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# **Municipal financing and urban development**

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## List of acronyms

ACFA	Alberta Capital Finance Authority
AMC	Ahmedabad Municipal Corporation
AREB	Association of Water Vendors
BCIE	Central American Bank for Economic Integration
BISE	Bank for Socioeconomic Initiatives
BOOT	Build/Own/Operate/Transfer
BOT	Build/Operate/Transfer
BRA	Boston Redevelopment Authority
BRL	Brazilian real
CBOs	Community-Based Organizations
CIDA	Canadian International Development Agency
CIP	Capital Investment Programme
CIS	Commonwealth of Independent States
CMZRB	Czech-Moravian Guarantee and Development Bank
COP	Colombian peso
DAK	Specific Purpose Grants
DAU	General Purpose Grants
DBSA	Development Bank of Southern Africa
DGI	Direction Générale des Impôts
ECOLOG	Local Economic Revitalization Programme in West Africa
FDU	Paraná State Urban Development Fund
FFDU	Fund for Urban and Infrastructure Development
FIA	Inter-American Foundation
FINDETER	Financiera de Desarrollo Territorial
FNDR	National Fund for Regional Development
FPM	Participation Fund for Municipalities
FPS	Social and Productive Investment Fund
FUNDE	National Foundation for Development
FUSAI	Salvadorian Foundation for Integral Support
GDP	Gross Domestic Product
GEL	Georgian lari
GTZ	German Technical Co-operation
HIPC	Heavily Indebted Poor Countries
IADB	Inter-American Development Bank
IADF	International Association of Development Funds
IBAM	Institute of Municipal Administration

ICMS	Tax on Services and Circulation of Goods
IDA	International Development Association
INR	Indian rupee
MDFs	Municipal Development Funds
MDGs	Millennium Development Goals
MIP	Municipal Infrastructure Programme
MUFIS	Municipal Finance Company
NBI	Urgency of Need Index
NGOs	Non-Governmental Organizations
PAD	Local Governments' Own Revenues
PDM	Partnership for Municipal Development
PDSF	Public Debt Service Fund
PRODEL	National Programme for Decentralization and Local Development
PROMUNI	Municipal Infrastructure Financing Programme
PWLB	Public Works Loan Board
SANEPAR	Sanitation Company of the State of Paraná
SBEE	Benin Water and Electricity Company
SEWA	Self-Employed Women's Association
SIDA	Swedish International Development Co-operation Agency
SPVs	Special-Purpose Vehicle
TIF	Tax increment financing
TIPS	Treasury Inflation-Protected Securities
TNUDF	Tamil Nadu Urban Development Fund
UDIC	Shanghai Urban Development Investment Corporation
UEMOA	West African Economic and Monetary Union
ULB	Urban Local Body
UN-HABI- TAT	United Nations Human Settlements Programme
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
USD	United States dollar
VAT	Value Added Tax
VRA	Virginia Resources Authority
ZAR	South African rand
ZMVS	Metropolitan Area of the Val le de Sula



## **Abstract**

This paper addresses the wide range of problems that municipal authorities face in financing urban development as they respond to the challenges of major shifts in their economic base resulting from falling trade barriers and a globalizing economy. The main emphasis is on developing countries, where the challenges are the greatest and the resource constraints most acute. Using case studies to reflect the wide differences in the degree of fiscal decentralization and financial autonomy that exist among countries in any particular region, the paper focuses on the challenges faced, local financial management and performance, partnerships to address pressing urban issues, and emerging trends in the financing of capital investments. The paper highlights creative initiatives in emerging, transitional and advanced economies. Although the focus is on finance, selected initiatives tend to: promote democratic local governance; foster partnerships involving communities and stakeholders in urban development initiatives; and strengthen the capabilities and resources of local governments as the pivotal partners in the development process. The paper documents the emergence of several important new trends: the broadening of locally generated revenue sources; the strengthening of local financial management, the growing reliance on partnerships to finance capital investments, and enhancements to promote access to long-term credit for municipalities. Particular importance has been given to the documentation of novel ways of tapping private sector resources, such as strategic partnerships and local development funds.

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# Municipal financing and urban development

## 1. Introduction

This paper addresses the wide range of problems that face municipal authorities in financing urban development as they respond to the challenges of major shifts in their economic base resulting from falling trade barriers and a globalizing economy. Concurrently, the devolution of administrative and financial responsibility from central governments has forced municipal authorities to finance a growing proportion of their recurring and capital expenditures at a time when, in most countries, migrants constitute a growing proportion of their population. Local authorities have had to: (1) enhance their economic competitiveness; (2) meet the demands for public services; (3) expand and diversify the local tax base; and (4) generate funding for capital investments. Municipalities are but one actor in the financing of urban development, but in many ways they are the pivotal one because of their statutory powers and their ability to act on all sectors within a defined geographic space. Households and private enterprises are the developers and builders of urban communities and the owners and operators of economic activities. But unless the municipality can deliver the supportive infrastructure and services they need, orderly development will be impaired. In developing countries, the rapid pace of urbanization and large migratory flows have increased the pressure on local government spending for urban development. In most of these countries, decentralization laws were enacted in the 1980s and 1990s amid fiscal deficits, financial crises and political unrest, eroding local revenue and disrupting access to funds for capital investment.

In this paper, the emphasis is placed on developing countries, where the challenges are the greatest and the resource constraints the most acute. They are the areas focused on by the Millennium Development Goals (MDGs) and associated 2015 targets adopted in 2001 (The Millennium Project, 2003). Reaffirming the world commitment to address the growing disparities in income and wealth across and within countries, multilateral and bilateral development organizations are making poverty reduction a priority. The

success of these efforts hinges on democratic local governance, partnerships involving communities and stakeholders in urban development initiatives, and strengthening the capabilities and resources of local governments as the pivotal partners in the development process.

## **1.1 Current issues and challenges**

In advanced countries, the combination of strong local tax bases, structured central/local fiscal relations and well-targeted transfers give local governments the means to drive their own economic, social and physical development, partner with private sector entities on development initiatives and work with NGOs on social programmes. Their fiscal resources allow them to access a range of financing sources, ranging from specialized municipal credit institutions and privately managed local development funds to commercial banks and international capital markets. Through strategic capital investments, they are able to manage growth patterns and improve the urban environment.

In transitional economies, the evolution of municipal finance for urban development reflects the path followed by each country as it integrates into the global economy. The sequencing of the reforms affecting legal and institutional frameworks and economic sectors is of paramount importance. Political, administrative and fiscal decentralization, changes in public and private roles and responsibilities, devolution of functional responsibilities, adjustments in central transfers and privatization of land and property ownership, all affect the capacity of municipalities to deliver services and manage urban development, work with local communities and enter into partnerships with the private sector. In general, they have managed their finances responsibly and launched jointly funded programmes with residents and developers to improve infrastructure and housing.

Major cities seek to compete in the regional and global economy. They strive to manage their finances responsibly in order to attract private investors, obtain investment-grade credit ratings and access capital markets. Where local authorities are not empowered to borrow, as in China, they have found

off-budget methods and instruments to obtain the financing needed to drive and implement urban development strategies and major projects.

In developing countries, municipal finance suffers from the fiscally destabilizing effects of asymmetrical decentralization. Where devolution is proceeding according to a planned legal, institutional and regulatory framework, local authorities benefit from more predictable finances and, in many ways, greater discretion. Successive *ad hoc* adjustments to correct imbalances tend to disrupt municipal financial management. In all cases, local authorities in developing countries lack the supportive framework enjoyed by their counterparts in advanced countries. They must be creative and experiment with innovative approaches if they are to meet their economic and social objectives, particularly in generating employment, expanding service delivery, upgrading the urban environment and improving living conditions for poorer communities. Government-sponsored Municipal Development Funds have provided some municipal authorities with resources for specific categories of projects, including revenue-producing services and infrastructure. Social programmes continue to rely on central funding and on support from bilateral and multilateral organizations. Lack of access to long-term financing hampers their ability to fund urban development. The best managed municipalities have been able to launch and sustain remarkable initiatives working with higher levels of government, private businesses, NGOs and CBOs as well as bilateral and multilateral organizations.

In poorer countries, local authorities are heavily dependent on central government transfers to plug any deficits in their operating expenditures, and on grants from donors to address their most pressing environmental and social problems. External funds are the main source of financing to upgrade and expand infrastructure and urban services. Decentralization policies have devolved functional responsibilities without the fiscal resources needed to discharge this mandate. The general poverty of the population erodes local revenue, which relies on a multiplicity of low-yield taxes and fees that are cumbersome to manage and difficult to collect. Their performance is further depressed by chaotic urbanization and the proliferation of informal activities.

The MDGs have opened up new opportunities for poor countries to access funding through the Heavily Indebted Poor Country initiatives for social and environmental programmes. Municipalities can benefit directly and indirectly from these financial resources. However, lack of technical and managerial capacity hampers their ability to make efficient use of the funding they receive, let alone to leverage the funds.

## **1.2 Outline of the paper**

The discussion of major issues and trends affecting municipalities, with an emphasis on their ability to provide services and finance improvements, is presented in five sections as follows:

- Municipal Finance for Urban Development
- Patterns and Trends in Municipal Budgeting
- The Performance of Major Sources of Municipal Revenue
- Special Funding Sources and Targeted Funds
- Private Finance of Municipal Infrastructure and Services

There are no global or regional statistics on the experiences of municipalities when managing their finances under these circumstances; this is due to the wide differences in the degree of fiscal decentralization and financial autonomy that exist across countries in any particular region. With the few exceptions presented in this paper, national statistics on municipal finance are also lacking. This dearth of basic data has dictated a structure that focuses on the challenges faced, local financial management and performance, partnerships to address pressing urban issues, and emerging trends in the financing of capital investments.

In an interconnected regional and global context, networks provide the channels for the exchange of experiences and the transfer and adaptation of successful concepts and mechanisms. Hence, the importance given to creative initiatives in the various sections of the paper. The cases presented have been selected to provide broad geographic coverage of interesting initiatives addressing the challenges of municipal financing of urban



development. Particular importance has been given to the documentation of new sources of financing capable of tapping private resources, such as strategic partnerships and local development funds.

Although differences clearly exist between developing, transitional and advanced countries, there are equally striking differences within each region. An in-depth review of studies and reports conducted by national institutions and bilateral and multilateral aid organizations permitted the selection of a series of cases that describe the range of issues faced by municipalities, how they have responded to them, their capacity to identify and work with strategic partners, the difficulties encountered and the results achieved. The fact that countries in different parts of the world have developed comparable approaches illustrates the emergence of several significant new trends: the broadening of locally generated revenue sources; the strengthening of local financial management; partnerships to finance capital investments; and enhancements to promote access to long-term credit for municipalities. The cases described in the following chapters illustrate innovative approaches to address these challenges. Some have received international recognition as “best practices”.

## 2. Municipal finance and urban development

Decentralization, globalization and the priority placed on poverty reduction as a major objective of sustainable development have highlighted the critical role of local government and the importance of building up their technical, managerial and fiscal capacities. Globalization has also had an impact on public finances. The fiscal capacity of governments in many parts of the world was adversely affected by the decline in tax rates on relatively more mobile factors of production as a result of trade agreements, competition and a reduced role for central government. In the poorer countries, government expenditures on social programmes, including health, education, welfare and poverty reduction, are being scaled back due to lack of resources, heavy indebtedness and insufficient funding from outside sources, thereby undermining the achievement of the Millennium Development Goals.

In 2004, the International Commission on the Social Dimension of Globalization recommended fair rules for multilateral trade and production systems, better international policies regarding global resources, and more accountable multilateral institutions to address social imbalances and organize financial networks. The commission enjoined governments to establish property rights, promote gender equality and ensure labour rights. It advocated fostering opportunities for national and cross-border networking, co-operation and exchange among local authorities, and instituting policies that support and empower local communities. These recommendations have implications for local development policies, social inclusion programmes and municipal finance.

Two major emerging issues are affecting the performance of local authorities in both industrialized and developing countries. The first is the gradual devolution of the responsibility for infrastructure investment and the delivery of services to local government, a trend that has increased their fiscal burden. In some countries, such as Brazil and Indonesia, municipalities have taken advantage of this new autonomy to develop innovative approaches – participatory budgeting in Porto Alegre and other Brazilian municipalities, and the matching grants provided by the central government to Indonesian municipalities that showed good fiscal

capacities as well as met specified need criteria. In other parts of the world, overcoming a tradition of centralized administration is proving difficult, particularly in many African, Asian and former CIS countries. The other major issue affecting the performance of local government is the rapidly evolving relationship between local and regional fiscal authorities. While there is a relatively smooth transition to a complementary role between regional and local authorities in the European Union, the situation is far less clear in developing countries, with the exception of India and Russia where State/provincial government exercises a high degree of control over municipal finance.

Worldwide, there are substantial variations in both the sources of local revenues and the autonomy of local government to determine the scope and rate of local taxes. Central transfers are still the main source of revenue for municipalities, although their contribution is diminishing in North America and the European Union. With the exception of advanced countries, most local sources of revenue are still determined and collected by the central government, leaving little opportunity for local authorities to assess often significant local economic activities in order to fund improvements in social services or invest in the infrastructure required for sustainable urban development.

## **2.1 General trends in fiscal decentralization**

While each country is charting its own economic and social development path, shaped to some extent by history and tradition but determined mostly by contemporary political and economic factors, decentralization has become a worldwide trend underlying the various approaches. Where progressive, planned devolution has taken place, as in Europe, the reallocation of functions among the various tiers of government has been guided by the concept of subsidiarity. Where political pressure has been the driving force, devolution has proceeded in a sporadic manner, resulting in serious imbalances between responsibilities and budgeting powers. In general, effective control over revenue has lagged far behind the expanding scope of municipal responsibilities. Despite these constraints, local authorities are

taking a lead role stemming from their statutory powers and their ability to act across sector boundaries in a defined geographic space.

Assembling comparative information on municipal finances is a difficult task. Government finance statistics compiled by the International Monetary Fund only provide aggregate figures on revenues and expenditures for all sub-national entities combined. Research on decentralization and inter-governmental fiscal relations were undertaken by the World Bank, regional development banks and other international organizations in the late 1990s. These comprehensive studies have not been updated because of the difficulties and high cost of assembling data for a large number of municipalities. Recent statistics are only available in countries where decentralization and municipal development programmes are currently under implementation, as well as in countries where specialized institutions and associations of municipalities are compiling such information, as in the case of Brazil and West Africa.

The rising share of total public expenditures channelled through local authorities testifies to the expanding scope of their responsibilities. In Indonesia, local government expenditures jumped from 17 per cent in 2000 to 28 per cent of public expenditures in 2001 following the enactment of decentralization laws (Shaw and Thompson, 2002). However, wide variations in degrees of decentralization and fiscal capacities across and within regions prevail: from under five per cent to over 15 per cent in Latin America; from less than 10 per cent to more than 50 per cent in Asia; and from around 10 per cent in North Africa to under 10 per cent in Sub-Saharan Africa, exclusive of South Africa, where provincial and local governments account for 29 per cent and 21 per cent of public expenditures, respectively (Shaw and Thompson, 2002). Incomplete fiscal data and uneven geographic coverage within sub-regions preclude attempts at meaningful aggregation. Given the wide variations encountered in any one region, averages would be unrepresentative of most situations and have limited comparative value across regions.

In developing countries, municipalities lack the sophisticated supportive framework from which their counterparts in the advanced countries derive technical and financial assistance. Furthermore, their fiscal autonomy is

often constrained by the mismatch between devolution of control over expenditures and devolution of control over revenue, curbs on borrowing, caps on particular categories of expenditures, and limits on their discretion to reallocate funds among budget categories. Overcoming a tradition of centralized administration is a challenge, particularly in many African, Asian and former CIS countries. Central recording of transactions relating to wealth-producing assets, including land registration and control of high-yield tax bases, has largely not been devolved, nor is it likely to be devolved in the near future since central governments are striving to strengthen their own finances.

Providing adequate financing for the expanding scope of local responsibilities requires changes in taxation policies and inter-governmental fiscal relations, the development of municipal credit markets and access to long-term credit, together with rationalized expenditure patterns and improved municipal financial management. Major challenges that must be addressed include the following:

- Large numbers of smaller, financially weak municipalities
- Asymmetrical decentralization
- Retrenchment of central government transfers
- Weak local revenue sources
- Lack of strong domestic capital markets
- Impediments to the development of municipal credit institutions
- Inadequate capacity and rules for sound financial management at the local level
- Lack of mechanisms to finance urban capital investment
- Lack of funds for the maintenance of existing assets

Despite these constraints, democratic local governance has enabled local government to address poverty and exclusion, establish participatory processes, implement multi-sector programmes and enter into partnership agreements with private enterprise, NGOs and CBOs to promote job creation and foster social inclusion. Most recently, concepts of “rights to

the city” and “access to urban services” have expanded and reinforced the interaction between local government and civil society.

## 2.2 Balancing national and local perspectives in fiscal decentralization: the experiences of Brazil and Bolivia

In Brazil, the 1988 Constitution defined the powers of municipalities as federal entities and stipulated their share of national and regional tax receipts. Inter-governmental transfers to municipalities increased accordingly, accounting for an average 51.3 per cent of total revenue in 1989 and 66.7 per cent in 2003. Central transfers declined following the 1998 financial crisis, but have gradually recovered since. However, their relative size compared with total local revenue is a function of the locality’s size. An estimated 50 per cent of Brazil’s 5,559 municipalities have populations below 10,000 and are economically very weak (see Table 1).

**Table 1. Distribution of Brazilian municipalities’ average revenues (by population size)**

Population (000)	Total revenues (million real)		Tax receipts (%)		Transfers (%)		Other (%)	
	1989	2003	1989	2003	1989	2003	1989	2003
Less than 2	0.8	3.3	1.1	2.3	70.8	90.9	28.1	6.8
2 to 5	1.0	3.8	1.5	2.6	72.5	89.4	26.0	8.0
5 to 10	1.2	5.5	2.7	4.2	70.3	85.9	27.0	9.3
10 to 20	1.9	9.3	3.7	4.8	68.5	85.8	27.8	9.4
20 to 50	3.6	18.4	6.6	7.5	67.2	80.2	26.2	12.3
50 to 100	10.0	44.4	8.9	12.2	62.5	73.4	28.6	14.4
100 to 200	22.2	107.6	10.9	14.0	61.5	64.6	27.6	21.4
200 to 500	48.8	222.9	16.5	20.4	58.0	61.1	25.5	18.5
500 to 1000	118.6	530.9	18.3	20.5	53.2	62.4	28.5	17.1
1000 to 5000	241.9	1349.0	28.8	25.0	46.2	52.3	25.0	22.7
More than 5000	2946.4	9240.6	22.6	37.8	32.4	42.7	45.0	19.5

*Source: IBAM 2002, 2004.*

The Participation Fund for Municipalities (FPM) receives from the central government 22.5 per cent of the revenue collected from taxes on incomes and industrial products. The distribution formula favours smaller municipalities, which receive a higher amount of resources on a per capita basis. Transfers from the FPM are the prime revenue source for 81 per cent of the municipalities, and in 28 per cent of them account for over 50 per cent of all current revenues. In 2003, FPM distributed a total 22.9 billion Brazilian *reales* (BRL) (or USD 8.4 billion<sup>1</sup>). The central government also transfers to the municipalities 50 per cent of the Tax on Rural Property, but this amount represents only a small percentage of total revenue.

The States transfer to the municipalities 25 per cent of the revenue collected from the Tax on Services and Circulation of Goods (ICMS). Each municipality receives a share of the ICMS collected within its jurisdiction and accounting for 75 per cent of the total transferred. This allocation method favours larger and stronger municipalities. The remaining 25 per cent is computed according to a formula based on population size and other criteria. In 2003, ICMS transfers totalled BRL 30.6 billion (USD 11.2 billion). The States also transfer to the municipalities 50 per cent of the Tax on Vehicles they collect (see Table 2).

**Table 2. Distribution of revenue and tax collection in Brazil (2003)**

Government tier	Total revenue		Collected taxes	
	BRL billion	%	BRL billion	%
Central government	918.5	72.9	470.0	67.4
State government	209.3	16.6	189.2	27.2
Municipal authority	132.2	10.5	37.4	5.4
Total	1,260	100	696.3	100

*Source: IBAM, 2004.*

Municipal finances reflect Brazil's regional disparities. The North and North Eastern parts are much poorer and less developed than the South. Massive emigration to southern cities, particularly São Paulo, deprives the northeast of its working-age population. The main household sources of income

1. Exchange rate as of December 2, 2004: 1.00 BRL= USD0.366233

are remittances and pensions. Municipal resources are very limited and entirely dependent on central transfers. Significant capital injections from outside sources are needed to launch and sustain development initiatives (Bremaeker, 2004).

Bolivia's Decentralization Law illustrates an ambitious attempt to coordinate inter-governmental fiscal relationships within the context of poverty reduction efforts. Bolivia's annual per capita income is approximately USD1,000. About 50 per cent of the poor live in urban areas. Their numbers were swollen by migratory flows during the economic crises of the 1980s and 1990s. This rapid urbanization of poverty is putting pressure on municipalities to deliver basic services. In 1994, Bolivia's Popular Participation Law (LPP) created 312 new municipalities and restructured inter-governmental transfers. The role of municipalities in the provision of services was expanded. In addition to their responsibilities for the management of healthcare, education, culture and sports, access roads and micro-irrigation projects, 20 per cent of the total national tax collection is transferred to municipalities. Since the transfer is based on population size according to the 1992 census, lack of updated population counts penalizes those areas experiencing high demographic growth. In municipalities with a population over 50,000, transfers account for 50 per cent of total revenue, while in municipalities with a population under 15,000 they account for 95 per cent. The financial weakness of the smaller Bolivian municipalities is underscored by the fact that as much as 70 per cent of total local taxes are collected in only 10 municipalities. The smaller municipalities are unable to meet the demand for social services, and typically face the additional challenge of supporting impoverished rural populations.

Bolivia's National Policy of Compensation regulates capital transfers, targeting them to priority sectors for social development and to strengthen municipal capacity to fund capital investments that improve local services. Concomitantly, the policy imposes controls over municipal debt. Eight priority sectors have been identified through consultation with stakeholders from all over the country; they include healthcare, education, basic services, productive infrastructure (such as irrigation), rural access roads,



rural electrification, the environment, natural resource management and institutional strengthening (Brakarz, 2003).

### **2.2.1 Reconciling development and equalization policies in fiscal decentralization**

Charting an appropriate course for decentralization that does not disrupt the delivery of basic services and other functions devolved to the local level is a challenging task. The difficulties encountered often require a process of successive adjustments to correct serious imbalances that affect the economic and social life of the population. Indonesia's experience with fiscal decentralization demonstrates that it is possible to undertake a phased national reform programme with policies that reflect national disparities and modulate the central government's role to address inequalities and national priorities (see Box 1).

### **2.2.2 Restructuring the frameworks for regional/local fiscal relations**

In the European Union, the role of regional authorities has been redefined and their powers increased, to reflect a supranational space where economic growth is shaped by globalization and spatial development is structured by networks of cities and transportation corridors. Local authorities must align their plans to regional strategies in order to access funding for a wide range of support programmes. In developing countries, provinces tend to act as an intermediate tier with varying degrees of authority over local government. In transition countries, the situation is often exacerbated by resentment and distrust. To defuse tensions and promote collaboration, roles must be redefined, overlapping competences sorted out and new frameworks for fiscal relations established. The process is neither easy nor smooth.

India and Russia present interesting and contrasting cases where the provincial governments exercise a high degree of control over municipal finance. The Russian Federation and the CIS countries are at different stages in the transition from centrally planned to decentralized market economies. Their legal and institutional frameworks are still in a state of flux. New laws and regulations can alter inter-governmental relations and change the

scope of local powers and responsibilities. In Russia, the 1994 fiscal reform put municipal finance under the control of regional authorities. From 1996 to 2002, the Tax and Budget Codes were restructured and revised several times. Regions still do not adhere to uniform practices regarding the sharing of revenue with their municipalities, the major sources of transfers being primarily Value Added Tax (VAT) and taxes on profit and income (see Table 3).

Successive reforms have restricted the fiscal autonomy of municipalities and created serious imbalances between budget authorizations and mandated responsibilities. Some municipal budgets rely on regional equalization transfers, while others rely on proceeds from regulated taxes. There is no clear assignment of functional and fiscal responsibilities between the various tiers of government in Russia. *Ad hoc* assignment of functions to municipalities persisted until the structure of government responsibilities was codified in the late 1990s. Federal and regional expenditures grew as these authorities took over some of the local responsibilities. In practice, local government has little autonomy in decisions regarding service delivery (Chernyavsky, 2002).

India has experienced rapid economic growth since 1990 at an average annual rate of 4.3 per cent in real terms. Constitutional amendments in 1992 and subsequent decentralization laws have given urban local bodies (ULBs) substantial political autonomy. However, political devolution has not been matched by fiscal decentralization. The States are still heavily favoured fiscally, while the local level, comprised of 3,682 ULBs and 247,033 rural

**Table 3. Russia: local government expenditures in the consolidated national budgets**

Year	Share (%)
1995	37.6
1997	31.7
1998	29.8
1999	27.5
2001	26.7

*Source: Chernyavsky, 2002.*

**Box 1. Development and equalization strategies under adverse economic conditions: Indonesia's fiscal decentralization process**

Starting in 1997, Indonesia went through an economic recession, a financial crisis and political disturbances that eroded the improvements in living standards achieved over the previous decades. The currency was devalued by over 80 per cent, GDP contracted by 13.8 per cent, the level of poverty doubled and political strife erupted. Prior to the year 2000, and despite its diversity and size, the country had a highly centralized administrative and fiscal system. The central government collected 94 per cent of general government revenue and funded 60 per cent of sub-national spending. Transfers included a combination of subsidies, earmarked grants and shared taxes from central and provincial governments.

