CLIMATE FINANCE DECISION MAKING TREE

This climate finance decision-making tree guides local and regional governments through a series of questions that help them consider different financing tools. Each financing tool is described, including advantages, disadvantages and case study examples. Here is an overview of the decision-making tree and the financing tools available to local and regional governments. To use the decision making tree, visit: http://www.solutions-gateway.org/show?page=financetool

Supported by: Global Platform for Sustainable Cities, gef, URBAN LEDS, ICLEI Local Governments for Sustainability, UN-HABITAT FOR A BETTER URBAN FUTURE, TAP Transformative Actions Program

Funded by:

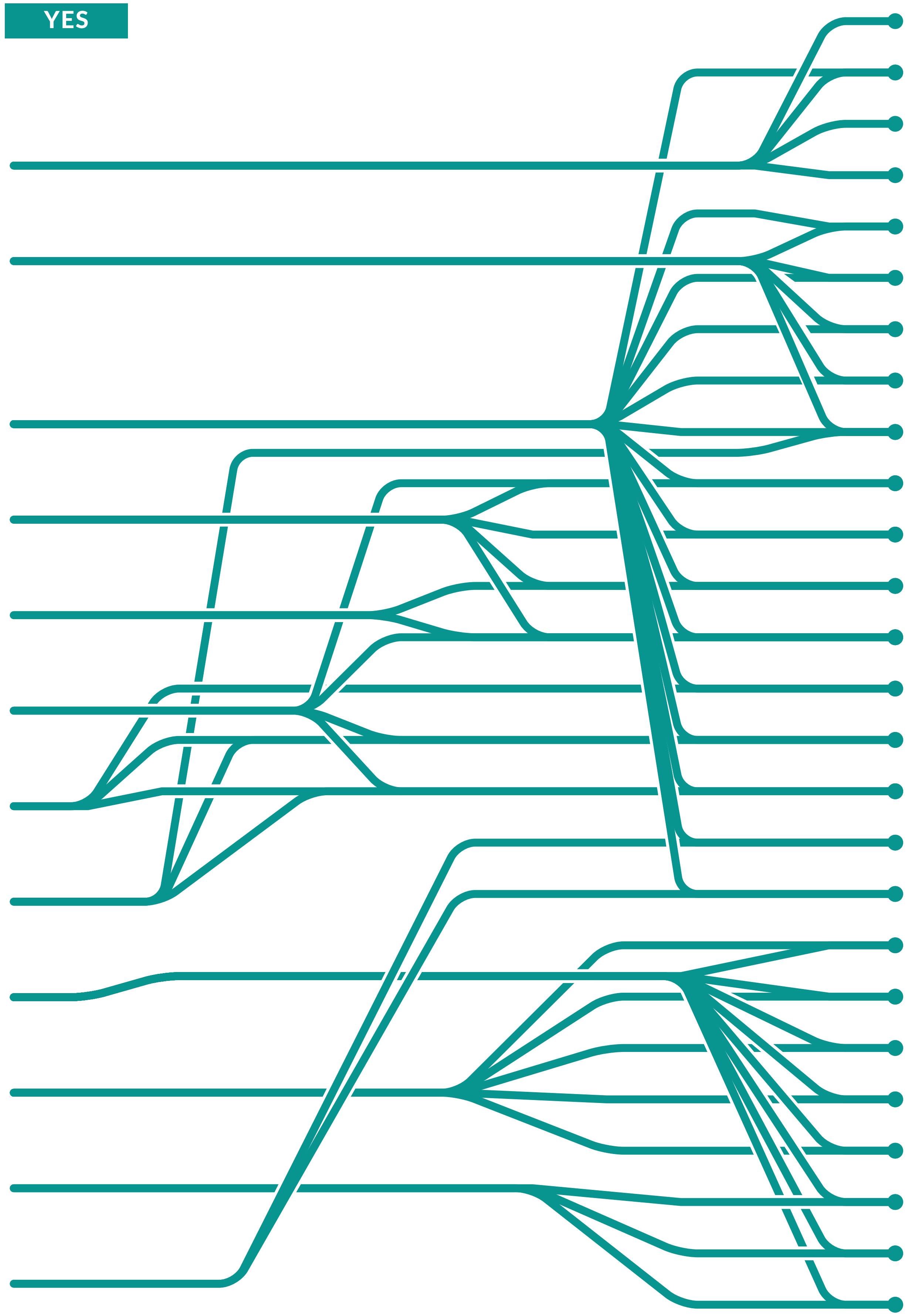
NO | **Questions for Local and Regional Governments (LRGs)** | **YES**

Own-source financing

- Does the LRG have sufficient own financial sources for the project?
- Does the LRG have an asset/land to be sold or leased?

External financing

- Is the LRG able/interested to enable private sector participation?
  - Does the LRG want to engage the private sector partner to deliver public services?
  - Can the LRG co-finance private sector participation?
  - Can the planned project generate revenue?
  - Is the LRG eligible to apply for a private loan/be borrower of a debt?
  - Can the LRG raise private capital?
- Is the LRG eligible/interested to apply for external public finance?
  - Is the LRG able to apply for grants and subsidies?
  - Is the LRG eligible to apply for a public loan?
- Does the LRG need help accessing loans because of a lack of creditworthiness?



Financing tools

- T1 Cash/direct investment
- T2 Subsidies/incentives
  - T2.1 Tax advantages
  - T2.2 Interest-free and low interest loans
- T3 Land/asset sale
- T4 Land/asset lease
  - T5 Land value capture
- T6 Sale of development rights
- T7 Equity
- T8 Energy Performance Contract
- T9 Privatization
- T10 Public private partnership
- T11 Revolving fund
- T12 Private sector loan
- T13 Crowdfunding
- T14 Municipal (green) bonds
- T15 Blended finance
- T16 Risk mitigation
- T17 National grants and/or subsidies
- T18 International grants and/or subsidies
  - T18.1 UNFCCC Climate Funds
  - T18.2 EU Funds
  - T18.3 Multi-and bilateral financial institutions
- T19 Public loan
  - T19.1 Government loans (sometimes at concessional rate)
  - T19.2 International public loans

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TOOL 1: CASH/DIRECT INVESTMENT

RETURN TO THE TREE

Finance source

Local government's own – source revenue

Definition

When the local government has enough savings and liquidity can use cash instead of debt issuance to fund projects. It is most commonly used in cases when project sizes are small, project sponsors have limited access to debt, local governments are closely approaching their debt limits, or there are prohibitions on use of debt[1].

