, the worldwide leader among institutions specialising in the provision of loans to local governments. Facing difficulties in obtaining financing and severely hampered by disastrous losses incurred by FSA, its American credit enhancement affiliate acquired in 2000, Dexia also drew harsh criticism in countries where shareholders who were displeased with these losses (including Belgian communes) were located, and where it had engaged in the unbridled promotion of exotic structured loans that proved to be time bombs for the local governments that had subscribed them. Dexia was placed in technical bankruptcy and owes its survival to a bailout plan implemented by the Belgian and French Governments, which, aware of the institution's outstanding balances with their respective local governments, decided to recapitalise it and guarantee its borrowings. This decision assumes a special and symbolic dimension because Dexia represented the last manifestation of a privatisation process initiated by the French Government some twenty years ago<sup>3</sup>.

Dexia's temporary return to a semipublic status is reflected, *inter alia*, in the suspension of its geographic expansion strategy, particularly into emerging economies, where situations appear to vary, depending on the institutions specialising in the financing of local governments. A number of them, such as Caisse de prêts et de soutien aux collectivités locales (CPSCCL) in Tunisia, have traditionally been able to turn to international donors, and should not encounter any particular difficulty in obtaining financing. Other institutions such as the Development Bank of Southern Africa (DBSA) and the Tamil Nadu Development Fund (TNDF) in India that turned to the market, at least in part, for financing, may have to finance their operations by also seeking funds directly from international donors (if possible, with subsidised products), provided these donors offer loans in local currency.

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<sup>3</sup> 1986: Transformation of the CAECL (Caisse d'Aide à l'Équipement des Collectivités Locales), a public entity, into CLF (Crédit Local de France), a private company with State shareholding, followed by the gradual divestment by the State, which sold its final shares in 1995. Dexia was established from the merger between CLF and CCB (Crédit Communal de Belgique) in 1996.

## WHAT ARE THE SOLUTIONS TO THE CRISIS?

**In the United States.** The U.S. Government has not yet signaled a willingness to implement significant structural reforms. Crisis responses to date have focused on the financial system (whose problems are far from being resolved), and the issue of sectoral policies has not been raised in earnest. The two GSEs for mortgage market refinancing continue to post colossal losses (US\$37 billion for Fannie Mae for the first half of 2009 only) as a result of the provisioning related to the increase in the number of unpaid loans by borrowers, and are in need of new capital infusions from the Treasury Department. The administration is reportedly preparing to separate these two institutions by establishing a bad bank for each one of them to hold nontransferable assets (Zandi, Chen, de Ritis & Carbacho-Burgos, 2009). Monolines are also reviewing this same type of scheme. A number of credit enhancers are attempting to isolate their toxic assets in special purpose vehicles in order to re-enter the municipal market bonds with a AA or AAA rating. Views differ on the future and sustainability of this activity, as confidence in rating agencies has been severely eroded. The world's three largest agencies (Fitch, Moody's, and Standard & Poor's) constitute a *de facto* oligopoly. Their methodologies for the analysis of structured products have proved to be flawed and they face accusations of conflicts of interest (White, 2009).

Local government associations, for their part, have presented proposals to relaunch the bond market through guarantee mechanisms. The first, tried and

Office buildings in Pittsburgh, U.S.A. Markus Dourhy/Peter Arnold Inc.



tested, would be to get the federal Treasury, on a temporary basis, to guarantee municipal bond issues under the stimulus (Emergency Economic Stabilization Act of 2008). The second, which offers the advantage of a possible sustainable solution pertains to the establishment of a mutual guarantee fund, which would seek to insure new fixed rate bonds that are either general in nature or linked to revenue-generating services (revenue bonds). This guarantee instrument would be established at the national level, and managed on a nonprofit basis by local governments themselves. However, an allocation from the federal government to capitalise this fund would be essential, and it is not clear that such a project would receive the political endorsement needed to achieve this objective. The establishment of a public-private infrastructure bank at the federal level was also proposed (Rohatyn, 2009). On the whole, operators and markets remain in a state of uncertainty. Many stakeholders appear to hold the view that once the low point of the crisis has passed and toxic products have been isolated, with a certain degree of oversight of securitisation activities, there will be no reason why sector activities should not resume at pre-crisis levels.