In the major drive to decentralize the country, from 1999 to 2001, the share of public expenditures channelled through local governments rose from around 17 per cent to over 30 per cent; two-thirds of the central government's civil servants were reassigned to the local level; and more than 16,000 service facilities were transferred to district governments across the country without major disruption to government services. Since then, Indonesia has continued to decentralize more cautiously correcting any imbalances and addressing major concerns as it proceeds. Decentralization laws in 1999 devolved wide responsibilities to local government in urban and rural districts. Cities and villages are now responsible for providing healthcare, education, public works, communications and the management of land and other environmental resources, as well as support to agricultural, manufacturing and commercial activities. Further regulations enacted in the year 2000 mandated the provinces to undertake functions that localities are unable to perform. Nevertheless, local authorities have achieved a significant degree of autonomy and their appointed heads report to elected local assemblies. The devolution of responsibilities was matched by the devolution of control over expenditures, but the decentralization of revenue did not follow. In 2001, the routine transfers of the past (largely used to pay the salaries of local civil servants, along

with general development transfers) have been replaced by General Purpose Grants (DAU) currently set at 25.5 per cent of net central government domestic revenues, and split between local governments and the provinces on a 90:10 basis. The allocation formula is based on fiscal needs and capacities. Expenditure needs are based on an index of four weighted indicators: population, area, poverty level and prices, while fiscal capacity is measured by collections of own revenue and shared taxes. The DAU, which accounted for 71 per cent of total local government revenues in 2001, is the most important equalization mechanism.

The Specific Purpose Grants (DAK) are matching grants for certain regions based on urgency of need and national priorities. The allocation formula is still in the process of finalization. The shared revenues include taxes from land, fees on property transactions and revenues from natural resources. The regulations specify the portion distributed to provinces and districts. In 2001, shared revenues represented around 12.7 per cent of revenue in urban localities, and may contribute to widen regional disparities since resource-rich jurisdictions receive the bulk of the transfers.

Local governments own revenues (PAD) are derived from tax levies, profits of local government-owned enterprises and other levies. In 2001, the own revenues of urban municipalities were estimated at around 9.7 per cent of total revenues. In 2004, local government was empowered to institute new taxes upon satisfying certain “good tax” criteria, and to set local tax rates though within the ceilings stipulated by the regulations.

Two major impediments impair local revenue expansion, namely the lack of a major, locally controlled tax base, and the proliferation of low-yield taxes and levies. Since revenue from land and property taxes continues to flow to the central government before being redistributed to the provinces and regions, local government has resorted to levying

*Box 1. (continued).*

a multiplicity of low-yield taxes and charges. Their proliferation led to a recent revision mandating central approval of new social taxes.

In view of the hardships endured by impoverished populations, the central government in 2003 decided to reinstate the targeted transfers for basic education, health, and infrastructure services. In parallel, a separate “poverty alleviation grant” funded through the World Bank was provided to local authorities for capital investments that contribute to poverty alleviation. Access to the grant is conditional on partnership with CBOs in the preparation of proposals, the selection of projects and the implementation of activities, as well as on adopting provisions ensuring that communities participate as full partners in decisions regarding the allocation of funds.

*Source: Chakeri and Lewis, 2004; Menon and others 2003; World Bank, 2003a.*

bodies, remains quite weak. ULBs are unable to fund local infrastructure and services out of central and State government transfers alone.

Decentralization did not significantly change the revenue base for Indian municipalities. Revenue generation is still regulated by State governments. Setting or capping of tax rates and control over municipal expenditure and taxation are common. State governments can borrow freely, unless they have outstanding loans or the loans require sovereign guarantees. Municipal corporations must obtain State government approval prior to issuing debt.

The challenges faced are daunting but the stakes are high. It is estimated that Indian cities and towns have a potential of producing 70 per cent of the country’s gross domestic product by 2020, but lack the services needed to realize this potential. The National Sample Survey Organization estimates that only 45.8 per cent of urban households have tap water within the premises; 25.5 per cent of households have no access to latrines; and only 18 per cent of households are served by municipal garbage collection (Prakash Mathur and Thakur, 2004).

### 2.2.3 Dealing with economic marginalization and social hardship

Largely marginalized from the global economy and with the notable exception of South Africa, Sub-Saharan African countries are bearing the brunt of the social cost of globalization. Rapid urbanization, civil strife and wars compound the impacts of economic crisis and natural disasters. Municipalities find they are unable to plan and implement projects and deliver services to impoverished populations, let alone formulate viable development strategies. Yet, decentralization has been proceeding more or less smoothly since the mid-1980s. In the countries of the West African Economic and Monetary Union (UEMOA), and despite their lack of adequate technical, managerial and fiscal resources, local government has become the prime providers of services and investment in basic infrastructures. Even though transfers from the central government are still dominant, the contribution of local taxes has been growing steadily. By 2003, the contribution of locally collected revenue to municipal budgets in the region ranged from a low of 45 per cent in Côte d'Ivoire to a high of 80 per cent in Niger, a marked improvement over previous years (see Table 4).

**Table 4. Structure of municipal operating revenue and expenditures in selected West African countries (%)**

Operating revenues	Benin		Burkina Faso		Mali		Côte d'Ivoire	
	1996	2000	1996	2000	1996	2000	1996	2000
Municipal taxes	4	22	4	2	4	19	4	6
Transfers	50	51	53	58	60	54	65	45
State subsidies	12	3	0	0	1	14	13	14
Land revenues	2	3	9	17	0	3	1	1
Services revenues	2	10	9	9	33	7	11	14
Other	11	11	25	8	5	3	5	9
Expenditures								
Capital expenditures	20	28	30	39	30	34	20	18
Personnel	31	23	23	16	26	24	17	20
Others	49	49	47	45	44	42	63	62

*Source: PDM 1996, 2000.*

Even though recurrent operating expenditures are the largest component of local budgets, there has been a steady rise in capital expenditures financed from local resources. They vary considerably from year to year as a function of both the collection rate of local taxes and the availability of transfers and subsidies from the central government. In some instances, the central government has created new mechanisms to encourage local development and provide supplementary resources: for example, the purpose of Benin's proposed Inter-communal Solidarity Fund is to promote the balanced socioeconomic development of municipalities.

Generally, financial autonomy is related to the size of a municipality. In Burkina Faso, for example, smaller municipalities tend to operate at a deficit, while larger cities of 50,000 inhabitants or more balance their budget and have per capita investment rates roughly twice those of smaller municipalities.

Although fiscal decentralization also started in the 1980s in East African countries, it only gained momentum from the mid-1990s onward. Wide variations prevail throughout the region. In the year 2000, Ethiopia's State governments accounted for 31.2 per cent of total public expenditures and raised 18.9 per cent of revenue, while Uganda's local governments accounted for 28 per cent of expenditures but raised less than eight per cent of revenue. South Africa's provincial governments accounted for 46 per cent of total expenditures but raised an average of only four per cent of their revenues, while local governments accounted for 25 per cent of public expenditures, but raised 92 per cent of their revenues. Functional responsibilities also vary across countries. In Ethiopia and South Africa, State/provincial government is responsible for healthcare and education and, in the case of South Africa, welfare. In most other countries, these functions are still discharged by central government and NGOs have stepped in to fill the gaps left by inadequate delivery systems.

The local revenue bases also differ across countries. Ethiopian States rely predominantly on shared taxes (personal income, business, and sales taxes, excise). In Kenya, local government relies on property tax and, since the late 1980s on local payroll and business taxes. In Uganda, the most significant sources of local revenue are income, wealth and poll taxes; the property tax

is only significant in the larger urban centres. In South Africa, provincial government generates revenue from motor vehicle fees, hospital charges and more recently, gambling. Local government depends on surpluses from services, mainly electricity and water supply, property rates and, in large metropolitan areas and district councils, a business tax.

In all countries in Sub-Saharan Africa, central transfers provide the main source of local finance. Ethiopia uses a single-block transfer scheme based on a complex formula. In FY2000, Kenya adopted a transfer system distributing five per cent of income tax revenues to local government. In South Africa, the national government transfers to provinces and municipalities an unconditional block grant, known as the “equitable share”, based on the size of the population living below the poverty line. This transfer funds more than 95 per cent of provincial expenditures, but less than 10 per cent of municipal expenditures on average. The Municipal Infrastructure Grant programme and other conditional transfers, some of which are off-budget, fund capital expenditures on infrastructure and urban services (Municipal Development Programme, 1996, 1997, 1998, 2002,). In 1995 the South African government launched the Municipal Infrastructure Grant Programme<sup>2</sup> to “ensure that all communities have access to at least a basic level of service.” The programme funds all categories of infrastructure as well as some community facilities, and devotes a percentage of the cost of every project to build the technical and managerial capacity of municipalities.

The MIFG programme offers household grants to cover basic services costs. It aims to reach poor urban and rural communities. The allocation formula combines three indicators to assess needs: number of families earning less than 800 rand (ZAR) per month, lack of water supply, and rate of unemployment in the community. To ensure their involvement, the communities must make all funding requests, and municipalities play a major role as they prioritize the requests. It is then for provincial governments to review their eligibility and submit the proposals to the

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2 In 1998, MIP was recognized as a Best Practice under UN-HABITAT Best Practices and Local Leadership Programme.



national government. The grants are disbursed to the community through the municipality. Structured for geographic outreach and speed of delivery, the programme has completed over 2,500 projects. In 1998, the government expanded the programme's scope to reinforce links with local economic development, and the budget has steadily grown, reaching ZAR2,357 million in 2003/2004. At the time of writing, this was the largest and most ambitious programme of its kind in the world<sup>3</sup>.

## **2.3 The evolution of financial systems towards more transparency and accountability**

Accountability for performance is a cornerstone of good governance and a major financial management tool. It places as much emphasis upon transparency as upon finance. Increasingly, mayors, councils and city managers are held accountable for financial outcomes, as well as for the quality of the services they deliver and the projects they implement. Democratic local governance has fuelled increasing demands for local empowerment and for greater public participation in determining how public revenues are raised and spent. From conventional public budget hearings to participatory budgeting, people are demanding a voice in the resource allocation procedures and supervision of implementation.

Demands for greater accountability and transparency by voting and taxpaying constituencies have combined with constraints on the financial resources available to the public sector to fuel political pressures for improved municipal financial management. Reform of existing systems and the introduction of newer concepts and techniques have provided valuable alternatives in financing and operating public services. Reform has also opened the public sector more widely to many innovations and efficiencies that hitherto were largely confined to the private sector, prompting governments to improve their accounting and budgeting routines.

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3 Unpublished updated information graciously contributed by MIP project officers. Quoted in Serageldin *and others* (2003) *Local Authority driven interventions and processes*

As recurring expenditures have increasingly come to dominate budgets, techniques for determining expenditures and measuring actual performance have been developed and incorporated into budgetary routines. Best practice demands that capital expenditure be budgeted and accounted for separately from recurring operating expenditures; that operating expenditures be financed from fees, charges, regular taxes, regular shared revenues and recurrent government grants, and not allowed to exceed these current revenues, and that borrowing (when permitted by law) be restricted to financing capital investments, with the possible exception of making up for temporary cash-flow shortages. These principles of financial management are increasingly worked into public finance legislation as it relates to State/provincial and local budgeting; they provide a framework for financial management and assessment of performance whereby local officials and elected representatives are held accountable for their own actions.

Until very recently, practice has varied across countries in terms of scope and effectiveness. Accounting systems for those activities to be funded from general revenues are often much simpler in form but cover a wide variety of functional domains. Unfortunately, in many countries, and particularly in developing countries, local financial systems typically fall far short of the structure and rigor needed to provide instruments and indicators for policy formulation, resource allocations and strategic capital investment decisions. With many accounting systems currently in use in State/provincial and local government in various countries, incompleteness is the typical state of affairs. Therefore, unit costs and other indicators derived from these numerical data will not usually account for the totality of the resources either committed or consumed.

Because of the importance of proper, functioning capital markets to the world economy, concern has been focusing much more on the development and implementation of accounting practices within the private than the public sector. A whole range of international accounting standards have been promulgated by the International Accounting Standards Board for the private sector. Discussions are currently in progress to widen their scope to certain countries which, until now, have not fully recognized them. These include the USA, the UK and Canada.

The Public Sector Committee of the International Federation of Accountants has only recently begun to issue what is known as the International Public Sector Accounting Standards. Adherence to these standards has met with some resistance because central governments are reluctant to yield any degree of sovereignty to international bodies. Furthermore, the range and complexity of their functions require sophisticated systems of financial accounting that tend to overwhelm the capacity of government finance and budget staff. The new system is even more of a challenge for local government.

Municipal financial accounting systems rely on two main formats. For revenue-producing functions, the financial accounting systems are often quite similar to those used in private sector enterprises, particularly when the activities are performed by an entity that is legally separate from core functions though funded from budgeted general revenues. Under the influence of decentralization and economic transition, the number of categories and entities financed through off-budget sources has multiplied during the past decade, particularly in Eastern Europe. Some have been established specifically for the purpose of circumventing constraints of State/provincial and local governments on financial autonomy, as happened in China and is now occurring in India and elsewhere (Freer and Petersen, 2004).

### **2.3.1. New trends in local financial management: Performance-based budgeting and accrual accounting**

Performance-monitoring for local government began to take off in the mid-1980s, with the UK and the USA leading the way. Individual councils began to develop performance indicators, although these tended to measure what was measurable rather than setting markers for the achievement of specified objectives. Elsewhere in Europe, governments have taken to performance-monitoring, although national mandated systems have largely been avoided. No matter how tight the definitions, the indicators used must take into consideration the different ways in which service delivery is organized. Data variations will sometimes arise on the sole basis of different interpretations, rather than differences in substantial performance.

Future success may well lie in local indicators, benchmarked against similar jurisdictions, rather than national data.

Performance indicators should reflect local objectives, be understood and supported by local officials, and integrated in performance review systems. Using simplified performance information to consult and involve communities has helped cities engage citizens in shaping the future of their communities, as happened in São Paulo, Brazil and Bogotá, Colombia.

A distinction should be made between performance *measurement* and performance *budgeting*. “Performance budgeting“ accounts for the measurement of outputs relative to the cost of inputs based upon the best determination of costs possible with the data at hand. When performance measurements are based on unit costs, their usefulness for performance-based budgeting depends on the degree to which cost computations for both budgetary estimates and reported final results are consistent with and account for total economic resource consumption. Those performance measurements not based upon unit costs are used for a variety of management purposes, but are not direct, integral components of performance-based budgeting.

Data produced for the purposes of performance measurement must be reviewed by senior finance and budget officials, as well as other senior officials in managerial positions, to ensure that selected indicators development goals and objectives correlate and that all critical inputs and services are covered. Municipal finance is more and more focused on the sources and modalities of securing funding for programmes and projects to leverage scarce local resources. At the same time, accounting practices are increasingly shifting their own focus away from the manner in which fixed assets are financed, concentrating instead on the financial costs of the resources consumed by the use of these assets in service delivery.

Plans, programmes and budgets are primarily concerned with inputs, whereas the public is concerned with outputs. For example, in the supply of water, plans, programmes and budgets are concerned with supply sources, treatment, transmission and distribution. The customer is concerned with the quality and cost of potable water flowing from a tap. Performance reflects both outputs (the services and products delivered) and outcomes, i.e., the degree of user satisfaction with the outputs. Performance budgeting

must be complemented by a participatory assessment of policies and programmes. This requires credible monitoring and financial reporting systems. Incorporating these features can be done in a strategic manner, giving service managers a reasonable degree of flexibility and discretion to make changes to service delivery methods, during the course of the budget period, in order to ensure that final outcomes are closely in line with the budget.

Performance measurement allows a review of the budget where outputs are related to specific municipal development objectives. In more developed budget systems, measurement of financial performance against the budget is only a starting point. Many sophisticated performance measures have been developed, which allow much better decision-making about the quantity, the quality and the value-for-money of services being provided.

To meet the objectives of accountability and transparency, performance-budgeting systems are moving away from cash-based “receipts and payments” to accrual-based “income and expenditure” accounting, thereby shifting the focus from cash expenditures to costs, in terms of consumption of economic resources. Costs – in terms of resource use – of any business or public activity must include expenditures on the operation and maintenance of all premises, plant and equipment administration and management, including taxes, and the capital cost recovery of all fixed and working capital. A reasonable margin to cover contingencies and risks can be added. Most financial budgets and accounting statements in the world’s public sector are still prepared and reported on a cash-flow basis, impairing their usefulness for performance measurement. However, in some countries, laws are coming into force to require the use of accrual accounting, which is greatly facilitated by computerization.

For some public services (in particular water supply, sewerage, drainage and transport), operation and maintenance costs represent small inputs in terms of economic resource use, compared with the massive quantities of land, buildings, infrastructure and equipment that are in constant use, to keep the systems functioning. Yet, despite this massive input of fixed assets there has been a great reluctance, all over the world, to account for their use. Consequently, public service decisions, especially with respect to pricing

of services, are often made on the basis of cash flow data for operating expenses.

Currently, the need for comprehensive cost analysis and accounting for fixed assets is better recognized. Depreciation costs are charged in operating statements. The net worth of fixed assets is periodically revalued to their current values and the operating statements are charged with notional interest, reflecting the opportunity cost of capital invested.

Reform of existing systems and transition to newer financial systems usually take several years to implement. To prepare and update an inventory of fully recorded and valued fixed assets, the local government or other service delivery unit needs specialized personnel which they may not necessarily have. They must either build this capacity, or procure the services by contracting out.

Local governments in some advanced countries are adopting cost-based accounting to include the cost of capital in the consumption of economic resources, in response to central government requirements for cost-based performance measurement. However, in those developing countries where revenue collection is inadequate, municipal budgeting ceases to be an instrument of sound financial planning and becomes another vehicle for local political manoeuvres. Progress is being made worldwide towards more transparent local financial management. For example, two of the world's largest countries, Russia and Indonesia, have very different cultures and histories. Yet, each one over the past few years, has promulgated legislation requiring the use of full accrual accounting by State/provincial and local governments. In Russia, St. Petersburg and a few other major cities embarked on this course in the 1990s. As housing and shelter are among Russia's most pressing social concerns, related financing and budgeting must undergo a complete overhaul. In Indonesia, capacity-building is helping local authorities implement accrual-based budgeting, but progress is still slow.

Less ambitious trends have appeared in smaller countries. For example, Macedonia in 2003 conducted a series of national seminars sponsored by UNDP on: "Strengthening Local Self-governing Institutions through Capital Development, Transparency and Financial Accountability", in a bid to build

capacity prior to reform of local financial systems. In the poorer countries, donor-sponsored fiscal decentralization includes the development and institutionalization of accounting reforms to ensure that the systems meet donor requirements. Capacity-building is extended to local governments to ensure proper implementation of the new systems, often starting with pilot initiatives (Jones, 2003; Jones and Wagstaffe, 2002; Jones, 2004).

### **3. Patterns and trends in municipal budgeting**

The municipal budget reflects policies and strategies for the delivery of mandatory and locally approved public services. Its structure should make it an instrument of municipal management. The budget should be capable of demonstrating the extent to which the budgeted financial results have been realized, the intended activities performed and the anticipated outcomes achieved. Lack of financial management skills at the local level often impedes the preparation of accurate and comprehensive budgets. In many countries, local budgets are just lists of cash receipts and payments that are not categorized in any useful way. Often, there is no clear distinction between operating and capital expenditures. Budgets respond primarily to the mayor's priorities, requests by councillors, potential funding from higher tiers of government and outside sources, and electoral promises.

In spite of continued reliance on central government transfers, locally generated revenues have risen steadily. Transfers account for the bulk of local resources in most countries, particularly for capital investments, and are usually based on a redistribution of certain centrally collected revenues: a partial redistribution of VAT, entitlement grants for recurring expenditures, and grants for specific projects. Transfers bridge the gap between the revenue-raising capacity of municipalities and mandatory local expenditures. The three main sources of local revenues are the property tax, a tax on economic activities (including sales tax) and user fees for services. Although locally based, and therefore reflecting the range of economic activities found in a locality, these taxes are often set at the national or regional tier (as is the case in India), and may be collected by a central administration on behalf of municipalities. In several West African countries, the central government retains a portion of the tax collected. A variety of low-yield local taxes are also to be found, often the holdovers from the colonial era.

Efficient tax collection is a daunting problem, particularly in parts of those areas of the world experiencing rapid urbanization. Lack of up-to-date records and inadequately trained personnel, together with the prevalence of informal housing and of unstructured, "floating" economic activities, are major obstacles to increased financial self-reliance of local government. This



has prevented the development of multi-year capital investment strategies, which are indispensable if local authorities are to be in a position to ensure an adequate supply of serviced land, the delivery of improved services and, generally, to meet the goals of sustainable urban development. There are notable exceptions where municipalities have been steadily increasing the efficiency of local tax collection. In Brazil, a series of reforms culminating in the enactment of the 2000 Fiscal Responsibility Act redefined the responsibilities of State/provincial and local government by imposing fiscal management standards, spending limits on personnel expenditures and mandating the preparation of capital improvement programmes. In Africa, UEMOA countries have significantly increased the yield of local taxes, including assessments on property improvements and on informal economic activities.

Salaries, wages and supplies are the principal expenditures of local authorities and leave few resources for the maintenance of existing assets and the capital investments required to finance urban development. In most countries in Africa, Asia and Latin America, municipalities are not able to borrow long-term funds on the capital markets and instead must rely on targeted transfers for capital investment. This may be due to legal constraints or a lack of the technical and managerial skills needed to identify potential funding sources. As a result, most local capital budgets reflect immediate needs or political expediency, rather than long-term development strategies. Brazil's participatory budgeting, first established in Porto Alegre in 1989, is a notable exception and is being widely emulated. The scheme addressed immediate as well as strategic needs, providing significant infrastructure and service improvements to poorer communities. Some cities have also been able to devise coherent strategies to ensure that a stream of relatively small annual capital improvements became an integral component of a long-term development strategy. A rolling four-year capital investment programme, has allowed the city of Szczecin, Poland to improve its financial management standards to the point where it became attractive for local and foreign investors, obtaining a credit rating and borrowing through commercial financial institutions.

### 3.1 Reliance on central transfers

Inter-governmental fiscal transfers include three components: (i) shared taxes, such as income and VAT taxes that are more efficiently managed at the national or regional level; (ii) distributional grants to somewhat equalize mismatched needs and resources among local governments; and (iii) specific-purpose grants. Other contributions from central or State/provincial governments to support local budgets are common accepted practice. These *ad hoc* grants to plug unplanned deficits are often provided on a piecemeal, year-to-year basis and, together with private debt, contribute to national financial crises, as in South East Asia in 1997 and Brazil in 1998.

In most developing countries, local authorities have little understanding of redistribution formulas or rules governing central transfers. Hence, the tendency to consider these as grants to balance the local budget irrespective of their economic or social purpose. Operating expenditures, once determined, are relatively inflexible and difficult to adjust in the face of adverse short-term changes in financial circumstances, which encourages local authorities to cut back or defer outlays on maintenance and capital expenditures. The environmental and social impacts of infrastructure neglect or delayed maintenance include breakdowns and deterioration of existing systems, water losses and perched water tables, contamination and corrosion.

Since estimates of grant and revenue-sharing allocations are hardly ever made available to local authorities in adequate time for them to prepare their own annual budgets, the practice is to assume amounts equivalent to the previous year's transfers without any assurance that the budget amounts will actually materialize. Fluctuations in central transfers invariably lead to *ad hoc* budget cuts, or unplanned expenditures if the funds cannot be rolled over to the following year. Whether the objective is greater efficiency in collection or greater fairness in distribution, central funding will usually be accompanied by some measure of control or supervision over the relevant local activities. Cumbersome controls encourage corruption and politicization of allocation decisions. They can also become stifling of local initiative and negate some of the benefits of decentralization and democratic governance.

Estimating revenue for budgeting purposes cannot be separated from local politics. Even when some financial data can be relied on, the computation of revenues is frequently tweaked to obtain the highest possible transfers and grants under the allocation formulas applied by central or State/provincial governments. Revenues are understated when transfers are granted to plug forecasted budget deficits, or when redistribution formulas favour localities with lower revenue-generating capacity. Revenues are overstated when transfers are related to the performance of local revenue collection.

In Indonesia, decentralization has expanded local government current revenue<sup>4</sup>. Between 1999 and 2002, current revenue in nominal terms grew by a factor of 3.4 at an average annual rate of 57 per cent. Central government grants contribute a dominant though slightly decreasing share, from 76 per cent in 1999-2000 to about 69 per cent in 2002. Meanwhile, the contribution of shared revenue grew from under 13 per cent to over 18 per cent in 2002. The contribution of local revenue sources declined steadily from about 13 per cent in 1997-1998 to less than seven per cent in 2001.

