# ANNEX B

# Operational Experience in Implementing the Policy Framework for Sustainable Cities

If cities are to improve the quality of life for their residents and for the nation as a whole, they must be *livable*. To achieve that broadly defined goal, they must also be *competitive*, *well governed and well managed*, and *bankable*. The strategy proposes an agenda for creating cities that meet these four important criteria. This annex describes the policies and institutional behaviors, both national and local, required to achieve each goal, and the activities and instruments with which the Bank currently supports them. It also reviews emerging challenges and areas in which the Bank's knowledge and intervention could be improved under a new Bankwide strategy. Some proposed indicators for measuring progress on each of these criteria are provided in attachment 2, and data for a few of these indicators are portrayed in Annex D.

## Making cities livable

Livability represents the valuation by households of an acceptable quality of life. The Bank's commitment to livable cities should be geared to ensuring the poor a healthful and dignified living standard that affords them the opportunity to improve their welfare through equitable access to the resources of society. Meeting this target would also go a long way toward enhancing the well-being of other groups.

For the purposes of the strategy, livability is defined as the absence of extremes of poverty or inequality; a healthful environment, with particular attention to the most dangerous urban threats to health and safety (such as air pollution from lead and particulates, waterborne diseases, traffic accidents, and disasters); a minimum degree of personal security, with low risk from crime and violence; inclusiveness of civil protections and opportunities for participation in the political process; and cultural and recreational amenities that feed the soul and inject life into the community. The livability of cities is essentially the "bottom line" for sustainable urban development.

### Reducing urban poverty—how the Bank can help

Concerted and well-coordinated efforts across national and local levels and across sectors are needed to ensure that programs promoting jobs, training, childcare, credit, and income support reach the urban poor, and that barriers to their access to housing, land, health care, education, safe transport, other infrastructure services, and cultural and recreational amenities are removed. Attention should also go to eliminating policies that penalize the informal sector—for example, by proscribing commercial and industrial activities in low-income residential areas—which have a particularly negative impact. Providing tenure security has multiple economic and social benefits for the urban poor, since it gives residents incentives to invest and gives them a stake in the formal urban society.

Multisectoral approaches to helping low-income urban populations. Apart from low-income housing projects and components for public works employment, the Bank's urban operations have traditionally taken a cross-sectoral approach to urban poverty. This approach is consistent with the comprehensive or integrated perspective that research increasingly suggests is most effective in understanding and meeting the needs of the poor.[13]

The main operational instrument has been integrated development projects for low-income neighborhoods, typically called slum upgrading, which the Bank started supporting in the mid-1970s to provide urban or periurban settlements with basic improvements in water, sanitation, transport (footpaths and access roads), lighting, drainage, solid waste collection, community social service facilities, and increased security of tenure (box B.1). Evaluation of most of these projects initiated in the 1970s and 1980s shows that they succeeded in demonstrating the effectiveness of low-cost improvements as an alternative to the slum clearance policies of governments at the time. The operations reached a large number of households (25,000 on average per project in the first decade of such lending), including the poorer segments of the population living in the settlement area. Slum upgrading generated high economic returns through increased land values and catalyzed private investment in housing that was several times greater than the public investment (Cohen 1983).[14] Secure tenure has been a particularly important outcome of these programs.[15] In addition to addressing sources of poverty and inequality and restoring community and personal pride, slum upgrading helps reduce environmental health risks for all city residents and is associated anecdotally with reduced violence.[16]

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[13] *For example, a recent poverty study in Peru found that the additional positive impact on per capita income of one new infrastructure service increases with the total number of services available to households (services counted in the study included sanitation, electricity, water, and telephone). Adding a fourth service has an additional impact about seven times greater than does linking a second service to households. Other studies of projects in Peru found that electrification and sanitation services together increase the returns to education significantly in rural and urban households alike.*

[14] *More recent evaluations of many of these projects by the Bank's Operations Evaluation Department and others are summarized in Kessides 1997.*

[15] *For example, a recent empirical study in urban communities in Indonesia found that a change in status from squatter to moderate tenure security increased the probability of subscribing to garbage collection by 32 percent; a change in status from squatter to high security raised the probability by 44 percent (Hoy and Jimenez 1997).*

[16] *Citation from El Mezquital community upgrading component of Guatemala Municipal Development Project. Other studies have found links between community-based neighborhood upgrading and reduced violence, in São Paulo State in Brazil and in Bangladesh. Social assessments in Jamaica found that residents of low-income neighborhoods credited public electrification with helping to reduce crime (Moser and Holland, 1995).*

**Box B.1 Enhancing the quality of life for the urban poor in Indonesia through the Kampung Improvement Program**

The classic example of slum upgrading remains the Kampung Improvement Program in Indonesia, a combined effort of the local and national government that extended improvements to some 50,000 hectares of unserved urban communities over 30 years and reached an estimated 15 million people. About a third of this coverage was achieved under four Bank-financed projects in 1975–88. The 1995 impact evaluation of the Bank-supported projects confirmed that they unleashed private investment in the settlements and that residents credited the program with enhancing the quality of their lives. Little evidence was found that the poorest residents were pushed out by gentrification, in part because the program was extended so widely to cover unserved parts of the cities. The evaluation estimated that the program investments yielded a minimum 12 percent rate of return even when their useful life was limited to five years because of rapid redevelopment of the areas.

Later Bank urban assistance to Indonesia has been directed to the many issues that the Kampung Improvement Program did not address, such as the need to broaden improvements to the urban environment, to reform utilities to ensure sustainable water and sanitation services, and to strengthen local government capacity and cost recovery (including through deeper community participation).

*Source:* World Bank 1998a.

Urban projects also include more proactive efforts to forestall the periurban sprawl that increases the costs of extending primary infrastructure networks. Rather than ineffective master planning, recent projects such as the Second Urban Development Project in Guinea have introduced simpler planning tools to help local officials monitor settlement trends and to set aside the basic rights of way needed for later development as demand warrants (Farvacque-Vitkovic and Godin 1998).

There is renewed demand for Bank assistance for slum upgrading. Lessons from the El Mezquital initiative in Guatemala City were instrumental in designing a slum upgrading project in fiscal 1999 for Caracas, Venezuela, which also builds on experience under an earlier low-income settlement project in that city. (box B.2)

What is different about the recent projects is that they tend to be community-initiated rather than government-initiated, and many involve the private for-profit sector. A good example of tripartite partnership involving private enterprises is the slum network initiative in Ahmedabad, India (box B.3). Two pilot Bank-funded projects planned for the cities of Tijuana and Ciudad Juárez in Mexico have engaged the *maquila* industries as partners in financing services to low-income communities.