Advantages

Using own cash is the fastest and easiest way to secure funding and avoids the added cost of interest payments and therefore, is less costly than borrowing.

Disadvantages

Using own money as a major investment also means to take a high risk and lose all the savings entirely.

Cases studies

Only very few local governments have the capability to finance projects on a cash/direct investment basis. Usually finance is a mixture of different tools and comes from different sources.

1 Infrastructure Financing: A Guide for Local Government Managers, University of Nebraska at Omaha, 2017

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TOOL 2: SUBSIDIES

RETURN TO THE TREE

Finance source

Private sector resources leveraged by local government's land/asset policy

Definition

A subsidy is a form of financial aid or support extended to an economic sector (or institution, business, or individual) generally with the aim of promoting economic and social policy[1]. Subsidies come in various forms including: direct (cash grants, interest-free loans) and indirect (tax breaks, insurance, low-interest loans, depreciation write-offs, rent rebates)[2,3].

The most common subsidies used by local governments are:

- **Producer oriented subsidy:** Local government can provide a subsidy to the investor or solution provider, such as providing special tariff for using renewable energy;
- **Consumer oriented subsidy:** The subsidy can be designed to subsidize a behavior of consumers, for example subsidizing purchasing of electric cars.

Advantages

Subsidies are part of local government's expenditure plan. Local government has control over the beneficiaries, and the conditions/deliverables attached to it.

As a form of grant, it is the most direct incentive a local government can deploy as an "incentive" to promote policy implementation.

Disadvantages

Public resources are usually limited. This instrument is not sufficient for financing large scale infrastructure projects.

Free market economists also argue that subsidies unnecessarily distort markets, preventing efficient outcomes and diverting resources from more productive uses to less productive ones.

Cases studies/suggested literature

- https://www.ifo.de/DocDL/dice-report-2016-4-kemfert-december.pdf
- https://www.economicshelp.org/blog/19041/economics/solutions-for-declining-industries/
- https://www.livemint.com/budget/expectations/farmers-may-get-interest-free-loans-premium-free-insurance-1548764098831.html

1 Myers, N.; Kent, J. (2001). Perverse subsidies: how tax dollars can undercut the environment and the economy. Washington, DC: Island Press. ISBN 1-55963-835-4.
2 Collins Dictionary of Economics. Retrieved 05/09/2013.
3 Is That a Good State/Local Economic Development Deal? A Checklist (2014-06-03). Naked Capitalism

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TOOL 2.1: SUBSIDIES/ TAX ADVANTAGES TO PROJECT DEVELOPER

RETURN TO THE TREE

Finance source

Local government's own – source revenue

Definition

There are several "tax advantage tools" local governments can use to attract developers of sustainable projects.

- **Tax holidays:** Temporary exemption of a new firm or investment from certain specified taxes, typically at least corporate income tax. Sometimes administrative requirements are also waived, notably the need to file tax returns.
- **Special zones:** Geographically limited areas in which qualified firms can locate and thus benefit from exemption of varying scope of taxes and/or administrative requirements.
- **Tax credits:** A tax credit is a tax incentive which allows certain taxpayers to subtract the amount of the credit from the total they owe the state. Incentive tax credits may be used to encourage behaviors like investment or parenting. A credit directly reduces tax bills, unlike tax deductions and tax exemptions, which indirectly reduce tax bills by reducing the size of the base (for example, a taxpayer's income or property value) from which the tax bill is calculated. Investment Tax Credits (ITC) and Production Tax Credits (PTC) are two commonly used tax credits to stimulate investment in sustainability projects.
- **Investment tax credit:** Deduction of a certain fraction of an investment from the tax liability. Rules differ regarding excess credits (credits in excess of tax liability) and include the possibility that they may be lost, carried forward or refunded.
- **Investment allowance:** Deduction of a certain fraction of an investment from taxable profits (in addition to depreciation). The value of an allowance is the product of the allowance and the tax rate. Unlike a tax credit, its value will thus vary across firms unless there is a single tax rate. Moreover, the value is affected by changes to the tax rate, with a tax cut reducing it.
- **Accelerated depreciation:** Depreciation at a faster schedule than available for the rest of the economy. This can be implemented in many different ways, including a higher first year depreciation allowances, or increased depreciation rates. Tax payments in nominal terms are unaffected, but their net present value is reduced and the liquidity of firms is improved.
- **Product Tax Credits (PTC)** is based on the quantity and quality of the product of a sustainable project, such as renewable energy generated per year. The government can define the percentage of tax basis depending on the technology employed. This method motivates investor to maintain good performance of sustainable project overtime.
- **Reduced tax rates:** Reduction in a tax rate, typically the corporate income tax rate.
- **Exemptions from various taxes:** Exemption from certain taxes, often those collected at the border such as tariffs, excises and VAT on imported inputs.
- **Financing incentives:** Reductions in tax rates applying to providers of funds, e.g., reduced withholding taxes on dividends.
- **Accelerated depreciation** can have the effect of reducing the developer's taxable income in earlier years and thus provide for a better return on equity investment. Government might issue taxation policy to allow extra amount tax basis to be depreciated[1].

Advantages

Taxation is a flexible incentive that government can use to motivate good behavior with limited investment. By structuring the tax policy, investors are directed to preferred project type, technology. Investment Tax Credit (ITC) and Product Tax Credits (PTC) are successfully used in many OECD countries as effective measure to support renewable energy development. Those tax preferred policies not only encourages private investor to develop environmental friendly project, but also ensures the long-term performance and keep upgrading of employed technology.

Disadvantages

Governments cannot give favorable taxation conditions without first taxing citizens to obtain the money. This means that subsidies come with the hidden cost of taxation. Ultimately, taxpayers will have to pay higher taxes in order to fund government subsidy programs.

Cases studies

- https://www.nytimes.com/2018/11/13/business/economy/amazon-hq2-va-long-island-city-incentives.html
- https://www.euki.de/wp-content/uploads/2018/09/fact-sheet-incentives-for-electric-vehicles-no.pdf

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TOOL 2.2: SUBSIDIES/ INTEREST-FREE AND LOW INTEREST LOANS

RETURN TO THE TREE

Finance source

Local government's own – source revenue

Definition

The borrower pay no or low interest.

In the case of an interest rate subsidy, the amount of subsidy is the amount of interest saved by the recipient company during the investigation period[1].

Advantages

Subsidized loans are cheap loans, always help liquidity and do not force the business into focusing on financial return.