From 1999 to 2002, local government expenditures in Indonesia have risen by a factor of 3.3 at an average annual rate of 55 per cent in nominal terms. Capital spending increased by 60 per cent annually, slightly outpacing a 52 per cent increase in operating expenditure. However, the overall structure of local government expenditure has barely changed. Wages are still the dominant component, although its share has decreased slightly from over 50 per cent to under 45 per cent of total expenditure. Conversely, other recurrent expenditures have increased somewhat, from 17 per cent to about 21 per cent of the total.

In 2004, the five major sources of local revenue were: (1) central government transfers (DAU, DAK and others); (2) own revenues (PAD); (3) carry-overs; (4) borrowings; and (5) other revenues (e.g., transfers from provincial governments). The major components of local expenditure are: (1) civil service salaries, purchases of goods, travel expenditures, loan interest payments, others; (2) unforeseen expenditures; (3) assistance to

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4 “Current revenue” as used here does not include carryovers from previous years.

regions and communities in the jurisdiction; (4) reserve funds; and (5) development expenditures.

Among development expenditures, the most notable categories are trade and transportation (about 11 per cent of total expenditure in 2002), regional development (6.4 per cent), state apparatus (5.7 per cent) and education (5.0 per cent) (World Bank 2003b; Menon, 2003; Chakeri and Lewis, 2004; Freire and Petersen, 2004).

### **3.2. Control of local revenue generation by provincial/ regional government**

Despite the wide differences in economic, demographic, social and cultural circumstances, India – a rapidly developing economy – and Russia – a country in the midst of a difficult transition – have both opted to give provincial/State government control over the taxes that municipalities can levy and collect.

In India, *octroi* (a traditional tax on the entry of goods into an area for consumption, use or sale) is appreciated as a buoyant source of revenue by municipal government, but is also viewed as a barrier to free trade and is being phased out. Only Gujarat, Maharashtra and Punjab allow municipalities to levy *octroi*. The latter State has taken a decision to abolish it and is exploring the possibility of substituting a new tax called the Local Area Development Tax. Abolishing *octroi* without a substitute tax in place has substantially eroded the revenue of municipalities in such States as Haryana, Orissa, and Rajasthan, where per capita receipts fell from a high of 272 Indian *rupees* (INR) in 1997/1998 to INR80 in 2001/2002. Other local taxes include those on land and buildings; animals and boats; tolls; professions, trades, employment and entertainment; but few municipalities have the capacity to activate all the tax revenue sources within their powers.

Transfers and shared taxes bridge the gap between the revenue-raising capacity of municipalities and their expenditure needs. These transfers influence their spending patterns and help reduce geographic inequalities. State/provincial transfers are a major component of municipal revenue, contributing an average 31.7 per cent in 2001/2002, including assigned

revenues, compensatory grants, revenue-sharing arrangement and grants-in-aid. These transfers have increased by a factor of 1.7 between 1997/1998 and 2001/2002. Unlike Brazil, India has no statutory provisions defining the modalities of State transfers to municipalities. This accounts for the wide variations observed among the States and the lack of stability in State-municipality fiscal relations. State financial resources are not strained by their transfers to municipalities, since these account for only 2.43 per cent of their budget. The allocation criteria include indicators of size, fairness, need and efficiency (see Table 5).

The expectation that functional devolution will be accompanied by a corresponding transfer of fiscal powers has not been fulfilled in India. Inter-governmental relations continue to be characterized by unpredictability and instability. Lack of distinction between the capital investment account and the general revenue account in transfers adds to the confusion caused when transfers are accounted for under the same headings, whether or not they have been previously included in the plan. The figures for total per capita revenue and per capita local revenues in selected States illustrate the wide variations existing across regions.

**Table 5. India: the role of transfers in municipal finances (2001/2002)**

State	Transfers (INR million)	% of Total municipal revenue	Per capita transfers (INR)
Maharashtra	94,177	13.8	239.6
Uttar Pradesh	77,488	74.5	232.1
Karnataka	60,859	51.9	347.7
Rajasthan	51,703	83.3	403.5
Tamil Nadu	46,770	33.7	180.7
Gujarat	31,395	17.8	175.5
Kerala	17,949	44.5	296.9
Punjab	8,489	10.1	105.1
Orissa	8,047	44.2	153.8
Haryana	7,892	39.5	135.5
Bihar	5,559	62.0	64.4
Assam	1,624	29.7	65.1
Goa	941	33.6	258.6

*Source: Prakash Mathur and Thakur, 2004.*

Since 1991, tax reforms in India have reduced income tax rates, custom duties and excises, and simplified the system ahead of efforts to institute a value-added tax (VAT). These reforms did not extend to municipalities. Municipal revenue has risen at an average annual growth rate of 10 per cent, but this is not enough to deliver services at acceptable levels, as evidenced by an average expenditure level estimated at INR577 per capita in 2001/2002. Municipalities in several States including Bihar and Uttar Pradesh are almost entirely dependent on transfers to operate local services. This dependency has risen over the past five years, primarily in Haryana, Orissa and Rajasthan. In the *octroi*-levying States of Gujarat, Maharashtra and Punjab, transfers as a proportion of total municipal revenues are low but have been rising with the abolition of *octroi* due to compensatory grants.

The large variation prevailing among localities underscore the link between urbanization, economic strength and fiscal capacity. Municipalities in Bihar generated an average of INR39.5 per capita compared with INR1,493 in Maharashtra and a country-wide average of INR482. Many States have posted high annual growth of own revenues. Between 1997/1998 and 2001/2002, Kerala, Karnataka, Maharashtra, Gujarat, Punjab and Tamil Nadu were among the better performing States, while Assam, Bihar, Haryana, and Rajasthan were found lagging. In the stronger States, the municipalities contributed 82.2 per cent of the total increase in public revenue. Overall municipal revenues rose in parallel with the increase in the State's GDP.

Disparities among India's municipalities are extraordinarily large and have increased in the first phase of the decentralization process. In 2001/2002, municipalities in Maharashtra with a share of 14.4 per cent in total urban population account for 48.5 per cent of the total municipal revenues in India: 12 per cent in Gujarat, 7.6 per cent in Tamil Nadu, 6.2 per cent in Andhra Pradesh, 5.9 per cent in Karnataka and 4.6 per cent in Punjab. The remaining States, with over 50 per cent of the country's urban population, account for only 15 per cent. Municipalities levy user fees but the charges do not seem to reflect the costs of providing the service. Municipalities in Gujarat and Maharashtra have taken on the largest range of responsibilities, including water supply, sewerage, hospitals, transport and other services. *Octroi* taxes

provide them with the revenues needed to operate these services (Prakash Mathur and Thakur, 2004).

In Russia, municipalities account for less than 10 per cent of revenue in the consolidated federal budget. The increase in the share of the federal government is in part due to the discontinuation of VAT transfers and the restructuring of the debt of some enterprises and “organizations”. While the budget of regional governments increased, municipalities’ revenues were sharply cut back – falling from 10.9 per cent in 1997 to 6.5 per cent in 2002 – as the 1998 financial crisis substantially reduced public receipts and led to a shift of revenues from local to provincial (*oblast*) budgets (see Table 6).

**Table 6. Distribution of revenues between budgets at all levels in Russia (% of GDP)**

Years	Federal budget	Federal budget (excl. transfers)	Regional budgets	Regional budgets (excl. transfers)	Local budgets
1992	18.8	n/a	6.8	n/a	7.0
1993	13.1	n/a	8.4	n/a	8.2
1994	13.6	n/a	9.7	n/a	8.5
1995	14.2	n/a	7.5	n/a	7.3
1996	12.8	10.8	9.1	4.9	10.2
1997	13.8	10.8	10.4	6.6	10.9
1998	11.9	9.7	8.9	6.3	8.7
1999	12.9	11.3	8.3	7.1	6.8
2000	16.0	14.6	10.0	8.7	6.4
2001	17.5	15.1	10.1	7.8	6.2
2002	16.3	13.5	10.9	8.3	6.5

*Source: Chernyavsky, 2002.*

In Russia, local government is legally allowed to levy 22 different taxes and fees that are considered own-revenue sources (but including those taxes shared with federal and regional government), in addition to local fees and the sale of assets. Transfers as a budget heading cover the annual share of federal and regional taxes negotiated and assigned to local budgets, as well as equalization grants for redistribution purposes. The structure of municipal revenue over seven years is shown in Table 7.

**Table 7. Structure of Russian municipal revenues (1996-2002 - in %)**

Revenues/years	1996	1997	1998	1999	2000	2001	2002
Tax revenues, including:	59.5	60.5	63.6	69.4	68.2	61.2	53.5
VAT	7.1	7.5	7.9	6.8	5.3	0	0
Profit tax	11.5	9.3	9.1	14.6	13.5	16.7	10.9
Income tax	16.95	18.2	18.4	16.6	16.8	21.1	23.3
Property taxes	9.2	8.9	10.0	7.8	6.2	6.7	7.1
Sales tax	-	-	0.02	2.8	2.9	2.8	2.5
Local taxes*	n/a	n/a	11.2	13.4	14.9	5.1	3.1
Non-tax revenues	2.4	2.2	3.7	3.6	3.5	4.3	6.0
Transfers	37.8	37.3	32.5	26.7	28.3	34.2	40.5
Municipalities' own revenues	-	-	24.92	27.6	27.5	18.9	18.7

\*This excludes individual property tax, but includes land tax

Source: Chernyavsky, 2002.

Available data is neither complete nor uniform. For the year 2000, figures were available from 48 cities only. Overall, from 1996 to 1999, the share of tax revenues grew in Russia while the share of transfers declined. However, from 1999 to 2001 the share of transfers from the federal budget grew to 80 per cent, as municipalities and local budgets became more dependent on transfers as a source of revenue. Fiscal imbalances have increased in some regions, most notably in the Volga Federal District where, in the Komi-Permyatsky autonomous *okrug*, 80 per cent of municipal expenditures are funded by transfers.

Income tax has been the main source of transfer revenue for Russian municipalities from 1997 to 2002. However, the *Law on Financial Principles* requires that at least 50 per cent of income tax revenues be transferred to local budgets, though it falls short of specifying how they are to be allocated among sub-national entities. In practice, local authorities negotiate these allocations with regional government in the annual budget cycle. The significance of the profit tax as a source of local revenue grew after 1998 when VAT transfers were discontinued. Local authorities also negotiate their shares in profit tax revenues with regional government. Given these uncertainties, municipalities must contend with instability and lack of predictability in their financial resources. As shown in Table 7, the



municipalities' own revenues include property taxes, the sales tax, local taxes (including land tax) as well as shares in VAT, corporate profit and individual income taxes set by federal law. These revenues declined sharply after 2001, when the housing and communal service taxes were abolished.

The distribution of tax revenues for budget purposes highlights the wide variations that prevail, due to the combined effect of regional economic strength, the individual circumstances of each municipality and the uneven system of inter-governmental fiscal transfers in force in each region. Similarly, municipal expenditure patterns reflect successive adjustments in devolution policies. Their functional structure over the 1996-2002 period is shown in Table 8.

**Table 8. Functional structure of local expenditure budgets in the Russian Federation (%)**

<b>Expenditure items/ years</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Local administration	3.3	4.3	5.3	5.7	6.0	6.5	6.7
Infrastructure and economic activities	8.3	6.6	7.0	6.3	5.7	10.5	9.9
Housing and communal services	26.6	27.0	30.3	27.4	28.9	24.6	19.5
Education	25.6	26.2	28.1	28.1	28.0	28.0	33.2
Culture, arts and cinema	2.1	2.1	2.3	2.5	2.8	2.6	3.0
Public health and fitness	14.5	14.5	15.0	15.8	16.0	14.9	15.5
Social policy	7.2	6.3	5.7	5.5	4.8	6.5	7.6
Other expenditures	12.4	13.0	8.6	8.7	7.8	6.4	4.6
<b>Total expenditure</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

*Source: Chernyavsky, 2002.*

Expenditure patterns exhibit greater stability than might be expected. Emerging trends include increased expenditures on administration and a levelling on housing and communal services, due to new federal legislation that has effectively increased residents' contributions. Spending patterns remained constant from 1999 through 2001 in major categories of municipal expenditures (housing and utilities, education and health) as well as in smaller social categories. In 2001, these spending items increased sharply. Changes in the accounting systems, whereby capital investment in the housing and utility sectors were recorded as spending in the industrial,

energy and construction sectors, artificially increased local expenditures on these categories.

More than 120 federal laws passed since 1999 call for providing subsidies to specific population groups. Regional and local authorities are expected to pay for 37 categories of subsidies and benefits. The fiscal impact of these mandates has not been adequately assessed. The largest federal mandates are estimated at 3-4 per cent of GDP, or 20-25 per cent of the consolidated regional and local budgets of the Russian Federation. The most onerous mandate is a regulation on civil servants salaries. In November 2002, a long-overdue resolution increased salaries by a factor not exceeding 1.7. Regions were to be compensated for the additional expenses incurred, but in the end federal transfers met only about 10 per cent of the added cost; this forced regional authorities and municipalities to trim expenditures on other budget items, starting with deferral of badly needed maintenance of existing assets and curtailed capital investment (Chernyavsky, 2002).

### **3.3 Building local capacity to raise and manage own revenue sources in West Africa**

In sharp contrast to the situation prevailing among developing countries in East Asia and East Africa, municipalities in UEMOA must rely on locally collected revenue, which ranges from 45 per cent (Côte d'Ivoire) to 85 per cent (Niger) of municipal budgets. The two principal revenue sources are the commercial tax (47 per cent) and the property tax (24 per cent). Other sources are charges for public services (19 per cent) and revenues derived from leasing public lands. In the case of commercial and property taxes, it is left to national legislation, rather than local authorities, to determine the assessment rate, and the central administration is responsible for collection. Therefore, the central administration is responsible for the preparation and periodic update of tax rolls, sending out tax bills and enforcement of collection. This system was designed to make up for a lack of local capacity, particularly in smaller municipalities, but tends to lag behind changing conditions; this often results in under-taxation in those municipalities experiencing rapid economic development or spatial expansion, as cadastral records rarely keep up with new development.

Commercial tax is theoretically levied on all economic activities and assesses separately the rental value of fixed capital (premises and equipment) and the value of output. The fixed capital assessment rate varies considerably from country to country: from six per cent to 12 per cent in Senegal, and two per cent and six per cent in Togo; in Benin, five per cent for the premises, six per cent for heavy machinery and 10 per cent for other equipment; and a uniform 10 per cent rate in Burkina Faso, Mali and Niger, though with the odd modulation in certain cases.

Tax authorities use various criteria to assess output value: volume of sales in Senegal, Togo and Burkina Faso; volume of sales, location of the activity and value of imports in Benin; nature and location of the activity and sales volume in Côte d'Ivoire; and nature and location in Mali. Even though this tax is based on purely local economic activities, in some countries central government retains part of the yield: 64 per cent in Côte d'Ivoire and 50 per cent in Togo. In Mali, 40 per cent is redistributed to the regions and to rural areas.

All UEMOA countries assess property tax based on the calculated rental value of improvements. Only three countries – Benin, Côte d'Ivoire and Senegal – tax undeveloped land. Various formulas are used to calculate the taxable value of improvements, and most countries exempt from taxation a fixed percentage of the value of residential property. The tax rate can vary according to location (Benin), the building type (Côte d'Ivoire), or the comfort standards of a residence (Burkina Faso). Senegal, Niger and Togo use a uniform rate. Property owners are generally responsible for paying the tax, although some countries tax the holder of a usufruct (Benin, Niger and Senegal) or, alternatively, the occupant (Niger) or beneficiary (Senegal). As is the case for commercial tax, in some countries central government retains a share of the property tax yield: 10 per cent in Benin, 40 per cent in Niger, 50 per cent in Togo and 72 per cent in Côte d'Ivoire.

A recent evaluation of local revenues by the *Partenariat pour le Développement Municipal* (PDM, 2003) points out a number of weaknesses in local taxation practices that impede the ability of local governments to undertake necessary public capital investments:

- The complexity of a system that is based on a multitude of levies that are often difficult to collect and place the tax burden on a limited number of activities.
- The inability of local governments to set their own tax rates, which stands in the way of local initiatives to undertake improvements.
- Inadequate or obsolete information on taxable activities allowing a significant proportion of the population to escape local taxes.

As a result, local authorities in Africa's UEMOA area still rely heavily on transfers from the central government. This lack of financial autonomy has impeded their ability to assume full self-governance and define appropriate and largely self-financed development strategies (Municipal Development Programme, 1996, 1997, 1998, 2000, 2001, 2002, 2003).

### **3.4 Mandating responsible municipal financial management**

The decision-making authority and financial autonomy that local governments obtain through decentralization policies do not necessarily lead to responsible financial management, as the experience of many developing countries demonstrates. From Brazil to Morocco to India, municipalities are running budget deficits. In those countries where they are empowered to borrow, many have accumulated debt which they are unable to repay.

In South Africa and Brazil, the constitution grants municipalities specific powers and fiscal resources. This privileged status gives those wide decision-making powers and discretion in their use of revenues. In Brazil, dynamic mayors have used their new constitutional authority to launch reforms and innovate in areas critical to sound municipal governance, including (1) Participatory planning and management in Porto Alegre; and (2) Partnerships with private enterprise, NGOs and CBOs for economic and social development initiatives, in Santo André, Belo Horizonte and Recife, among others. Unfortunately, many more have failed to manage their affairs responsibly, forcing the federal government to step in and rein in their runaway finances (see Box 2).

## **Box 2. Brazil's fiscal responsibility law**

In Brazil, the privileged status of State and municipal governments under the 1988 constitution strengthens the role of mayors and governors in the national administrative framework. However, these same constitutional guarantees have also provided an impetus for municipal mismanagement, including a proliferation of municipalities through fragmentation to reach 5,559 in 2003. Dependency on central transfers and shared revenue combines with excessive politicization of local governance to encourage a short-term focus and a widespread lack of coherence and continuity in municipal management. Combined with a fiscal stability programme adopted in October 1998, the constitutional amendment established rules for responsible fiscal management; in May 2000, the “Fiscal Responsibility Act” set out rules and standards for responsible fiscal management. For the three tiers of government, the law mandates multi-year budgeting with fiscal targets, contingent liabilities and cost controls, along with balanced-budget principles and incentives to mobilize own resources.

The law caps expenditures on personnel at 60 per cent and relates them to tax revenue. On the other hand, expenditures on education are mandated at no less than 25 per cent. The law limits borrowing to the financing of capital expenditures, with the setting aside of adequate reserves to offset increases in long-term financial obligations. The law also mandates public access to fiscal and budgetary information.

In 2001, “The Statute of the City” established general directives for urban policies, mandating regularization of informal settlements and upgrading of the living environment in areas housing lower-income communities. These national priorities are, in turn, reflected in municipal budgets.

*Source: Serageldin and others 2003.*

### **3.5 Lack of funds for maintenance of existing assets**

In developing countries, asymmetrical decentralization has led to serious imbalances. The funding provided barely allows for the delivery of poor quality services or inadequate coverage of settlements within the jurisdiction. Local governments must look to other sources, domestic and external, to supplement their own.

Given that they directly impact on day-to-day activities, operating expenditures are almost always perceived as the most urgent. Invariably, priority is given to payrolls. Next are those supplies and services considered to be urgently needed. Priority operating expenditures and financial constraints frequently lead to deferment of maintenance of existing assets. Unlike capital investments, for which a variety of external sources of finance can be found, funding for the maintenance of existing assets is lacking. Even as it continues to perform, existing infrastructure deteriorates and becomes less efficient with the passing of time. Preventive maintenance is increasingly converted into crisis management, impairing the functional efficiency of many cities in the developing world. Particularly in the larger urban centres, authorities must purchase expensive parts from current revenue and delay the renewal of plants, facilities and networks. When infrastructure projects carry outstanding debt, debt service often pre-empts necessary maintenance of the assets. The cases reviewed here highlight the environmental and social consequences of the deferred maintenance and neglect of existing assets.

### **3.6 Capital investment programmes and budgets**

Capital investments can be funded from central or regional grants, as in the case of South Africa's municipal infrastructure grant, or by donors, mostly for social development and environmental improvements, or by borrowing from municipal development funds and capital markets. In addition, the potential contribution of local stakeholders and communities should not be overlooked.

Municipalities must acquire the technical and managerial capacity to tap external sources and identify strategic partners to help finance a variety of

projects. This implies a capacity to layer plans into components for which organization, financing and implementation can be separately structured and executed. Layering maximizes leveraging of local resources, but requires a capacity to coordinate inputs and cash flows to ensure coherence and integrity of planned activities.

Capital investment budgets are a major undertaking for local government. Capital budgets are often not well linked to development strategies and spatial plans, or such plans may not exist or may be mere wish-lists of projects. Criteria for the prioritization of capital expenditure include (i) urgency of need, (ii) political significance, (iii) economic efficiency, (iv) availability of funding, (v) implementation capabilities, (vi) operation and maintenance costs of the completed assets, or life-cycle costing, if a local authority is to ensure that the assets and related activities will continue to operate over longer periods. In many infrastructure projects, the relation between capital investments and operation/maintenance costs is not adequately considered, and hardly ever accounted for, when choosing among available options (see Box 3).

### **3.7 The impact of popular participation on the allocation of capital investments: Participatory Budgeting in Brazil**

The emergence and spread of Participatory Budgeting in Brazil is rooted in a legal mandate requiring popular participation in local decision-making. As a result, municipalities have introduced a number of mechanisms, ranging from presentation of budget proposals for public comment to the actual involvement of residents in decision-making. Participatory budgeting was first introduced in Porto Alegre in 1989, giving the city international recognition as a leader in “popular democracy” with regard to local governance. The concept has now been adopted by about 180 Brazilian municipalities and is spreading beyond borders to Argentina, Uruguay, Peru, Ecuador, Colombia, Bolivia, Mexico and Chile. More recently, cities in other parts of the world have also been experimenting and adapting the procedure to their local conditions.

### **Box 3. Multi-year capital investment planning, Szczecin, Poland**

During Poland's transition period, priority was given to capital investments such as road construction and maintenance, water supply and sewerage systems, revitalization of communal housing, and improved education and healthcare facilities. Szczecin was the first Polish city to link its development strategy to a four-year capital investment programme (CIP). Approved by the City Council in 1997, the CIP proved to be one of the most important instruments of financial management during the transition. It allowed the city to determine its financial and development capacity and prepare forecasts for local and foreign investors.

In March 1998, the City Council adopted a resolution detailing the principles governing the preparation of the CIP, and established procedures, along with criteria for prioritization and selection of projects. The criteria included: assessment of existing needs; linkages to the city development strategy; technical aspects of projects; implementation costs; financing capacity based on the city budget; and sources and conditions of potential external financing.

The programme identified each item of capital expenditure by year, disaggregated by project, programme and department in charge. The CIP specified the sources of funding for each category, and proposed financing methods. Over its four-year duration, the CIP is submitted to the City Council for annual approval. The 'year one' CIP is integrated into the municipal budget.

Capital investment accounted for 39 per cent of the municipal budget in FY2000 and 43 per cent in 2003. Large investments on infrastructure (primarily highways) and roads were required for the expansion of the urbanized area, the regeneration of obsolete industrial zones, and greenfield housing developments. These investments could no longer be funded from budget surpluses. Borrowing from commercial banks to finance priority projects gradually increased the debt service burden to unsustainable levels, reaching 25 per cent of revenues. In the year 2000, the municipality was forced to curb borrowing and sharply reduce expenditures.



*Box 3. (continued).*

The transfer of the responsibility for education to local authorities further strained their operating budgets. Polish municipalities had to scramble and reshuffle budgets to adjust to the existing system, and faced even greater fiscal challenges to upgrade and bring it to the standards prevailing in the European Union. Those municipalities bent on spending and investing in their education systems had to reduce other expenditures, defer maintenance and curtail capital investments. Szczecin experienced its first budget deficits in 1998 and 1999.

Investments in environmental infrastructure (water supply, sewerage and treatment plants) are becoming important as Eastern European countries gradually move towards compliance with European Union guidelines. Public investment in housing is mostly for new residential land development. Affordable housing and renovation of the older housing stock are co-financed by grants from the central government. Two non-profit social housing agencies created by the Szczecin municipality can access loans on favourable terms from the National Housing Fund to build, renovate and manage affordable housing.

Communal housing repairs and modernization are managed by an independent budgetary unit and funded by rent collection. The CIP budget currently exceeds the municipality's financial capacities. Mobilizing and leveraging non-municipal resources in the form of credits, grants and private investments has become necessary to sustain the Szczecin's economic development and living environment.

The Szczecin municipality has managed to secure competitive central grants and credits. Partnerships between the municipality and private developers, homeowners' associations, street associations, educational groups and cultural associations have enabled the city to launch community-based programmes to improve living standards. The private partners contribute 35 per cent towards public works, housing, culture and social care, and close to 83 per cent to improve healthcare and educational facilities.

Box 3. (continued).

The CIP provided Szczecin with a formal decision-making mechanism combined with an instrument for financial management and a strategic tool for reporting and monitoring the performance and impacts of capital investments. The CIP has improved co-operation and communication among departments and agencies, involving citizens in the selection and prioritization of projects and promoting partnerships with citizens and private enterprises. Sound financial management has gone some way towards earning Szczecin an ‘investment grade’ rating of BBB- and BBB+ by two international rating agencies (Standard & Poors and Fitch IBCA).