Market-based financial institutions can also play a major role in neighborhood improvement. Caja Popular Mexicana give loans for water and roads to low-income communites; like Génesis Empresarial in Guatemala, which has worked with over 200 rural communities providing market-based loans and technical assistance

**Box B.2 Scaling up slum upgrading from a pilot to a citywide program in Guatemala City**

During a lull in the Guatemalan civil war in 1994 the Bank revised its moribund Municipal Development Project to direct support to a vibrant upgrading initiative in the El Mezquital area of Guatemala City that was fully designed and executed by community members. The loan built upon UNICEF technical support to lift the activities from a pilot stage to a full-scale project for El Mezquital and three other communities, benefiting almost 40,000 low-income residents through a wide range of basic services (water, sanitation, sewage treatment, drainage, electricity, street paving, public lighting, and other urban improvements). Costs were kept to only $1,300 per family, and most are being recovered from the households.

Perhaps the most outstanding achievement of the project was to encourage participation by final beneficiaries in planning, executing, and financing—some 1,200 residents were active members of the community-based organizations that represented the community in negotiations with city officials and handled financial transactions for the project. The organizations developed under the first project are operating and maintaining the new systems, recovering investment costs, preparing and executing new operations, and even assisting other communities.

The success of the El Mezquital initiative is the driving force behind a much larger follow-up project now in advanced preparation for Bank support—a project that would extend the activities into a much larger program for Guatemala City. Lessons from El Mezquital are being widely disseminated by the Bank and other agencies to many interested governments and other observers in Latin America and elsewhere.

*Source:* Peter Loach, Latin American and Caribbean Region, and the World Bank 1998c.

for investments such as rural water and electrification, both institutions have a repayment rate of above 96 percent. Sewa Bank in India also provides market-based loans to help low-income households hook up with utilities. There are many more financial institutions doing home improvement loans to low-income households and operating at scale (e.g., Grameen Bank [Bangladesh], Financiera Calpia [El Salvador], BancoSol [Bolivia], to name a few).

Undertaking community-based slum upgrading, relocating shop owners and residents from rights of way to permit urban road construction or other redevelopment, and removing encroaching settlements from disaster-prone areas or railway beds require a policy on involuntary resettlement that recognizes the practical realities of urban land markets and stakeholder politics. The experience with involuntary resettlement in connection with recent urban projects shows that it is possible to fully meet the spirit of the current Operations Directive on Involuntary Resettlement (OD 4.30) without stymieing urban development efforts, but that flexibility is needed to take account of different types of resettlement issues and appropriate variations in compensation in an urban context.

**Box B.3 Private enterprise helps to improve slums in India**

Private enterprise has helped improve slums in Ahmedabad, India, where the Ahmedabad slum networking initiative is providing all basic physical and social infrastructure services to 200 slums of the city, reaching 40,000 low-income families over five years. The costs of upgrading are shared equally among corporate, community, and city organizations, with matching loans provided by a local bank. Residents in the area paid their one-third share before investments were made. The executing agency for the program is Arvind Mills, Ltd., a major employer in the city, which formed a trust (SHARDA—Strategic Help Alliance for Relief to Distressed Areas) to implement the project.

*Source:* Shri B.K. Sinha, Municipal Commissioner, Ahmedabad.

Another type of urban project uses programmatic lending arrangements (lines of credit) to enable communities and local governments to request funding from a menu of potential investments in communal public goods. The AGETIP projects in a dozen Sub-Saharan African countries are of this type; these projects are similar in many respects to rural social investment funds.[17] Programmatic funding arrangements contribute most to broader urban development objectives when conceived as part of a strategy to build the institutional capacity and financial responsibility of municipalities through appropriate use of revenues and credits (see the discussion of municipal development funds below). The recently completed Urban Rehabilitation and Management Project in Benin in fiscal 1992 was unusual among the AGETIP projects in its emphasis on developing basic public works contracting as an instrument within a broader process of urban investment planning and management by municipalities.

Sector-specific approaches to serving the urban poor. While there is a strong rationale for providing a package of coordinated improvements in specific neighborhoods that are generally deprived, multisectoral urban projects often are not enough to address the deep policy and institutional problems in urban water and sanitation or urban transport. Extending services to the sprawling periurban areas and illegal settlements requires flexible and creative approaches, since conventional systems, especially for water and sanitation, can be prohibitively expensive and technically unsuited. Municipalities and utilities need to offer the communities a choice among service levels at different prices; facilitate partnerships with the communities and informal providers to devise services that meet demand and affordability criteria; and ensure that regulations or concession contracts do not dis-

[17] *AGETIP (Agences d'Execution de Travaux d'Intérêt Public) nonprofit agencies for delegated contract management have been created or supported by some 16 Bank-financed urban public works in more than a dozen francophone countries of Sub-Saharan Africa. The projects' main objectives are to generate employment and create public works infrastructure while introducing efficient project management practices, through delegated contracts issued and supervised by the agency on behalf of municipalities. See Frigenti and others 1998.*

courage service extension by imposing inappropriate standards, monopolies, or unremunerative service obligations.

The Bank's sector-specific operations in urban water and sanitation and in urban transport have given more explicit attention to the needs of low-income users in recent years. New ways of enlisting the private sector in this effort for water and sanitation are being explored through the Business Partnership for Development Program and through collaborative efforts between the water sector and private sector development groups to examine the issues associated with designing private concession contracts, regulatory frameworks, and tariff schemes to remove obstacles to serving poor customers. Bank-supported urban transport projects are increasingly incorporating a user perspective. Women are surveyed to determine their transport needs, and recent urban projects have included nonmotorized transport and pedestrian-oriented facilities, such as sidewalks. Traffic safety issues, which affect the poor and children in particular, are also being mainstreamed in transport sector work and operations.

Strengthening the attack on urban poverty. The Bank's urban work started from a commitment to confront the physical manifestations of urban poverty, and there is ample evidence that upgrading activities, when combined with tenure security, have broader benefits in helping to build communities and integrate marginal populations into the life of the city. By providing local public goods and catalyzing private savings and investment in housing and workplaces within the community, upgrading also facilitates income generation through the locally based service, production and trading activities (including renting-out of extra rooms) that are often the main livelihoods of the urban poor.