**In Europe.** The financial system in Europe has benefited from massive bailout plans. The return to public status of Dexia or Kommunalkredit, already cited, reflects the fact that local governments and the local economy sector were deemed priorities. State support for local governments included a pool of instruments: tax arrangements (VAT transfers), special transfers, and the stimulus targeting the local economy. Governments equipped with public or semipublic financing tools mobilised them for this purpose, especially with a view to restructuring certain loans or unblocking projects.

In France, the Caisse des dépôts et consignations (CDC) bought shares in Dexia. In Germany, a request was submitted to the Kreditanstalt für Wiederaufbau (KfW) to assist some one hundred local governments that were facing difficulties with respect to leasing contracts concluded with U.S. banks, the terms of which require revision owing to the downgrading of insurers. In Spain, the establishment of local investment funds is under consideration. The Spanish Government has implemented the initial legislative phases of a series of structural reforms in the urban development and housing sector, especially with respect to a new property law aimed at ending unrestrained urban development and establishing the framework for a social policy on subsidized housing. The Government also launched a support plan for the rental sector, together with a series of tax and legislative measures aimed at supporting supply. These initiatives are connected to a massive debt restructuring plan for developers (line of €3 billion), which proposes the leasing of unsold housing, as well as a program to repurchase land reserves.

These measures are part of a broader effort that should be undertaken by the State and which pertains to the entire urban sector, including the financing system of local governments, whose archaic system and negative externalities became patently clear when the real estate bubble burst. In this regard, Spain exemplifies a discernible trend in many European countries: Following the implementation of emergency bailout plans and stimulus packages, the economic and financial crisis sparked a wave of revision of provisions or legislation that were clearly outdated, especially in the area of local taxation, and, more generally, with respect to relations between the State and local governments.

**Developing countries: emerging economies.** Information on the provisions that the governments of emerging countries could have put in place to support their local governments is still scanty. It appears that those that planned special interventions implemented stimulus packages at the local level, which were deemed in general to be best suited to support employment. This approach presents a dual challenge: On the one hand, funds have to be quickly channeled, requiring efficient and reliable administrative networks, and on the other hand adequate local capacity is necessary to execute the plan within time frames consistent with its urgency. These two conditions are not easily met. In this respect, countries with instruments such as municipal development funds or urban development banks are better equipped than others.

This type of institution is in principle well suited to this kind of exercise. It also has the advantage of being a good recipient for financing from international donors that are not short of liquidity, at least not in the unsubsidised or barely subsidised segments of their array of financial products. However, they seek tried and tested programs and implementation vehicles. Opportunities exist for countries that possess this category of tools and are wrestling with a decline in liquidity on their market and a contraction of external investments and PPPs. The People's Republic of China, which is banking on a recovery at the local level to counter the economic slowdown, selected an innovative option: the launch of a US\$30 billion bond issue on international markets. An allocative key will be used to redirect these funds to the local governments through urban development and investment corporations (UDICs). These particular entities were established at the initiative of the Government in the late 1990s (Wu, 2009). They are owned by the local governments—which are not authorized to borrow—for which they hold assets and liabilities. They mobilise financing for infrastructure through bank loans, PPP arrangements, or real estate appreciation (building leases, etc.); they delegate project management of new investments and supervise the operations of existing investments. They are therefore used as vehicles for the implementation of a stimulus program at the local level, to be financed at the country level.



Old city of Cairo, Egypt

**Developing Countries: Least Advanced States and Fragile States.** Cities in least developed countries are in danger of being among the hardest-hit victims of the crisis. Already facing a substantial reduction in their resources, they are also grappling with public budget hardships. External investments and PPPs, from which they were already receiving very limited direct benefits, are still on the wane. Governments and the international community have mobilised around other sectors or around undeniably worrisome issues such as the food crisis. The food crisis and the effects of global warming could exacerbate the migration or social pressures that are already having an impact on the majority of these cities. In addition, a number of countries have in recent times initiated significant decentralisation reforms. The progress of these reforms, the implementation of which regularly encountered difficulties in the area of taxation and public finance, could be undermined by the effects of the economic crisis on public finances.