Source: Harvard University, Graduate School of Design, 2002.

in other parts of the world have also been experimenting and adapting the procedure to their local conditions.

Participatory Budgeting gives residents a voice in the annual allocation of capital investments. It is based on a delegation of statutory executive powers regarding the preparation of the municipal budget, and is launched at the Mayor’s initiative. There is no similar delegation of authority from the legislative branch, and the city council remains the statutory authority in charge of formal approval of the municipal budget.

Participatory Budgeting has four defining features:

- It ensures *representation* of residents, in each sub-area within the jurisdiction, in the decision-making process.
- It holds municipal officials to *account* on the achievements of the previous year’s budget and to provide estimates of revenues and expenditures for the upcoming year, in order to determine budget allocations for capital investments.
- It is structured to ensure *transparency*, through direct popular participation and an open voting system.

- It ensures *objectivity*, through the use of quantitative criteria for the prioritization of funding requests and the allocation of resources.

Participatory Budgeting is primarily an instrument for empowerment and social inclusion. Participation and social impact are its most important dimensions. It covers all capital investments, which typically range from five to 15 per cent of the total budget in Brazilian municipalities. It is a flexible instrument, since the rules can be amended at the end of each budget cycle, though admittedly they cannot be changed during the cycle.

Popular assemblies are the cornerstone of the budgeting process. Attendance has grown steadily over the years, in parallel with the growth of capital investments and as the importance of participation became evident to a wider spectrum of the population. The dynamics of attendance are complex and reflect the strategies and tactics of grassroots organizations and social movements; they are also a reflection of the mobilization efforts of groups who want to press for specific demands, and of the degree of coordinated action within the community. Outreach at the community level is needed to foster participation of low-income groups for whom the cost of attendance is high. This entails a significant commitment of resources on the part of the municipality, particularly in terms of personnel. Brazilian cities like Belo Horizonte and Santo André both rely on civil society for this outreach and mobilize community associations for the task.

Participation in decisions regarding the allocation of municipal funds for projects fosters a shift in the local political culture, one from confrontation and corrupt political bargaining to constructive civic engagement in local governance. Even though different priorities are selected in each cycle, recurring themes are evident in the consistent ranking of “housing,” “education,” “street paving” and “basic sanitation” among the top priorities. In all municipalities reviewed, the proportion of capital investments serving lower income communities has increased.

Belo Horizonte has instituted a two-year participatory capital investment budget, interlinked with a parallel process for the housing component of the budget. Half of the municipality’s capital investment budget is divided equally among the nine districts. The other half is targeted to improve conditions in communities where quality of life is poor. A number of

technical criteria, guidelines and regulations come into play, including the development standards that must be met if a project is to be submitted for funding under participatory budgeting. Documentation, demonstration of need and approval by relevant local agencies are major pre-requisites.

Allocation procedures are generally based on a two-step process. Capital investments are first allocated among sectors, and then redistributed across individual sub-areas in the municipality, under a formula combining voting patterns, indicators of service deficiency and population size. Resource allocation procedures ensure that most budget categories receive resources to meet the highest priority needs of the citizens, to balance between urban and rural interests, and to favour smaller size communities. In the quest for comprehensiveness and objectivity, the formula for the computation of deficiency can be complicated. Despite their complexity, participatory budgeting rules are generally viewed as fair and objective and their workings well accepted. The benefits of popular participation in local governance far outweigh any lack of scientific rigor in the methodology.

Participatory Budgeting has built trust and fostered co-operation between municipalities, social movements and CBOs by creating a space for the disenfranchised to participate in the allocation of local resources. Its impact on urbanization and its effectiveness in terms of social inclusion depend on the resources that can be mobilized for capital investment, so that people can hope that their living conditions will improve in a not-too-distant future (Serageldin, 2003).

## 4 Performance of major sources of municipal revenue

Locally generated municipal revenues fall into three broad categories: tax on property and economic activities; user fees for the delivery of services and the improvement of infrastructure; and borrowing to finance long-lived investments – generally, infrastructure. While well-managed municipalities maintain a proper balance across these categories, the rapid pace of urbanization in developing regions of the world, institutional constraints and weak management have combined to slow the efforts of local governments to increase their financial autonomy as part of devolution from the central to the local tier. Increasing the yield of locally generated revenue is, therefore, the major challenge faced by all developing countries. Inability to do so is apparent in the fact that most municipalities operate at a deficit that is made up by transfers from the central government.

Taxes on real property and, to a lesser extent, business activities are the major potential sources of local revenue. A combination of factors (ranging from technical issues, such as the lack of computerized databases, to complex legal issues of property rights under traditional and modern tenure patterns) have kept the yield of taxes on real property and business activities to a low level. More importantly, valuations do not reflect property values as a result of investments in infrastructure and urban projects. With the exception of North America and the European Union, most municipalities have no adequate records that reflect changing property values. Developing countries do not collect data on the various forms of physical development occurring on urban fringes. Collection rates in these settlements are often disappointing if any and, as such, registered properties and formal businesses bear disproportionate shares of the tax burden.

The price structure of user fees must reflect social concerns and, for the most part, does not cover the recurring costs of delivering the service, let alone the amortization of capital costs. As a result, most developed countries have moved toward more sophisticated means of recovering a varying portion of the public costs induced by private development. They range from betterment taxes, assessed on either or both existing and new development,

to exactions to fund social programmes. In the United States and since the mid-1980s, the proceeds of the linkage programme that mandates payments by developers of larger commercial development have financed both the construction of affordable housing and job training for residents of lower-income neighbourhoods in San Francisco and Boston.

The financing of capital investments through long-term bond issues is a well-established practice in developed countries, and the trend is spreading to other parts of the world except in situations of high inflation, structural adjustment or economic recession. However, access to financial markets requires efficient municipal financial management and skills. In instances where municipalities are not allowed to borrow, often ingenious alternative mechanisms have been used; one of them separates revenue-producing activities from the general budget, allowing a municipality to borrow against future revenue, as is the case with China's Special Purpose Vehicles (SPVs). Similarly, many US cities use tax increment financing, where the tax revenue induced by new development is allocated to service and repay the bonds issued by a municipality to provide improved infrastructures as needed.

#### **4.1 Taxes on property and business activities**

In developing countries, property tax has the potential to rank among the major sources of local revenue. Its administration demands genuine real-estate valuation capability to perform periodic revaluations of all taxable property over a maximum period of about five years. Setting up a computerized system capable of maintaining property and valuation records greatly facilitates this task. Where these capabilities exist, the next step is to ensure that the assessed valuations of all properties maintains are consistent with each other and with market trends. In many developing countries, property records are kept manually and valuation experts find it difficult to keep up with rapid urbanization. Tax valuations do not fully keep pace with actual values, and an increasing proportion of a given urbanized area is not included. In rapidly growing cities, cadastral records are obsolete, or only cover a limited part of the city, or are unable to keep up with changes in the use of land. Except for some regularized settlements, informal areas

and squatter settlements are not included; these properties are not titled or registered and, therefore, not taxed.

However, there are exceptions to these general patterns. In Egypt, a long tradition of quasi-autonomous management of the tax administration allows for the taxing of real estate, whether it is regularized or registered or not. In Indonesia, an occupancy tax is levied, ensuring some revenue in situations where property ownership is unclear or complex. In parts of West Africa, a simple *adressage* system, locating and numbering properties by street address, is used as an expeditious alternative to cadastres. This method allows speedy, efficient regularization of informal settlements and registering of property, which provide the basis for taxation.

Taxes on other types of personal property, mostly vehicles, are usually collected by national or provincial authorities. For instance, in the USA, municipalities collect these excise taxes based on the records compiled by State registries. In the Middle East, North Africa and West Africa, central governments control municipal finances. They provide transfer shared and redistributed revenues and directly manage the high-yield tax bases and revenue collection (including property and commercial taxes). Because of the size and role of the informal economy, and the prevalence of uncontrolled urbanization, formal real estate and business sectors are heavily burdened by taxation. Productive and beneficial use of a property, as well as its capital appreciation, are taxed. Owner-occupied and rental housing, commercial premises and locales used for workshops and other production activities, together with the income generated by these assets, are subject to one form of taxation or another.

Despite these cumbersome levies, the tax yield from the real estate sector is low relative to the market value of the assets and the rate of appreciation of serviced and non-serviced land. This situation is prevalent among developing countries due to a combination of six factors:

- Complex tenure systems, with layers of primary and secondary rights derived from customary rules and successive adjustments of past/colonial legal and institutional frameworks. Inheritance laws and fragmentation of property in historic centres and older

neighbourhoods compound the problems of updating records, identifying taxpayers, and billing and collecting taxes.

- Central governments control high-yield tax bases and the recording of wealth-producing assets, including land registries. High fees and cumbersome administrative procedures discourage regularization and the issuance of titles in informal settlements, increasing the cost of updating those valuations and tax rolls still managed by branch offices of central authorities. Additions, renovations and conversions are unreported and untaxed. Monitoring is sporadic for lack of cadastral information and updated records. Despite regulations mandating collaboration and co-ordination between the various tiers of government, central government officials are reluctant to work with municipal departments.
- In many countries, the central allocation (including grants, shared taxes and targeted transfers) is not related to locally raised revenues; rather, it is redistributed according to population size, social fairness, geographic balance and development potential. The relative weight assigned to these criteria varies across countries and within countries over time, in response to changes in the macro-context and political climate.
- Taxation systems based on real or imputed rental value, rather than capital value, understate the value of the assets; on top of this, rent and tenant protection regulations further depress property assessments based on rental valuation, thereby adding to the erosion of the municipal tax base. Interestingly, the market value is not affected, because the capital value of a property is split between an “ownership” component transacted on the formal market, and an “occupancy” component settled with key money shared by owners, renters and brokers.
- Tax rebates and exemptions granted to encourage specific segments of the housing market (multi-family rental units, co-operatives, etc.) or new urban development. In North and West African countries, exemptions from one or more taxes are granted for periods ranging from three to fifteen years.



- The treatment of informal development on the urban fringe. In most countries, these settlements are not taxed until they are regularized. In a few others, including Egypt, informal settlements are assessed by the tax administration (i.e., a *central* government agency) independently of status, since regularization is a *local* function. Property owners readily pay these taxes, as they are not burdensome and can be used to document occupancy and possession of urban land and buildings.

Given their buoyancy and significance to local revenues, taxes on commercial activities tend to overburden formal private enterprises. For instance, there are taxes on licenses to operate the business, on the exercise of a profession or occupation, on the rental value of the premises, and on the income derived from the businesses, among others. In many countries, market-stall holders usually pay a flat rate, except in instances where hawkers and other informal activities escape local taxation.

## **4.2 Challenges to improved municipal revenue**

India, Morocco and Côte d'Ivoire exemplify the challenges encountered by developing countries when looking to enhance the performance of municipal revenue sources. In Morocco, shared and redistributed taxes contribute close to 70 per cent of the revenue allocated to local government, principally from VAT, commercial and occupational taxes. Property taxes, service fees and market taxes provide the bulk of locally raised revenues. Metropolitan and provincial authorities collect charges for the services they provide and have separate taxing powers on market activities. Moroccan local authorities raise about 20 per cent of their revenues from a variety of small taxes and fees. Local budgets are balanced on a cash basis, with very limited surpluses available for capital expenditure or paying the accumulated arrears owed to regional public utility companies. This outstanding debt is usually consolidated into short-term loans. Budgets document revenues in great detail, but tend to lump expenditures by categories of input that are not related to specific activities and services.

Almost all the municipalities in Morocco are running operating deficits covered by central transfers that consist of two components: a lump sum, depending on the classification of the locality that accounts for about one third of the transfer; and a redistribution formula using fiscal revenue as an indicator of relative affluence, that accounts for about two thirds. The redistribution of commercial license taxes penalizes economically more buoyant municipalities. Capital investments are almost entirely dependent on transfers from central ministries and international donor funding; this results in an opportunistic approach to project finance, which undermines rational development strategies and plans to improve the functional efficiency and living standards of cities. The “capital investment” part is often left blank in the municipal budget when submitted for approval to the Ministries of Interior and Finance. The Municipal Development Bank allows localities an annual debt service burden of 40 per cent of recurrent revenue. This is a very liberal limit, compared with the ceiling prevailing in developed countries where a maximum of 15 to 20 per cent is the usual level. Most of the debt incurred is for infrastructure, transport terminals, road construction, markets and urban development (Harvard University, 1997-1998).

Since 2000, India launched several measures aimed at improving the finances of municipal governments. In 2001, bonds issued by local authorities were exempted from income tax and three new municipal funds were established: the Urban Reforms Incentive Fund; the City Challenge Fund, and the Pooled Finance Development Facility. The objective was to provide municipalities with the capital needed to improve services and enhance the functional efficiency of urban centres. The Urban Reforms Incentive Fund encompasses incentives to undertake structural reforms, including: repeal of the Urban Land Ceiling and Regulation Act; rationalization of stamp duty; reform of rent control laws to remove controls on new leases; computerization of property registration; and reform of property tax so that it may become a major source of revenue for urban authorities.

In West Africa, reliance on central government in all matters of tax assessment and collection does not allow communes any significant improvements in real estate tax yields. Central authorities are particularly unwilling to help

them update tax rolls and improve collection. In Abidjan, Côte d'Ivoire, the real estate sector is overburdened. There are no less than nine direct taxes on urban property, exclusive of taxation of rental income. Four basic taxes are levied and collected by the Ministry of Finance's *Direction Générale des Impôts* (DGI – inland revenue), which transfers to the communes a portion of the receipts according to a specific formula for each tax. The tax on built property is the mainstay of the taxation system. Other real estate taxes include the tax on unbuilt property, a tax on under-developed urban property to deter speculative land holding, and a tax on property belonging to real estate developers and building societies. Municipal councils can levy supplemental charges not to exceed 20 per cent of the tax. Two special-purpose taxes earmarked for infrastructure maintenance are also levied on all built property, and no temporary or permanent exemptions are granted: sanitation tax is collected by central government, while the municipality collects tax for road maintenance and refuse removal. Communes can levy additional taxes on real estate, which are collected on their behalf by the DGI, including: a tax on net income from built property; a tax on the capital value of undeveloped property; and a tax on the rental value of premises subject to the commercial license fees paid to central government.

The rapid urbanization experienced by Abidjan between the 1970s and 1980s has not been matched by a commensurate expansion of the tax base. Three factors contribute to the erosion of the tax base: (i) temporary exemptions granted to new construction for overly long periods, ranging from five to 20 years; (ii) central government control of tax rolls and rates; and (iii) the proliferation of informal development on the urban fringe through the unauthorized subdivision of tribal land. In those years, buildings in informal settlements were not legally recognized or taxed. When a regularization policy was adopted in 1977, the process was too cumbersome and lengthy. DGI estimates the performance of real estate taxes as ranging between 20 and 30 per cent. High rates discourage compliance. On top of this, the hardships deriving from structural adjustment, prolonged recessions and civil strife promote widespread evasion. In low-income communities, absentee landlords typically live in higher-income neighbourhoods and ignore tax bills sent to different addresses. A regulation mandating tenants to pay the tax if landlords cannot be identified or located is not enforced.

Furthermore, in outlying communes, tax collectors are unable or unwilling to locate and access properties fronting on unpaved streets, particularly during the rainy season.

Commercial taxes are the mainstay of municipal finance in West African cities. In Abidjan, they account for over 50 per cent of local revenue. There are two main taxes: the *patente* levied by the DGI on larger businesses with annual sales above a specified threshold; and the *taxe forfaitaire*, a flat-rate tax levied on small retailers and craftsmen and collected directly by the communes. Small shops and workshops pay on a monthly basis, while street vendors pay a daily fee for a ticket which allows them to trade on the sidewalks or in the designated market areas. In Adjamé, outside Abidjan, the *taxe forfaitaire* has generated 57.8 per cent of municipal revenue, while the *patente* has been contributing a declining share mainly due to inefficient collection.

Central authorities tend to view local commercial taxes as too numerous, difficult to manage and enforce, and low-yield in comparison with other forms of taxation. Yet, their contribution to local fiscal revenue cannot be overlooked. In case they are abolished, a substitute and equally buoyant, locally controlled tax must be instituted (Serageldin, 1990).

### **4.3 Taxes on Income**

At the local government level, taxes on income are not as common as taxes on property. However, in some instances, provincial government is authorized to collect income tax and local government may be allowed to assess a surcharge on the income tax levied by provincial and central government. Alternatively, a fixed proportion of the national income tax may be transferred to the local level.

### **4.4 User fees**

Pricing of user fees is a matter of public policy. In many cases, charges are levied at less than their financially efficient prices. Balancing financial and social factors, governments at all levels have put in place a number

of schemes to alleviate the hardships suffered by the poor. The three most commonly used are: (i) allowing a minimum consumption level per capita or household free of charge, as in South Africa; (ii) subsidizing charges for lower income populations; and (iii) establishing a pricing structure that is not discriminatory for small users. Social, economic and environmental arguments have been advanced for pricing public transportation at less than full-cost recovery. For water supply, social concerns and, in many cases, reassertion of pre-colonial traditions and religious beliefs have thwarted attempts to raise prices to financially sustainable levels since the 1980s. Under structural adjustment programmes, price increases have led to contentious debates and civil disturbances.

Most recently, the debate over the pricing of essential services has acquired a new dimension because of NGO-led movements advocating a legal “right to the city”. This right includes access to urban land and urban services for all residents. The debate is ongoing in many parts of the developing world. Nevertheless, there is some consensus regarding the desirability of charging for a public service even when the charge cannot cover full costs. In most circumstances, user charges are not devised to take into account the recovery of capital investments, even where an operational profit materializes. Expansion of services usually takes precedence over maintenance of systems, with political pressure and rapid urbanization weighing heavily in these decisions.

#### **4.5. Betterment taxes and development exactions**

In advanced countries, an array of impact fees and betterment taxes compensate local authorities for the additional expenditures incurred to extend infrastructure and services to new urban development projects or to upgrade services in the urbanized area. These fees are also structured to recapture part of the unearned increment in real estate values resulting from public investment. Because they are payable over terms of up to 10 years, betterment levies do not directly provide immediate funding for the capital investments. Revaluation of properties affected by public works improvements makes a major contribution towards municipal revenue through property tax assessments.

In the USA, cities have developed an interesting mechanism referred to as *linkage*, a scheme that leverages funds from the profits derived by real estate developers in the city's growth nodes. Linkage schemes essentially tap private capital to fund social projects. Linkage authorizes a municipality to impose impact fees on developers requiring zoning approval for proposed urban projects; the fee can take the form of either a payment or an in-kind contribution to the municipality. The concept was first introduced in San Francisco in 1982, and adopted in Boston in 1983 where it was institutionalized by the Massachusetts State legislature in 1987. Under the scheme, developers of all new commercial, retail, hotel or institutional structures, including hospitals and universities, with a floor area over a certain size pay an exaction fee. In Boston, the fee subsidizes the construction of affordable housing (elsewhere in the city) and job training, with a requirement that 20 per cent of any linkage payment be reserved for use in the area surrounding the development. The rationale behind the scheme is that there is a direct link between the construction of new commercial space and the increase in demand for affordable housing in the city, deriving from the influx of workers employed in the new commercial development.

In Boston, developers sign a Development Impact Project agreement with the Boston Redevelopment Authority (BRA) for real estate projects that include either an expansion, significant rehabilitation of property or new construction with a floor area of 100,000 square feet (9,290 m<sup>2</sup>) and require a zoning amendment. A linkage fee is levied on each additional square foot of floor space in excess of the 100,000 square feet ceiling. In 2004, linkage fees amounted to USD8.62 per square foot, out of which USD7.18 subsidized affordable housing and USD1.44 went to job training. This rate can be adjusted every three years to reflect inflation. The schedule of payments is spread out over seven years for downtown projects and 12 years for projects in other areas, and the fees are deposited in a Special Fund for Affordable Housing and Training. Alternatively, developers may choose to build affordable housing projects or create a job training programme. Between 1987 and 2004, linkage generated USD79.6 million for housing, adding 7,604 units to the city's housing stock, 6,116 of which were affordable. The scheme also generated USD15.2 million for job training and awarded

USD12.9 million to 190 different job programmes, such as school-to-work, family literacy or workplace-based education, creating over 1,000 jobs (Boston Housing Authority/Boston Redevelopment Authority, 2000, 2002, 2004; Avault, Consalvo and Lewis, 2000).

Linkage fees and other development exactions require that a legal urban planning framework be in place, that the rules be legally authorized and the procedures transparent. Furthermore, the urban economy must be buoyant enough if the programme is not to act as a disincentive to development. Many developing countries have instituted betterment fees and require developers to contribute to the costs of providing new services. They could benefit from the linkage concept as a way of redistributing the benefits of growth during periods of rapid economic development.

#### **4.6 Borrowing and debt service management**

Funding for capital investment requires access to long-term borrowing on terms broadly related to the working lives of the assets to be financed. Debt service can then be funded on an annual basis: from internally generated funds for revenue-earning services, or from general revenues for tax-borne services. Users of those services provided by public assets are expected to pay for current use as well as an appropriate share of the fixed asset costs, over the full working lives of the facilities – a situation that is rarely the case in developing countries, or in many advanced countries for that matter.

In situations of high inflation, economic recession, structural adjustment and other constraining factors, long-term borrowing is typically not available. The standard solution is to add the expected inflation rate to the “real” cost of money (“real” interest rate = nominal interest rate *minus* current inflation rate) adopt variable rates, or index either the principal or the annuity payments to the inflation rate. Alternatively, domestic loans are linked to a stable foreign currency, as has happened in many Latin American countries (Serageldin, 1995).

Several countries have indexed some of their debt instruments and other accounting information, such as asset valuation, in a variety of ways. In the 1970s, Israel issued public sector debt instruments of two types. The first

used a basic (approximating to real) interest rate that would subsequently be adjusted by a price index. The second was denominated in US dollars, so that returns to lenders would include any losses resulting from changes in the foreign exchange rate.

In the 1970s, it was common practice for countries in Latin America, such as Brazil, to issue many different types of indexed debt instruments where a basic interest rate was subsequently adjusted for inflation. More recently, the US Federal Government has issued indexed bonds, referred to as “Treasury Inflation-Protected Securities” (TIPS) where the principal is adjusted by the consumer price index every six months. In Brazil, the inflation indexation system, which was developed and extended to most markets between 1964 and 1970, was increasingly blamed for contributing to the continuation and dramatic acceleration of inflation in the 1980s and early 1990s. Brazil lost access to foreign capital markets while domestic borrowing to finance the growing public-sector deficit became increasingly expensive (Library of Congress Country Studies: Brazil, 1997).

#### **4.6.1. Management and control of short-term borrowing**

In the absence of long-term financing, local governments have tended to use short-term commercial debt where the option is available to them. Short-term borrowing by municipal authorities is normally limited to funding capital investment. In many countries, some authorities have sought continuously to roll over short-term debt used to fund capital expenditure. Debt has sometimes been used to plug recurrent budgetary deficits or for short-term cash flow management. Accumulated debt must be brought under control and refinanced, otherwise it can lead to financial crisis.

In the mid-1990s, a series of Russian laws established rather liberal borrowing rules for sub-national entities, authorizing municipalities to issue bonds and lottery tickets, extend and take out loans, and open accounts with banks and other financial and credit institutions. Municipalities took to borrowing from regional authorities to plug deficits, issuing municipal bonds and contracting short-term loans from banks. Eventually, municipal financial mismanagement and indebtedness led to the revocation of these laws. Following the 1998 financial crisis, a law “*On Specificity in Issuance*



*and Circulation of State and Municipal Securities and the Budget Code*” prohibits municipalities from contracting external debt or debt obligations exceeding 10 years. Issuance of debt obligations is limited to the financing of capital investment. Though justified by the need to curb runaway municipal finances, these restrictions act as a constraint on the financing of local public infrastructure projects in Russia (Chernyavsky, 2002).

In Indonesia, in the aftermath of the 1997 financial crisis, widespread default on outstanding loans from the National Development Fund still need to be resolved and the stability of the banking system fully restored before the issue of borrowing can be meaningfully addressed. In the meantime, regional government depends on donor and sovereign loan funds (primarily from the World Bank and the Asian Development Bank) for regional infrastructure projects. Despite favourable loan terms, arrears reached 40 per cent in 1998. Regional and local government was considered financially too weak to benefit from the regulatory framework authorizing sub-national entities to borrow on the financial markets. In the period leading to the 1997 financial crisis, private investors preferred to seek concessions and build-operate-transfer (BOT) contracts, fuelling a risky reliance on offshore financing.

While the Government of Indonesia grappled with the restructuring of a massive public debt (USD132.2 billion, amounting to 80 per cent of GDP), the financial markets had to absorb recapitalization bonds. The weakness of local government finances and their reliance on transfers and shared revenue, with own-source revenue only contributing an average five per cent of total resources, prompted the Ministry of Finance to prohibit all new borrowing from both domestic and foreign sources. The only exceptions are borrowing through on-lending institutions, for short-term working capital or profitable, locally owned enterprises. Since local governments have not yet been authorized to levy new sources of revenue, their financial situation remains weak (World Bank, 2003; Menon, 2003; Chakeri and Lewis, 2004; Freire and Petersen, 2004).