But the scale of urban poverty requires mobilizing other forces—including by the Development Economics (DEC) vice presidency and the Poverty Reduction and Economic Management Network (PREM), poverty analysis by DEC and PREM, social analysis by the Environmentally and Socially Sustainable Development network (ESSD), and the human resources perspectives of the Human Development Network—for a more concerted Bankwide attack on urban poverty. This effort needs to address the full spectrum of national and local policies, taking account of spatial and dynamic characteristics of poverty (including rural-urban links) and both income and nonincome dimensions. For example, the combined impact of concurrent tariff reforms in several infrastructure services on urban population groups needs to be viewed comprehensively, such as in city strategies or urban poverty assessments, as this issue is not covered by work on the separate sectors. Timely research and evaluation of past operational experience is needed to understand the nature and life cycles of urban poverty and the relative impacts of different interventions under different circumstances. Proposals for new research on several of these topics are well advanced under the Bank's Urban Partnership (see chapter 4) and in collaboration with PREM.

Many thorny social problems are emerging that may not be amenable to conventional urban lending interventions, such as poverty among the educated and the elderly, problems of youth and street children, urban pathologies such as drug use, and gangs, and domestic violence linked in part with poverty. The Bank could provide indirect support by facilitating research, knowledge exchange, and external partnerships.[18] The UNCHS is proposing to take the lead in international advocacy of tenure security. International networks of practitioners and nongovernmental organizations are also a major resource in urban poverty work. To promote and facilitate the scaling up of slum improvement and sustainable delivery of basic services, the Urban Thematic Group on Service Delivery to the Poor is supporting a network on urban upgrading made up of about 100 individuals, specialists, and organizations in Latin America. The Bank is facilitating the group's transformation into a knowledge-based network that will also provide training. Similar organizations are being formed in Asia and Africa, which the LAC Network will support.

#### Protecting the urban environment—how the Bank can help

Besides removing public health threats in slum neighborhoods, improving livability of the broader urban area requires protecting land, air, and water across a city and across jurisdictions. Top priority should normally be given to the near-term environmental threats to human health, notably from automobile and street-level emissions of lead and fine particulates and from inadequate water supply and sanitation. Safety risks from traffic accidents and measures to prevent or mitigate losses from potential industrial or climatic disasters also require attention. And efforts must be made to protect the cultural assets of cities, such as historical neighborhoods, deteriorating as a result of pollution or population pressure, and the encroachment that is destroying parks and open spaces.

Traditional approach to the problems. In the past the Bank's response to urban environmental challenges has been largely through "stand-alone" projects in water, sanitation, urban transport, and industrial pollution control. These interventions have often focused on physical targets (volume of waste treated) or quantitative pollution reduction (reduction of pollution loads from specific sources). But they have serious limitations in addressing the most critical environmental problems and achieving measurable environmental improvements. For example, the São Paolo Industrial Pollution Control Project significantly reduced particulate emissions from industrial sources, but because the main pollution sources were beyond the scope of the project, the city's ambient dust levels did not improve. Water and sanitation projects have rarely attempted to set priorities or to base their interventions on the most cost-effective approaches. Subsidies for industrial pollution control have not been very successful in promoting cost-effective and sustainable improvements in environmental performance.

Unlike operations directed to water and air pollution, solid and hazardous waste management has generally been part of broader urban development projects. Solid waste collection can account for a large share of municipal recurrent budgets,

[18] *For example, the Urban Partnership received an Innovation Marketplace Grant for a Street Children Initiative involving nongovernmental organizations and private foundations involvement in fiscal 1998–99.*

yet cities typically collect only about half the waste, and disposal methods are environmentally unsound. The municipal solid waste components of urban projects have sought to help local officials and stakeholder groups develop improved waste management systems, involving private contractors and communities. The Salvador Metropolitan Development Project in Brazil (closed in fiscal 1997) achieved substantial institutional development through its solid waste component, which dramatically raised rates of collection and safe disposal, introduced cost recovery, and put in place a metropolitanwide solid waste management system that garnered the project Brazil's highest environmental award (World Bank 1998d). Solid waste management has been the main activity in which private sector participation has been pursued through the urban portfolio. The Second Urban Development Project in Guinea, for example, introduced an innovative public-private partnership for collection and transfer.

Evolution of the Bank's approach to the urban environment. There is an increasing recognition that stand-alone interventions are most effective when guided by a consistent environmental policy framework that focuses on identifying the most critical environmental problems and their sources, determining cost-effective interventions based on alternatives across sectors, and introducing appropriate policy tools and mechanisms to implement the necessary measures. Such an approach requires methodologies and tools (for example, comparative risk assessment) to improve understanding of the links between economic development, land use, environmental impacts, and social implications. It also requires mechanisms for consensus building and for mainstreaming environmental priorities into policies and actions within the respective sectors or subsectors (water and sanitation, transport, industry, solid waste) and the city's political decisionmaking processes.

The Bank's main lines of environmental assistance to countries in the framework of national environmental action programs, environmental strategies, and institution building projects have rarely targeted urban environmental issues in a comprehensive way. Yet the urban environmental agenda needs to be seen as a central problem of urban management that is inherently cross-sectoral and united by a spatial perspective. For a more coherent focus on urban issues, the Bank's traditional environmental work needs to benefit from closer collaboration between environmental and urban staff and become adapted to:

- *Working with the most appropriate level of government.* Increasingly, capacity building and technical assistance should focus on the lower levels of government, although many environmental issues cut across jurisdictions and need to be addressed at the metropolitan, provincial, country, or even international level. The Bank is well positioned to foster dialogue and cooperation at all these levels.
- *Finding mechanisms to harness private initiative and capital for lasting environmental improvements.* The Bank can contribute to the dialogue among private investors, infrastructure regulators, and urban managers to create consistent and sustainable incentives that promote both good business and the public interest (box B.4).

**Box B.4 Taking a strategic approach to the urban environment**

The Bank has participated in such collaborative efforts as the Metropolitan Environmental Improvement Program (MEIP) and the UNCHS Sustainable Cities Program, which focus on setting environmental strategies and action plans in the urban context. Experience shows that these strategies are most effective when a local champion or an acute issue captures interest, stakeholders participate in all phases of the exercise, limited priorities are identified that can generate concrete results, and funding is available to ensure follow-up. Subsequent Bank projects have been identified from the MEIP exercises in Colombo, Sri Lanka, and Mumbai (Bombay), India.

The Bank and other donors also are supporting participatory strategic work under MELISSA (Managing the Environment Locally in Sub-Saharan Africa), which helps local governments develop local environmental action plans and share knowledge and capacity building activities.

*Source:* Carl Bartone, Urban Development Division; Utpal Mukhopadhyay, South Asia Environment Unit.

