

# POLICY BRIEF

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## Closing the Gap on City Climate Finance in Developing Countries

Mahesti Okitasari, Wenjie Liu, Richa Kandpal,  
and Kanako Morita

### Highlights

Addressing sustainable urban development issues and delivering the finance needed for climate mitigation and adaptation require closing the city finance gap. Structural changes and improved capacity for city climate finance in developing countries are necessary to overcome the prevalent barriers to accessing available financing. Well-designed and well-managed city climate finance is key for effective interventions to unlock investments and deliver implementation.

#### Recommendations:

- Prepare city-level climate finance plans and investment strategies.
- Diversify financial approaches and build community-driven sustainability financing.
- Improve internal capacity, information disclosure, and prudential regulations.
- Develop bankable projects and provide incentives to strengthen private sector engagement.

### Barriers in Developing Countries

Cities are pivotal intervention points to realise co-benefits and synergies in reducing emissions and achieving the SDGs (IPCC 2022). They generate more than 80% of the world's GDP and account for more than 70% of greenhouse gas (GHG) emissions (Carter & Boukerche 2020). City-scale climate action has a more direct and immediate impact on the population (CCFLA 2021). Cities mainly seek finance for transport, renewable energy, energy efficiency, water, and waste management (CDP 2021); increased support is needed for climate-compatible urban infrastructure development (IPCC 2022).

Cities in developing economies, especially those with populations exceeding 500,000, do not lack climate investment opportunities — indeed, across six sectors they amount to an estimated USD 29.4 trillion cumulatively by 2030 (IFC 2018). Yet investments are geographically imbalanced and insufficiently reach cities in the least developed countries, South Asia, and Sub-Saharan Africa (Knuth & Krishnan 2021). Less than USD 1.6 billion was approved for locally focused climate projects from 2003 to 2016 (Soanes et al. 2017). This is exacerbated by the inability of development finance institutions and multilateral development banks to mobilise climate investment for cities at the pace and scale required, due to the constraints of their mandates and balance sheets (UNFCCC 2019).

Compared to cities in developed countries, those in developing countries often need more functional capital markets and have lower creditworthiness, so they miss out on interventions by multilateral climate funds that are based on commercial viability (UNFCCC 2019). They have severe budget constraints, weak financial and decision-making independence, limited capacity to structure bankable climate projects, and/or inconsistent policy (CCFLA 2021). A lack of capacity hinders their efforts to access climate finance, as well as their climate mitigation and adaptation through financing from own-source revenue (OSR). These cities require support to enhance their capacity to collect OSR and strengthen financial management (UN-Habitat 2021).

## Building Robust Capacities

Realising the significant potential and scalability of cities' climate finance depends on meeting the preconditions to mobilising financing instruments, including national policy frameworks, governance, and choices (IPCC 2022). Cities suffering from weak decentralisation due to the reluctance of the state to transfer power and resources have limited financial empowerment and responsibilities, as well as insufficient OSR and human skills (AFD, IFC, UN-Habitat & IDB 2018). Public finance in poorer cities needs updating to reflect changing conditions and faces OSR limitations and unfunded expenditure mandates (Smoke 2019). Efforts toward reducing climate finance gaps in cities should go hand-in-hand with improving their competencies and responsibilities. This includes the complex and sensitive process of fiscal decentralisation, in which many efforts on subnational development finance have been disjointed (Smoke 2019). Building cities' capacities requires careful consideration of the potential risks of decentralisation, including legal and institutional frameworks.

Mobilising climate finance at scale requires cities to diversify sources of financing beyond OSR. Although cities differ in their ability to access climate finance, depending on their authority over economic sectors and capacity to borrow, most have access to finance through state or central institutions, commercial banks, and/or bond markets. Cities' access to climate finance may be expanded through enhancing financial management practices and introducing policies that support aligning climate goals with local priorities, and establishing market instruments that price environmental externalities or create tradable allowance systems (WB 2021). Common instruments are debt financing, value capture, funds, insurance, and public-private partnerships (PPPs) — each with advantages and drawbacks. Value capture requires sufficient land registries, strong political will, and the capacity to oversee projects. Debt

financing and climate finance instruments require sufficient local government capacity and an enabling environment (IPCC 2022). PPPs can increase costs due to inappropriate risk transfer and insufficient project size, and their effectiveness depends on mature financial systems; cities must enable their infrastructure to generate consumer revenue, incentivising the private sector to purchase equity (Floater et al. 2017).

## Policy Recommendations

The following recommendations are provided for local policymakers in developing economies to overcome critical obstacles to closing cities' climate finance gaps.

### 1. Prepare city-level climate finance plans and investment strategies in alignment with national climate policy and step up collaborative approaches

Strategic long-term visions and medium-term goals can help cities to prioritise investments and improve investment decision-making. Aligning these with national climate policy ensures the support of national policymakers. Concrete investment strategies are critical to identify funding gaps and optimise available resources. Before preparing a climate finance plan, policymakers should develop a climate finance taxonomy aligned with SDG finance and other global standards (i.e., the EU Taxonomy; the Climate Bond Initiative taxonomy), and project management platforms. Such taxonomies are criteria to evaluate how financial assets will support climate goals. When a national taxonomy is in place, cities should establish a qualified projects database and link it with the taxonomy. Where no national taxonomy exists, cities need to develop a catalogue aligned with best practices, such as the World Bank guidance on developing a National Green Taxonomy. Huzhou (China) developed a framework categorising projects and companies into green and non-green groups. By setting such standards the city connected projects and investors, and laid the foundation for expanding green, climate, and transition finance.