In Sub-Saharan Africa, South Africa and Zimbabwe have led the decentralization process. Regional governments in the two countries are empowered to borrow to finance capital investments. In Uganda, local authorities are allowed to borrow but have refrained from doing so for

lack of a municipal development bank. In most other countries, current debt burdens and legal constraints impede the development of municipal financial institutions.

#### **4.6.2 Credit enhancement, access to financial institutions and capital markets**

Local government needs sophisticated debt management capability to draw on the available range of financial options and instruments to finance capital investment needs. These capabilities are not currently prevalent among many local administrations in the developing world. To strengthen local finances and enhance municipal access to medium- and longer term credit, shared revenues are regarded as part of the local resources available to service debt and can be pledged as collateral. This entails that lenders can put up these revenues as guarantees, and central government can withhold them from municipal borrowers and authorize lenders to intercept the transfers in order to settle any arrears on debt service obligations.

International capital markets and multilateral financial institutions have focused on East Asia's credit market, in light of the strength of the regional economy, anchored by Japan and China, and the Asian countries' own performance as they rebounded from the 1997 financial crisis (Freire and Petersen 2004; World Bank 2003). However, these countries offer sharply contrasting financial environments. The Philippines was one of the first Asian countries to devolve functions and resources to local authorities. The 1991 Code allowed localities to create new own sources of revenue and gave them borrowing powers. Municipalities and provinces are authorized to issue bonds to finance self-liquidating, income-generating projects enhancing the quality of life in the city. Two government-owned banks and two municipal development funds provide local government with credit. A steady flow of generous central transfers and the power of State-owned financial institutions to intercept these transfers in order to settle arrears have allowed the municipal credit market and a limited domestic bond market to operate. A specialized bond insurance company enhances the creditworthiness of borrowing municipalities. A limit on debt service ceilings set at 20 per cent of revenues combines with restrictions on bond

issuance to prevent excessive borrowing. Since 1991, 13 local authorities have issued bonds, mainly for housing projects with the remainder funding public markets, ports and port terminals (Freire and Petersen 2004; World Bank 2003). By contrast, Vietnam has barely started on the transition path and local authorities there have little fiscal autonomy. Borrowing is restricted to capital expenditures and the State bank can extend loans to localities for only up to 30 per cent of project costs (Freire and Petersen 2004; World Bank 2003).

In India, the Ahmedabad Municipal Corporation became the first municipal authority to issue bonds on the capital market. A number of municipal entities and parastatals have since accessed the domestic capital market, with the back-up of credit rating agencies. Of these, nine municipalities have so far been able to issue bonds without requiring a guarantee from the State government or a bank, as traditionally required by lenders from municipal entities. These Indian municipalities can raise funds on the strength of their own credit rating.

India's Finance Commission has recommended several measures to shore up financially weak municipalities, focusing on the rationalization of inter-governmental fiscal relations through the following four techniques: (i) the transfer of specific amounts of revenue to municipalities, as in Himachal Pradesh; (ii) transferring designated shares of taxes raised locally but collected by State governments, including motor vehicle taxes as in Tamil Nadu; (iii) sharing of a pool of State revenues excluding loans, as in Karnataka, Madhya Pradesh, and Tamil Nadu; and (iv) increasing the participation of the private sector in improved service delivery and collection of user charges, as in Andhra Pradesh where the share of local bodies in State revenue increased from 39.2 per cent to 40.9 per cent. Furthermore, the 11th Finance Commission issued guidelines in 2004/2005 recommending a municipal grant programme to strengthen decentralization and provide incentives for local resource mobilization (Prakash Mathur and Thakur, 2004).

### **4.6.3. Income-generating enterprises**

Local government can establish separate income-generating enterprises to enhance overall revenue-generation capability. The advantage of income-generating enterprises is that their activities can be accounted for independently of general tax-borne activities. The role of revenue-earning enterprises is not, normally, to generate contributions to general public revenues, but rather to remove open-ended reliance upon such revenues. This alternative also highlights the full costs of operation, so that these may be more appropriately covered with user charges and carefully targeted subsidies.

In China, formal budgets account for only half of local government financial activity, due to significant off-budget financing. Own-revenue sources consist of special fees, taxes, profit distributions from locally owned enterprises, land leases and taxes on business enterprises (VAT and income). Property tax on urban and rural land generates a meagre two per cent of local revenue, while the business tax contributes 34 per cent, but exacts a heavy burden on businesses as it represents about half their profits. Since they have no borrowing power, municipalities have resorted to the ingenious mechanism of creating independent, wholly-owned companies, whose activities are off-budget, to provide funding for development projects, particularly infrastructure. These so-called (SPVs) are allowed to borrow on capital markets and use their operational revenues to amortize this debt. In China, they have become a major instrument in the implementation of large- scale urban development projects (see Box 4).

## **4.7 Municipal financial management under adverse economic conditions and structural adjustment**

In most African countries, the tax base of local authorities is inadequate to meet expenditures. High-yield taxes, namely VAT and taxes on income, sales and business are controlled by central government, while municipal authorities derive their revenue from property taxes and charges on services. Municipalities are not empowered to set tax rate structures or launch enforcement procedures. Inadequate technical and managerial capacity

#### **Box 4. The role of Special Purpose Vehicles (SPV) in China**

Municipalities in China have no borrowing power and rely on off-budget entities to secure the funding they need for investment, primarily in infrastructure projects. These Special Purpose Vehicles are wholly-owned companies operating on a quasi-commercial basis. Like State-owned enterprises, the SPVs raise funds by borrowing from State-owned banks and undertake investment projects on behalf of provincial and municipal authorities. They can obtain financing from the China Development Bank for terms of five to 10 years, and from commercial banks for three to five years. Because of their off-budget status, accounting and reporting systems are not standardized. Local governments are prohibited from guaranteeing their loans and the extent of their indebtedness is a major concern, as China structures its domestic financial markets and comes to play a significant role on the international capital markets.

SPVs and the companies they own can issue bonds to finance local projects and locally owned enterprises. The bonds are viewed as a contingent liability of the parent local government and are usually backed either by assets transferred to the SPVs by the municipality, or by the revenue stream of a self-sustaining project. Though non-performing loans have not yet been adequately dealt with, due to continued lending to unprofitable State-owned enterprises by China's four national banks, the domestic capital market continues to finance SPVs and the companies they own.

In China's booming economy, dynamic cities can use the SPV concept in creative ways to finance large-scale development projects. The Shanghai Urban Development Investment Corporation (UDIC), owned by the city, has issued bonds on the financial strength of the municipality to finance infrastructure and transportation projects. The implicit guarantee means that the city will not allow UDIC to fail. The city has also created an on-lending facility within UDIC to help suburban municipalities meet their shares of regional projects, starting with projects to control water pollution. The Shanghai Municipality

has financed USD3.5 billion out of total capital investments estimated at USD4.85 billion. UDIC is creating a fiduciary institution that will issue bonds to make up for the balance. Although the strength of the Shanghai Municipality is unequalled among Chinese local authorities, the UDIC initiative may offer a model that can be adapted in other districts and regions to finance projects involving multiple administrative jurisdictions.

*Source: Freire and others 2003; World Bank, 2003.*

contributes to obsolete valuations, poor collections and deficient financial management. Central government and parastatal organizations often owe cities large arrears.

In Africa, transfers from higher tiers of government lack stability, transparency and predictability – they are subject to sudden reductions. With the notable exception of South Africa, specialized municipal finance institutions in Sub-Saharan Africa are underdeveloped. Most local authorities may not issue general obligation bonds, but can issue revenue bonds to finance self-sustaining projects and may be able to obtain credit as the domestic capital markets develop in the region. In Botswana, municipalities receive 40 to 60 per cent of their operating budget as a formula-based block grant and the totality of their capital investment budget from the central government. Kenya uses formula-based block transfers; Malawi, general-purpose block grants and specific purpose transfers; in Nigeria, federal transfers include formula-based grants and targeted transfers; in Uganda, the constitution prescribes that localities can receive block, specific-purpose and equalization grants, but the situation on the ground is unclear (Mosha, 2004).

Almost all African local authorities receive shares of taxes collected by central government, but there are wide variations across countries: in Kenya, they are allocated 20 per cent of the tax levies on road fees and five per cent of the annual income tax; in Uganda, the Local Government Act of 1997 stipulates that 35 per cent of total revenue is to be transferred to districts, but it is not evident that any statutory transfers have actually taken

place in whole or in part; and in Malawi, no inter-governmental tax sharing system is in operation (Mosha, 2004).

Despite its role as a critical source of local revenue, property tax is far from providing its potential yield in Africa. In Kenya, Uganda, Tanzania and Zambia, valuation rolls are incomplete and obsolete. Though already exempted from some taxes, cash-strapped government agencies delay payment of transfers and grants, while residents are angered by the poor quality of urban services and refuse to pay for them. Land-consuming industrial and commercial projects benefit from tax exemptions, as do greenfield housing estates. The use of income tax as a source of local revenue is limited. Where it exists, as in Uganda and Tanzania, performance is crippled by the proliferation of informal activities, compelling authorities to charge flat rates on self-employed individuals. Trade licenses and fees are significant sources of local revenue in both East and West Africa. Increasing these fees has proved rather unpopular and led to widespread evasion. Few municipalities in Africa own income-generating enterprises, and those that exist do not contribute significantly to local finances.

User charges for services are low, the billings inefficient and the collections inadequate to cover the cost of providing the services. In many cases, central and local governments refuse to increase user fees, out of fear of angering politically potent constituencies or triggering civil disturbances. Similarly, local authorities are often unwilling to enforce collection of politically sensitive taxes. Providing services to poor sections of the population poses a major challenge. Local initiatives include free minimum consumption and grants for basic services, as in South Africa, or cross-subsidies as in Botswana, to secure a more equitable fee schedule (Box 5).

#### **4.7.1 Tax increment financing**

Tax increment financing (TIF) was first introduced in the USA and has become increasingly popular among local authorities eager to find off-budget resources for urban development projects. TIF involves economically and financially viable projects, such as the mixed-use projects and industrial and office parks which the scheme has extensively supported. A revenue-generating strategy for buoyant economies, TIF can become dysfunctional

### **Box 5. Cross-subsidies in Botswana**

Botswana encapsulates the difficulties in implementing decentralized fiscal policies under adverse economic conditions. Local authority reforms have devolved responsibility for constructing and managing a large part of the country's social infrastructure and a wide range of services. Local authorities prepare a six-year development plan concurrent with the six-year National Plan. Once a plan is approved, funds are guaranteed by the central government, ensuring that any projects started are eventually completed.

Municipal authorities are funded through their own revenue sources: revenue support grants, referred to as "deficit" grants; development grants; and loans from Botswana's Public Debt Service Fund (PDSF), which are frozen at the present time. Local councils charge a flat fee for urban services, accounting for 1.2 per cent to three per cent of total revenue. Other charges are directly linked to usage such as sanitation, waste removal, education and cost-sharing charges in health. Betterment fees are also levied on new urban development, primarily serviced sites and building plots. In Botswana, local government is not empowered to borrow on the domestic capital market. Furthermore, local authorities are required to seek authorization from the Minister of Finance to spend any amount exceeding 10 per cent of the balance in their General Fund Account. This creates a paradoxical situation where cash-strapped municipalities accumulate surpluses in their General Fund Account, and the national government uses these forced savings for its own purposes. The funds are deposited with the Bank of Botswana and the local council can only use the interest generated.

The country's capital, Gaborone, exemplifies the challenge cities face in meeting the requirements of rapid urban growth with their limited resources. Transfer grants cover approximately 60 per cent of the recurrent budget and the bulk of capital investments. They have been rising over the years due to the growing cost of operation and maintenance of infrastructure and expenditures on social security and welfare programmes. The revenue from rates and property taxes



*Box 5. (continued).*

account for around 25 per cent of total revenue, as squatter settlements represent 53 per cent of the total housing stock in the city. Valuation rolls are incomplete, and obsolete records impair billings and collections. Furthermore, central government and parastatal organizations do not pay the taxes they owe the municipality, and their arrears rose from USD2.4 million in 1999 to USD 6.4 million in the year 2000, plus USD0.7 million accumulated interest. The city taxes commercial premises and levies business taxes on licenses, market stalls and food vendors, as well as entertainment. These taxes are either annual flat rate taxes or payable on use of services. Low assessments, high default rates and the size of the informal economy, combine with the proliferation of unregistered businesses and inadequate records to erode revenue potential.

The Water Utilities Corporation operates Gaborone's water supply system, but the city Council is responsible for sanitation, extending the water-borne system to lower-income communities at a cost of over USD 20 million. Even a sharp increase in sewer connection rates will not recoup this cost. The city's solid waste collection and disposal system is to be privatized. Botswana's capital has launched an ambitious upgrading programme financed in part by service levies. The Council's inability to collect arrears is prompting the outsourcing of loan management to financial institutions or private companies. To meet its obligations, the city can only borrow from the central government through the Capital Account. In FY2000, the City of Gaborone owed seven million US dollars, payable over 25 years at an interest rate of 14.6 per cent.

*Source: Mosha, 2004.*

during downturns when receipts plummet, or tend to collapse during prolonged recessions.

TIF allows State and local authorities to meet the upfront costs of capital investments in infrastructure and other improvements that are needed to bring idle assets, particularly vacant land, into productive use through borrowing. TIF bonds are repaid from revenues generated by the additional

tax receipts on real estate, personal property, and businesses developed by the private sector through use of public assets.

It is assumed that receipts will be sufficient to service the debt as well as pay the operation and maintenance expenses of the new infrastructure. The ring-fenced status of a TIF district entails that bond proceeds can only be spent on expenditures within the delineated boundaries of the TIF district. Scaling down or deferring subsequent phases of the project do not release TIF bond proceeds for use as general local revenue.

The TIF concept carries significant risks. Estimates of incremental tax receipts to be derived from new developments are speculative. They may not materialize to the extent, or in the time-frame, anticipated. In such cases, the local government is forced to issue general obligation bonds to cover the shortfall, thereby incurring new debt to service off-budget borrowing. The new activities will place demands on public services: education, health, solid waste management, policing, and recreational facilities; these carry further capital, operation and maintenance costs that cannot be covered by the TIF bond proceeds and may not be met by the additional tax revenue. Imposing impact fees or exactions on developers and investors will work at cross-purposes with the need to accelerate the pace of private investment in order to ensure the financial viability of the development.

## 5. Special funding sources and targeted funds

With decentralization, municipalities have become increasingly dependent on the availability of long-term capital sources to finance the purchase or construction of fixed assets. Yet, financing of adequate maturity continues to be a scarce commodity in developing countries. Available funding has been largely confined to:

- Grants or occasional long-term loans from central government
- Loan funds sponsored or partially funded by central government
- Loans or credits from multi-lateral or bi-lateral development organizations
- Targeted domestic and foreign bond issues.

Funding from these various sources is not only limited when compared with the needs of local government, but tends to be allocated primarily to a few large municipalities or to specific categories of infrastructure. Except for loans from central government, most other sources draw on foreign funding which, in addition to standard interest costs, carries foreign exchange risks that cannot easily be borne by local authorities.

### 5.1 Municipal Development Funds

Many countries have established Municipal Development Funds (MDFs) to provide regional and local governments with much-needed capital. The Public Works Loan Board (UK) and the Crédit Foncier (France) are among the oldest and have served as models for other countries. Typically, MDFs have been sponsored by central governments, with international development organizations initially participating in the creation of these institutions. Some poorly managed MDFs have collapsed, while others have been sustained and continue to finance development projects. Yet others have managed to leverage local capital contributions, and a few have evolved into such noteworthy institutions as Columbia's *Financiera de Desarrollo Territorial* (FINDETER) and the Development Bank of Southern Africa (DBSA).

The basic operation of a municipal development fund is straightforward. Its initial capitalization is typically provided by the central government, ideally, in non-returnable funds. Where provided in the form of debt, eventual repayment may cause the fund to implode unless the debt can be refinanced from other sources. Adequate non-returnable capital can be enhanced by the government, or other provider, allowing the MDF to retain earnings rather than paying some form of dividend. Capitalization of a MDF can at times entail using the contributed capital as collateral for long-term borrowings. Unless a robust relationship of equity to debt is maintained, the risk of instability and eventual implosion remains.

### **5.1.1 The Public Works Loan Board, UK**

The UK Public Works Loan Board (PWLB) was established as early as 1793 and was institutionalized as a permanent body in 1817. It has served as a model for subsequent “local government loans funds” and “municipal development funds.” PWLB draws on the National Loans Fund to finance local authorities and other eligible entities. Its Board of 12 Commissioners is appointed by the Crown for four years; they review loan applications from local authorities and other bodies and collect repayments. At present, nearly all borrowers are local authorities. The Commissioners are legally required, before granting a loan, to satisfy themselves that an authority has the capacity for service and repayment. Rates of interest are determined by the Treasury. The PWLB’s record of debt-collection has been exemplary. All securities rank equally without any priority and are charged indifferently to all local revenues. The PWLB has made a substantial contribution to post-World War II reconstruction and to the construction of council housing in the UK.

In 1945, the Local Authorities Loans Act required virtually all borrowing to be from PWLB. This restriction was lifted in 1952 and by 1955 the PWLB became lender of last resort, as only the largest local authorities were able to borrow on the private capital markets. Subsequently, tighter access to PWLB loans, combined with the inability of smaller local authorities to obtain long-term credit, caused local authorities to rely upon excessive short-term borrowing through loans pooling or sinking funds. When loans

became due, they were simply rolled over. Minimum revenue provisions were based on asset lives and included in annual budgets, ensuring that loans would be gradually repaid over the agreed period. By 1963 the British Treasury, alarmed at the amount of local debt held in short-term instruments, restricted temporary borrowing to no more than 25 per cent of each local authority's debt portfolio. Access to the PWLB was relaxed and more local authorities were allowed to issue bonds.

During the 1980s, new controls on the fiscal discretion of local authorities were introduced in a bid to curb overspending. In 1981, capital expenditure had to be controlled by annual allocations. Capital receipts generated by privatization sales were designated for capital investments or to repay long-term debt. The "Block Grant" was calculated to penalize "high-spending" local authorities. In 1984, rate limitation capped the levy made by any council which the central government considered to be "overspending." In the 1990s, the Housing Revenue Account was treated as a separate fund and no transfers were allowed from local taxes or revenues to subsidize tenant rents. In 1995, capital controls were extended to companies controlled or influenced by local authorities and until 1998 some capital receipts had to be set aside as "provisions for credit liabilities". However, by 1999 the earlier capping limits on rate levies were replaced by multi-year reviews of local budgets, with restrictions on taxes as a last resort. Funding capital investment solely through grants can create incentives to invest in new assets and neglect the repair and maintenance of existing ones. This is probably the reason why in a capital-scarce situation, the tendency is to over-invest in fixed assets (IADF, 2004; Jones, 2004).

### **5.1.2. Financiera de Desarrollo Territorial (FINDETER), Colombia**

Providing long-term funding sources which municipalities can access to finance capital improvements requires more than the creation and capitalization of a specialized institution. The long-term viability of such an institution depends on its stability as a borrower, on access to the domestic and even possibly international financial markets, and on the institution's ability to recover loans from individual borrowers. Local government lack

of experience in debt management has often resulted in delayed repayment or outright default. Therefore, if a MDF is to succeed, credit availability must be matched by financial management capacities among borrowing municipalities. Through a combination of credit to both public and private entities with the assessment of their borrowing capacity and strengthening of their managerial capacity-building, Colombia's FINDETER has enabled devolved authorities to access private markets to finance most of their capital investments needs under favourable terms and conditions (see Box 6).

### **5.1.3. The Municipal Development Fund of Georgia**

Established in 1997, the Municipal Development Fund of the Republic of Georgia was part of a broader municipal development and decentralization initiative to fund capital investment in the repair and rehabilitation of municipal infrastructure and service equipment. Its success demonstrates that with adequate appraisal of project funding applications, a well-managed MDF can be sustainable without additional capitalization, even under the difficult adjustments experienced by former CIS countries (see Box 7).

### **5.1.4. The Alberta Capital Finance Authority, Canada**

The Alberta Capital Finance Authority (ACFA) was established in 1956 as a non-profit entity. Under its enabling legislation, the Province of Alberta guarantees ACFA debt. The Board of Directors includes the Lieutenant Governor of the province and five appointed representatives of the Class A shareholder. Each of the other groups of shareholders elects one director to the Board. By the end of 2003, ACFA assets totalled USD4.05 billion. Its loan portfolio stood at USD3.94 billion, while its own outstanding debt was amounted to USD3.97 billion. ACFA's credit is rated AAA and it raises capital in the Canadian and foreign financial markets.

The majority of ACFA borrowers are municipalities. Their financial constraints include balanced budgets and debt service limits. Borrowing terms range from three to as many as 30 years. Amortization and maturity terms on loans must be in tune with the working life-cycles of projects; these include water and sewer facilities, roads and bridges, transportation,

### **Box 6. FINDETER, Colombia**

In Colombia, decentralization has given municipalities strong revenue-generation powers along with responsibility for urban services, including water and sanitation, street lighting, education and health. Increases in the local share of national taxes have boosted central transfers and improved in local revenue generation, but municipalities are unable to access long-term funding for capital investments on the domestic capital market. Since they hold mostly short-term liabilities, financial intermediaries are reluctant to provide long-term financing, especially to municipalities with no track record of administering long-term debt. In 1990, to address this problem, Colombia restructured its Fund for Urban and Infrastructure Development (FFDU), which operated from within a mortgage bank, and established a Municipal Development Fund, known as FINDETER with sponsorship from the IADB and the World Bank. Unlike conventional MDFs, FINDETER is a second-tier lender which rediscounts loans granted by private banks to municipal borrowers for capital projects.

Since 1990, FINDETER has approved loans totalling 4.18 trillion Colombian pesos (COP) while the amount disbursed did not exceed COP2.61 trillion (62.4 per cent). Between 1990 and 1999, the total volume of approved loans grew from COP37 billion to 413.5 billion. The financial crisis of 1999-2001 resulted in a sharp reduction in FINDETER loan approvals (to COP229 billion). By 2001, new laws were passed that streamlined inter-governmental transfers and freed up extra revenues to address fiscal imbalances. FINDETER's operations were restructured and streamlined as well for improved efficiency and effectiveness. Over time, FINDETER has evolved from a municipal development fund that disbursed credit at *subsidized* rates, to a financial institution that provides credit at *market* rates. Loan approval has been devolved to the participating commercial banks, reducing the time needed to obtain credit from up to 18 months to around six months. In recognition of the growing scope for partnerships in local development, the range of borrowers was expanded to include public/private and private sector entities. Clients now include district and metropolitan authorities, private companies and NGOs that provide education, cultural and other public services.

In 2003, FINDETER-approved loans totaled COP1.02 trillion, a 64.1 per cent increase over the previous year. This significant growth was made possible by Law 795 of 2003, which expanded the range of capital investments that FINDETER could finance to include the environmental field, ; the law also broadened the range of borrowers and extended credit to leasing operations. Furthermore, a so-called “Automatic Rediscount” Scheme” authorizes intermediary banks directly to approve credits to finance education and services projects. FINDETER will typically lend the entire project amount. Loans maturities are much longer, up to 12 years, and grace periods of up to three years are often built into amortization schedules. Between 1990 and 2004, basic services accounted for the bulk of municipal borrowing from FINDETER, with urban services accounting for 37 per cent of disbursements, roads and transport for 30 per cent, and educational facilities for 13 per cent. As a second-tier lender, FINDETER rediscounts up to 100 per cent of loans made to devolved authorities by commercial banks, but does not take on the credit risk. Commercial banks are responsible for their own project appraisals and carry their own credit risks. Loans carry a variable interest rate and flat fees are charged for monitoring and loan commitment.

FINDETER fully covers its own operating costs, foreign exchange and credit risks, and produces a positive return on investment. A number of arrangements substantially reduce risk. Commercial banks are liable to FINDETER if their borrowers default, and any municipal revenue pledged as loan guarantee to the banks can be used to repay FINDETER. Furthermore, the percentage of municipal revenues that can be pledged is capped and lower bounds are set on debt service coverage ratios. Municipal infrastructure loans cannot exceed a maximum loan-to-value ratio of 70 per cent, and a municipality that defaults on a FINDETER-backed loan is barred from new funding through FINDETER.



Although it owns 86 per cent of FINDETER's capital, the Colombian government does not guarantee bonds issued by the fund; and at a difference to its predecessor FFDU, local government and financial intermediaries are not compelled to buy FINDETER bonds. FINDETER's financial strength has been shored up by recent changes in the management of inter-governmental transfers. Under these arrangements, shared revenues are used as part of the loan securities. In addition, however, FINDETER is granted power of interception over the transfers of these revenues. Interest rates declined and the share of private capital increased. Between August 2002 and June 2004, 64.75 per cent of FINDETER's resources originated in the public sector (COP954,281 billion) and 35.25 per cent in the private sector (COP519,579 billion). FINDETER remains critical to small- and medium-size municipalities, for whom it sets a ceiling on the maximum interest rate banks can charge on the loans the fund refines.

*Source: FINDETER, 2004; Freire and Petersen, 2004.*

land purchase, buildings, vehicles, machinery and equipment as well as airport infrastructure, irrigation works, energy efficiency projects and parking (Alberta Capital Finance Report: IADF, 2004).