The Bank's emergency assistance in response to urban disasters also needs to be mainstreamed and to be made proactive through disaster mitigation and prevention. This is being done by the new Disaster Management Thematic Group in the Urban Partnership, which received a fiscal 1998 Innovation Marketplace grant to set up the Market Incentives for Mitigation Investments (MIMI) facility with IFC and private sector participation. Cultural heritage activities have long been a component of urban lending, particularly as part of housing and land redevelopment, such as in the *medina* restoration component of an urban project in Tunis, Tunisia. The recently approved Bali Urban Infrastructure Project fiscal 1997 illustrates how community cultural identity and conservation can become a focal point for an integrated urban development effort.

## Making cities competitive

The Bank's 1991 urban policy paper emphasized the importance of cities serving as platforms for productive businesses and households, an outcome that requires creating an enabling environment for the urban economy. The relevant spatial unit for this economy is not an administrative jurisdiction such as a municipality. Instead, it is a self-defined economic area linked by a shared labor market and common infrastructure network—what might be called a "commutershed," the unit that represents a particular local and subregional economy in the minds of its participants. Policies that permit the participants in this economy to be productive also make them *competitive* in a world of liberalized markets. Increasing the competitiveness of cities increases the competitiveness of the country as long as residents and firms pay the full scarcity value of the resources and services they use.

The productivity of cities derives from economies of urban scale and agglomeration as well as from natural assets, such as universities, trade corridors, and historical or cultural roots, and proximity to mineral resources. Cities can enhance their productivity—or competitiveness—by developing policies and institutional frameworks that reinforce these sources of advantage and prevent diseconomies of agglomeration. Cities therefore need efficient factor markets and infrastructure as well as a supportive, predictable climate for business. Market failures or government failures affecting the local economy can be sufficient to deter investors, dampen productivity, and drive firms into the informal sector.

In today's global arena low costs of doing businesses are not sufficient to be competitive. Cities must also offer high-quality services and workers who can meet the demands of the information age. The real test of competitiveness is sustained growth over time and in the face of shifts in the internal and external environment, such as major market adjustments for certain industries. Cities able to adapt to changes in markets or in their natural asset base also provide an environment in which households can achieve their economic potential and weather shocks—by facilitating flexible labor markets, good education and training, and widely available market information.

Facing a competitive global and national economy, local governments increasingly seek to become more proactive to enhance growth. But local economic development strategies centered on luring industries with tax breaks and other incentives often weaken the city's finances without producing net private investment; at best, they prompt a transfer of firms from another region. Studies of industrial location decisions show that firms are influenced more by elements affecting major labor and transport costs and the overall tax structure than by special tax incentives (Bradbury, Kodrzycki, and Tannenwald 1997). A more effective and sustainable program for local economic development would consider the totality of a city or subregion's assets and bottlenecks not only from the perspective of certain prospective investors but also for existing employers including the small-scale and informal sector. It would also take into account the impacts on different groups (such as the potential for sharing the benefits of growth with the poor and unemployed) and the role of nontraded as well as traded sectors in the local economy.

Local strategic planning aims to help the city identify market signals and its capacity to respond. This approach includes:

- Description and analysis of what is happening in the local economy and surrounding markets
- Participation by all the city stakeholders—private firms, workers, officials, financiers, community groups, infrastructure providers, universities, and research institutes—in defining how they want the city to evolve, what bottlenecks and requirements need to be addressed, and what they are prepared to contribute to the process
- Formation of active partnerships as commitments to implementing the strategy.

Such participatory economic development strategies have been more successful than ad hoc investment incentive schemes in building on the existing advantages of a city and its environs—for example, as a center for transport, tourism, or financial services—and in enlarging its market "niche" by creating stronger links to supportive activities. These strategies can also help a city acquire new economic roles when its traditional lead industries or markets are in decline—as they have in Glasgow, for example. Barcelona offers a prime example of strategic development planning: it used the preparation for the 1992 Olympics as an impetus for actions to strengthen its regional economic position in southern Europe. Other cities, including Fortaleza, Brazil, have studied the Barcelona experience in undertaking their own strategic exercises.

#### How the Bank has helped foster competitiveness

Promoting efficient development of urban housing, land markets, and infrastructure, through both national and local policy and institutional reforms, has been the central policy agenda of the Bank's urban development assistance program. By focusing on these major sources of urban productivity, as well as on the quality of municipal taxation, regulation, and administration more generally, the program has contributed to a positive climate for urban business.

Work on housing has had macroeconomic and microeconomic benefits in many countries where the Bank has sustained an extensive dialogue (box B.5). In China, for example, policies piloted under the Enterprise Housing and Social Security Reform Project fiscal 1995 have been endorsed by the Chinese government as part of a strategy of transition from socialist welfare housing to a market-based system. The Bank's housing program in Ghana helped avoid decapitalization of the national social security fund. Sectoral dialogue in Chile contributed to measures to

**Box B.5 Reforming national housing policies and institutions in Mexico**

In Mexico, a series of four housing operations approved between 1986 and 92, totaling over US$1 billion, spurred commercial banks to lend to home buyers and, even more to low-income households. The projects brought about deregulation in the housing sector leading to savings in housing costs, dismantling of inefficient state housing agencies, and restructuring of housing subsidies. The operations introduced clients' participation in the design and selection of home types and locations, previously unheard of in low-income housing in the country, and put commercial builders in touch with a new low-income clientele.

*Source:* World Bank, Operations Evaluation Department, evaluation reports pertaining to Housing Development Project (FY86), Housing Finance Project (FY88), Low-Income Housing II (FY90), relating housing components of Mexico City Earthquake Rehabilitation and Reconstruction Project (FY86), and Housing Market Development (FY92, ongoing).

**Box B.6 Promoting private real estate market development in Mali**

The Second Urban Project in Mali (closed in FY94) supported the creation of a privately managed agency to auction large tracts of formerly public land for sale as individual plots with secured titles. The auctioning created an efficient and transparent process, which by its large scale avoided speculation, recovered full costs, and delivered profit for the city and the central government. Under the FY97 follow-up project, the agency is being transformed into a land developer of future commercial and residential plots, also to be auctioned.

*Source:* Abdelghani Inal, Africa Region Transport group; implementation completion report on Mali Second Urban Project; and Farvacque-Vitkovic and Godin 1998.

separate housing subsidies from finance, which helped with concurrent financial sector and pension reforms. The Ghana Home Finance Company, one of the very few primarily private and self-sustaining housing finance institutions in Sub-Saharan Africa, and India's Housing Development Finance Corporation, which has established one of India's first private commercial banks as a subsidiary, were both supported in their early stages by Bank urban operations.

