CITIES ALLIANCE IN ACTION

West Africa's First Municipal Bond Enables Pro-Poor Investment in Dakar

By Omar Siddique, Senior Urban Specialist, Cities Alliance Secretariat

Project: Dakar Municipal Finance Programme

Partners: The Bill & Melinda Gates Foundation, USAID, the Public-Private Infrastructure Advisory Facility (PPIAF), and AfD. Cities Alliance manages the initiative on behalf of the Bill & Melinda Gates Foundation.

Duration: 2011-2016

Key Result:

- Dakar launched its first municipal bond in January 2015 to raise financing for infrastructure projects to benefit the livelihoods of the city's street vendors.

On 15 January 2015, the city of Dakar, Senegal issued its first-ever municipal bond as part of its model for mobilising infrastructure finance from domestic capital markets. The bond is a 7-year, tax-exempt bond amounting to USD 40 million at an offer rate of 6.6 per cent, paid semi-annually. It will finance the relocation of existing city markets to a central built marketplace, which is expected to provide improved livelihood opportunities for about 3,000 street vendors.

This bond issuance is the first municipal bond in Senegal and West Africa. It is part of a strategy developed by the city leadership to decongest Dakar's streets and provide improved commercial space for street vendors, which make up a high proportion of the city's informal economy.

In preparation for the bond issuance, the city formed the Dakar Municipal Finance Programme in 2011 to strategically position itself as a creditworthy issuer in the regional market, with the support of the Bill & Melinda Gates Foundation, PPIAF, USAID and AfD. The Cities Alliance manages the initiative on behalf of the Bill & Melinda Gates Foundation.

Urban infrastructure is created more efficiently when cities and local governments are empowered to plan, design and pay for the assets created.

Other cities and countries throughout Africa will no doubt be watching Dakar's experience very closely. Like Senegal, many are grappling with rapid urbanisation that has brought with it large infrastructure backlogs, both existing and in the future.

According to a World Bank, AfD and Cities Alliance report, some USD 25 billion per year is required to meet the municipal investment gap in Africa, while the current investment capacity of African local governments is estimated at USD 10 billion over ten years.[1]

It is clear that significant changes are needed in urban economic and financial governance, planning and management arrangements to develop cities' capacity to finance and provide essential infrastructure and services.

Challenges for urban finance systems

Many developing African countries have adopted decentralisation policies and the move to enhanced local governance, and considerable responsibility for service provision has been given to local governments. However, this has often been done without corresponding decentralisation of revenue sources to support the provision of these services, or without support

[1] Paulais, Thierry, 2012. *Financing Africa's Cities: The Imperative of Local Investment*. Washington, DC: World Bank and Cities Alliance.

programmes to develop human resources and strengthen public sector management systems.

As a result, African local governments remain heavily dependent on either conditional transfers from the central government (as in Ethiopia and Uganda) or ad hoc revenue sources (such as land transfer taxes in Kenya), or both.[2] There are also significant policy and capacity deficits in investment planning, public sector management, as well as the maintenance of infrastructure and land management. Without such capacity, a city's fiscal position deteriorates and it is unable to finance needed investments.

Despite their very pressing needs and the potential viability of many projects, most African local governments have limited access to capital markets and private sector finance for infrastructure projects. Essential and impartial supporting capacity, such as rating agencies, are also in very limited supply. And while many governments have legislated for fiscal decentralisation, lack of implementation of the laws remains a major problem.[3]

Quite simply, the lack of decentralisation of revenue sources and good governance in local government, has long retarded development in African cities, undermining service planning and delivery standards, human resource and systems development, and reducing the resources available for investment. For their part, international development agencies often prioritise rural development and agricultural sectors, and adopt sectoral approaches to urban development, with little attention being paid to urban local government policy and capacity.[4]

New municipal financing mechanisms needed

Despite these challenges, specialised financing tools for local investments have been developed in a number of African countries with different approaches and legal status (state owned or private), such as the FEC, Fonds d'Equipement Communal (Morocco), FEICOM, Fonds Spécial d'Equipement et d'Intervention Intercommunal (Cameroon) and ADM, Agence de Développement Municipal (Senegal). In creating these funds, central governments were motivated to provide capital investment to local governments, with some funds designed to partially function as credit institutions.

There is now a pressing need to develop new modalities for the provision of (urban) infrastructure and services through partnerships with development agencies, community finance systems and the more consistent and earnest engagement of the private sector. A clear challenge is to utilise existing resources as a catalyst for sustainable structural change in the key elements of the infrastructure finance market, requiring that it leverage resources from both local and international capital markets.

Addressing this could include providing grant or concessional resources to bridge the consequent 'viability gap'[5] with targeted subsidies and credit enhancement mechanisms. In the context of decentralisation and the need to tap local financial markets, there is a need to utilise, and further strengthen, the full range of sovereign, sub sovereign and non-sovereign lending, guarantees and financing partnership facilities.

As a basis for financing, investments are also needed to build the technical and functional capacity of municipal and utility finances that are key to sustaining operation, maintenance and capital replacement of basic infrastructure (water supply, sewerage, solid waste management, drainage, etc.). This requires a fundamental reorientation of national attitudes to local government: towards viewing cities as viable businesses. Failing to address local governments' inadequate financial capacity impedes the ability of municipalities and urban utilities to cope with the increased demands of urbanisation. As a result, operating and maintenance of assets is not prioritised, balance sheets are unable to sustain debt

[2] UN-Habitat, 2013. *Property Tax Regimes in East Africa*. Nairobi: UN-Habitat.

