



Financing Local Development

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Introduction

Successful local development in the knowledge-driven global economy requires places to be truly distinctive, appealing and productive. Just as firms must innovate and invest to succeed, localities have to adjust, reinvent, and differentiate themselves. They must modernise their transport, communications and other infrastructure and build up human capital. But all this comes at a cost.

The real challenge for local development is finding the investment to achieve all this, particularly as it can take 30-50 years to fully transform a locality or region from “industrial economy” mode to “knowledge economy” mode.

Such investment does bring returns, but many localities do not have the surplus cash, or the power over their own investment decisions, to make it possible. They also need the skills to seize their chance of success if the opportunity arises to make new investment and share the risks and costs with other public and private entities, such as hosting a global event, or being chosen to host a new research centre.

Investment is itself a driver of growth at local level and increasingly local authorities are seeking to attract investment which will enhance enterprise and innovation, human capital and skills, trade and employment.

Armed with the right tools and approaches, local development can emerge as an important arena for new investment that yields rates of returns that neither public nor private sectors can afford to ignore. This Policy Brief looks at OECD experience with financing local development and how local authorities can make the best of their investment opportunities. ■

How has local development financing changed?

Local development has in recent years become part of mainstream thinking about increasing productivity, creating jobs and wealth, fostering entrepreneurship, building human capital and improving incomes. There are a number of reasons for this. One is the realization that the longer-term impact of phenomena such as globalisation, population growth and ageing, technological development, and climate change has given local economies more scope to add value to national success. At the same time, it has become increasingly clear that national policies alone are not enough to address the widespread and growing economic disparities between regions and localities within OECD countries, and that local development is a key issue.

Local development has already changed significantly over the past two decades. Economic development in cities and regions is now much less about roads, bridges, and factories and much more about telecommunications, re-used brownfield land, high-tech business space, creativity hubs, science parks, supply chains, knowledge capital, small companies, joint promotion, and community development. But these offer less tangible collateral – you can see a bridge or factory, but not a supply chain – and often less well-tested investment returns. So attracting investment for these assets requires something new.

At a time of tight public budgets and a need for local economies to deal with a global world, public funding alone is not a solution; if local development is to be successful and sustainable over the longer term, the private sector needs to be involved too. The private sector has begun to take much greater interest in local development, often in tandem with the public sector. The result has been a much wider set of financial tools for local development – but to take advantage of them, local administrations need to acquire the financial skills to use them effectively.

Delivering economic development to a locality or region is complex as it is subject to influences well beyond the control of local, regional or national governments. Equally, the time-frame for seeing results is closer to a business cycle (12-15 years) than to the electoral cycle (3-4 years). As a result, local development is more likely to succeed if it is treated as a long-term partnership between public, private, and institutional sectors.

The public sector part of the partnership has two basic roles – to ensure delivery of economically sensitive public services such as education, planning and amenities, and infrastructure; and to foster collaboration among private and public sector actors, to ensure that development projects are delivered in a professional manner.

A great deal has been written about how to develop local *economic* strategies, but very little has been written about how to establish the local *investment* strategies to pay for them. Many local economic strategies are never fully implemented because they did not identify the investment resources in advance and assumed private sector involvement without doing anything to attract it.

When local development works well, however, it produces real returns for all those involved: jobs, incomes, growth, improved asset values and tax revenues for the public sector; profits, new niche markets, and a rising flow of further investment opportunities for the private sector.

The tools available for financing local development vary substantially from one place to another, even when designed to achieve similar aims. For urban re-development, for example, the United States uses tax credits and incentives where the United Kingdom uses grant aid. Europe uses guarantee systems to address small business lending issues that the United States has tackled through regulation. Some areas offer tax incentives to encourage foreign direct investment (FDI), while others offer direct subsidies. And some countries issue public bonds to support activities that in other countries are the preserve of private fund managers. ■

How does local public funding affect local development?

There are significant differences between governments in how local public funding is collected and distributed – how much tax is levied or spent at local level and how far local governments depend on transfer payments from higher tiers of government. Research carried out by the Council of Europe found that the share of local taxes in local government budgets varies between countries from 1-2% to 60%.

Countries with higher tax levels tend to rely on public funds to support publicly-led economic development efforts, whereas countries with lower tax levels tend to presume greater private sector involvement in economic development.