Disadvantages

This, as subsidies in general, create dependence and can´t be a long-term financial scheme.

Cases studies

- https://www.invest-in-bavaria.com/en/info-centre/good-to-know/subsidies.html

1 https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1998:394:0006:0019:EN:PDF

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TOOL 3: SALE OF LOCAL GOVERNMENT OWNED LAND/ASSET

RETURN TO THE TREE

Finance source

Local government's assets

Definition

The sale of local government-owned land or asset can provide finance for infrastructure development. Land sales however require a trusted and coherent legal framework, strong institutions and clearly defined and enforceable property rights (World Bank, 2013).

Urban land values are created in part by public investment. They reflect the capitalized value of access to road networks, water supply, schools and other services made possible by municipal investment.

Auction-based land sales can be particularly effective in countries lacking systematic land valuation.

Advantages and usage

Land sales can incentivize sustainable infrastructure development in the absence of wider policy frameworks mandating sustainable infrastructure development.

Sale of municipally owned land can sustain infrastructure finance for a longer period of time. In countries where all urban land is owned by the public sector, land is by far the most valuable asset on the municipal balance sheet. It often is the most valuable municipal asset under other landholding regimes.

There are various ways that increases in urban land values can be captured, but the sale of land or land rights has the advantage of producing revenue quickly and being easier to administer than betterment taxes, land re-adjustment schemes, or universal property taxation.

Moreover, municipally owned urban land is not a static asset. It can be 'created' by expanding the urban area into rural zones at the urban fringe. A legally empowered, active asset manager can also acquire additional land from current users for urban re-development, or for highway and airport construction. It can then re-sell part of the land after its value has been enhanced by public investment.

Even without public improvements, urbanization and economic growth tend to drive up land prices, adding to the value of land held on local balance sheets.

Disadvantages

Land resources are limited and are a one-time income flow. As a general rule, asset sales of this kind have been viewed as a temporary financing expedient and fiscal experts have warned cities not to become dependent upon asset sales as a significant or continuing source of capital financing[1].

Case studies/suggested literature

- Local Government Best Practice Guideline for the Sale, Exchange & Transfer of Land
- http://knowledge.ckgsb.edu.cn/2014/09/03/policy-and-law/the-role-of-land-sales-in-local-government-financing-in-china/
- LAND LEASING AND LAND SALE AS AN INFRASTRUCTURE-FINANCING OPTION George E. Peterson1World Bank Policy Research Working Paper 4043, November 2006

1 LAND LEASING AND LAND SALE AS AN INFRASTRUCTURE-FINANCING OPTION George E. Peterson. World Bank Policy Research Working Paper 4043, November 2006

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TOOL 4: LOCAL GOVERNMENT OWNED LAND/ASSET LEASE

RETURN TO THE TREE

Finance source

Local government's assets

Definition

Many local governments are "cash poor, land rich." They have limited fiscal autonomy and/or small budgets. Nevertheless, they control substantial holdings of land and built-up properties that they do not need for public use now or in the foreseeable future. The assets local government can use as finance sources include land and existing infrastructure, such as water and energy facilities.

Besides direct selling a land or asset, (see tool 3 land sale), land or existing infrastructure assets (e.g. water and energy infrastructure) can be leased to private sector developers and/or operators at a price. Leaseholds are rental agreements between the owner of land or of an infrastructure asset (in this case a city or a public sector entity) and the land developer or asset operator (usually a company). The resulting revenue can be used as initial capital for upfront costs related to public infrastructure investments[1].

Advantages

Land lease can encourage private sector participation without compliance of usual liquidity requirements of private sector to participate projects. It is also cheaper than bearing borrowing costs.

Disadvantage

Evidence suggests that land leaseholds should be primarily used to leverage new infrastructure assets tied to a city's land use plan to avoid risk of inefficient or underused infrastructure development (e.g. development that does not meet local needs or that is not located where potential users are). Leasehold frameworks and related revenue stream should be systematically linked to a city's land use plans. Down the line, leaseholds are likely to need to be complemented by taxes and charges to pay for maintenance and expansion of infrastructure service provision. (World Bank, 2013)

Case studies/suggested literature

- https://content.next.westlaw.com/Document/I5c7c3570097b11e798dc8b09b4f043e0/View/FullText.html?transitionType=CategoryPageItem&contextData=(sc.Default)&firstPage=true&bhcp=1
- Land leasing and land sale as an infrastructure-financing option, The World Bank, 2006

1 Financing the Transition: Sustainable Infrastructure in Cities, WWR& Long Finance,2015 March

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TOOL 5: SALE OF DEVELOPMENT RIGHTS

RETURN TO THE TREE

Finance source

Local government's land or asset

Definition

The sale of development rights is an important source of infrastructure funding in some parts of the world. Applying this instrument means that cities separate land ownership from the right to further develop that land sell the right to further development within a given area. The sale of development rights can be structured in a variety of ways ranging from simple density standards to complex auctions. The best approach in a given environment will depend on the capacity and resources of the issuing municipality.

The requirements for employing the sale of development rights include:

- The combination of culture, law and administrative strength must be such that development rights are excludable.
- There must be sufficient market demand for additional development in the location where the rights will be assigned.
- The law must include provisions that allow cities to create and sell additional development rights.
- The city must have an up-to-date comprehensive plan for growth and infrastructure management.
- The city must have an adequate administrative infrastructure[1].

Advantages

The sale of development rights can be used to manage and limit growth as well as to encourage it.

Disadvantages

The sale of development rights through open auctions may prevent low and moderate-income households from acquiring those rights and thereby limits their ability to invest in their land.

Case studies/suggested literature

MTR Corporation Limited

The MTR Corporation Limited is a government-led public leasehold system. It allows the MRT exclusive rights on long-term 50-70 year government-controlled land leases and associated development rights above and adjacent to the stations. The MRT divides the large government leased parcels into smaller parcels that are offered to private sector developers within a competitive bidding process. The prices reflect the increased value due to the transit station. The MRT is one of the few places in the world where a transit agency makes a profit. The profit largely comes from the success of real estate development that is realized as a result of the accessibility that comes with the provision of transit.