### **5.1.5. The Development Bank of Southern Africa**

The Development Bank of Southern Africa (DBSA) was established in 1983. It is wholly owned by the Republic of South Africa. It was reorganized after 1994 with a mission to mobilize and provide finance and expertise, as well as to establish partnerships to develop infrastructure and improve living standards in Southern Africa. DBSA total assets are valued at USD3.41 billion, with total borrowings of USD1.57 billion. The bank's credit ratings are excellent, partly thanks to an uninterrupted string of net surpluses since creation, and total capitalization stands at USD1.71 billion. DBSA does not pay taxes or dividends to the government. Bond issuance in local currency

### **Box 7. The Municipal Development Fund of Georgia**

In this Caucasian country, access to finance by local authorities and utilities has been the main challenge to efforts to reverse the decline in living standards arising from the breakdown of basic urban services. The MDF supervisory board is appointed by the country's president and the fund is supervised by the Ministry of Finance. It is set up as a self-funded revolving fund through the mobilization of domestic and external capital resources. The start up capital was provided by a USD1.5 million loan from IDA. Repayments by borrowers and limited financing from government are expected to provide for the servicing of debt owed to MDF.

A preliminary assessment in 2002 showed that MDF funding of 83 capital investment projects worth about USD 17 million resulted in significant improvements in the quality of municipal service delivery in the 12 participating local authorities. Around 55 per cent of MDF financial resources went to rehabilitation of urban roads and another 20 per cent to improved water supply and sewerage systems. More generally, the assessment highlighted the link between MDF performance and the technical and managerial capacity of local government. To gain access to MDF financing, local authorities must identify feasible capital investments and demonstrate their capacity to repay. The MDF assists in the preparation of proposals. Local authorities must improve revenue collection, budgeting and financial management. In Georgia between 1998 and 2000, budgetary income increased by 30 per cent and debt capacity by a factor of 2.5, thanks to a combination of trimming administrative costs, adoption of competitive procurement procedures and creation of financially autonomous local utility companies.

Even under optimistic assumptions, only about 30 local authorities and utilities were able to borrow from MDF in the short-and medium-term, and their total borrowing capacity was unlikely to exceed four million Georgian laris (GEL) (or USD2.0 million). In a bid to keep its customer base as large as possible, while addressing an accelerating

deterioration of municipal infrastructure and services, MDF offers financing that combines loans with matching grants made possible by access to IDA funding. MDF loans can only be used for rehabilitation of existing infrastructure, including replacement of equipment. They cannot be used for land acquisition, purchase of vehicles or budget support (including working capital for commercial enterprises).

A new IDA credit provided USD13.1 million towards additional capitalization of USD24.8 million; USD6.7 million is to be derived from loan re-flows (principal and interest, net of operating expenses), which in 2002-2003 totaled USD5.7 million, and an additional five million US dollars will be provided by borrowing local entities in the form of upfront contributions. MDF extends financing in local currency for a maximum USD600,000 equivalent. Borrowers are expected to meet 20 per cent of project costs. MDF provides 40 per cent as a grant approved by the Government of Georgia and funded through IDA. The remaining 40 per cent is extended as a loan over 10 years at a fixed annual interest rate of 15 per cent, with a one-year grace period. Eligibility requirements are that debt service does not exceed 25 per cent of prior-year operating surplus and total debt does not exceed 60 per cent of ordinary income. Arrears on salaries must not exceed 10 per cent of total income and transfer payments to plug unplanned budget deficits must be less than 25 per cent. This structure is expected to ensure MDF's financial sustainability while promoting local development, fostering sound municipal financial management and improving the quality of the living environment.

*Source: Medlock, 2004.*

is its current main source of funding. DBSA also receives loans from international development financial institutions.

DBSA makes grants, lends, invests, underwrites capital issues and arranges other types of funding. As a partner to borrowers, it acts as a catalyst and provides assistance. Total loan approvals to date stand at USD4.45 billion and disbursements at USD3.93 billion, with investments in debt and equity funds amounting to 902 million South African rand (SAR) (or about USD115 million). Some 75 per cent of DBSA lending is within South Africa, with the remainder in other countries in the region. About 60 per cent of loans go to water, energy, road and drainage projects; 15 per cent to commercial projects; the remainder is for education, sanitation and social infrastructure (Robinson, 2004a).

### **5.1.6. The Philippine Municipal Development Fund**

The Philippine Municipal Development Fund is an initiative of the World Bank and other donor institutions. Established in 1984, the Philippine Municipal Development Fund provides both loan and grant funding for capital development projects. For large projects, grant funding can meet up to 70 per cent of the capital cost. Loans are tied to grants in various structured ways.

Local government water and sanitation projects must be privately managed and under “design, build, operate” arrangements. Local authorities use operators’ lease payments to service the debt contracted for the relevant project. A parallel initiative, undertaken with the Land Bank of the Philippines, has added sewerage components to some of the water projects. Raising the revenue needed to meet debt service obligations has proved a challenge for this initiative, as sewerage charges are difficult to enforce.

An important stated purpose of the MDF was to attract private capital for local infrastructure funding. Programme administrators sought sound projects and creditworthy local authorities where governments were reluctant to risk damaging their credit ratings through borrowings on private markets at commercial interest rates. Banks have a marked preference for shorter debt maturities than are appropriate for the economic life of

infrastructure, and are unwilling to address the cash-flow issues resulting from short amortization schedules.

The Bankers' Association of the Philippines has voiced concern over insuring members against the credit risks associated with lending to local government. A Local Government Unit Guarantee Corporation has been created to guarantee loans and rate the credit of individual local authorities. By mid-2003, the entity had guaranteed some USD33 million worth of loans. The unit's capitalization (about seven million US dollars) is still small, but is supplemented by uncalled capital pledged by over 20 participating banks. However, debt maturities in line with the life cycle of public infrastructure projects are still lacking (IADF, 2004; Freire and Petersen, 2004).

## **5.2 Regional/State funds for urban and regional development**

In countries where the regional/State authorities have broad competences and a role in governance with commensurate financial resources, they can create special funds to support municipalities within their jurisdictions. Countries with a federal structure have led this trend, as illustrated by the outstanding examples of Tamil Nadu, India, as well as Paranacidade and Para Urbe, both in Brazil.

### **5.2.1 The Tamil Nadu Urban Development Fund (TNUDF), India**

In India, fiscal responsibilities have largely remained under central government control, as State and local expenditures are not matched by own-source revenues. Until very recently, only the largest local authorities (municipal corporations) had significant borrowing powers, while smaller ones had virtually no power to borrow for capital expenditure and very little authority to raise local revenues. In Tamil Nadu, the Urban Local Bodies Act of 1998 brought all of the State's urban municipalities under common legislation with respect to their powers to borrow. Such borrowing may take the form of debentures (bonds) secured on local government assets or revenues. However, debt service must be payable from designated revenues, such as user charges or escrowed tax collections. The TNUDF is unique

in that it has managed to evolve over the years from a State-controlled and managed fund into one of the most creative local development funds, offering a range of innovative financial products (see Box 8).

### **5.2.2 The role of the States in urban development finance in Brazil**

Their pre-eminent role in a federal system gives States in Brazil the responsibility and power to assist municipalities in their transition to fiscal autonomy. Two recent developments in Paraná State illustrate the evolution of a municipal development fund from a purely financial institution to one that takes an active role in building local capacity through technical assistance in project evaluation.

The first, Paranácidade, was established in June 1996 as a non-profit autonomous entity to promote urban and regional development. It took over the functions of the Paraná State Municipal Assistance Foundation and manages the Paraná State Urban Development Fund (FDU) that provides financing for municipal capital investment throughout the State. Paranácidade also provides technical assistance to strengthen institutional development at municipal level. Specific areas of assistance include administrative, human resource, tax and financial management as well as urban planning and information systems. Paranácidade is supervised by the State Secretariat of Urban Development, and is accountable to the State legislature. The fund assists municipalities with project identification and implementation. This has increased operational efficiency and fostered a sense of ownership on the part of municipalities.

The FDU runs an urban development programme (Paraná Urbano) funded by a loan from the IADB. From 1996 to 1999, Paraná Urbano financed 2,356 projects of which 1,942 were capital investment and 414 dealt with institutional development. Basic infrastructure accounts for 84 per cent of projects, with street paving, water and sewerage and purchase of heavy equipment dominating funding requests. Overall, 380 out of the 399 Paraná State municipalities have benefited from Paraná Urbano. The programme also funds public agencies operating at the regional and city level. The Sanitation Company of the State of Paraná (SANEPAR), established in

### **Box 8. The Tamil Nadu Urban Development Fund (TNUDF), India**

The TNUDF has evolved from a municipal trust fund to one established and managed by the public and private sectors. The initial fund, known as the Municipal Urban Development Fund, was financed entirely by the public sector to reduce the massive backlog of infrastructure investment and improve the delivery of basic urban services. It was launched in 1988 with a concession loan from the International Development Association (IDA).

In 1996, in order to achieve managerial efficiency and attract private capital for urban infrastructure, the fund was converted into an autonomous financial intermediary. Established as a trust fund with private equity participation, the TNUDF was the first public-private partnership in India that provided long-term municipal financing for infrastructure without guarantees. Instead of merely channelling public funds, the purpose is to attract financing from the private sector. The fund also manages a separate grant fund owned by the State government to finance poverty alleviation projects. The TNUDF is managed by a private corporation, the Tamil Nadu Urban Infrastructure Financial Services Ltd. Financial institutions have committed to provide an amount equal to 44 per cent of the initial contribution of the Tamil Nadu State Government. The Fund's Management Board is comprised of representatives from the State government and participating financial institutions. Borrowers are required to stick to conservative financial management practices and to meet performance targets, including for debt service reserves and making appropriate sinking fund contributions.

The fund's debt financing depends mainly upon the surpluses of the municipal borrowers, a situation similar to revolving funds in Europe and the USA. The TNUDF is making a significant contribution to capital investment needs for large, lumpy and non-revenue-generating projects. For many small local governments that are unable to access the markets directly, the fund provides a pooling mechanism and indirect access together with enhanced credit. Such arrangements

*Box 8. (continued).*

can be especially appropriate for sewerage projects, which require substantial funds over repayment periods of 20 years or more.

*Source: Freire and others, 2004; INTA, 2004; Singh, 2004; World Bank 2003, 2004.*

1963, provides water supply to about 98 per cent of the population. The utility covers its costs, including capital depreciation, without any direct subsidies from the government. SANEPAR relies on loans from public financial institutions including FDU/Paranácidade. Under Paraná Urbano, SANEPAR received a BRL60 million loan to extend the reach of the sewerage system.

Paranácidade has developed its own software to compute the borrowing ceiling for each municipality under the federal Law of Fiscal Responsibility. Municipalities must put up their mandated State transfers as collateral in case of default. This guarantee combines with active involvement of the regional municipal associations to ensure that non-performing loans are quasi unknown (IADF, 2004).

Another Brazilian State, Pará, has also established a dedicated fund to finance programmes and projects that promote economic development and mitigate regional disparities. The Economic and Development Fund transfers some USD25 million annually to eligible municipalities. These non-mandated, discretionary transfers require only modest local counterpart contributions. The fund channels resources through Pará Urbe, a multiphase programme that supports municipalities undergoing institutional adjustment and enables implementation of Institutional Action and Investment Plans in all municipalities. Through discretionary transfers, the State of Pará promotes municipal tax revenue, more rational municipal spending and compliance with the Law of Fiscal Responsibility. The Pará Urbe programme is administered by the State of Pará Department of Urban and Regional Development, and receives 40 per cent of the funds allocated to the Economic and Development Fund. The balance is financed by an IADB loan to the State and by other State resources. The purpose is to



make the *Pará Urbe* programme a permanent system of non-mandated, matching-grant types of transfer to municipalities for capital investments in infrastructure and local and regional services, with a view to promoting inter-municipal compacts and collaborative action (Rietti and others 2002).

### **5.2.3. Local partnerships for the establishment of Development Funds**

Macro-economic conditions allowing, opportunities may open up for joint action and partnerships to access funds for capital investment. In developing countries, and beyond enhancing the capacity of local authorities to obtain funding on favourable terms, central government leadership, guidance and participation are critical to the ability of smaller municipalities to finance capital investments. In poorer countries, strong external, technical and financial support, mostly from donors, is needed to help mobilize stakeholders to set up development funds. Local governments must also be legally empowered to create such funds. Alternatively, the fund can provide the mechanism needed to overcome the regulatory constraints hampering the municipalities' ability to finance capital investments. The examples described below illustrate the potential of these local partnerships.

### **5.2.4 The Kommuninvest Corporation, Sweden**

In Europe, municipalities are empowered to engage in collective, inter-municipal initiatives. Swedish municipalities used this approach to establish the Kommuninvest Corporation through which they could raise funds on the capital markets (see Box 9). As for the concept of pooled financing, it has been imported and adapted by leading municipal development funds in developing countries, as in the aforementioned case of India's Tamil Nadu Urban Development Fund.

In Central America, national economic constraints combine with the general poverty of the population and the weakness of municipal institutions to call for outside partners when setting up development funds.

### **Box 9. The Kommuninvest Corporation, Sweden**

The Kommuninvest Corporation is a co-operative association of municipalities established in 1986 in Sweden by 10 municipalities and the Örebro County Council. All Swedish municipalities can join the association. Wholly owned by its member municipalities, Kommuninvest provides funding for a range of capital investments, including infrastructure and educational improvements. Lending terms are the same for all member municipalities, irrespective of loan size. Kommuninvest raises funds through bond issues on the European, Swedish and Japanese capital markets. The co-operative nature of the venture keeps overheads to a minimum. In the year 2000, Kommuninvest was able to issue a 500 million euro bond, its largest single issue to date. The average interest rate on loans granted in 2003 was 4.2 per cent, down from 4.84 per cent in 2002. Kommuninvest provides member municipalities with 35 per cent of their total borrowed funds. It is the largest municipal lender in Sweden

The members of Kommuninvest Co-operative Society must sign both joint and separate guarantees to cover all of the credit market company's obligations. Its solid financial condition is strengthened by the municipalities' right to levy taxes, a constitutionally guaranteed right that contributed to Kommuninvest's AAA credit rating on bonds denominated in foreign currencies. Swedish municipalities are currently slowing down on new capital investment and most borrowing is to refinance old loans. Membership is conditioned by the municipalities' ability to meet five major parameters: available and prospective liquidity, financial flexibility, financial capacity, obligations and commitments, and external factors.

*Source: Winter, 2004.*

### **5.2.5 The Nejapa Local Development Fund, El Salvador**

A town located in the San Salvador metropolitan area, Nejapa is experiencing very rapid expansion. Some 79 per cent of the 30,000 residents are considered “poor”, with 48 per cent living in “extreme poverty”. A majority live in slums and squatter settlements where 38 per cent are overcrowded, 84 per cent lack water supply, and 49 per cent have no electricity.

A Local Development Fund was established in 1997 to generate a sustained flow of resources for local community initiatives to promote and coordinate the roles of major stakeholders, and to foster consensus and collaboration for sustainable development. A Compensation Fund was set up, providing seed capital to enable the municipality to launch economically viable projects. This fund helped overcome national regulations that constrain local government ability to pre-finance investments.

The Local Development Fund is managed by a board of members representing various stakeholders: one central government official, two municipal officials, four representatives of the two major local enterprises (the Nejapa Power Company and EMBOLSAVA (representing Coca-Cola)), two representatives of the Association for the development of Nejapa, two members of FUSAI and FUNDE (NGOs) and two representatives of the FIA and SIDA. The fund has mobilized USD814,297, of which 64 per cent in international co-operation grants, with the private sector providing 17 per cent, other local stakeholders 12 per cent, the municipality four per cent and the community three per cent. The Municipality intends to contribute about 20 per cent over time, as central transfers to local authorities are expected to increase substantially under El Salvador’s recently adopted decentralization programme.

The Nejapa fund has developed 12 projects requiring investments of USD368,682. The projects directly benefit 53,753 individuals and organizations in the public, private and social sectors. In 1998 and 1999, the fund financed projects for environmental recovery (reforestation and water-related projects), infrastructure (bridge construction and electricity), housing, and social services (Rodriguez and Garcia, 2000).

## 5.2.6. The Czech-Moravian Guarantee and Development Bank (CMZRB)

The CMZRB is the only development bank in the Czech Republic. It extends financing to small- and medium-sized enterprises and to municipalities, mainly for economic development, housing construction and reconstruction, and infrastructure projects.

The Municipal Finance Company (MUFIS) was founded as an affiliate of the Czech-Moravian Guarantee and Development Bank in 1994 to manage a Programme Agreement signed between the Czech Republic and the USA to introduce a Housing Guarantee Programme. The scheme has been implemented as a Programme of Municipal Infrastructure Finance. The CMZRB owns a 49 per cent share of MUFIS, the Ministry of Finance a similar share and the Union of Towns and Communities of the Czech Republic the remaining two per cent. The objective was to encourage the Czech banking system to provide long-term loans at acceptable rates to support the development of municipal infrastructure.

Under the programme, 112 loans in excess of 1.4 billion *korunas* (CZK) (or USD45 million) have been provided in support of 122 housing-related projects. The borrowers are municipalities or associations thereof as well as local utilities. The loans are for up to CZK100 million on fixed interest over a maximum of 15 years with a negotiable grace period.

Eligible projects must be housing-related and involve the following:

- Construction and reconstruction of technical infrastructure networks for housing projects;
- Construction or reconstruction of sewerage systems, waste water treatment plants, and landfills;
- Conversion or improvement of heating systems;
- Construction and refurbishment of communal rental apartments, housing estates, and homes for senior and disabled citizens;
- Construction or improvement of *in situ* roads and public transport infrastructure (Robinson, 2004b).

### **5.2.7. The Virginia Resources Authority (VRA), United States of America**

In 1984, recognizing a growing need for environmental infrastructure throughout the territory, the Virginia General Assembly passed legislation to establish the Virginia Water and Sewer Assistance Authority to finance infrastructure projects. In 1988, this became the Virginia Resources Authority (VRA) to reflect its expanded range of infrastructure finance options. The VRA was initially created to issue bonds for solid waste projects but is now authorized to finance water, sewer, solid waste, airports, public safety and brownfields remediation projects through the Virginia Pooled Financing Programme. The VRA has issued over USD1,500 million in bonds to fund projects throughout Virginia.

The legislation has been further amended to allow VRA to serve as financial administrator and manager for the State's three federally-funded revolving loan funds: the Virginia Water Facilities Revolving Fund in 1986, the Virginia Water Supply Revolving Fund in 1987, and the Virginia Airports Revolving Fund (VARF) in 1999. Together the three funds have raised over USD1.1 billion to finance over 350 wastewater, drinking water and airport projects. In addition, VRA co-administers the Combined Sewer Overflow Matching Fund with the Virginia Department of Environmental Quality. Funding for the Virginia Water Facilities Revolving Fund and the Virginia Water Supply Revolving Fund is provided through US Environmental Protection Agency grants that require State matching funds. Funding for the Virginia Airports Revolving Fund is determined by the State's General Assembly.

The VRA's Board of Directors comprises seven members appointed by the State Governor and confirmed by the General Assembly, and four *ex officio* members, representing the agencies involved. The Board sets administrative policy and approves loans for borrowers under VRA bond programmes. The VRA completed its third issue of the Virginia Pooled Financing Programme on November 17, 2004. Thus far, nine localities and service authorities had borrowed just under USD58 million to finance water, sewer and public safety projects; in the process they took advantage of a blended "Aaa/AA" rating from both Moody's and Standard & Poor's rating agencies.

For most municipalities, the VRA programme offers among the most attractive interest rates in the market. This is in addition to savings on issuance costs. On average, savings exceed 70 per cent, compared with single-project financing. The VRA passes along to local governments the savings accrued from the pooled approach. It does not impose an up-front bond issuance fee. Moreover, annual loan servicing fees are reduced by about 20 per cent. Through a special arrangement with a commercial lending institution, all pooled loan borrowers are eligible for interim financing at competitive rates, and the interest costs can be capitalized once long-term financing is secured (Thomas, 2004).

### **5.2.8. Local development banks and funds offering credit to both public and private borrowers**

Some funding entities that began as “municipal development funds” have now evolved into mixed corporate finance institutions. These may be public corporations, public-private partnerships or wholly commercial institutions similar to investment banks. In the case of wholly commercial institutions, capital is raised by issuing shares on the market and shareholders expect to receive either dividends or enhanced share values. Borrowing is on commercial terms. With support of favourable credit ratings, interest rates are competitive and sustainable. These institutions are in a strong position to demand and impose hard budget constraints upon borrowing local governments.

The impressive growth and diversity of municipal financing institutions led in the year 2000 to the creation of the International Association of Development Funds (IADF), headquartered in Washington, DC. It has a current membership of over 150 institutions. IADF provides linkages between the funds and well-known financing institutions, as well as with credit-rating agencies. It is assembling an invaluable library of operating techniques on sub-national capital funding and related financial management.

### **5.2.9. The Bank for Socioeconomic Initiatives (BISE), Poland**

In the face of asymmetrical fiscal decentralization and economic restructuring, Polish municipalities raise the needed funds to meet capital needs mainly from local banks and the National Fund for Environmental Protection, as well as specialized European financial institutions such as the Nordic Investment Bank, the European Investment Bank and specialized European Union funds for eligible projects. Entry in the European Union is expected to lead to a larger role for European institutions in Poland. The BISE is a private bank financing projects that create new jobs. It focuses on small- and medium-size enterprises as well as municipal and other local authorities. Since 1993, the BISE has financed over 1,200 projects, including water supply, solid waste collection and disposal technology, school construction and modernization. Typically, lending is short term and BISE carries no substantial long-term liabilities.

The BISE derives its funding from several international financial institutions including the World Bank, the Development Bank of the Council of Europe (for loans to small- and medium-size enterprises and local authorities) and the Nordic Investment Bank for long-term loans to local authorities that fit the life-cycle of their capital assets.

The BISE is subject to national controls on bank lending operations and to the rules for public procurement and competitive bidding. The bank works mainly with smaller local authorities, a constituency comprised of 2,800 communes and 300 towns. Its largest municipal client is a town of 150,000 people. The bank's focus on this specific market accounts for an average loan size of about USD300,000 on a project size of around USD800,000 in towns with a population of 30,000 (Medlock, 2004).

## **5.3 Special funds**

Social Investment Funds were introduced in several countries in Latin America, Asia and Africa over the last decade to finance projects aimed at social development and poverty reduction. Environmental Funds are similarly structured but focus on environmental management, pollution control and the preservation of natural resources.

### **5.3.1. Bolivia's experience with Social Investment Funds**

Bolivia has tried to improve the performance of its Social Investment Fund by integrating it into the system of inter-governmental fiscal transfers aimed at promoting decentralization and redistribution of fiscal revenues to the poorer areas. External donations and credit are the main financial source of the funds, which co-finance an estimated 30 per cent of municipal capital investment.

International co-operation funding is administered by Bolivia's Social and Productive Investment Fund (FPS) which consolidates two national investment funds: the FIS and the Local Development Fund. The FPS pools international co-operation funds and distributes them among the municipalities to finance projects in national priority sectors. These grants are generally non-refundable. Bolivian municipalities have been split into five groups according to an "urgency of need" index (NBI). For an individual municipality, the higher the NBI for a specific service, the higher the transfer will be and the lower the counterpart funding required.

At the apex of the system, the Unique Directory of Funds guides FPS policy and coordinates the grants provided by the social and local investment funds, as well as the loans provided by Bolivia's National Fund for Regional Development (FNDR). Municipalities submit projects that are ranked by reference to their Institutional Adjustment Plans, which are prepared by FNDR in collaboration with municipal teams. In order to be eligible for investment funds, the municipality must sign agreements with the national funds and commit to allocate money in accordance with the approved financial strategy. FPS distributes grant funds according to a compensation policy formula and the funds are included in the annual budget. FNDR loans are provided for eligible projects on the basis of a municipality's creditworthiness. The FNDR monitors the projects' financing schemes and has developed a comprehensive database to assess the performance of municipal finance.

During the 1990s, Bolivian municipalities made extensive use of their borrowing powers, and often imprudently so. By 1997, the Ministry of Finances had to impose constraints on borrowing: the debt ceiling was set at 200 per cent of the previous year's municipal revenue, and the annual



debt service must not exceed 20 per cent of that same revenue. Two years later, many Bolivian municipalities either exceeded this limit or were close to surpassing it. This situation led the Ministry in 2001 to introduce a Programme of Local Development and Fiscal Responsibility in a bid to sort out the financial situation of indebted municipalities. With support from a USD87.3 million IADB loan, the programme funds social and productive projects through FPS, and other urban projects through FNDR credits. To access these funds, municipalities must submit fiscal adjustment and investment plans, identifying weaknesses and assessing needs.

By blending grants and loans, the programme seeks to implement strategic actions that support decentralization, increase local resources and foster sound fiscal management; it also looks to promote involvement of the private sector in municipal finance. To achieve these objectives, Bolivia's Programme of Local Development and Fiscal Responsibility helps build the technical and managerial capacity of municipalities, with special emphasis on fiscal management as well as on administration of property cadastres and tax rolls. The programme also sponsors credit ratings for the major municipalities, a prerequisite for bond issuance (Brakarz, 2003).