Assistance to reform in the housing sector has been evolving into a wider focus on the development of land and real estate markets, particularly in Europe and Central Asia and in some African countries (box B.6). The FY95 housing loan to Russia, based on extensive prior sector work,[19] has led to economic reforms to facilitate land development, including passage of a federal law on title registration and a presidential decree on the use of auction procedures in disposal of municipally owned land. Based on the project experience, titling and registration systems are being extended to a larger number of cities than originally participated in the project, and comprehensive regulatory action plans are under preparation in some of them. More recently, projects in Moldova and Albania (FY98) are supporting reforms of property rights and land registration affecting both urban and rural beneficiaries.

Economic infrastructure financed under the Urban Development operations is normally limited to local and communal public goods (e.g., urban streets, sidewalks, drainage, public lighting) and solid waste management. The larger network-based infrastructure and major policy or institutional reforms in water and sanitation, urban transport, power, and telecommunications are covered by separate projects in those sectors, but such activities are critical to urban development as well. Work under the specific infrastructure sectors and the private sector development business of the Bank, and advice and financing by the IFC, supports infrastructure that happens to be urban. But this work does not normally deal with municipalities as regulators nor with the impacts of infrastructure activities on urban spatial development, land markets, or municipal finances.

[19] *Notably including the sector study of USSR Housing Reform by Bertrand Renaud and others 1993; and Bertaud and Renaud, 1997.*

**Emerging challenges and areas for a strengthened response**

The Bank's Urban Development program supports the basic conditions for competitive cities, but these efforts could be enhanced and complemented through more collaboration with other parts of the Bank Group. Macroeconomic and country competitiveness analysis by PREM, and structural adjustment operations to implement the resulting recommendations, need to take account of the related issues at the level of local government and the urban economy. Recent work on real estate market development, for example, has benefited from the creation of a cross-network thematic group (the Land and real estate initiative, or LARI) involving staff from the Transportation, Water, and Urban Development Department's Urban Development anchor unit (TWURD), the Bank's Financial Sector Development Department (FSD), Private Sector Development Department (PSD), and Rural Development Department, which received a recent Innovation Marketplace grant in FY98. Similarly, assessments of the local business environment and of infrastructure investment or reform proposals affecting urban areas would benefit from partnering expertise in the Finance, Private Sector, and Infrastructure network (FPSI) with the urban staff's knowledge of municipal management and finance issues and land market development in cities.

The proactive approaches to city and subnational regional development are where the Bank has been relatively little engaged. With rare exceptions in recent years (although more common in the first decade of the Bank's Urban Development work), the Bank has not taken a citywide approach to urban analysis, looking at the workings of a city within its subregion as an integrated socioeconomic unit rather than as a collection of subsectors or of project areas. One factor deterring a citywide approach is the frequent absence of representative agencies that have broad jurisdictional mandates (such as an authoritative metropolitan-wide agency). Nevertheless, in the last year, Bank urban staff have worked with coalitions of local authorities and counterparts in Vietnam (box B.7), and in the West Bank-Gaza, Ukraine, Thailand, and South Africa (box B.8) to respond to interest in defining economic development strategies for cities or subregions.

The strong expressed demand by local governments shows the evident need for the Bank's urban staff to facilitate and contribute to participatory city studies and city strategies to help overcome shortcomings in city data availability, provide analytical support, and bring together public and private stakeholders. This effort should also draw in macroeconomists in PREM and DEC and the Private Sector Development's Business Environment unit (which is a partner in the West Bank-Gaza strategy work). And it requires working with external partners building analytical tools and capacities to support city studies and city development strategies, such as the Sustainable Cities Program of the UNCHS- and UNDP-supported Urban Management Program (UMP), UNCHS' Urban Indicators Program, and the OECD/Club du Sahel's ECOLOC (Local Economies) program for subnational regional economic analysis in francophone Africa (box B.9).

**Box B.7 Bringing a development vision into focus—city strategy formulation in Haiphong, Vietnam**

In late FY98, the Bank responded to a request from the government of Vietnam and local authorities of the city of Haiphong to provide technical inputs to, and facilitate a process of, defining an economic development strategy for the city. The work, which has extended through separate stages of discussion and analysis over several months, has helped provide an analytical basis for steering economic growth and infrastructure services for Haiphong, linking this growth to the surrounding region, and tying urban growth issues to the problem of poverty reduction in similar regions around the country. The advice provided by the Bank in the first stage identifies the most important areas of need to support a growth strategy in Haiphong, and suggests alternative options in the areas of government and management. The purpose of this work and the options presented are in keeping with *Doi Moi* reforms applied at the local level, aimed at increased efficiency in collective decisions, spending, and management.

The essential message from this activity is that the city is lagging behind a rapidly evolving economic transformation. The initial report recommends a "small bricks" strategy focused on small scale improvements in neighborhoods, by which both governance and physical improvements can be achieved. A city development strategy for Haiphong begins with an understanding of its rapidly changing productive structure—one that is moving from hard industries to labor-intensive, light manufacturing exports. The most important finding of this report is that Haiphong's future lies as much in promoting light manufacturing exports and a stronger service base, as in promoting an export processing zone and industrial parks (the initial interest of the city authorities). Policy should therefore support the creation of jobs in labor-intensive export of shoes and garments and in the development of "softer" services to support future growth. At the same time, environment and governance are inextricably linked to successful investments, and measures need to be taken on both these fronts. A key strategy for all these objectives is for the city to become more actively involved directly at the neighborhood level, where the public infrastructure is undercapitalized and where the city has already demonstrated excellent results in service delivery (for instance, in improving water supply).

The analysis in this first stage concludes that the city has ample scope to broaden its development strategy to include components beyond, perhaps even more important than, the special economic zone. Further, the city has the financial and revenue base to greatly increase its capital investment to support new components, but it should weigh tradeoffs in spending on a few large infrastructural investments in contrast to many smaller ones, like streets, drainage, and other neighborhood improvements.

*Source:* Campbell, Global Urban Partnership, forthcoming.