1 Land-based Finance for Local Governments, UN-Habitat 2016

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TOOL 6: LAND VALUE CAPTURE

RETURN TO THE TREE

Finance source

Private sector resources leveraged by local government's land/asset policy

Definition

Public regulation, planning or investment can increase the value of land. For example, improving road infrastructure will increase the value of land in suburbs. "Up-zoning", i.e. changing an area for more intense development and commercial use, will increase the demand for such areas, thereby also increasing its value. Land-value capturing (LVC) allows the public sector to financially participate in such a value increase[1]. The LVC works, whenever people perceive value they are willing to pay for it. People will often pay higher value to a house, where it has good access to where the residents want to go. In other words, the money is a reflection of the value created by the improved accessibility and the accessibility makes the land more productive. This uplift in value due to improved accessibility will vary depending on the local circumstances.

Existing LVC methods tend to focus on either specific developments or a general taxation or levy. The first is a development-based approach and the second a taxation-based approach. Most of the methods, however, include elements of both approaches and it is therefore often difficult to categories them into one or the other.

Today's LVC approaches take a much more balanced view of how value should be shared and captured. And that is not only unlocking new sources of funding, it is also creating a much stronger link between assets, funding and users[2]. It makes sense therefore that the extra profit generated by transit should be shared between the agency providing the transit, i.e. the taxpayer, and the people who own the land. The potential, therefore, to unlock this extra value through a partnership between the public and private sectors needs to be explored.

Advantages

When there is proper collaboration between the private sector developer and the public sector, the Land Value Capture mechanism can:

- Support economic growth to be achieved in an environmentally sustainable way;
- Build a more competitive city region and a higher quality of life for its residents and businesses.
- Build sustainable, healthier communities.
- Reduce the cost of living.

In addition to the benefits in terms of public finance, many authors point out that land-value capture can also help to improve the economic efficiency of municipal investments, contribute to social equity, and serve as a tool for urban growth management and land price control, as well as reduce uncertainty for private developers about the timing of project approval and infrastructure provision[3].

Disadvantages

It is not easy to release and subsequently capture this added value. The implementation of LVC methods in the local government will require the following challenges to be addressed:

- Acceptance of the principle of LVC and the benefits

There needs to be an acceptance in principle from all the key players that LVC is a valuable tool that can contribute to the future funding of transit infrastructure and the long-term success of that infrastructure.

- A willingness to change and to act

The application of LVC methods often requires changing some traditional views, policies and a willingness to work across non-traditional boundaries with partners who may have different values and objectives. This requires delivery models to be developed in collaboration with the key stakeholders.

- Collaboration between public and private sector stakeholders

Any successful LVC method requires collaboration. It needs to develop strong working relationships with municipalities, senior levels of Government, and the private sector. This needs to work at two levels - strategic forums and working arrangements related to specific projects and sites.

Case studies/suggested literature

- https://www.befs.org.uk/wp-content/uploads/2017/05/Edinburgh-City-Region-Land-Value-Capture-analysis-v2.1.pdf
- Francesca Romana Medda and Marta Modelewska: Land value capture as a funding source for urban investment, 2011
- https://blogs.adb.org/blog/transforming-cities-land-value-capture
- https://www.london.gov.uk/sites/default/files/land_value_capture_report_transport_for_london.pdf
- https://todresources.org/blog/hudson-yards-a-value-capture-case-study/

1 Kamiya, Marco 2016: New solutions to close the gap on municipal finance
2 https://home.kpmg/xx/en/home/insights/2017/05/funding-wisely-unlocking-urban-transit-with-land-value-capture.html
3 The Potential of Land Value Capture for financing urban projects, Inter-American Development Bank, 2017

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TOOL 7: EQUITY

RETURN TO THE TREE

Finance source

Private sector resources leveraged by local government's land/asset lease or buying capital share

Definition

Equity is the difference between the value of the assets and the value of the liabilities of something owned. Alternatively, equity can also refer to a corporation's share capital. In this case the value of the share capital depends on the corporation's future economic prospects.

Advantages

- Less burden: With equity financing, there is no loan to repay, which is particularly important when the project has no revenue-generation mechanism.
- Credit issues gone: If the local government lacks creditworthiness, equity can be preferable or more suitable than debt financing.
- Learn and gain from partners: Equity creates new partnerships and connections.

Disadvantages

- Share profit: Investors will expect to have a share of the profit. However, it could be a worthwhile trade-off if you are benefiting from the value they bring as financial backers and/or their business acumen and experience.
- Share control: Investors may want to have control on the project.
- Potential conflict: Sharing ownership and having to work with others could lead to some tension and even conflict if there are differences in vision, management style and ways of running the business[1].

Case studies/suggested literature

- https://www.investeurope.eu/about-private-equity/private-equity-in-action/

1 https://www.thehartford.com/business-insurance/strategy/business-financing/equity-financing

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TOOL 8: ENERGY PERFORMANCE CONTRACT

RETURN TO THE TREE

Finance source

Private sector resources leveraged by local government's land/asset lease or buying capital share

Definition

An EPC is a contract where an array of services is agreed and the provider of the services is able to guarantee that a minimum of energy savings and/or sustainability value will be achieved. An Energy Service Company (ESCo) implements a customized energy service package, consisting of planning, building, operation & maintenance, optimization, fuel purchase, (co-) financing and user behaviour[1].

Advantages

- This model can be suitable for municipalities that lack the financial and technical capacities as it offers a "no risk, no investment" approach, where the municipality does not have to raise upfront costs, unless it is the preferred option. EPC contracts can guarantee that a certain percentage of savings will be achieved, with the risk taken by the ESCo; if the guaranteed performance is not achieved, the ESCo would pay back the local government.
- Costs for maintenance are saved during the contractual period, and there is the guarantee that the ESCo – participating in the share of the saving – will keep the system at its best performance.
- This model can bring expertise and give clarity on the viability of the project, building market capacity.
- Smaller municipalities could connect with neighboring municipalities with similar needs, to engage a single ESCo that aggregates these similar projects to lower transaction costs and facilitates financing.

Disadvantages

- Provided that the contractual length is long enough to reach payback for the ESCo (i.e. 7 years) and includes maintenance services, the local government is committed for this period of time to the ESCo.
- The model might not be applied in locations where an enabling environment is lacking, such as in the case of emerging countries. Municipalities might need to provide bank or state guarantees.

Case studies/suggested literature

- https://eumayors.eu/news-and-events/news/1512-new-case-study-vantaa,-finland-esco-procurement-for-energy-renovation-of-municipal-buildings.html
- https://enerpower.ie/esco-case-studies/
- http://open_jicareport.jica.go.jp/pdf/11826047.pdf
- https://www.mm.dk/pdffiles/CITIES100_2016.pdf

1 Standard EPC documents , European Energy Service Initiative, 2010

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TOOL 9: PRIVATIZATION

RETURN TO THE TREE

Finance source

Leveraging private sector investment through outsourcing services

Definition

The most common form of privatization in local governments occurs when governments contract with private sector service providers, for-profit or nonprofit, to deliver individual public services, such as road maintenance, custodial services, fleet maintenance and water system operations and maintenance[1].