While countries in Africa in particular have enjoyed substantial budget surpluses in recent years, 2009 will not signal the end of an average deficit on the order of 5 percent of GDP. The international community initiated a number of support programs for African economies that were affected in particular by the decline in revenues from export products. However, cities are rarely included in the top

priorities addressed by these action plans, and local governments could miss out on many of their direct benefits. Developing countries with export revenues could draw on the Chinese example to redistribute to their local governments investment and activity support programs in rural areas. However, the institutional framework and implementation tools are lacking in most cases. A specific initiative aimed at supporting the local governments in these countries should be given consideration (Paulais & Pigey, 2009).

**New financing, new financial instruments?** Climate change has led to the establishment of new types of financing instruments, such as those derived from carbon financing in the area of mitigation, and funds or initiatives in the area of adaptation. However, with respect to local governments, particularly those in developing countries, a gap remains between needs and financing. These financing instruments are inadequate, fragmented, and relatively poorly adapted; they are often complex and costly to use and, for the most part, target sovereign borrowers rather than local governments (Paulais & Pigey, 2009). These local governments primarily need advisory services and support, not only with respect to the technical aspects of dossiers, but also in order to tap into financing opportunities from various sources and place themselves in a position to use them in parallel (which is difficult owing to reasons such as financial features, timetables for use, administrative constraints, cumbersome directives, etc.). For some time, there has been a resurgence of the concept of renewable funds, which, in some measure, addresses these concerns.

This model was used in the 1980s in the United States, where subsidies were provided by a federal agency for environmental protection. States created renewable funds (states revolving funds) within which subsidies were combined with market resources to establish heavily subsidised loans for environmental investments. The Jessica (Joint European Support for Sustainable Investment in Cities Areas) fund, which was recently established by the European Community and targets urban renewal operations, allows for the blending of subsidies from the European Economic Community, State aid and transfers, the local governments' own revenues, private sector investments, and loans or guarantees provided by the European Investment Bank (EIB) and other banking institutions. The fund has its own unit that provides support to cities in the area of implementation. A number of financial tools and initiatives that were recently proposed in various parts of the world are similar to this model, thus suggesting that, in the face of a global crisis, there was a certain level of policy convergence.

## TOWARD POLICY CONVERGENCE?

The effectiveness of the recovery from the financial crisis at the local level will be contingent on the type of reforms and measures that central administrations will have succeeded in promoting. In the final analysis, this crisis will have called into question the paradigms that had been governing the sector for several decades.



Medellin, Colombia

It had been claimed that the modernisation of systems called for the exclusive use of structured financing, financing on the markets, and public-private partnerships. This claim has been debunked. However, it would be a mistake to believe that these techniques and tools are outdated. They remain a fundamental component of the various solutions that have been devised to restart the production mechanisms of sustainable cities.

These solutions reflect a certain level of pragmatism, especially by applying the economic concept of semipublic status, but in a renewed spirit that will make full use of the gains achieved in recent decades. In view of the stagnation and even the relative decline in international aid and the parallel growth in needs, this approach appears to be even more critical for the least developed countries. Financing of sustainable urban investments will, more than ever in the post-crisis period, depend on the mobilisation of local savings, the promotion of investments particularly in housing and construction, land and real estate appreciation, and second generation public-private partnerships.



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## ABOUT THE AUTHOR

Thierry Paulais is an urban planner (DPLG/ENPC, Paris) and an economist (Doctorate in Economics, Paris X University). He began his career in different engineering consulting firms. Later he served in companies advising local authorities on investment economic analysis and financing strategies, in France and in more than twenty countries. He then joined the Caisse des Dépôts et Consignations (CDC), the French financial institution that is collecting savings, and financing social housing and land development. At CDC he was the head of a team in charge of a credit line and loans for urban development projects for municipalities in financial difficulty, in France and French Overseas. In 2000 he joined the Agence Française de Développement (AFD), to establish and manage the Urban Development Division, which has been involved notably in financing cities directly and through intermediaries in Sub-Saharan and North Africa, Middle-East, and South-East Asia. In 2008, he joined the Cities Alliance secretariat in Washington DC, notably to lead a research/publication program on the financing of African continent cities. He is author or co-author of several books on different topics related to housing and urban development economics and the financing of municipal investments.