Where local governments rely heavily on local taxes to fund their budgets, they are more likely to see local economic development as a way of increasing their tax base to finance local services, assets, and amenities. Such local development is highly oriented towards attracting and expanding business and human capital development. Here, economic development finance is often about incentives for private sector investment and the primary interface is with business, investors and developers.

Where local governments rely heavily on national government to fund their budgets, they are more likely to see local economic development as a way of addressing social and spatial disparities. Such local development is often more oriented towards public and social sector activities – helping the unemployed into work and finding new sources of entrepreneurship and employment. Here, economic development finance is more about investing in the infrastructure to make private investment more likely, and often requires extensive liaison with higher tiers of government to attract funds.

Most OECD countries will see themselves as operating somewhere between these two extremes, but private finance is essential in all models, to achieve long-term economic development that is financially and commercially sustainable. ■

Where does the private sector fit in?

The key to most progress on local economic development finance is a new relationship with the private sector. It helps local government by providing capital that would not otherwise be available, and more quickly and efficiently than the public sector. Using private finance also transforms local development into investment, rather than expenditure, which is more sustainable.

For the private sector, there is a chance of moving into new markets and businesses, and building relationships with new partners, as well as diversifying investments and building predictable returns.

There are multiple mechanisms for the public and private sector to share the costs and risks of local development projects, such as public-private partnerships (PPPs), tax-based incentives, credits, and privately-funded mechanisms that support public sector endeavour.

Glasgow, for example, has used PPPs in two major areas, education and health. In Baltimore, tax incentives for new home construction and enterprise development have played a major role in bringing private sector investment into the regeneration of inner city and rundown neighbourhoods.

And new investment tools are constantly emerging, especially for cities. Business Improvement Districts were invented in Canada, but have since spread to the United States, South Africa, Australia, and beyond. Regional Investment Funds, first piloted in Germany, have spread throughout the EU's regional development system and continue to grow. New approaches to infrastructure levies and development fees, common in Asia and in many other countries, are starting to be taken seriously in Europe.

Concern about climate change is meanwhile inspiring mechanisms to encourage cleaner and greener economic development, along with financing to pay for it. The "congestion charge" for motorists entering Central London not only reduces congestion and pollution by encouraging travellers to use public transport, bicycles, or their own two feet but also helps finance urban transport improvements.

National governments and agencies are also critical financial partners in local economic development in many countries. Development agencies, development banks, and special regional funds also play a key role. Most such entities work to develop specialist financing to bridge the gap between public grants and wholly commercial finance or between public assets and private investors. The goals of such funds are often to make deals sufficiently attractive to commercial financiers. In Germany, for example, the Stuttgart Regional Investment Bank (L-Bank) finances small and medium-sized companies, export and house construction.

International financial institutions (IFIs) such as the World Bank or the Asian Development Bank are also potent partners for local development, bringing substantial financial resources and expertise to the table. Because the IFIs are not-for profit, they can deliver capital at affordable costs, and also provide technical support, promotion of good practices, and additional grant finance.

Commercial banks and investment institutions are now also playing a key role in financing local development. Often, this builds upon the success of public-private joint ventures that lead the banks to recognise valid new markets or niches where they were previously inactive. Pension funds have also begun to play a particular role in urban redevelopment and SME financing.

Catalan Banks, for example, have played a major role in financing the re-development of Barcelona and fast-growing smaller companies in Australia and New Zealand are seeing their growth supported by public and private venture capital programmes. In cities and regions across Europe, municipal pension funds are now significant investors in small firms and urban regeneration. ■

Why do local financial skills matter?

Taking advantage of innovative financing ideas implies a high level of financial skills at local level. Local development often fails to attract enough investment, even though there is capital available in the markets, because of an inability to draw up an attractive investment/development package.

The underlying problem is that local development practitioners and financiers appear to lack some important skills, notably in communication, leadership, and technical financial matters.

Local leaders and potential investors often have trouble **communicating** with each other. Local leaders focus on social and public policy needs rather than the potential return on investment, while financiers ignore the wider benefits that can build a shared approach to a local market.

Local leaders often fail to exercise **leadership** in choosing the best methods of finance, focusing on the need for new financial tools, rather than using existing tools such as congestion charging or bonds because they are seen as too complex, politically unpopular, or untested.

Technical skills in project financing, strategic asset management or project financing are often in short supply among local development practitioners, partly because they command high salaries that local development organizations cannot afford. However, when they do possess these skills, they access commercial and institutional finance much more effectively.

“Soft” skills such as negotiation and marketing skills are also important for attracting investment but these too are often in short supply.