Advantages

Privatization boosts the local economy, is tax base, meaning that private companies under government contract pay taxes into government coffers and offer employment to communities. Private firms operating under government contracts have strong incentives to deliver on performance.

Privatization also urges improvements in the company through competition. When a state owned entity is privatized it loses its government protection and is forced to adapt to the market by providing better services or products in order to survive and thrive.

Disadvantages

Privatization of certain state entities such as water and electricity authorities may just create single monopolies. These may eventually seek to increase prices at the detriment of the consumer with no controls.

The government loses dividends after privatization as seen with most successful companies that are developed through privatization. These dividends are instead channeled to wealthy individuals[2].

Case studies/suggested literature

- https://hbr.org/1991/11/does-privatization-serve-the-public-interest
- https://www.jstor.org/stable/4165457?seq=1#page_scan_tab_contents

1 https://reason.org/policy-brief/local-government-privatization-101/
2 https://www.enotes.com/homework-help/advantages-disadvantages-privatization-airlines-455874

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TOOL 10: PUBLIC PRIVATE PARTNERSHIP (PPP)

RETURN TO THE TREE

Finance source

Depends on the type of PPP; mixture of public and private

Definition

A typically long-term cooperative arrangement between one or more public entities and a private organization, where there is an allocation of risks between the two partners. The aim of this relationship is to use public policies and regulations to leverage private sector financing, who will receive payments from the public entity for providing a defined service.

Advantages

PPP enables municipalities to access financing and technical expertise, and to benefit from operational efficiency, while shifting performance and technology risks to the private sector.

Disadvantages

- The model has relatively high transaction costs.
- If one party feels they are losing some of the control they may work on adopting more rules and regulations throughout the process instead of working together
- Different actors work with different timelines: non-profits long-term, for-profit organizations short-term, government agencies' timeline is heavily influenced by elections.
- Small and medium cities might find difficulties in accessing these arrangements.

Case studies/suggested literature

- https://www.thebalancesmb.com/public-private-partnership-types-845098
- https://www.pppinindia.gov.in/toolkit/pdf/case_studies.pdf
- https://www.ishackproject.co.za/

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TOOL 11: REVOLVING FUND

RETURN TO THE TREE

Finance source

Mixture of own and private sector sources

Definition

Revolving fund is a fund set up for specified purposes with the concept that repayments to the fund may be used again for these purposes.

Advantages

- Once implemented, the revolving fund model can be self-sustaining.
- The repayments can be utilized to finance additional projects.
- A revolving fund builds market capacity.
- There is no fiscal year limitation.
- Revolving funds might provide a solution for locations where there is an underdeveloped public/municipal credit market, when there is a credible and capable fund manager and the ability to enter into multi-year contracts.

Disadvantages

- Recovering operating costs in early years can be difficult.
- The repayment periods may be long (typically 5–8 years or even more).
- The Fund may vary from year to year, due to financial sources mobilized and the return of investments.

Case studies/suggested literature

- Innovative financing schemes, Lessons learnt from the Covenant of Mayors Community, 2019
- https://www.microfinancegateway.org/sites/default/files/mfg-en-paper-community-managed-revolving-fund-feb-2008_0.pdf

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TOOL 12: PRIVATE SECTOR LOAN

RETURN TO THE TREE

Finance source

External funding / Private sector sources

Definition

Commercial loans are lent by private banks and other financial institutions (e.g. insurance companies, pension funds). Per definition a loan is given in exchange for future repayment of the loan value amount along with interest or other finance charges. A loan may be for a specific, one-time amount or can be available as an open-ended line of credit up to a specified limit or ceiling amount.

Advantages

A great advantage of using this type of external funding is that it allows financing projects the local government could not fund on its own. Loans can also be used for making large capital equipment purchases to facilitate growth that the local government couldn't afford otherwise.

Disadvantages

To apply for loans creditworthiness is usually a pre-condition.

It should also not have been forgotten that lenders require a return on their investment. Interest adds to the overall cost of the investment and can make the external funding more of a financial burden than originally planned.

Case studies/suggested literature

- https://siepr.stanford.edu/research/publications/risky-business-bank-loans-local-governments
- Guidelines on Local Government Borrowing and Recent Developments in NALAS countries, 2011

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TOOL 13: CROWDFUNDING

RETURN TO THE TREE

Finance source

External funding/ Private sector sources

Definition

Crowdfunding is an alternative source of income for local governments. It is guided by the principle that citizens can voluntarily invest a certain financial amount into a proposed project.

Advantages

- Particularly suitable for funding small projects
- Fast way to raise finance with no upfront fees
- Good way to test the public's reaction to the project idea
- Also ideas that may not appeal to conventional investors can often get financed
- Investors can become loyal customers

Disadvantages

- Requires lot of work in building up trust and interest
- There is no guarantee to reach the required funding target
- Failed projects risk damage the reputation

Case studies/suggested literature

- http://climate-adapt.eea.europa.eu/metadata/case-studies/ghent-crowdfunding-platform-realising-climate-change-adaptation-through-urban-greening
- http://dx.doi.org/10.1787/b3f7a1c5-en
- http://pocacito.eu/sites/default/files/BikeLane_Denver.pdf
- www.bettervest.com
- https://thesunexchange.com/
- https://www.fedgroup.co.za/ventures/impact-farming
- http://www.m-akiba.go.ke/index.php
- https://www.fsdafrica.org/knowledge-hub/blog/the-story-of-kenyas-m-akiba-selling-treasury-bonds-via-mobile

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TOOL 14: MUNICIPAL (GREEN) BONDS

RETURN TO THE TREE

Finance source

External funding leveraging private sector sources

Definition

A green bond is a bond specifically earmarked to be used for climate and environmental projects. They are often verified by a third party, which certifies that the bond will fund projects that include benefits to the environment. (Green) bonds can be issued by development financial institutions (e.g. World Bank, European Investment Bank), commercial banks, state/municipalities or corporations (e.g. SNCF). Based on this, local governments have two options to benefit from the green bonds:

- Issuing own (green) bonds

The issuer of a municipal bond receives a cash purchase price at the time of issuance in exchange for a promise to repay the purchasing investors, or their transferees, (the bond holder) over time. Repayment periods can be as short as a few months (although this is very rare) to 20, 30, or 40 years, or even longer. The issuer typically uses proceeds from a bond sale to pay for capital projects or for other purposes it cannot or does not desire to pay for immediately with funds on hand.