As part of city-level climate finance plans, policymakers should establish a collaborative management mechanism to coordinate policies between regulatory government bodies. Climate projects must be aligned with the plan, supported by a monitoring and operational project performance plan for long-term management. ICT-based management can help monitor real-time progress, trace funding, and integrate cost, schedule, and risk management. Working with other cities to promote common standards and modes of project implementation is crucial to enable joint procurement.

## 2. Diversify financial approaches and build community-driven sustainability financing

Market-based solutions can be a complementary source of climate finance for cities of all sizes. Land value capture (LVC) can be attractive for city governments and developers to finance resilient and climate-smart urban development. Curitiba (Brazil) used LVC to convert flood-prone areas into greenspace capable of capturing and retaining stormwater. Policymakers should partner with communities and strengthen regulatory frameworks (e.g., dispute resolution and zoning) and financial management practices (e.g., contracting, monitoring) when implementing LVC to reduce contestation risk. An alternative is coupling climate or municipal bonds with infrastructure development. Cape Town (South Africa) issued green bonds accredited under the Climate Bond Initiative to upgrade water infrastructure, with bond listing and marketing through a private-sector intermediary. As such green bonds are debt-based instruments, cities should account for their costs, benefits, and efficacy for climate action. Interventions harnessing market-based mechanisms must be carefully designed with local communities to secure flows of finance towards them. Care is needed to prevent divergence from the public good toward profiteering.

Community-driven sustainability financing through non-formal market mechanisms diversifies approaches at the community level, providing opportunities for cities with weak capital markets. This can be achieved by combining non-formal market mechanisms with grassroots financial innovations to incentivise and mobilise resources that promote local sustainability. Tools include time banking, local exchange trading systems, local complementary currencies, and community share. They require policymakers to create accountable and inclusive conditions by strengthening community organisations and building community funds. Time banking could be combined with grassroots financial innovations by encouraging trade between communities using an alternative currency. Members receive credits for providing services and incur debits for using services. Sarafu-Credits, a community currency in Kenya, is used for environmental improvement in informal settlements through tree planting, trash collection, and food gardens.

## 3. Improve internal capacity, information disclosure and prudential regulations to increase access to financing

Increasing access to finance requires policymakers to improve legal and statutory rules, control and oversight, operational and financial autonomy, the rigidity of expenditures, demand for capital investment, and access to third-party funding (AFD, IFC, UN-Habitat & IDB 2018). Policymakers must adjust cities'

inadequate risk–return investment profiles by linking financing to the achievement of measurable, pre-agreed results to strengthen accountability in project development (WBG 2019). One strategy is to promote GHG emissions accounting and climate-related information disclosure in alignment with global standards such as GHG Protocol and the Task Force on Climate-Related Financial Disclosures. Climate-informed capital investment planning generates forecasts of GHG emissions and lifecycle cost estimates as part of routine city budgeting procedures (WB 2021; Whittington & Lynch 2015). An example is the Integrated Climate Change Response Investment Plan in Addis Ababa (Ethiopia). Data collection capability can be improved by collaborating with civil society and communities. Bogotá (Colombia) has developed open data and technology to enhance transparency in financing by introducing a betterment levy for financing infrastructure projects. The Transparency Index in Bogotá has been developed with the private sector and civil society to identify and measure risks in administrative and financial management and public service delivery.

Innovative financing cannot compensate for the capacity deficits of local governments, and cities must have adequate OSR. Policymakers should improve the accountability, efficiency, and transparency of revenue collection and expenditure to unlock a broader range of financing mechanisms. Hargeisa (Somaliland) provides an example of strengthening city financial management capacity through digital reforms, redesigning local tax systems, and participatory governance for improving OSR. The regulatory environment is also being enhanced for accessing financing. Local control over tax rates is key to improve access to credit at the city level; small cities must consider surcharges on specific national and property taxes. A functional planning system and land/property registry are critical success factors in deploying effective land-based financing. To ensure such mechanisms are inclusive, policymakers should design land ownership models suitable to local contexts, such as community land reserves. Flexibility in land use policy can accelerate implementation and facilitate consensus, as evident in land-based financing for municipalities in China.

## 4. Develop concrete pipelines of bankable projects and provide incentives for private sector engagement

Developing bankable projects depends on cities' ability to prepare for them. Policymakers must align project proposals with Nationally Determined Contributions and the SDGs to improve their eligibility for climate finance. First, policymakers should strengthen their capacity to conduct feasibility studies, develop financial models, and improve financial management systems. In Kampala (Uganda), collaboration with the national

government and development partners has strengthened project preparation, implementation, and evaluation, including climate-smart capital investment planning (KCCA 2023). In developing bankable projects policymakers must reduce contingent liability, ensuring alignment of the financials, public interest, and national climate plans.

For large and medium-sized cities with sufficient revenue, de-risking urban projects through public finance and financial instruments like blended finance can encourage private investment. An example is the Water and Sanitation Pooled Fund in Tamil Nadu (India). Stable and transparent OSR and intergovernmental transfers can reduce investment risks and improve access to external finance (UN-Habitat 2021). De-risking modes for urban projects in developing countries are limited; they include co-financed PPPs. For example, implementing transport-oriented development through PPPs requires cities to establish a special purpose entity to distribute risks transparently. Policymakers must consider incentives that include fiscal measures and tax reductions. This strategy can foster decarbonising technologies and green industries, and signal the capital market to leverage broader private and social capital. It includes subsidies to align incentives with social goals and developing supportive tax regimes for environmentally beneficial activities, such as sustainable drainage systems or green roofs.

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#### Authors

Mahesti Okitasari, Wenjie Liu, Richa Kandpal, and Kanako Morita

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Tokyo, Japan