### **5.3.2. Special funds financed by debt swaps and discounted debt under the HIPC initiative**

In a formal sense, as commonly used in financial markets, debt swaps are used by two or more partners to exchange legal liabilities for already incurred debt. Each partner carries financial obligations, but the transaction is mutually advantageous in terms of meeting some strategic objective. Debt swaps are also used in an entirely different context when central governments or other public entities in developing countries have run up foreign debt obligations that have become either very burdensome or totally unsustainable under changed macro-economic circumstances.

To further their international development aid goals and assistance to poorer countries, creditor countries can also agree to discount the debt and allow indebted governments to repay the balance in local currency. The debt service proceeds of these "swap" arrangements are deposited in a fund to support new local capital investment or to promote strategic objectives of a

social or environmental nature. One of the first such “swaps” involved Costa Rica’s debt and helped preserve the rich ecosystem of its national rainforest reservations. More recently, “swaps” have been used to fund poverty alleviation initiatives in accordance with the Country Poverty Reduction Strategy in Heavily Indebted Poor Countries (HIPC) (World Wildlife Fund, 2003). In general, an agreement on social objectives requires compliance with national priorities and stipulates that projects be undertaken by NGOs. In Egypt, a special fund for debt owed to Switzerland, Italy and Germany has been set up to finance rural development, job opportunities for women, and environmental improvements. Projects are to be implemented by private enterprises and civil society organizations<sup>5</sup>. The Heavily Indebted Poor Countries initiative was set up in 1996 by the World Bank and IMF to help alleviate debt in developing nations. The debt cancelled to date is estimated at USD36.3 billion, or less than 10 per cent of the total (IMF and World Bank, 2000).

As part of the HIPC initiative, the Bolivian Strategy for Poverty Reduction enhances the role of local authorities in improved service delivery to impoverished populations and in local development. The strategy relies on municipalities to develop and implement action plans to reduce poverty. Some USD20 million is transferred annually to local authorities to invest in Bolivia’s eight national priority sectors. The redistribution formula for the allocation of HIPC funds underscores the programme’s focus on poverty alleviation. To ensure geographic coverage, 30 per cent of the resources are evenly distributed across the second tier of government, the departments, and within these among the municipalities according to the aforementioned index of urgency of need (NBI). The remaining 70 per cent is directly distributed among municipalities according to their NBI ranking. While the capital investment sectors are predetermined, the municipalities are not under any obligation to present specific projects to obtain funds. In other words, HIPC resources are considered as an integral part of non-conditional inter-governmental transfers. In Bolivia the allocation process included extensive consultation with major stakeholders and focused on the potential role of CBOs, “productive groups” and indigenous populations.

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5 Information communicated by Egyptian mission at the UN, July 2004

The success of the strategy has been undermined by structural impediments: (1) The national strategy became a hostage to politics, resulting in a lack of continuity as successive revisions led to changes in approaches and instruments; (2) Systematic monitoring of the Poverty Reduction Strategy was halted in 2003; (3) Even though the HIPC initiative reduced Bolivia's debt service burden to about USD1.57 million annually for 15 years, the relief was not sustained. Both the domestic and foreign debt has risen and is reaching levels similar to pre-HIPC intervention levels. These structural impediments hamper Bolivia's ability to meet the Millennium Development Goals by 2015 (Brakarz, 2003; Control Social, 2004).

## **6. Private-sector financing of municipal infrastructure and services**

### **6.1 Privatization of municipal service delivery**

#### **6.1.1 Overview and main features**

Starting in the 1980s, “privatization” became an international trend embraced by countries all over the world. This was prompted by international and bilateral development organizations advocating the greater use of private sector entities as a way of improving efficiency and effectiveness in the delivery of public services.. This trend was sustained by instances of policy and regulatory failure, bureaucratic impediments, public sector inefficiencies and ineffectiveness of public delivery of services. Depending on the project or the service under focus, there was a gradual recognition and acceptance of the fact that private enterprise, NGOs or CBOs could undertake the task more efficiently and with greater effectiveness than public authorities.

The trend started with massive privatization of public utilities – electricity, telephone, transport, gas, etc. – throughout the world, with little regard for the impact of these transfers on the poor, or for the fact that some utilities were natural monopolies where the discipline of competition (a major justification for privatization) was substantially absent. Most of such privatization involved industries that were controlled by top- or second-tier governments. In many instances, and along with its service delivery capability, the private sector has been able to supply much-needed capital investment, which was raised through methods which for various reasons were not available to the public sector. Unfortunately, in some cases, the outcomes have not matched expectations. There is a large body of literature discussing these issues, and a review of the privatization experience is beyond the scope of this paper.

Privatization of public service delivery requires many years of operation for comprehensive and robust evidence to emerge regarding the extent of success or failure. More rigorous analysis is needed to determine, in each

situation, whether private profits are generated through genuine economic efficiency of operations, or by allowing the plant and equipment to continue deteriorating, or by raising prices to levels beyond the means of lower-income communities as happened in some Latin American countries. Moreover, the ability of private operators to cash out or withdraw allows them to increase profits by under funding or deferring expenditures on replacement and preventive maintenance. When the private contractor walks away from essential services, the public sector has to pick up these functions.

Privatization of local services entailed changes to existing procedures and the introduction of new modalities of supply and delivery of services, including the contracting out of all or part of individual services, public-private partnerships, franchises, and forcing internal service units to compete on a commercial basis as happened in Eastern Europe. However, the scope for privatization at the local level was limited to a relatively small number of services. These included: public transport, water supply (though not often enough associated with sewerage and sanitation), solid waste management, and sundry activities including janitorial and cleaning services, information processing and accounting, landscaping, and vehicle and plant maintenance. The success of the outcomes depends on specific circumstances and the respective perspectives of the major stakeholders.

In the larger urban centres of developing, transitional and advanced countries, privatization has effectively if gradually transferred revenue-producing services, including water supply and solid waste management, to specialized multinational firms serving many local authorities (Brocklehurst, 2001). Although not complete monopolies, the large size of many firms allows them to resort to predatory pricing to secure contracts in new locations and to exact substantial indemnities and guarantees from local governments. Many of the activities are capital-intensive and the high entry and exit costs make it difficult for potential competitors to compete against entrenched interests. Concessions granted to foreign enterprises also inhibit any substitution, since cancellation of the contract for unsatisfactory performance carries heavy political and financial risks. The contractor is usually compensated and the sponsoring foreign government placated.

## 6.1.2. Impact on local financial management

Privatization requires changes in local government financial management. Conventional contracting-out procedures and outsourcing are now referred to as “public/private partnerships”. Reversing or altering a particular mode of service delivery – public, privately provided or contracted out – is not a straightforward task. Many activities are capital-intensive or have significant institutional implications. These entry or exit costs can be quite high, making it difficult for potential competitors to compete against entrenched interests, as happens in many concession situations in developing countries. Privatization, and for that matter the awarding of concessions, has not been devoid of corruption, including lower initial bid prices to secure the contract, followed by later requests for contract amendments.

At both the national and local levels, privatization provides an expedient way around constraints on other types of financing, especially for capital expenditures where restrictions on public sector borrowing were in force. Perceived economic efficiency contrasted with the wasteful use of labour in many public sector areas, facilitating cost savings along with quality improvements. However, a portion of those “wages and salaries” that were previously recorded under “administration” was shifted to “expenditure on services” in budgets and accounts and recorded as “payments to contractors”.

To some extent, privatization has brought about transparency and accountability on the part of local government with respect to financial management and rigorous budget practice. It has forced greater attention on cost recognition and control, leading to improved accounting and a greater concern with cost recovery and payment collection, where it was previously assumed that any shortfalls would automatically be covered from general public revenues.

The financial discipline and commercial outlook of competing private enterprise forced public administrators to lower costs, achieve greater efficiency and improve the quality of outputs. Opening up public services to market participation created more opportunities for competition in the delivery of these services. The private sector ushered in valuable, new and welcome services and labour-saving technologies in a bid to achieve

greater “returns” on the huge amounts of capital invested in utilities. While privatization has forced governments to examine entrenched practices and to consider alternatives for their alteration or replacement with considerable success, it is no panacea. There are many ways of involving the private sector in public service delivery on a rational basis short of outright privatization.

Public-private partnerships require significant delegation of authority but can be very productive. Locally based partnerships involving CBOs and micro-enterprises have resulted in more empowerment and social inclusion. Solid waste management and recycling have become prime mechanisms for the simultaneous promotion of environmental and social objectives. Many award-winning schemes can be found around the world such as in Santo André, Brazil, and the “Scavenger communities” in South-Africa’s North-West Province. Furthermore, in poor countries labour-intensive activities are significant sources of productive employment; partnerships between local authorities, communities and micro-enterprises can help achieve these objectives.

## **6.2 The major issues in various regions**

Local government boundaries have evolved over time, shaped by history and tradition. They have often undergone ad hoc adjustments for political, economic and social purposes. The “redistricting” in South Africa – referred to as “demarcation” – reduced the number of municipalities from 806 to 284 in order to enhance financial viability as well as technical and managerial capacity. There is hardly ever perfect congruence between optimal sizes and locations of jurisdictions for the purposes of service delivery and revenue generation. This is particularly the case when large assets, such as stadiums, shopping centres, transport stations and airports fall within one local jurisdiction that derives significant tax revenues from them. Against this background, and for each of the services it delivers, it becomes incumbent upon each locality to consider whether it should manage it on its own, or combine some services with one or more neighbouring municipalities. Either separately or jointly, local authorities can outsource the management and delivery of one or more services to private operators, non-profit

organizations or community groups. In Europe, there are strong incentives for inter-communal compacts and in some instances, as in France, national legislation mandates co-operation in the larger urban centres<sup>6</sup>. In transitional and developing countries, local authorities are reluctant to engage in joint action, which typically requires some delegation of powers and sharing of revenues. In Latin America, political affiliations create divisive forces impeding the development of joint activities.

Many local authorities in developing countries have opted to establish separate operating units for some services with their own assets, staffing and management. These enterprises are managed by a “board” or a committee where the municipality is represented. In transitional countries, these semi-independent entities were viewed as an intermediate step in the process of privatization. This was particularly the case for housing maintenance and solid waste management. Similarly, the various jurisdictions can choose jointly to contract out combined service “packages” to a private sector entity, which might be either publicly or privately managed or supervised. The organizational structure will always be a major concern, along with representation of partners in decisions regarding all aspects of management and finances.

In many cities, formal privatization has not benefited lower income communities. This emphasizes the need for the public sector to play a role in the delivery of essential services. The abolition of “social” charges and other forms of subsidization of minimum consumption levels for basic services is troubling, as poor urban families are often unable to pay even the minimum charges required for access to basic infrastructure and services. This situation has prompted the emergence of parallel systems, ranging from well-managed facilities sponsored by NGOs and charitable foundations to highly inadequate, poorly run initiatives operated on an *ad hoc* basis by local groups with or without outside support.

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6 *Loi du 12 juillet 1999*, commonly referred to as *Loi Chevènement* and subsequent revisions.



### **6.2.1 Granting concessions for the operation of revenue earning services: the experience of Abidjan, Côte d'Ivoire**

Abidjan, Côte d'Ivoire, has a long history of privately operated utilities and services under the "concession" regime. Before the disruptions and chaotic environment brought about by wars and civil strife, Abidjan's services functioned remarkably well compared with the situation prevailing in neighbouring countries. Communes within Abidjan's administrative boundaries paid the city an annual contribution for the services provided, according to a formula combining population and revenue.

A French water company, SODECI had the concession for the operation of the water supply system. It was also awarded a contract for the maintenance of the sewerage and drainage networks. These contracts contained clauses that shielded the company and shifted any risk involved in the operation of the system to the government. Even then, subsidized connections for poor households were abolished under the Structural Adjustment Programme and the vast majority of lower income renters now purchase water from property owners, shopkeepers and water vendors. The company was entitled by contract to compensation for any discrepancy between actual consumption and the estimates developed by the Ivorian Water Directorate (the basis for the negotiation of concession contracts); yet the company contended that maintenance of underutilized systems was inefficient, and periodically shuts off the mains supplying areas with high concentrations of low-cost rental housing and squatter settlements, in a futile attempt to put water vendors out of business.

The company's performance regarding the maintenance of the sanitation network has been seriously inadequate. Frequent obstructions, mainly due to defective solid waste management, were not attended to promptly, although local authorities were charged high fees for the service. However, the company's sunk investment in plant and equipment and its presence on the ground gave it a virtual monopoly, as competitors were unable to match the terms it offered.

Abidjan's solid waste management has also been privatized. The various companies in charge tended to the primary road network and the main market areas. However, their trucks were ill adapted to the high organic content of the wastes. The service was too infrequent for an equatorial country. Garbage spilling from overflowing dumpsters was not collected (Serageldin, 1995).

## **7. Joint funding of infrastructure and urban services**

Local authorities have been major participants in capital development projects. In transitional countries, privatization became a strategic objective from the early 1990s onwards. Private sector entities are now involved in most local government functions through outsourcing, contracting, concessions and partnership agreements.

In China, provincial and local authorities increasingly look to public/private partnership as an option to fund or implement infrastructure and urban development projects. Partnerships with private investors range from the granting of concessions to joint venture agreements to Build/Operate/Transfer (BOT) or Build/Own/Operate/Transfer (BOOT) schemes. The public sector provides land for urban development and the construction of infrastructure and facilities (mostly new high-grade highways and toll roads), as well as repayable equity or loans. The private partners provide equity and shareholder loans. Concessions and BOOT agreements are more attractive to private and foreign investors for a number of reasons: they can offer security in the form of guarantees of minimum revenue or profit, loss protection, repayment of capital, tax exemptions and other fiscal incentives, together with preferential loan repayment terms. Provincial/State authorities can use assets and revenue-backed securities to finance their shares in the investment.

### **7.1 Linking formal and informal systems and providers**

Of special interest to poor countries are solutions based on partnerships between municipalities, NGOs and CBOs. In these countries, integrating poor communities into the city fabric and giving them access to basic services is hampered by several factors: the spread of chaotic urbanization, mounting population densities in the central zones, the obsolescence of existing conventional systems, and the lack of resources to maintain and upgrade existing systems. To improve living conditions for under-served communities, systems and networks using different technologies and serving different population groups and geographic areas must be interlinked. Solid

waste management is one of the services most affected by the need to merge traditional solutions with modern technologies.

In West African cities, potable water supply is another area that can benefit from this approach. Award-winning programmes in Cotonou, Benin demonstrate the importance of linking formal and informal service providers (see Box 10).

## **7.2 Joint funding of community-based initiatives for the delivery of basic services**

Micro-credit institutions have mostly focused on giving micro-entrepreneurs the credit they need to start up and expand their businesses. Recognizing the importance of home-based income-generating activities, particularly for women, these institutions began to offer loans for housing. They gradually expanded their lending range to help poor families access land and basic infrastructure services. Today, they have become major partners in municipal initiatives to improve the living conditions of poor households in both urban and rural areas. The potential of these partnerships is best illustrated by the experiences of Guatemala's Génesis Empresarial, the PROMUNI programme and the partnership between the Ahmedabad Municipal Corporation and SEWA Mahila Trust to upgrade slums through the Parivartan programme (see Box 11).

In Ahmedabad, the major commercial, industrial and financial centre in the State of Gujarat, India, 45 per cent of the population of 3.5 million live in slums and under-serviced areas. Constrained by budget deficits and the need to improve financial management, the Ahmedabad Municipal Corporation (AMC) embarked on a series of reforms that won international recognition for their achievements. The next step was the launch of the Parivartan programme to improve living conditions in the slums (see Box 12).

**Box 10. Linking formal and informal systems: Cotonou, Benin**

In Cotonou, deployment of a solid waste management scheme was conceived as an environmental initiative. The service is run by an NGO that employs local youths to collect the waste. Subscribers pay monthly fees for the service. Two committees comprised of community residents devise plans, define the responsibilities of each partner, and monitor the operation of the service with technical support from the NGO. The municipality is responsible for transporting waste from dumping stations to the disposal sites, in compliance with environmentally sound practices.

The NGO promotes recycling by community groups, mostly women. They do so through ecologically sound practices, including biological treatment of polluted runoff water and composting of organic wastes, in a bid to reduce the number of dumpsites from 30 to five. Bilateral aid from GTZ-MEHU provided start-up funds for the scheme in 1995. In the first five years of operation, 80 per cent of the population subscribed to the service. Collection rates were on the order of 95 per cent; and 200 permanent jobs were created. A community bank enables female recyclers to access micro-credit and expand their activities. The Partnership for Municipal Development (PDM), a regional organization, has provided the municipality with capacity building and technical support, facilitating the launch and institutionalization of the scheme.

In 1998, the piped water supply system operated by the Benin Water and Electricity Company (SBEE) served less than 50 per cent of Cotonou. Only 16 per cent of households were directly connected and 32 per cent purchased potable water. The PDM encouraged the municipality to work jointly with informal vendors in order to ensure affordable delivery of potable water to poor settlements in the peripheral urban wetlands, where half the city's population live. This entailed reaching out to the vendors, getting them organized and building up their capacities. A formal Association of Water Vendors

*Box 10. (continued).*

(AREB) was created grouping 300 vendors, a core group representing 20 per cent of potential members.

The Municipality and the SBEE recognize AREB as a formal partner, and the utility grants AREB members preferential pricing for water purchases. A survey of AREB-operated fountains showed undisrupted service and improved quality. The municipality is constructing 24 public fountains in non-regularized settlements and they will be operated by AREB members. The PDM acts as mediator and facilitator to overcome the conflicts and distrust prevailing between small vendors, SBEE and the municipality. PDM is planning to replicate this partnership concept in other West African cities to improve the delivery of services to the poor.

*Source: Seradelgin and others, 2003.*

#### **Box 11. Génesis Empresarial, Guatemala**

Génesis Empresarial was established in 1988 to improve living conditions for low-income rural communities, providing micro-credit for access to infrastructure services. Génesis loans are not subsidized and the interest rates charged reflect the costs of the funds obtained from various sources of capital. Current rates range from 21 per cent on funds from the Central American Bank for Economic Integration (BCIE) to 30 per cent on funds from commercial banks and Génesis own funds. In 1993, Génesis Empresarial entered into an agreement with BCIE through its PROMUNI fund to extend financing to projects for the introduction of electricity, water and other services to rural communities. Participation in the programme requires that at least 90 per cent of residents agree to request the service. The programme is implemented through groups of four to 12 families, with loans ranging from USD120 to USD450 per household and repayment over one to four years.

Collective liability and submission of a documented land title held by one household in each participating group are the conditions for eligibility. Repayments are monthly with an option to pay after harvests, and are running at a rate of over 92 per cent. Génesis assists borrowers all along the process: organizing themselves, registering the project committee with the local authorities, preparing technical reports, applying for matching grants and credit, interacting with contractors, and managing group loan accounts. Because of the financial burden of technical assistance, PROMUNI did not achieve a positive return on investment (and then only 1.2 per cent) until 1998.

From 1993-2000, the programme supported the development of 79 projects reaching 9,000 residents in 143 communities in various districts across Guatemala. The total amount lent was over 32 million quetzals (GMQ) (or USD4.1 million). From 1988 to 2002, Génesis worked with close to 83,000 clients and granted 129,000 loans amounting to USD184 million. The average loan amount was USD489 with a default rate around eight per cent. As of December 2002, the programme served 35,452 clients carrying USD17.3 million worth of loans (see Table 6.1). A Génesis client, San Juan Sacatepéquez Municipality (population: 137,136) is located 31 km from Guatemala City. Génesis lent USD323,600 to introduce electricity to all but two of San Juan's 25 communities with a combined population of 9,825. Génesis is now providing them with credit to introduce potable water, improve housing and foster small and micro-enterprises.

*Source: Búcaro and Edgar, 2003; Serageldin and others, 2001.*

## **7.3 New trends in partnerships for local development**

In developing countries, where decentralization is a recent or ongoing process, municipalities are particularly reluctant to delegate authority or share revenue with peer entities. This reluctance accounts for the difficulties encountered in getting municipalities to collaborate on joint initiatives. Formalizing collaboration through negotiated agreements and inter-municipal compacts is an even more challenging task, as there are no institutional incentives fostering strategic associations other than through external aid entities. The successful initiatives mostly focus on economic development, as in the case of the ABC Region in Greater São Paulo, Brazil, where seven municipalities must cope with economic restructuring, particularly the rebuilding of the local economy based on new growth sectors following the decline of the automotive industry (Santo André Mayor's Office, 2003).

The difficulties in mobilizing and structuring alliances of stakeholders to promote local development are illustrated by experiences in Central America. In poor regions bypassed by development, programmes promoting development must also foster social inclusion. Inter-municipal initiatives can significantly enhance the effectiveness of these efforts, as in the case of the Valle de Sula Metropolitan Area strategic association in Honduras. The challenge is to overcome distrust and apprehension. The participatory process required to reach consensus on objectives, operating modalities and action plans takes anywhere from two to three years, and the institutional framework must be organized before any activities can be launched. Implementation of partnership agreements often requires the creation of a large number of assemblies, committees, boards and delegations that may become cumbersome to the point of reducing the effectiveness of the alliances.

### **7.3.1 Alliance of stakeholders to drive local development: San Andrés Valley, El Salvador**

San Andrés Valley is located four kilometres from the San Salvador metropolitan area; it includes 11 municipalities with a total population of 368,358. Its profile is fairly typical, with large stretches of agricultural land



and industrial activities, particularly “*maquiladoras*” (sweatshops), and has the potential to develop new agro-industries and tourism. This is an immigration area where sustained growth puts land under strong pressure, leading to chaotic urbanization. Some 1,000 firms are established in the area, of which the majority are micro-enterprises employing up to four workers.

In 1993, the San Andrés Foundation launched a participatory process to prepare a plan for the development of the region, and created an alliance of stakeholders to drive the process. Representatives of 200 organizations participated in the preparation of the plan, which was completed in the year 2000. The major issues addressed included, regional planning, education, culture and recreation, the environment, public health and local economic development.

A Management Group for the development of the San Andrés Valley brought together the various stakeholders to implement the plan. The National Foundation for Development (FUNDE) and the Salvadorian Foundation for Integral Support (FUSAI) facilitated the process. The Management Group comprised representatives of 10 local authorities, 25 government institutions, 13 NGOs, 12 CBOs and 18 firms located in the valley, who all formally committed themselves to take on responsibilities for plan implementation in accordance with the guidelines established by a general assembly. A Co-ordination Commission, effectively the board of directors, was created to ensure the smooth functioning of the alliance and facilitate cross-sector schemes. Work groups took on specific tasks and the management oversees the implementation of the agreements reached by the Board of Directors.

A share of the revenue generated by the San Andrés Valley Office of Planning is allocated to the Management Group. The Association of Municipalities provides financial and technical support to help ensure the continuity of the alliance. Between 2002 and 2003, USD66,000 was mobilized to finance municipal development projects. The Management Group has promoted awareness of and compliance with the norms and regulations established by the Regional Development Plan. The group has enhanced perceptions of the area as a good location for private investment, and created attractive

conditions for environmentally sensitive investors. An Environmental Committee of 23 enterprises balances income generation and protection of the environment. Local government is strengthening its own management capacities and four municipalities are implementing a joint action plan for local and regional development. Civic group involvement in governance has given the area the social vision it sorely lacked. Another benefit was that it made it easier for the Management Group to encourage micro-enterprises and to curb any housing projects that disregarded environmental regulations (FUNDE and FUSAI, 2004).

### **7.3.2 Decentralizing investment in urban development in Central America: the PRODEL programme in Honduras**

In Honduras, municipalities have access to four main sources of revenue: service fees, six local taxes (with the property tax, income tax and sales tax accounting for over 40 per cent of revenues), central government transfers, and borrowing through the issuance of bonds (subject to Central Bank and Ministry of Finance approval). Only the larger, financially sounder cities have access to bilateral and multilateral funding, given the present state of development of local financial markets.

The National Programme for Decentralization and Local Development (PRODEL) has expanded the scope of municipalities' responsibilities from administrative and managerial tasks to promotion of social and economic development. PRODEL-sponsored strategies of municipal decentralization are adapted to the degree of development and the local circumstances of each municipality or association thereof, while reinforcing efficiency and transparency. In 1998, only eight per cent of the municipalities were considered "developed", the remainder being classified as under-developed or lagging. Only 25 per cent of the municipalities in Honduras are able to fulfil the functions and responsibilities implied in the transfer of competences and resources under PRODEL; but the fundamental premise is that the "vicious circle of no decentralization for lack of local capabilities" can be broken.

PRODEL has identified 40 municipalities that are able to handle a decentralized programme of public capital investments in the short run. The

rest require capacity building if they are to implement projects funded by the Honduran Fund for Social Investment. The so-called “*Mancomunidades*” are associations of municipalities facing common challenges but which conform to the principle of *subsidiarity*. Today, 48 *Mancomunidades* operate in Honduras, addressing basic service delivery, environmental management, cultural and ethnic issues and other areas of common interest. They have become a new intermediate tier of government but are still vulnerable to political pressures and social changes, on top of being constrained by local capacities (see Box 12).