- Align investment plans with other issuers

Advantages

- Green bonds can enhance an issuer's reputation - showcasing their commitment towards green growth and sustainable development. Governments may want to make a political statement and demonstrate their commitment to certain environmental (e.g. combating climate change) and/or sustainability objectives (e.g. stimulating green growth or shifting to a green economy).
- Green bonds provide issuers with improved access to a specific set of global investors who may have mandates to invest in green/sustainable ventures. Attracting new investors is often an important benefit of issuing a green bond and many green bonds issued to date report being oversubscribed.
- The issuance of green bonds can create new market demand - domestic bond issuances help strengthen and in some cases create domestic capital markets[1].

Disadvantages

- The necessary preparatory work (institutional set up, verification) takes time and costs money.
- Many times it is determined by national regulations if a local government can issue bonds or not.
- To make municipal bonds successful on the market, it needs a highly detailed, structured, skillful and diligent management process.
- (Green) bonds typically fund large-scale, capital-intensive (green) infrastructure projects such as energy efficiency projects, transit, or renewable power, among others, that can be repaid from steady, modest, long-term cash flows[2].

Case studies/suggested literature

- http://sustainia.me/resources/publications/Cities100_2015.pdf
- https://www.youtube.com/watch?v=_wPnciVnRwo
- https://www.youtube.com/watch?v=i3gIJrABLSc
- https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/
- https://www.greenbondpledge.com/files/files/Green-City-Playbook_2018.pdf
- Municipal Bonds for Infrastructure Development in South Africa, Dr Juergen Goebel, GIZ and SALGA, 2017
- http://www.capetown.gov.za/media-and-news/Green%20pays%20City
- https://www.esi-africa.com/event-news/interview-kevin-jacoby-green-bonds/
- http://www.waterafrica.co.za/index.php/features/water-usage/102-city-of-cape-town-green-bond)

1 https://www.globalgreenbondpartnership.org/
2 http://www.gogreenbonds.org/

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TOOL 15: BLENDED FINANCE

RETURN TO THE TREE

Finance source

External funding leveraging private and public sector sources

Definition

The term blended finance implies the mixing of both public and private funds through a common investment scheme or deal, with each party using their expertise in a complementary way. The concept and model was developed within the Redesigning Development Finance Initiative from the World Economic Forum, who defined it as "the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets." Blended finance is a structuring approach that allows organizations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or a blend of both).

The main investment barriers for private investors addressed by blended finance are (i) high perceived and real risk and (ii) poor returns for the risk relative to comparable investments[1].

Supporting mechanisms have been traditionally used by development funders in a Blended Finance package to attract and support private sector investors by managing risks and reducing transaction costs. These mechanisms can generally be classified as providing:

- Technical Assistance, or grant funds to supplement the capacity of investees and lower transaction costs.
- Risk Underwriting, to fully or partially protect the investor against risk through appropriate risk mitigation
- Market Incentives, guaranteed payments contingent on performance of future pricing and/or payment in exchange for upfront investment in new or distressed markets.

Advantages

Blended finance is a critical tool that can mitigate early-entrant costs or project risks, helping re-balance risk-reward profiles for pioneering investments and enabling them to happen[2].

Blended finance improves terms for borrowers by lengthening the time horizons for capital providers, avoiding the risks associated with short-term capital flows faced by recipients of capital in emerging and frontier markets[3].

Disadvantages

- blended finance is mostly available for higher-income countries with a strong enabling environment: stable and well-regulated financial markets
- more easily attracted to large projects, where it is typically brought in on the back of large public sector investments (or guarantees)[4]

Case studies/suggested literature

- Blending public and private funds for sustainable development, Richard Samans, World Economic Forum, 2016
- Blended Finance, University of Gallen, 2016

1 https://www.convergence.finance/blended-finance
2 https://www.ifc.org/wps/wcm/connect/CORP_EXT_Content/IFC_External_Corporate_Site/Solutions/Products+and+Services/Blended-Finance
3 Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders, OECD, 2015
4 OECD – GIZ Conference: Closing the gap for water in line with SDG ambitions: the role of blended finance, 4 -5 October 2018, Eschborn, Germany

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TOOL 16: RISK MITIGATION

RETURN TO THE TREE

Finance source

External future funding commitment leveraging private and public sector sources

Definition

The most commonly used risk mitigation mechanisms are guarantees (e.g., risk guarantees and credit guarantees) as well as risk insurance (e.g., political risk insurance). Guarantees and risk insurance products can cover the failure of the public sector party to meet specific obligations within a project. By mitigating critical government performance risks for private investors, risk mitigation products are useful tools to enhance the bankability of infrastructure projects[1].

Advantages

- Increased opportunities: through risk mitigation the local government can grasp opportunities in the market which were earlier not available to it.
- New partnerships: benefits from various partnership opportunities that otherwise would not be possible.

Disadvantages

- Strict assessment: benefitting from risk mitigation tools is preceded by a rigorous assessment of the applicant's creditworthiness and a financial analysis. Sometimes, this process becomes quite lengthy and complicated.
- Financial considerations: it is not suitable for loss-making businesses.

Case studies/suggested literature

- https://www.sida.se/contentassets/95cc74d7ae78433db642fbe82a552138/10201165_guarantee_portfolios_2017_webb.pdf
- Understanding the challenges for infrastructure finance, Torsten Ehlers, 2014

1 https://ppp.worldbank.org/public-private-partnership/financing/risk-mitigation-mechanisms-products/guarantee-and-risk-insurance-ifis/guarantee-and-risk-i

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TOOL 17: NATIONAL GRANTS AND SUBSIDIES

RETURN TO THE TREE

Finance source

External public sector sources

Definition

Grants are non-repayable funds disbursed by the government or international financing institutions. The eligibility criteria are always defined by the donors.

The types of national and subnational subsidies are very similar. Please refer to tools 2; 2.1 and 2.2.

Advantages

- The big advantage of grant finance is that it doesn't have to be paid back and usually there are no financing costs associated, unless the grant requires co-financing.
- National grants can be used in locations where there is no market capacity and limited creditworthiness.