Renewed and improved efforts to develop such skills are a key imperative for all who aim to build the market for local investment.

Some local governments, for example, have used the fact that effective development can raise local tax revenues to create ongoing funding streams for specific aspects of local development. A good example of this approach is taxing hotel use to help pay for promoting tourism, improving amenities, and developing the workforce in the hospitality industry. Philadelphia finances such local urban development using a 7% tax imposed on every rental of a hotel room. Another example is to use rental income from assets, such

as small business accommodation, to help finance wider local economic development programmes and enterprise support.

A second type of financing involves local government borrowing to support investment in the productive infrastructure of a local economy. Two increasingly important types are loans from major financial institutions, or bond issues. The City of Turin, for example, issued a bond to support infrastructure improvements associated with its strategic development plan for the city and preparing for the 2006 Winter Olympics. ■

Can local development lessons be exported?

Learning from each others' local development experience between countries is complex, not least because different countries have very different ways of organizing and funding their systems. Responsibility for raising and spending tax varies from country to country, and so do methods for defining, calculating and appraising public sector debt. As a result of these and other differences, the financing tools for local development vary widely between different countries.

Given these major differences it may be tempting to conclude that the possibility of transferring local development financing tools between countries is limited. However, practical experience suggests otherwise. It can be helpful to understand the range of tools and approaches adopted elsewhere, not to copy them but to reinforce and confirm local choices, or to adapt them to local circumstances.

Indeed, understanding how other countries use local development finance tools may be as important as the tools themselves, particularly as many local development practitioners have more tools available to them than they use. It can also be helpful to share and develop financial skills for local development. Leadership in financial innovation is also a skill that can be learned from

Box 1.

KEY PRINCIPLES FOR LOCAL DEVELOPMENT FINANCING

The OECD has developed 10 principles for local development financing:

- i) Smart finance for smart cities and regions, promoting the fiscal relationships with higher tiers of government.
- ii) Promoting active private sector leadership in local development finance and investment.
- iii) Metropolitan finance for metropolitan amenities, sharing costs and benefits.
- iv) Capturing and sharing the benefits of growth locally.
- v) Flexibility in public funding to enable private co-investment in local development.
- vi) A new approach to managing public assets locally to achieve financial leverage.
- vii) Fostering financial innovation in public and private sectors locally.
- viii) Long-term market building in local economies by the private sector.
- ix) Focusing on the quality of the local financial propositions not on the supply of finance.
- x) Building capable specialist intermediaries at local and wider levels.

other countries. Evaluating local development finance tools is also an essential backdrop to transnational dialogue and exchange.

The key to learning from local development lessons in other countries is to look at how and why a particular approach or instrument has worked, rather than simply borrowing it. It is all about adapting, not adopting, the successful experiences of others.

Ontario, Canada, invented Business Improvement Areas with a mix of public and private funding in the 1960s. They have been widely copied across the world and there are now approximately 50 000 worldwide. But perhaps more interestingly, the idea is now being introduced in widely differing localities using different tools to raise money – the common denominator is that a critical mass of businesses are willing to pay for particular services. ■

Where do we go from here?

Important changes are taking place in financing local development. Global opportunities for cities and localities have led to a renewed impetus for new financial tools. Properly appraised public borrowing at local and regional levels is no longer considered heresy. Using the tax system to provide a different incentive structure for place-based, as well as issue-based, investment has now become common.

Addressing how public assets can be better used to generate private co-investment (rather than being sold for a once-only “current value” price) is now the new mind-set. There is also new thinking about the organisational structure needed to promote financial innovation. As cities have to help nations respond to shifts in new global value chains, so renewed interest in supporting investment into cities is occurring.

All of this has been increasingly supported by a realisation that improved local and regional investment is not solely about how much money is available from various sources. It rests much more upon the quality of propositions that are developed, the robustness of their management, and the returns they can offer to private and public investors.

It is important that local development comes to be viewed much more as an investment that local governments and their partners can make, rather than simply a matter of local government expenditure.

By creating jobs, re-using disused land, and fostering new forms of entrepreneurship and investment, local governments are fostering the factors of growth in their economies and the growth of the tax yield in the municipalities.

Given the pace of innovation in local development finance, there is scope for a much more systematic observatory on the transferability of successful models. The OECD will work with international financial institutions and national/local partners to help develop this approach with the aim of encouraging greater confidence and innovation in how local development is supported and how it can become a focus of productive investment. ■



For further information

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For further reading

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