## Making cities well governed and managed

Good city governance and management is essential for competitiveness and livability, especially if the urban area is growing rapidly. This third dimension of sustainable cities is defined here in terms of accountability in the exercise of local au-

**Box B.8 Johannesburg and the World Bank: A city-level comprehensive development framework**

The city of Johannesburg is in the process of restructuring itself as a metropolitan government. Labeled iGoli 2002, the plan includes fundamental changes in the overall governance structure of the city and involves a radical restructuring of the fiscal, institutional, and regulatory framework for the delivery of municipal services. In addition, the city is undertaking bold reforms in the areas of local economic development and the establishment of metropolitan health and policing districts. Underpinning each of these areas is a plan to address the problem of urban poverty on a sustainable basis. The city has asked the Bank to provide a comprehensive package of technical assistance in support of iGoli 2002 and assist in donor coordination. The engagement with Johannesburg raises the possibility of implementing the approach of a comprehensive development framework at the city level—an issue that is pertinent in an era of decentralization and urbanization. Furthermore, the engagement with Johannesburg draws solely on the Bank's ability to coordinate the international experience of urban development. No lending relationship is expected. The engagement will test the limits and possibilities of a pure knowledge bank as the basis for a city-level CDF.

*Source:* Junaid Kamal Ahmad, Resident Mission South Africa.

thority, and integrity and transparency in the use of public funds, and the knowledge and capacity required to execute local government responsibilities in response to the demands of the constituency. The trend toward democratization is an important force in strengthening urban governance by making local offices contestable.

#### Requirements for good governance and management—how the Bank can help

Establishing good urban governance lays a foundation for better urban management. As a first prerequisite, the national framework of intergovernmental relations, which determines the municipality's incentives and accountability, should be clear and predictable. There is no universally accepted assignment of responsibilities for service provision, expenditure, and revenues among levels of government, however. The Bank's urban program has made intergovernmental frameworks a key part of the policy dialogue, especially in recent years as decentralization remaps relationships among cities, provinces, and the center; this work needs to be reinforced through close coordination with the macroeconomic and public finance dialogue with the country. National intergovernmental policy frameworks need to take account of the capacity and experience of local governments in different countries—in the Europe and Central Asia region, for example, local governments were effectively stripped of any significant role during the socialist era. Tenuous political relationships across levels of government can complicate efforts to formalize rational center-local sharing of powers, but also underscore the importance of doing so.

**Box B.9 Accounting for the local economy in West Africa**

The OECD/Club du Sahel's ECOLOC program has devised a simple economic accounting methodology for subregions in West Africa and has worked with partners in these local economies (governmental and nongovernmental) to analyze the region's strengths and bottlenecks. The approach, applied initially in Senegal, Mali, and Côte d'Ivoire using readily available local data, permits analysis of the linkages between the main economic activities of the subregions and both domestic and international markets.

Six conclusions emerged from the first three case studies:

- The modern sector firms in these subregional economies are very dependent on the broader national and international markets.
- The informal sector plays the major role in the local economy, mainly to satisfy immediate consumer needs, and is the most heavily taxed.
- The small and medium-size enterprise sector is least developed and is poorly linked to agriculture, both providing inputs and taking outputs. More generally, urban enterprises are poorly attuned to the demands of the hinterland, losing market opportunities for agriculture and agroindustry .
- The state dominates the economy in all the subregions.
- Local taxation captures at best 0.5 percent of local domestic product, indicating that the city administration does not function at the service of the local economy.
- The local domestic product would readily support a tripling of local fiscal revenues to improve public services and investments.

*Source:* Club du Sahel Secretariat 1997.

Recent urban development projects in Mali, Mauritania, and Senegal incorporate explicit "city contracts" between the local governments and central government to define rights and responsibilities and give practical meaning to decentralization goals. In Latvia and Georgia sector work for recent Bank municipal development projects is helping the national government specify a rational allocation of responsibilities for service provision in each sector, and the resulting revenue and expenditure assignments, for cities and administrative units across a range of sizes. Technical assistance to South Africa provided timely and pertinent advice on wide-ranging urban management and finance issues even though the client did not seek a lending operation (box B.10).

A good incentive system for municipal governance also requires a rational distribution of relative roles and responsibilities between the local government and the private sector—both nonprofit and for profit. Participation of communities and entrepreneurs also mobilizes ideas, skills, and resources for better management. The Bank's urban development work has traditionally empha-

**Box B.10 Providing timely advice on urban management and finance after apartheid in South Africa**

In South Africa the Bank's technical assistance played a valued role in brokering national debates on amalgamating racially separated municipalities into more unified city structures. In Cape Town, for example, this work outlined the economic, institutional, and fiscal options for creating a two-tier metropolitan government and mechanisms for delivering municipal services, contributing to an emerging consensus about the city's restructuring.

The Bank also advised the South Africans on the design and implementation of reform in the system of fiscal grants from central to local governments. The existing, ad hoc arrangements were based on racial objectives and created perverse incentives that led to subnational budget deficits. The new system is based on predictable criteria, focusing on poverty indicators and fiscal capacity measures and designed to respect macroeconomic constraints.

This advisory work in South Africa was unusual in its duration as technical assistance funded by the Bank's sector work budget without an active lending program. An independent evaluation of the advisory work found that the clients strongly appreciated its style and content, perceiving it as very timely and relevant to their needs.

*Source:* Junaid Kamal Ahmad, Resident Mission, South Africa, and James F. Hicks, Africa Region 1 Urban group.

sized community and NGO involvement in preparing and implementing specific projects. The Bank has promoted commercialization, competition, and private sector participation in urban services mainly in stand-alone operations—for water and sanitation (in particular, through leases and concessions), roads (toll concessions for bridges and urban motorways, and contracting out of maintenance), and urban transport (bus and rail concessions). Municipal solid waste management under urban projects has been contracted out at the collection stage and through build-operate-transfer arrangements for disposal facilities. Private sector practices of contract management for small-scale municipal works have been promulgated through AGETIP-type agencies, which are beginning to face competition for this role under more recent projects (such as in Senegal). But even where private operators or investors *produce or deliver* essential urban services, the local government remains responsible for *provision*—ensuring the overall quality and availability of the services by setting the conditions for private operation, and through involvement in planning, regulating, and financing as needed.

As another approach to improving governance and management, urban development projects have promoted and disseminated experiences with public budgeting processes and "scorecarding" the quality of public services. Urban projects also provide local governments with training, information systems, and tools for management, such as land and housing market audits, simple cadastres, rapid infrastructure assessments, and financial planning and management methods. The World Bank Institute has been providing "integrity training" to municipalities and is preparing a core urban management course. Urban staff should explore further collaboration with the Public Sector Management Group on applying lessons from national civil service reform and anticorruption activities to the municipal context (box B.11).

#### Emerging challenges and areas for a strengthened response

An increasingly important issue for the Bank is how to foster good governance and management practices among a much larger number of local governments than can be reached by the Bank's urban development or related projects. Working with municipal associations, including both the well-established international professional groups of city managers and newer national or subregional associations, is an important means of "wholesaling" training, technical assistance, and knowledge sharing in ways that are efficient and relevant to the Bank's clients.

