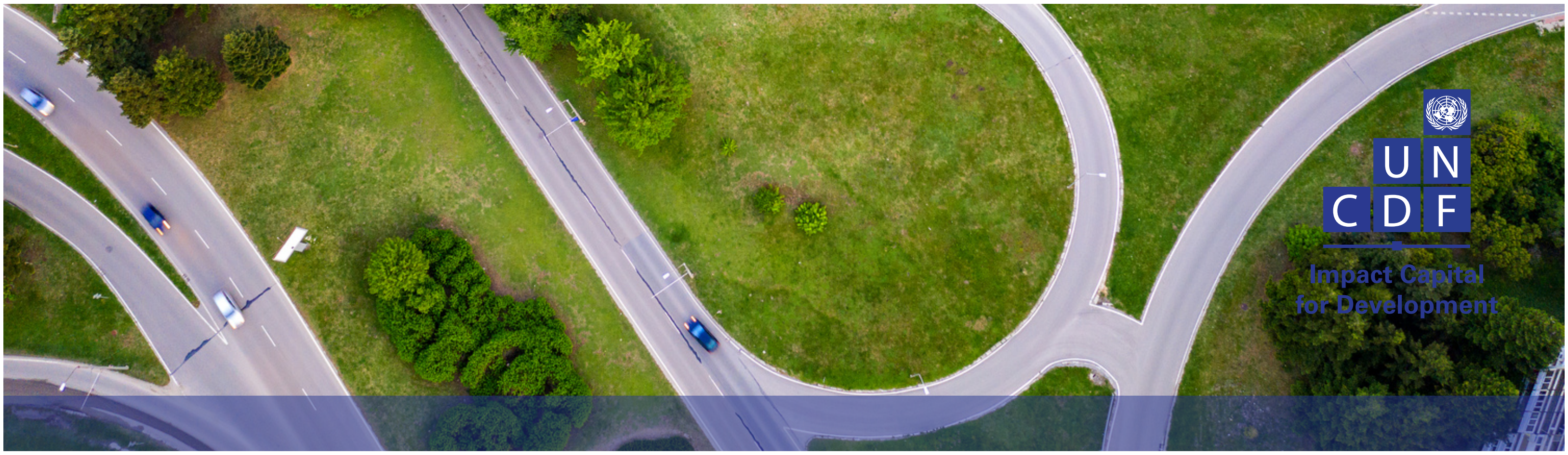
Impact Capital for Development

POLICY BRIEF

Bridging the Local Infrastructure Financing Gap through Domestic Capital Markets



Bridging the Local Infrastructure Financing Gap through Domestic Capital Markets

I. Why Are Domestic Capital Markets Important?

Investing in city infrastructure is integral to most development strategies, and it is well recognized that such investments contribute to economic growth and human well-being. For example, improved roads and transportation allow for greater mobility of people, goods and services; cleaner water and sanitation lower morbidity; and green spaces improve sustainability.

However, the current level of traditional financing mechanisms alone cannot deliver the necessary volume of local investments due to growing populations and the associated high demand for public services, increasing land values, and expanding local fiscal space. Reforms to improve both assigned and own sources are important if local governments are to be empowered to take proactive decisions on infrastructure rather than continue as passive responders to scattered grants.

These reforms are a first step towards empowering local governments to blend public sources of finance with private sources, so local public goods, such as infrastructure projects, can be created on a scale that lifts the city to higher growth in an equitable and environmentally responsible manner. Given the gaps between the investments needed and the available public sources of finance, blended finance becomes critical, and a key component of the package is access to capital markets by cities and local governments. In particular, local government borrowing and the issuance of municipal bonds would play a key role in achieving sustainable and transformative infrastructure finance by attracting investments at scale.

II. What Are the Typical Bottlenecks?

Despite the inherent value proposition of investing in municipal infrastructure, domestic capital markets remain significantly underdeveloped in most parts of the world due to a number of challenges.

Legal authority to borrow

For example, cities must have the legal authority to borrow, create and pay for the use of the assets over time; however, many cities and local governments do not have this level of authority, and if they do, the direct borrowing is highly regulated with specific formulas that limit the amount of debt.

Clear revenue stream

Cities also have to be able to demonstrate a clear revenue stream to repay the borrowings for potential lenders to assess, which depends on the rationality of intergovernmental fiscal rules and the stability of own source revenues, including powers to levy and raise user charges.

Excessive borrowing at national level

Another challenge is excessive borrowing at the national level, which reduces fiscal space for cities to borrow locally and invest in infrastructure. Such lack of domestic savings increases borrowing costs for cities and stimulates capital flight, making long-term funding scarce for local governments.

III. Examples of Effective Domestic Capital Market Development

Cities and local governments need holistic support of national and municipal policies that strengthen own source revenues, intergovernmental fiscal rules, and municipal borrowing frameworks to expand access to capital for cities of all sizes. In particular, below is the summary of best practices for promoting domestic capital markets, followed by different country cases that illustrate the successful practices of creating enabling conditions that linked capital markets with municipal finance.

- Promote **debt** that can lend to local and regional governments for transformative projects
- Implement **equity partnerships** that crowd in investment to local projects from domestic and international investors and build confidence through replicable projects
- Create **specific budget lines for technical assistance** for local and regional governments to build their capacity to structure transformative financeable projects

- Establish and increase intermediary instruments that **channel climate finance** to local and regional governments for effective public and private investment
- Create non-sovereign regional or global **guarantees** for local transformative investments
- Develop **blended finance** instruments and **public-private alliances** for city investments
- **Advocate for local infrastructure investment** as a prerequisite for national development

While connecting cities and local governments to capital markets may seem difficult at first glance, there have been many examples of success. For instance, UNCDF worked with the **Government of Bangladesh** to develop a framework that aimed to expand the use of direct debt financing for municipal investments from domestic financial institutions, followed by an initiative to expand access to capital markets through municipal bonds.