Disadvantages

- Grants are in time limited and not always sustainable once the project ends.
- There are usually limited grant funds available which might result in partial funding.
- Grants are in many cases not local demand driven and local priorities have to be modified in order to adhere to grant requirements.

Case studies/suggested literature

- Tilman Buchholz, Federal Ministry for the Environment, Nature Conservation, Building and Nuclear Safety, EUKN Policy Lab for Spain, Madrid, 2017
- Guide to Municipal Finance, UN-HABITAT, 2009

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TOOL 18: INTERNATIONAL GRANTS AND SUBSIDIES

RETURN TO THE TREE

Finance source

External public sector sources

Definition

Grants are non-repayable funds disbursed by the government or international financing institutions. The eligibility criteria are always defined by the donors.

International subsidies are mostly used by the European Union, although it is important to note that subsidies are managed directly by EU national governments, not by the European Commission[1]. For the types of subsidies please refer to tools 2; 2.1 and 2.2.

Advantages

- The big advantage of grant finance is that it doesn't have to be paid back and usually there are no financing costs associated, unless the grant requires co-financing.

Disadvantages

- Grants are in time limited and not always sustainable once the project ends.
- There are usually limited grant funds available which might result in partial funding.
- Grants are in many cases not local demand driven and local priorities have to be modified in order to adhere to grant requirements.
- Grant opportunities are usually advertised through calls for proposals and it might be difficult to understand the financial architecture, gather information and find the most suitable grant for the project.
- The submission of a grant-request is time-consuming and might require external competence.

Case studies/suggested literature

- https://www.dw.com/en/e-u-farm-subsidies-a-billion-euro-business/av-49793666
- https://www.thegef.org/topics/gefsgp
- https://www.adaptation-fund.org/apply-funding/

1 https://ec.europa.eu/info/funding-tenders/how-eu-funding-works/types-funding_en#subsidies

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TOOL 18.1: UNFCCC CLIMATE FUNDS

RETURN TO THE TREE

Finance source

External public sector sources

Definition

The United Nations Framework Convention on climate change established a Financial Mechanism to provide funds to developing country Parties in implementing the Convention.

The operation of the Financial Mechanism entrusted to the Global Environment Facility (GEF) and the Green Climate Fund (GCF) as an operating entities.

In addition Parties have established four special funds: the Special Climate Change Fund (SCCF), the Least Developed Countries Fund (LDCF), both managed by the GEF, the GCF; and the Adaptation Fund (AF).

These multilateral climate funds use mainly grants and concessional loans.

Advantages

These funds aim to achieve a balance between adaptation and mitigation, taking into account country-driven strategies, and the priorities and needs of developing country Parties, especially least developed countries and small island developing States, considering the need for public and grant-based resources for adaptation.

Disadvantages

- These funds are not or rarely accessible directly for local governments, but through national governments or accredited entities.
- Associated with high administrative expensive.
- Complex and lengthy application processes.

Case studies/suggested literature

- https://unfccc.int/topics/climate-finance/the-big-picture/introduction-to-climate-finance
- https://www.thegef.org/
- https://www.thegpsc.org/
- https://www.greenclimate.fund/home
- https://www.adaptation-fund.org/
- https://climatefundsupdate.org/

TOOL 18.2: EU FUNDS

RETURN TO THE TREE

Finance source

External public sector sources

Definition

The EU and the European Commission provide support through a wide range of funding programmes, covering funding opportunities as well as advice on how to access funding and put it to use.

There are two major political commitments giving the frame and shaping the urban policy:

- The Urban Agenda for the EU was launched in May 2016 with the Pact of Amsterdam[1]. It represents a new multi-level working method promoting cooperation between Member States, cities, the European Commission and other stakeholders in order to stimulate growth, livability and innovation in the cities of Europe and to identify and successfully tackle social challenges.
- Furthermore, in the 2014-2020 programming period the urban dimension is also at the very heart of Regional Policy. At least 50% of the European Regional Development Fund (ERDF) resources for this period will be invested in urban areas and around 10 billion euros will be directly allocated to integrated strategies for sustainable urban development. Besides the Structural Funds there are also other programmes and initiatives focusing on urban development.

Advantages

The EU provides funding for a broad range of projects and programmes, covering different sectors, businesses. Projects of all sizes can benefit from EU funding, allowing them to implement and to develop new ideas. It can also facilitate collaboration and learning between partners throughout Europe and enable local governments to build an international profile.

Disadvantages

- Researching the various opportunities and navigating the EU funding system can be daunting.
- Application processes can be long and complicated.
- Most of the funds are time-limited.
- The submission of an application is time-consuming and might require external competence.

Case studies/suggested literature

- https://www.covenantofmayors.eu/support/funding
- https://europa.eu/european-union/about-eu/funding-grants_en
- https://www.wheel.ie/funding/guidance/european-funding/getting-started-eu-funding

1 https://ec.europa.eu/futurium/en/content/pact-amsterdam

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TOOL 18.3: MULTI– AND BILATERAL FINANCIAL INSTITUTIONS

RETURN TO THE TREE

Finance source

External international public sector sources

Definition

Multi- and bilateral financial institutions use the same instruments to channel funding as national financial institutions, including (concessional) loans, grants, equity and guarantees.

Bilateral channels are thought to be easily captured by vested interests and this desire for political gain is often claimed as characteristic of their assistance (Verdier, 2008). Multilateral agencies are assumed to possess a degree of autonomy from the states that control and fund them that prevents political capture[1].

Advantages

Multi-and bilateral finance can create new and strong partnerships.

Disadvantages

- Bilateral donor interests appear to skew the aid allocation process in favour of strategic and political considerations.
- Multilateral channels are more selective than bilateral ones.

Case studies/suggested literature

- https://www.ebrd.com/who-we-are/our-donors/bilateral-donors.html
- https://unfccc.int/topics/climate-finance/resources/multilateral-and-bilateral-funding-sources

1 Bilateral versus multilateral aid channels, Nilima Gulrajani, 2016

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TOOL 19: PUBLIC LOANS

RETURN TO THE TREE

Finance source

External national or international public sector sources

Definition

Per definition a loan is given in exchange for future repayment of the loan value amount along with interest or other finance charges. A loan may be for a specific, one-time amount or can be available as an open-ended line of credit up to a specified limit or ceiling amount.

Advantages

Public loans are important source of resources for a government to finance public spending and fill holes in the budget.