[3] UCLGA and Cities Alliance, 2013. *Assessing the Institutional Environment of Local Governments in Africa*. Morocco: Cities Alliance and UCLGA.

[4] The World Bank's Urban Local Government and Development Project Phase II (ULGDPII) in Ethiopia is a notable exception, as is the GIZ and KfW implemented Leveraging Urban Spending for Urban Poor (LUSUP) project in Ethiopia, funded by the Bill & Melinda Gates Foundation and managed by the Cities Alliance.

[5] Such funding can be applied in a variety of ways, to capital expenditures, to operational expenditures, or both, depending on the context of the intervention in terms of the capital market, legal framework, city finances, national government funding structures, and the characteristics of the infrastructure sector in question.

needed to improve service delivery, and capital cannot be raised for infrastructure investments. This is most visible in the continued growth of informal settlements and slums, where inefficient, expensive parallel systems of service provision fill the gaps created by public authority and market failures.

A sustained focus on financial governance is essential to support the urban infrastructural and other investments that are so critical. Continued policy dialogue and development is needed on issues including public finance mechanisms, effective land value capture systems, utility corporatisation, urban development funds, municipal bonds and credit risk assessment and rating, tariff policies and regulatory frameworks that contribute towards establishing a sound enabling environment for urban development, creating asset inventories, and condition assessment and performance benchmarking of existing assets.

Recognising potential new revenue sources and timely measures for improving municipal and utility finances would be key to the sustainability of urban investments, and it would provide a foundation for mobilising private sector finance. Operationally, this requires significant and sustained support to build financial management capacity and strengthen financial management systems as a basis for more innovative and efficient finance. This includes introducing double entry accounting, systems to track customer base and physical asset management, and information technology capacity to integrate them.

Capital investments in environmental infrastructure need longer-term financing to facilitate affordability and mitigate the large size of these investments. Multilaterals can provide the catalyst for mobilising domestic resources through credit enhancements for direct borrowings of larger cities and by developing a mechanism of pooling of loans to smaller cities, as their needs are too often ignored. Senegal provides an opportunity for both – supporting larger cities such as Dakar and working with the Municipal Development Agency (ADM) for smaller Senegalese cities.

Technical assistance that supports municipal financing systems – rather than projects – will likely facilitate and produce greater development impacts.

Learning from Dakar's experience

The experience gained in Dakar with its groundbreaking municipal bond will be extremely informative for other national and city governments in Africa. It raises the following questions:

- First, based on the Dakar experience, what are the generic enabling conditions that allow cities direct access to commercial finance, and what is needed for cities to fulfill these conditions?
- Second, does this bond issuance have lessons for secondary cities in Senegal and Africa? Larger cities have often been able to access markets more successfully.
- Finally, from the perspective of development partners, does the Dakar model provide opportunities for technical assistance that finances a system of projects, rather than individual projects?

Larger cities have been able to access markets directly. For example, in Africa, Johannesburg – after a major restructuring of its finances – has been regular in issuing bonds on the basis of ratings of AA and above. The city has also tapped into longer-term funds, issuing bonds with 15-year maturities. Similarly, in South Asia larger Indian cities have tapped local markets based on ratings and raised finance through municipal bonds, and smaller cities through pooled bonds.

The situation has been different for smaller cities (or smaller issue sizes for larger cities) due to transaction costs. Their municipal demands tend to be small relative to typical debt market offerings, and transactions costs tend to be high. In such cases, there are significant advantages to pooling these demands through intermediation.

Intermediation allows the drawdown of capital in synergy with construction demands, thus reducing costs. As long as there is no cross collateralisation of risks – i.e., one municipality paying for the default of another – intermediation is efficient for servicing the small and repetitive debt demands from municipalities. International experience shows that even larger cites use intermediaries for smaller offerings; New York City uses the New York State Financial Environment Corporation.

International experience also shows certain obvious common areas on the demand and supply sides of financing environmental infrastructure in small and medium towns. First, there is a need for local, long-term debt to finance these investments. Second, intermediation has been specifically designed by state policy, albeit in widely varying historical circumstances. Third, all intermediaries provide support for smaller local governments for project preparation. Fourth, the cost of credit varies (as is to be expected) inversely with the strength of state support, and the allowable security packages.

Cities Alliance support for policy research

Bond issuances and accessing commercial finance must be viewed within the larger context of decentralisation. The central idea being that city infrastructure is created more efficiently when cities are empowered to plan, design and pay for the assets created. This premise can be implemented and tested only if there are accompanying policies that enable a systemic municipal finance framework, defined as efficiency in own-source revenues, stability in the assigned sources, and a borrowing mechanism that is capable of repeated access.

This area has been a focus of Cities Alliance policy-oriented research, notably with the World Bank and AfD through Thierry Paulais' seminal publication *Financing Africa's Cities: The Imperative of Local Investment*, as well as the City Enabling Environment (CEE) rating methodology jointly produced with UCLG Africa that aims to advance the agenda of effective, concrete decentralisation in Africa.

For development partners, it may be useful to base their support for municipal finance reform by identifying a broad typology. For example, in countries where the devolution framework continues to be *ad hoc* and own sources sluggish, development support could be designed for policy initiatives that strengthen both, as in the case of Senegal.

In cases where the demand-side factors (devolution and city actions) are relatively developed but there is an absence of a borrowing framework, development support would be best used in designing access, as in the case of Indonesia or the Philippines. If the premise of decentralisation is nationally accepted, then technical assistance that supports municipal financing systems – rather than projects – will likely facilitate and produce greater development impacts.

Dakar's bond will raise financing to build a new market for the city's street vendors. Photo: Juliet Bunch/Cities Alliance