The World Bank Institute has been nurturing regional and subregional intermediary associations as channels for training and technical assistance activities—such as the Municipal Development Program in Sub-Saharan Africa and the Latin American Municipal Capacity Building NGO, SACDEL, which has several chapters in Latin American countries. These and similar networks have been evolving into self-supported NGOs for "South-South" sharing of skills and best practices. The Municipal Development Program, for example, though established in 1991 at the initiative of the World Bank Institute and supported by several donors, has become increasingly independent in its planning, execution, and financing. Under this program Africans provide technical assistance, consulting, training, and policy analysis to local African governments at their request. Other networks or associations of municipalities, urban research institutes, and municipal training centers exist or are emerging in other regions and should be supported by the Bank as mechanisms to deepen institutional development, making it more cost-effective and more relevant to local needs.

A second persistent issue is how the Bank can address the critical management needs of metropolitan areas, particularly of megacities, given the usual absence of a metropolitan agency that is empowered to lead the component municipalities, often a dozen or more. In past projects the Bank has been instrumental in the creation of umbrella agencies; a few, such as the metropolitan development authorities in Manila and Calcutta, have continued to play important roles in the city but without the powers required to address interjurisdictional issues effectively. The Bank has focused its efforts more recently on metropolitan-wide management of sectoral or subsectoral activities such as water, public transport, and solid waste, where the rationale for cross-border collaboration and externalities are tangible. Even in the absence of a formal executive agency, the Bank could be catalytic in encouraging city strategy exercises to identify stakeholders' shared interests and concerns in metropolitan cities where a coalition exists with vision and broad credibility.

**Box B.11 Understanding and addressing municipal corruption**

Two factors are required for corruption to flourish in a municipal system. The first is systems of governance that are vulnerable to corruption. This vulnerability is created through unregulated and arbitrary discretion of officials who do not have to be openly and completely accountable to the public. This lack of accountability is related to the flow of information from the government to the public and from the public to the government. A second and necessary condition is a set of perverse incentives that motivates individuals or groups of individuals to take advantage of vulnerability. Perverse incentives can include extremely low wages, lack of monitoring systems, pressure from superiors, low risk of being captured and prosecuted, and unpredictability of administrative procedures. A strategy to reduce corruption needs to reduce both vulnerability and perverse incentives.

Specific programs that have been effective in addressing and reducing municipal corruption recognize and address the vulnerability of structures and processes and pervasiveness of incentives that lead to corruption. Successful programs have at least two dimensions: The first dimension is the internal reform of both structure and process within the municipal administration. The most outstanding case of this has been the municipality of La Paz, Bolivia, in the 1980s and early 1990s, during the administration of Ronald MacLean. A complete overhaul of the administration, including reduction in staff and redesign of processes, permitted the municipality to emerge from a catastrophic situation driven by corruption to one of stability and good management. The second dimension refers to reforming the interaction of citizens and stakeholders with municipal government. This external reform is exemplified by the Campo Elias, Venezuela, initiative of the World Bank Institute. The reform focused principally on a series of public participatory actions, including a participatory budget, practical mechanisms to assure flow of information to the public, and development of standardized and integrated system of administrative procedures. Through these measures the municipality was able to ensure open monitoring of municipal governance and uncover and remedy corruption that had been entrenched for many years.

*Source:* Maria Gonzalez de Asis and Victor Vergara, World Bank Institute.

## Making cities bankable

For some cities, bankability represents the aim of becoming sufficiently creditworthy to access banks and capital markets. Ahmedabad, for example, turned its financial performance around in a few years to become the first city in India to be rated by a domestic agency and issued an investment bond. But for all cities, bankability can be defined simply as financial soundness, reflected in respect for hard budgets and efforts to mobilize fully and use judiciously even weak resource bases. Both sound financing and good overall city management involve establishing links between the services provided by the city and the payment for them by users and beneficiaries through tariffs or taxes. This "social compact" is weak or missing in many urban areas and is key to restoring accountability and responsibility on the part of both city officials and the citizenry.

**Policy and institutional conditions for bankability—and how the Bank can help**

A major focus of the Bank's urban development program is providing technical assistance and policy advice to local and national governments on the fundamentals of sound municipal finance. These fundamentals include *rational intergovernmental assignment of functions* as well as:

- *Expenditure management* (capital and recurrent budgeting and investment selection practices)—including decisions to transfer activities and investments from local government departments to separate corporations, such as utilities or project companies, with full or partial municipal ownership or full privatization, as appropriate; and management of assets (such as real estate holdings).
- *Revenue mobilization and cost recovery* (sound pricing for public services, use of suitable fees and charges, property and other local taxation)—also depending on decisions about what activities should be financed privately, for example, on a nonrecourse basis.
- *Intergovernmental transfers* that are predictable and consistent with "hard budget" incentives.
- *Financial administration,* including generally accepted accounting, auditing, disclosure, asset and liquidity management, procurement, and payment procedures.
- *Access to credit,* based on a legal and regulatory framework that allows municipal bankruptcy, collateralization, and prudent mechanisms of credit enhancement, such as revenue escrows and intercepts of fiscal transfers. Financing strategies could include choices between bank credit and bonds (general obligation or revenue bonds) for various purposes.

A toolkit for governments covering each of these components is under preparation by the Municipal Finance Thematic group.

The main vehicle for urban policy advice and assistance to instill these practices has been operations supporting specialized municipal finance institutions—often called municipal development funds—in countries virtually lacking a municipal credit market. While some municipal development funds have had ambiguous mandates and politicized their lending, many have introduced sound municipal lending practices and helped their clients adopt the good financial management needed for creditworthiness, thereby contributing to effective demand from local governments for a formal credit market (box B.12).

In some cases commercial banks are prepared to lend to municipalities but need some help in term transformation and in assessing municipal credit risk. The Bank supported FINDETER in Colombia, a second-tier intermediary that refinances loans to municipalities by participating commercial banks and financial corporations and helps the lenders with credit analysis. In Poland World Bank loans go directly to commercial banks that meet certain performance criteria, and these banks on-lend on market terms to local governments and municipal enterprises with no intermediary

**Box B.12 Building better municipalities through finance and technical assistance in Brazil and the Philippines**

A recent impact evaluation of several municipal development fund projects in the Brazilian states of Paraná and Rio Grande do Sul and in the Philippines measured their effects on the financial practices and institutional capacity of the recipient local governments compared with nonrecipients. In both countries the projects required municipal governments applying for a subloan to submit a financial action plan with a comprehensive reform package. The evaluation found that participating municipalities in one of the Brazilian projects also credited it with helping to improve their procurement, professionalism, information technology, and community participation practices.