During the process, a key challenge was a lack of municipal creditworthiness, which led the banking sector to see municipalities as a risk. Interest rates were another issue, and banks seek guarantees for such lending. To address this situation, the Government of Bangladesh set up several specialized financial institutions for infrastructure financing with its own funds that can be used to lend to municipalities within that institution's legal-administrative framework.

For example, the Infrastructure Development Company Ltd. (IDCOL) was set up to finance green energy projects, and the Bangladesh Infrastructure Finance Fund Ltd. (BIFFL) was established to finance multisector infrastructure. International financial institutions were another source for indirect municipal borrowing – the World Bank loaned funds to the Government of Bangladesh backed by sovereign guarantee, which has then been on-lent to municipalities.

Another example of effective domestic market development practices is the ongoing work of first-ever water infrastructure green revenue bond in **Tanga, Tanzania.** Due to population growth and expansion of service areas and economic activities, water demand increased yearly in Tanzania, and the water production level does not match installation capacity and the required demand/supply gap increase.

The loss of revenue is still high due to dilapidated water supply infrastructure, which posed an opportunity for UNCDF to help scale up water investment projects. Since government funds were limited, UNCDF provided technical support to the Tanga Urban Water and Sanitation Authority (UWASA) to issue a 10-year water revenue bond amounting to US$23.1m as part of project investment cost, with third-party credit guarantees from development partners, including UNCDF and other local and international organizations. The revenue raised from water bills would be used to service the debt, including principal and interest payments. This example illustrates the feasibility of meeting dire infrastructure needs by leveraging domestic capital markets with the required technical assistance and credit guarantees.

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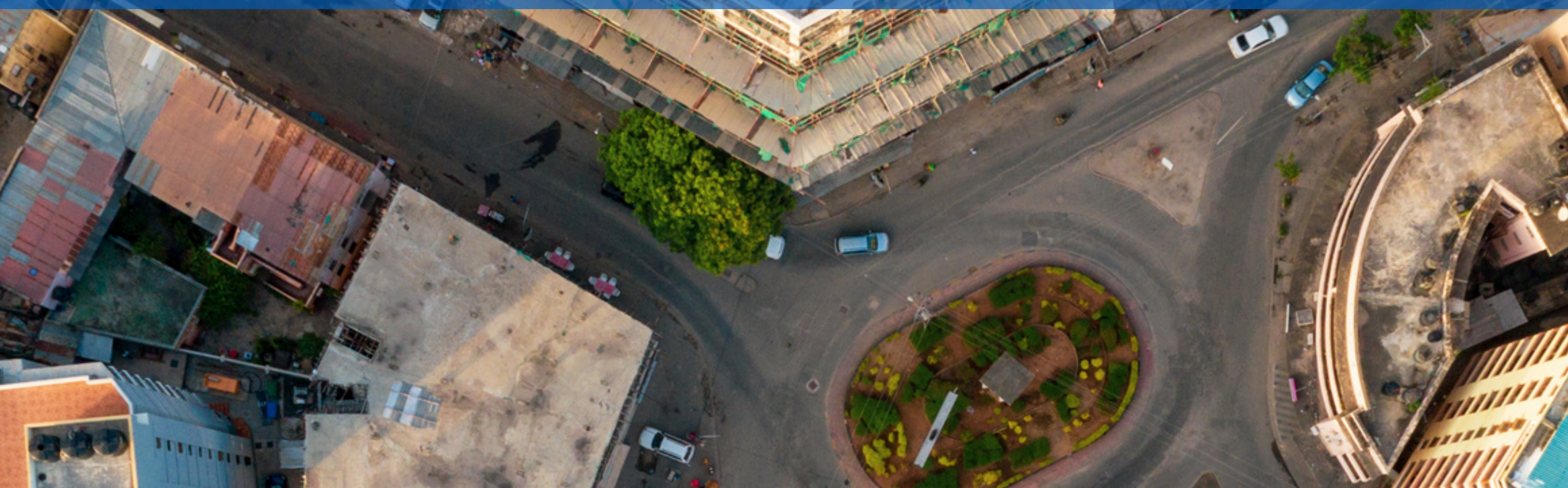

This policy brief's content directly comes from the UNCDF's flagship publication – Local Government Finance is Development Finance. For more information about the book, download here or via + QR code

For more information on the work of the Local Transformative Finance Practice, visit https://www.uncdf.org/local-development-finance

SCAN ME

The UN Capital Development Fund makes public and private finance work for the poor in the world's 46 least developed countries(LDCs).

UNCDF offers "last mile" finance models that unlock public and private resources, especially at the domestic level, to reduce poverty and support local economic development.

UNCDF's financing models work through three channels: (1) inclusive digital economies, which connects individuals, households, and small businesses with financial eco-systems that catalyze participation in the local economy, and provide tools to climb out of poverty and manage financial lives; (2) local development finance, which capacitates localities through fiscal decentralization, innovative municipal finance, and structured project finance to drive local economic expansion and sustainable development; and (3) investment finance, which provides catalytic financial structuring, de-risking, and capital deployment to drive SDG impact and domestic resource mobilization.

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