#### **Box 12. The Valle de Sula Region, Honduras**

The Valle de Sula Region houses 25 per cent of the Honduran population, generating 55 per cent of the country’s GDP and 40 per cent of exports. Economic development is concentrated in specific areas. Far from benefiting from inflows of low-income migrants, many municipalities, including San Pedro Sula, are unable to deal with the increased demands on housing, infrastructure, services as well as productive and social facilities. This situation prompted the establishment of the first *Mancomunidad* in Honduras, the Metropolitan Area of the Valle de Sula (ZMVS), in 1993. This is a permanent, self-managed, non-profit organization whose goals are to promote balanced regional development and to improve the quality of life of residents. The 17 municipalities in the ZMVS (11 founding members in 1993 were joined by another six in the year 2000) feature various degrees of institutional development, budget resources and fiscal capacity.

Within the ZMVS, it is for the Mayors’ Assembly to formulate policy, with the Executive Direction in charge of implementation. A Decentralization and Municipal Development project funded by SIDA and implemented by UNDP has produced a shared regional vision for integrated sustainable development. The most notable aspect of the plan is that it integrates organized civil society into the formulation and implementation of regional development projects. Increasing

ZMVS revenue sources is the top priority. ZMVS is funded through a 0.5 per cent assessment on each municipality's annual revenues, an amount insufficient to cover operating costs. The Foro Valle de Sula 2020 strategic plan focuses on access to basic services, efficient and rational use of public resources in the region, and creating synergies among stakeholders.

Source: Funes, 2002.

## 7.4 Tapping migrant remittances

Manuel Orozco's work on immigrant Latino communities in the USA highlighted the emergence in the 1990s of hometown associations among emigrant communities. These associations combine social functions in the USA with coordinated efforts to support their hometowns in Latin America. Hometown associations are small, private, voluntary organizations lacking formal organizational structures. Between 20 per cent and 30 per cent of migrants contribute to these collective remittances. An interesting feature is the evolution of the support they fund through charitable activities, mainly linked to the Church, and the shift towards improved infrastructure and services projects in their hometowns and villages. These include potable water, sanitation, street paving as well as community facilities (schools, health centres, parks). These projects can lead to productive partnerships between the associations, local authorities and CBOs to meet community needs.

Mexico has taken the lead in recognizing the potential of hometown associations and in attracting their investments by offering incentives to finance development projects. Special hometown development funds are created to leverage association funds with grants from State, federal and, more recently, municipal governments. Zacatecas, Jalisco, and Guanajuato – a region of high emigration – were the first Mexican States to set up such funds to support “employment-generating projects”, mainly garment factories. Jobs were created and contributing emigrants' relatives were

given preference in hiring. Nevertheless, the projects perpetuate the deplorable features of the “*maquiladoras*” system. Similarly, San Salvador has managed to attract remittances to fund infrastructure and urban services projects by giving hometown associations voting rights in the city’s participatory budget process (see Box 13).

**Box 13. Cuenca, Ecuador: “Improve your neighbourhood” programme**

In Ecuador, Azuay is the province with the highest rate of emigration. Between 1990 and 2002, some 249,000 people left the province, accounting for 45.3 per cent of the national total. In the year 2000, Ecuadorian emigrants remitted USD1.3 billion, of which USD600 million went to the Azuay province. The municipality of Cuenca receives around USD400 to USD500 million annually. The city of Cuenca has become a magnet, acting as a gateway for those who want to leave the country and the Andean region.

The city has launched the “Improve your Neighbourhood” programme to capture migrants’ remittances. The scheme services “consolidated” neighbourhoods (i.e., those with a high percentage of privately owned housing), providing or improving infrastructure, planting trees and paving streets. Neighbourhood residents submit a request for improvements to the municipality, either directly or through their neighbourhood organization. The municipality undertakes the technical studies and calculates the costs for the residents. The scheme awards “Public works packages” of USD30,000 to USD40,000 to local engineers and builders who operate as small contractors, hiring labor and delivering the works within 60 days. Property owners are charged a share of the cost (based on lot frontage) and payable over five years, plus a 12 per cent management fee. A 15 per cent discount is offered for prepayment of the full amount. To date, repayment rates are close to 98 per cent. The municipality works with local banks which grant loans at slightly below-market interest rates (around 11 per cent in 2003). The funds are used to pay the engineers or builders undertaking the public works. Property owners make their payments directly to the bank or, in some cases, to the municipality.

The programme has achieved impressive results. Between 2000 and 2003, more than 700 small contractors delivered improvements valued at about USD21 million. Over 90 km of urban streets have been paved and serviced. The programme's popularity stems from its impact on the quality of the living environment and the impact on property values. A house originally valued at USD20,000 could now sell for USD35,000 – at a cost of “only” USD1,500 to the owner. Furthermore, the city's attractiveness for external capital investments and for tourism is enhanced.

*Source: Serageldin and others, 2003.*

## **7.5 Building the capacity of municipalities and improving local financial management**

Lack of experience and a dearth of statistical and spatial information have proved to be the main obstacles to effective transfers of planning responsibility from central to local government. In Central and West Africa, the Partnership for Municipal Development (PMD – or PDM in French) was created in 1991 as a joint initiative between African governments and bilateral and international donors. Its mission is to support the decentralization of planning and financial responsibilities to local authorities. PMD provides information on development trends, supports institutional reform initiatives, offers technical assistance and builds the technical and managerial capacities of municipalities. Of the 24 countries in the region, 15 are members (see Box 14).

PDM's achievements demonstrate the need to build the capacity of weak municipalities to establish participatory schemes, improve service delivery and urban governance, mobilize stakeholders, engage citizens and enter into partnerships to improve living conditions and promoting economic development. PDM's success also highlights the need to provide municipalities with the longer-term technical, managerial and logistical support they need to develop, implement and monitor strategic action plans and public investment programmes. institution is the most effective

mechanism which bilateral and multilateral development organizations can think of if they want to give poor countries a better chance to meet the Millennium Development Goals.

**Box 14. Africa's Municipal Development Programme (PDM)**

In 1997 PDM and Club du Sahel launched a joint initiative, the Local Economic Revitalization Programme in West Africa (ECOLOC). The purpose was to strengthen the capacity of local governments to plan and manage their economic and spatial development in the context of the decentralization of urban governance from national to local governments. PDM focuses on the following three areas:

- Documenting local economic and social conditions in their sub-regional environment to provide local officials with the quantitative and qualitative reference framework necessary to make informed development decisions. The working hypothesis is that national economies are made up of distinct local components consisting of urban poles and their hinterland.

Documenting these areas is a prerequisite for the formulation of a coherent and sustainable development strategy.

- Evolving a consensus among local stakeholders on the nature of a development framework. In order to do so, local committees representing mayors, business and union leaders, and representatives of civil society oversee the documentation work and participate in the elaboration of a Local Development Framework consisting of:
  - A common diagnosis of the recent evolution of the area, including strengths and weaknesses. The emphasis is on the inter-linkages between the urban area and its hinterland, between public improvements and private investment, and among economic activities. Special emphasis is placed on the fiscal autonomy of the municipality.

- A common strategic vision for the development of the local economy and ensuring its competitiveness at the regional and national level.
- A set of priority objectives to develop high-potential economic activities and improve the quality and efficiency of infrastructure and public services.
- A public capital investment strategy based on the mobilization of local resources and an equitable sharing of capital investment costs between the public and private sectors.
- Implementation of the Local Development Framework through a reorientation of municipal capital investment policies; mobilization of local resources, including participation of the private sector and NGOs; identification of and negotiations with foreign donors; applying for grants from the central government.

Local development frameworks were prepared for eight cities and their hinterland in the first three years of the ECOLOC programme. Work on an additional 20 cities was launched in 2001-2002. The PDM provides technical assistance to individual communities monitors municipal finance; publishes the results of its studies; organizes topical workshops and capacity building programmes on current development issues in West Africa, including the implementation of decentralization policies in the various countries; and has created a Website with access to an expanding database. Local governments value PDM assistance in organizing partnerships to improve the delivery of basic services and in enhancing municipal financial management and performance. Since 2000, PDM has organized the “Africities” annual summit that brings together senior government officials, NGOs, private investors, academic institutions and bilateral and international donors. PDM has supported local initiatives and assisted municipalities in their effort to meet their new responsibilities under a decentralized framework.



*Box 14. (continued)*

PDM work is sponsored by French co-operation services, the Canadian International Development Agency (CIDA), the World Bank, the German co-operation agency (GTZ), the United States Agency for International Development (USAID) and the Canadian Federation of Municipalities.

*Source: CIDA, 2003*

## 8 Concluding remarks

Together with decentralization, democratic local governance and the economic and social impacts of globalization are the major factors that are affecting municipal finance and reshaping the way urban development is financed. Asymmetrical decentralization has presented local governments with a major challenge: how do they fund devolved functional responsibilities in the face of inadequate transfers from central government and limited access to funding from other sources? Democratic local governance has fuelled growing demands for accountability and transparency in municipal management, particularly as regards the allocation of scarce local resources and their performance. Globalization has compounded uneven spatial distribution of economic activity and widened disparities in income and wealth across regions, countries and within countries, and these inequalities affect urban centres as well. Some benefit from a privileged location while others are bypassed. These imbalances are further deepened by the social dimension of globalization, which has exacerbated poverty and led to massive population movements.

Municipalities are hard pressed to find the resources needed to fund urban development policies that foster poverty alleviation and social inclusion. This challenge is further compounded by the growing concentration of wealth in the private sector brought about by globalization, the concomitant cutback in government expenditures, and the disengagement of the international community from urban issues in developing countries. Municipalities must learn to tap into private resources and access capital markets in order to finance the delivery of urban services and urban development programmes.

Partnership with the private sector has become as much of a necessity as it is with NGOs and CBOs. The various modalities of privatization of municipal functions and services, the evolution of municipal development funds and the diversification of their services, together with the emergence and rapid growth of private local development funds, have opened up new opportunities that municipalities must tap into in order to finance development.

## **8.1 Decentralization, municipal performance and accountability**

With the exception of advanced countries, where at least the larger cities have a long experience of managing their finances, the devolution of functional responsibilities has presented local governments with a major challenge, often compounded by adverse economic and political conditions. In Eastern and Central Europe, factors such as local political autonomy, links to the West and participation in regional and international networks, have helped cushion the burdens of devolution, as has prospective membership of the European Union. Grants extended to promote social, economic and environmental objectives have provided much-needed funding for urban projects. In Africa, Asia and Latin America, transfers from central governments have declined steadily, particularly for large cities, and charting an appropriate course for decentralization without disrupting the delivery of basic services devolved to the local level has proved a challenge. Only a few countries have formulated successful policies to redistribute resources that are more efficiently collected at the national level and equalize the burden on municipalities that are economically weak or face higher per capita expenditures. Effective instruments used to foster smooth decentralization include:

- Local statutory rights guaranteed by the constitution or by national legislation.
- Mandatory transfer of shared tax revenues.
- Formula-based redistribution favouring smaller and fiscally weaker municipalities.
- The sharing of fiscal revenue through formulas that take into account the incidence of poverty.
- Inter-governmental agreements and inter-municipal compacts and joint initiatives.

The experiences of Brazil, Bolivia and South Africa stand out in this respect. Other countries, such as Indonesia, have had to undertake successive adjustments to correct serious imbalances that affect economic and social life.

Even municipalities in very poor countries have made considerable efforts to reduce their reliance on dwindling transfers from central governments. Despite adverse economic conditions, many local authorities in East and West Africa have managed to increase the contribution of locally collected taxes. In UEMOA countries, these taxes now account for close to 50 per cent of municipal revenue – a significant increase over a relatively short time span. In Burkina Faso, the *communes* do not receive any transfers from the national government.

A growing demand for accountability and transparency in municipal budgeting has accompanied political and fiscal decentralization. There is marked trend for more rigorous financial management, clear procedures for the allocation of resources, and the participation of residents in decisions affecting their communities. Of particular interest is the transparency mandated by the Brazilian legislation and the spread of participatory budgeting, first instituted in Porto Alegre, to municipalities in Brazil and other Latin American countries (Serageldin, 2003).

Accountability requires some measurement of performance and, since the mid-1980s, local authorities in Western Europe, the UK and the USA have started to measure the real costs of delivering public services. Accrual-based, multi-year budgeting provides more or less robust indicators of performance and is becoming a more popular alternative to the traditional cash-flow based local budgets. In developing countries, most municipalities lack the capacity and resources required for sophisticated monitoring of financial performance. Nevertheless, publicizing even basic, quantitative and qualitative indicators enhances community understanding of urban management and development challenges, and promotes citizen participation in local governance.

## **8.2 Ability of municipalities to provide serviced land and basic services**

The effectiveness of municipal authorities to improve the supply of serviced land and to deliver basic services is clearly a function of both the pace of development they face and the country's level of economic development.

Generally, the developed and some transitional countries have the financial and administrative resources to manage development and provide urban residents with a wide range of services. Stable or declining populations have facilitated this task. In contrast, developing countries have for the most part been unable to keep up with the demand for serviced land, or provide adequate basic services to residents of their rapidly growing urban centres. The four major obstacles they face are the following:

- Shrinking central government transfers;
- Inadequate local tax bases to pay for the delivery of services to a growing population;
- Inadequate institutional capacity to prepare mid- and long-term development strategies and the capital improvement programmes necessary to implement these strategies; and
- Limited if any access to capital resources for investments in infrastructure.

Sources of municipal revenue vary widely across countries, with property tax the most significant, followed by fees for services. Many countries also levy taxes on economic activities according to varying formulas; taxes on income are rare. Other countries feature multiple low-yield assessments and fees that contribute little to shore up their finances. Partial redistribution of centrally collected taxes – such as VAT, entitlement grants for recurring expenditures, and designated grants to either equalize disparities among municipalities or carry out specific projects – is another source in most countries, though to varying extents.

Few municipalities have complete authority over taxation. Rates are often set by national or regional authorities and, as is the case in the Middle East, North Africa and West Africa, property taxes may even be collected by a central authority and only partially redistributed to the municipality. Whether collected nationally or locally, yields are often problematic. A dearth of up-to-date cadastral information and the size of the informal sector are major impediments to property tax collection, particularly in those localities experiencing rapid expansion. Consequently, a disproportionate tax burden is borne by existing properties and formal economic activities, while new

development escapes taxation. Similarly, increases in private property values, often the result of public improvements, are rarely captured due to obsolete tax rolls and inadequate capacity to revalue properties. These conditions erode municipal revenues, depriving local authorities of the funds needed to increase the supply of urban land and extend infrastructure networks. Inadequate local revenue also impairs municipal ability to access capital markets and enter into partnership agreements with private entities, NGOs and CBOs to implement urban development initiatives.

User fees provide a significant portion of municipal revenues, particularly in developed countries. Widespread as they may be, user fee yields in developing countries have usually been lower than operating and amortization costs; this is because many governments have set rates below their economic level in order to alleviate hardships on the poor. Even wealthy countries have found it necessary to subsidize the cost of public transportation for environmental economic and social reasons. In developing countries, NGO-led social movements have advocated the provision of free or subsidized services to lower-income and poor families. Apart from its moral merit, this approach would entail a significant increase in central transfers to local authorities and service providers, if the systems were to be sustained and operating deficits plugged.

A general lack of resources and difficult access to capital markets impede the development of long-term capital improvement programmes. The exception in this respect is the set of municipal reforms in Brazil, which imposed fiscal management standards, limited personnel expenditures and mandated the preparation of multi-year capital improvement programmes. Elsewhere, multi-year budgets are introduced gradually as a mandatory requirement under national public finance regulations.

Financial constraints are reflected in two widespread trends: the lack of funds for the maintenance of existing assets, and the inability of many municipalities to undertake the capital improvements needed to keep up with urban growth, let alone guide urbanization and development. While some countries have provided grants for capital investment in infrastructure, central funds are in short supply in most parts of the developing world and

are often channelled to larger cities. As a result, it is not uncommon for existing infrastructure to deteriorate due to lack of maintenance.

In developing countries, medium- and small-size municipalities lack the technical skills to develop the coherent urban investment strategies required to access grants and loans from donors and MDFs. Santo André (Brazil) and Szczecin (Poland) stand out as successful examples of a forceful commitment to implement the reforms needed for financial planning and management, and a determined effort to leverage local resources, access credit and obtain funding from multilateral and bilateral organizations.

Long-term credit is critical to the ability of municipalities to fund urban development. The performance and impact of MDFs such as FINDETER in Colombia and the TNUDF in India demonstrate that a combination of credit and technical support to local authorities can result in significant improvements in the provision of infrastructure. In situations where local government has encouraged citizen involvement in decision-making, the servicing of lower-income areas has made remarkable progress, as the experience of participatory budgeting in Porto Alegre and Belo Horizonte in Brazil demonstrates.

In an attempt to circumvent legal, regulatory and fiscal constraints on their budgets and capital investments, local governments in both developed and developing countries are looking into off-budget alternatives. Examples include special purpose vehicles (as in the case of China), and assessment and impact fees through which private developers pay for part of the public infrastructure needed for their projects (a common practice in the USA). Tax increment financing is another creative concept which municipalities use across the USA to borrow outside the statutory limits set on general revenue bonds. The “linkage” programme first launched in San Francisco extends this principle to non-infrastructure public programmes, namely the construction of affordable housing and job training.

### **8.3 Local capacity to meet the goals of sustainable development**

The ability of local governments to meet the environmental and social goals of sustainable development, and in particular to address issues of poverty and social inclusion, depends on their technical, managerial and fiscal capacities as well as on their ability to involve local stakeholders in the development process. In many parts of the world, globalization has affected the financial resources of both national and local governments, as taxable economic activities moved to other locations. The situation is further compounded by the increased local fiscal burden resulting from the shifting of responsibility for infrastructure investment and the delivery of services to local governments. Further complexity is introduced by new development overlapping municipal boundaries and imposing an unexpected financial burden on those areas housing poorer populations or hosting immigrants. Households in these under-serviced communities and outlying areas find themselves paying higher unit costs for inferior quality services.

In many countries, high-yield tax bases are still largely controlled by the central government and are not likely to be turned over to the local level in the near future. Although local authorities are nominally responsible for managing their own affairs, their real autonomy is restricted by the dominant role that national governments continue to play in determining the local tax base, setting the tax rates, and the collection and redistribution of tax revenue. Municipalities are faced with a mismatch between their newly acquired responsibilities to provide services and fund capital improvements and a lack of control of their revenue sources. The consequent scaling back of public expenditures on both capital investment and social programmes is having an adverse effect on urban development and impeding achievement of the MDGs.

In developing countries, the deterioration of existing infrastructure and the inability to meet the demands created by rapid urbanization have led to chaotic urbanization, the proliferation of informal settlements and the emergence of informal providers of basic services. This has been the case particularly with water supply in Tanzania, Botswana, Kenya, Mauritania and Benin. NGOs have contributed to the alleviation of hardships endured



by the poor by providing them with some services. Their interventions have targeted specific communities selected in accordance with their own objectives and criteria.

Programmes addressing the social dimension of urban development are still largely dependent on inter-governmental transfers or international aid. Debt swaps and discounted debt under the HIPC initiative are only beginning to be used to finance environmental and social programmes. Bolivia is an exceptional case where funds are channelled through local authorities. Their integration into the pool of resources available to finance urban development could open up new perspectives well worth exploring.

Sustainable urban development requires significant capital and operating expenditures, particularly in situations where urban expansion requires the corresponding provision of urban services. Furthermore, making services available to low-income families necessitates substantial subsidies which municipalities are unable to generate from their own revenues. Unless the inequality generated by globalization, decentralization, central/local fiscal relations, and the dynamics of urban growth are addressed, the sustainability of urban development, particularly in developing countries will remain highly problematic.

#### **8.4 Privatization of municipal services and the need to link formal and informal providers in developing countries**

Privatization at first elicited expectations that many public functions could be more efficiently performed by the private sector. This takes several forms: spinning off service units, outsourcing or contracting out specialized functions, granting multi-year concessions, entering into BOOT agreements or outright sale to the private sector. In many countries, revenue-generating enterprises such as telecommunications, gas and electricity, water supply, and public transport have been sold off to private entities. In developing and transitional countries, privatization was advocated by international and bilateral organizations as a way of improving the efficiency and delivery of

public services, tapping into the ability of the private sector to raise capital in markets that were closed to public bodies.

Privatization is by now a well-established trend. Despite some misgivings regarding the privatization of municipal services in developing countries, the trend is not likely to be reversed. However, enthusiasm has been somewhat tempered and the momentum slowed down. The weariness stems in part from the fact that various forms of privatization experienced in some countries were associated with corruption and the transfer of public assets to influential individuals and multinational corporations. In other cases, the expected benefits in terms of higher quality services did not materialize, or failed to reach the poorer segments of the population.

In both advanced and developing countries, specialized multinational firms have secured concessions for the management of water supply and solid waste collection. Size and political influence have allowed them to secure favourable terms from municipalities. Concerns are being voiced and protests have erupted in some countries. Public authorities are now exercising greater caution when reviewing the rationale for privatization of specific functions and services and thinking through their social implications. Greater importance is placed on transparency in the award of contracts and concessions, and on the monitoring of performance.

At the local level, contracting out some aspects of service delivery is the most common form of privatization. It is often referred to as a public-private partnership, despite the fact that the “private” party does not share in the financial risk. Privatization has generally been able to serve segments of the populations that are able to pay, but lower-income areas are usually underserved on account of their inability to pay.

Evidence supports the widely held view that people are more inclined to pay private operators, but may be less willing to pay government, thereby boosting the performance of privately managed services. However, the failure to deliver on promises of greater efficiency, higher quality services and consumer choice erodes support for all forms of privatization. People opt out of existing systems that fail them. They refuse to pay for inadequate services and seek alternatives. In poor countries, reliance on informal service providers and vendors, unauthorized tapping of ground water of dubious

quality and illegal dumping of refuse perpetuate unsanitary conditions and poor health records.

In developing countries, and particularly the very poor, there is an urgent need to address inequalities in access to basic services. This is an issue that privatization will not resolve. Such disparities arise from a legacy of inadequate urban policies and ineffective responses, which the current dynamics of urban development can only compound. Many governments do provide subsidized access to poor families and some, like South Africa, extend these subsidies to minimum consumption levels. In the many developing countries, linking formal and informal service providers remains the most effective way of providing and improving services to lower-income communities.

## **8.5 Building the capacity of municipalities to fund local development**

Strengthening the capacity of municipalities to plan and manage their economic, spatial and social development remains a major challenge worldwide, as do publicizing successful approaches and providing the institutional framework to support reform. In adverse economic conditions or institutionally fragile environments, building the capacity of weak municipalities requires long-term support that must be provided by strong locally-based institutions. The achievements of the Partnership for Municipal Development, jointly funded by African governments, bilateral and multilateral organizations, demonstrate the potential of this approach. Sponsoring local capacity-building institutions is an effective way of fostering the achievement of the Millennium Development Goals.

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## **Appendix. List of Cases Reviewed by Region**

### **Africa**

#### **East Africa**

2004 East African Region Decentralization and Municipal Finance Context

2004 Botswana and Gaborone

#### **West Africa**

2004 West African Region Decentralization and Municipal Finance Context

2003 Benin: Programme for the Protection of the Environment and Water (Cotonou)

2000 Côte d'Ivoire: Abidjan

#### **Southern Africa**

2004 South Africa: Development Bank of South Africa (DBSA)

2003 South Africa: Municipal Infrastructure Program (MIP)

#### **Arab States**

1998 Morocco: Municipal Development Bank and Fez

2004 Egypt: Debt Swap

### **Asia**

#### **East Asia**

2004 Indonesia Decentralization and Municipal Finance Context

2004 China: Special Purpose Vehicles (SPV)

2004 Philippines: Philippine Municipal Development Fund

2004 Vietnam

## **South Asia**

2004 India Decentralization and Municipal Finance Context

2003 India: Ahmedabad, Parivartan

2004 India: Tamil Nadu Urban Development Fund (TNUD)

## **Europe**

### **Eastern Europe**

2004 Czech Republic: Municipal Finance Company (MUFIS)

2004 Georgia: Municipal Development Fund

2004 Poland: Bank for Socioeconomic Initiatives (BISE)

2003 Poland: Szczecin Capital Improvement Program

2004 Russia Decentralization and Municipal Finance Context

2004 Slovakia: Local Governance and fiscal Decentralization

### **Western Europe**

2004 Netherlands: BNG

2004 Sweden: Kommuninvest Corporation

2004 UK: Public Works Loan Board

## **Latin America and the Caribbean**

### **Central America**

2002 El Salvador: Local Development Fund of Nejapa

2004 El Salvador: San Andrés Valley Management Group

2004 Guatemala: Génesis Empresarial Foundation

2003 Honduras: Decentralization (PRODEL)

2002 Honduras: Mancomunidad Metropolitan Area Valle de Sula (ZMVS)



## **South America**

2003 Bolivia: Decentralization, Social Investment Funds and Strategy for Poverty Reduction

2004 Brazil Decentralization and Municipal Finance Context

2002 Brazil: Housing and Participatory budget, Belo Horizonte

2002 Brazil: Housing and Participatory budget, Porto Alegre

2004 Brazil: Paranácidade

2002 Brazil: Pará Urbe

2004 Brazil: São Paulo Action Centre

2004 Colombia: Financiera de Desarrollo Territorial (FINDETER)

2004 Ecuador: Cuenca Improve your Neighbourhood Program

## **North America**

2004 Canada: Alberta Capital Finance Authority

2004 US: The Boston Linkage Program

2004 US: Tax Increment Financing (TIF)

2004 US: Virginia Resources Authority (VRA)

Total number of cases: 43

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