*Source:* World Bank 1998e.

institution. The measure of success for these schemes is the growth of market-based credit to municipalities, for longer terms, by a competitive banking system. This growth ultimately requires increased access to capital markets for long-term funds.

#### Emerging challenges and areas for a strengthened Bank response

Municipal finance assistance under urban projects is increasingly seen as part of a systematic and longer-term approach to developing municipal finance systems as part of national capital markets. Such an approach requires differentiating forms of assistance based on the actual and potential creditworthiness of municipalities and the requirements of different types of investments (box B.13). This implies that:

- The Bank should have the capacity to provide assistance in financial management for cities interested in its help. This requires developing the capacity to provide self-standing advisory services, as in South Africa (see box B.8), for local government clients.
- For the financially stronger municipal clients, the Bank should have high expectations, gearing any assistance to helping them become fully creditworthy as soon as feasible. The Bank should also define a clear exit strategy for its financial assistance to creditworthy municipalities.
- For cities with little prospect of market access (often in countries virtually lacking municipal credit activity), special intermediary arrangements such as municipal development funds may continue to be needed. The Bank should support municipal development funds only when they are designed explicitly as a means of transition to self-sustaining, competitive commercial lending, have appropriate incentive frameworks, and follow best practices, which are now well understood from experience. The transition may be long for many municipalities, but it should nevertheless be an agreed upon goal.

**Box B.13 A nationwide financial framework for municipalities in the Philippines**

The Philippines is preparing a national urban policy agenda to set out the means and conditions for implementing existing laws on fiscal decentralization. To support this process, the Bank is working with the national government to define and implement a local government units financing policy framework. The framework will set up a comprehensive system for improving local governments' access to domestic and external financing of different types and sources and for building their capacity to use finance.

The framework will outline roles of participants in the system, promote the local governments' self-reliance, and expand their access to private credit. Financial dependence on the national government will be reduced by enforcing a "graduation policy" allowing the more creditworthy local governments to access private capital through commercial bank loans, bonds, and build-operate-transfer arrangements, and by limiting national government credits and grants to the resource-poor local governments, and for social and environmental aspects of local investments. The Bank's urban lending program will provide financing and technical assistance to help carry out this financing framework.

*Source:* Zearley 1998.

- The Bank's financial advice to cities should help them distinguish among suitable financing sources for different types of expenditure—for example, investments and services capable of being commercialized can be transferred to private financing (through concessions, project companies, or outright privatization); for municipal investments with nonrecoverable costs and social externalities, general revenue financing and intergovernmental transfers should be developed that can be leveraged with credit.

Complements to the Bank's municipal finance assistance. Assistance to municipalities under the urban development program could achieve greater leverage in countries where enhanced and coordinated efforts are also under way by the Bank's Capital Markets Development Department, PREM, DEC, and Financial Sector Development Department, and by IFC's Financial Markets Advisory Department, to create the underlying conditions for long-term domestic credit markets. The basic infrastructure of the banking system and capital markets includes sound policies for long-term savings (including reform of pension plans and other institutional investors); underwriting and distribution networks for securities (municipal and other); market-making capabilities for securities in secondary markets; regulation and supervision of securities, including accounting, auditing, and disclosure standards for all financial market players; reliable settlement, custodial, and payment systems; and a ratings industry, credit enhancement, and hedging mechanisms associated with municipal debt obligations, to protect investors against municipal credit risk and allow municipal borrowers to manage their liabilities.

**Box B.14 How IFC aids the financing of private infrastructure concessions at the subsovereign level**

In recent years, IFC has become increasingly involved in the financing of private concessions or build-operate-transfer (BOT) projects at the subsovereign level, particularly in water and sanitation. IFC is reviewing possible investments in private water and sanitation projects at the municipal level in Bolivia, Brazil, Indonesia, Mexico, and Vietnam, and in private toll road concessions at the provincial or state level in Argentina, Brazil, and Colombia. More provincial concessions are expected to seek financing in the future, driven by the decentralization and privatization of public services and by the increasing demand for transport, water, and sanitation infrastructure in developing countries.

The challenges in developing bankable private infrastructure projects are compounded at the subsovereign level by the difficulty of evaluating and pricing subsovereign performance risk and by the fact that the contingent liabilities of subsovereign government agencies (as in the case of termination compensation provisions of a concession, or commitments by a municipal utility under a take-or-pay agreement in a BOT project) can be significant relative to their financial resources. Thus the viability of financing a private infrastructure project at the subsovereign level often depends on the ability of financing institutions to mitigate the associated subsovereign performance risks.

IFC has explored different approaches to mitigating subsovereign performance risk for specific infrastructure projects, including backup liquidity facilities involving national development banks able to intercept revenue transfers from the national government, partial risk guarantees, and the diversification of subsovereign performance risk through pooled investment vehicles.

*Source:* Francisco Tourreilles, IFC.

Further actions to enhance municipalities' access to private finance. National reforms aimed at making municipalities and other subsovereign governments more financially autonomous pose a dilemma for the Bank and other international official finance institutions. The Bank's loans or guarantees require sovereign backing, yet national governments are increasingly reluctant to issue guarantees or counterguarantees of borrowing by subnational entities, both in order to limit their own contingent liabilities and to avoid moral hazard. And IFC cannot transact with a subnational entity or municipal company unless the company has majority private ownership or is on its way to privatization. But the Bank can help creditworthy municipalities access capital markets by providing advice and technical assistance, which also comforts potential private partners, and IFC can assist private project companies or utilities that have minority subnational ownership or where there is some perceived subsovereign risk (for example, of termination of a concession by a local government). IFC is looking at ways to mitigate subsovereign risk on a case-by-case basis (box B.14).

Innovative approaches to engaging private finance for urban investment should be further explored. For example, the Bank could provide a slice of sovereign-guaranteed lending or guarantee in structured financing packages to mitigate the perceived riskiness of newly or marginally creditworthy local governments as partners to the private sector. The Bank (or IFC, if utilities are privatized) could also play a catalytic role through financial participation in a national or regional risk-pooling institution, such as a bond insurance agency or bond bank.[20]

[20] *For example, in June 1998 the Innovation Marketplace approved a pilot proposal to explore setting up a subsovereign finance and guarantee corporation in Europe and Central Asia that would raise resources on the market and carry out transactions without sovereign guarantee with subnational entities in the form of loans, bond underwritings, subsovereign partial risk or partial credit guarantees, and hedging instruments.*