A great advantage of using this type of external funding is that it allows financing projects the local government could not fund on its own. Loans can also be used for making large capital equipment purchases to facilitate growth that the local government couldn't afford otherwise.

Disadvantages

To apply for loans creditworthiness is usually a pre-condition.

It should also not have been forgotten that lenders require a return on their investment. Interest adds to the overall cost of the investment and can make the external funding more of a financial burden than originally planned.

Case studies/suggested literature

- https://www.dmo.gov.uk/responsibilities/local-authority-lending-pwlb/about-pwlb/
- https://www.muenchen.de/rathaus/wirtschaft_en/business-development/finance-funding.html
- https://www.bmz.de/en/ministry/approaches/bilateral_development_cooperation/approaches/financial_cooperation/index.html
- https://dced.pa.gov/programs/local-government-capital-project-loan-program-lgcpl/
- https://www.eib.org/en/products/lending/loans/index.htm
- https://www.adb.org/site/public-sector-financing/financial-products

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CLIMATE FINANCE DECISION MAKING TREE

This climate finance decision-making tree guides local and regional governments through a series of questions that help them consider different financing tools. Each financing tool is described, including advantages, disadvantages and case study examples. Here is an overview of the decision-making tree and the financing tools available to local and regional governments.

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TOOL 19.1: GOVERNMENT LOAN

RETURN TO THE TREE

Finance source

External public sources

Definition

The government offers loan programs through different departments that support individuals, communities, and businesses according to their unique needs. These loans provide capital for those that might not qualify for a loan on the open market. Government loans differ from private loans (see tool 12) aiming for long-term benefits at the social and economic levels.

Advantages

Government loans are usually offered at discounted interest rates compared to those offered by private lenders.

Other benefits of government loans may include fixed and subsidized interest rates, no credit history checks, allowing deferred payment, flexible income-based repayment plans and there are no prepayment penalties.

Disadvantages

Because government loans often have more attractive terms than market-rate loans, demand for them can be high and selection criteria can be tough. The application process can also be time-consuming.

Case studies/suggested literature

- https://www.investopedia.com/articles/investing/100714/introduction-government-loans.asp
- https://www.dmo.gov.uk/responsibilities/local-authority-lending-pwlb/about-pwlb/
- https://www.muenchen.de/rathaus/wirtschaft_en/business-development/finance-funding.html
- https://www.bmz.de/en/ministry/approaches/bilateral_development_cooperation/approaches/financial_cooperation/index.html
- https://dced.pa.gov/programs/local-government-capital-project-loan-program-lgcpl/

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TOOL 19.2: INTERNATIONAL LOAN

RETURN TO THE TREE

Finance source

External / International public sources

Definition

International Financial Institutions (IFIs) are established by more than one country and subject to international law. Owners and shareholders are generally governments or other international institutions.

IFIs can refer to members of the World Bank Group such as International Finance Corporation (IFC); regional development banks such as Asian Development Bank (ADB) and European Bank for Reconstruction and Development (EBRD); and export credit agencies of individual country governments, such as US Export Import Bank (EXIM).

IFIs have a different mandate to commercial lenders. They take a long-term view with respect to an investment and have a stronger appetite for risk. They are prepared to finance projects which commercial lenders are not[1].

At the global level, loans provided by international financial institutions are important source of public financing particularly for developing countries.

Advantages

IFIs are important in project finance because they play a significant role in supporting large scale infrastructure projects in emerging markets. They can provide critical capital and catalyze the participation of other players.

IFI's provide a political risk umbrella for other lenders. Accordingly, it may give comfort to commercial lenders who invest alongside IFIs, that political channels exist whereby the IFI is able to speak directly to the Member Country should any unforeseen problems or difficulties arise during the life of the investment.

Disadvantages

IFIs often use their leverage over governments in developing countries to promote the interests of their major shareholders and don´t consider local priorities.

To access these loans is complex and lengthy and usually an agreement between the country and the bank has to be in place as a condition to access these funds.

Case studies/suggested literature

- https://www.eib.org/en/products/lending/loans/index.htm
- https://www.adb.org/site/public-sector-financing/financial-products
- http://documents.worldbank.org/curated/en/403951468180872451/pdf/Municipal-finances-a-handbook-for-local-governments.pdf

1 https://www.lavan.com.au/advice/banking_finance/the_importance_of_international_financial_institutions_in_emerging_market_p

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CLIMATE FINANCE DECISION-MAKING TREE

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The Global Platform for Sustainable Cities (GPSC), managed by the World Bank, is a comprehensive support mechanism to participating cities of the Sustainable Cities Integrated Approach Pilot (SC-IAP) program of GEF that aims to:

- Promote and advise on an improved approach and method to integrated urban planning and performance, to strategically guide the 28 participating cities in the SC-IAP;
- Capacitate and connect the participating and prospective cities on integrated sustainability planning by taking as starting points their concrete contexts, barriers and opportunities to achieve integration with a focus on urban infrastructure, policy, people and investments;
- Provide access to a wide range of existing tools and knowledge relevant to integrated urban planning and implementation that will support the cities to deliver effective integrated urban planning.

The GPSC is designed to support the participating cities of the SC-IAP to address the challenges and opportunities they face in their urban growth, development, and infrastructure and assist 'the change process' to a sustainable trajectory. The GPSC supports the cities to scale up their efforts conform to global standards, practices and knowledge and to improve their performances towards low carbon, resilient inclusive and sustainable development.

To succeed, these cities need local and regional government decision-makers and technical staff with diverse new skill sets that are interdisciplinary and able to function across sectors at the local and regional scales.

An **Urban Low Emissions Development Strategy (Urban LEDS)** defines a pathway to transition a city to a low emission, resilient, green, and inclusive urban economy, through its integration into existing city development plans and processes.

The Urban-LEDS project is addressing integrated low emission and climate resilient development in urban areas by offering guidance, tools, and technical assistance. Further, local governments are mobilized to commit to the Global Covenant of Mayors for Climate & Energy (GCoM), and guided in exploring access to financing. Experts are supporting multilevel governance discussions between all levels of government. The project provides an effective monitoring and reporting platform offering an integrated MRV (Measuring, Reporting, and Verifying) process, vital to tracking progress and accelerating climate action within cities on a country-by-country basis.

The project supports more than 60 cities in 8 countries: Brazil, India, Indonesia and South Africa (from Phase I) and countries added in Phase II: Bangladesh, Colombia, Lao PDR and Rwanda. In addition to these countries, 16 European cities act as source cities and support peer-to-peer exchange and cooperation.

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