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# Municipal finance conditions & trends

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**CENTER FOR URBAN DEVELOPMENT STUDIES**
**Harvard School of Design**

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**TABLE OF CONTENTS**

ACKNOWLEDGEMENTS ..... 6

1 INTRODUCTION ..... 7

1.1 Current Issues and Challenges ..... 7
1.2 Organization of the section ..... 8

2 MUNICIPAL FINANCE FOR URBAN DEVELOPMENT ..... 10

2.1 General trends in fiscal decentralization ..... 11
*2.1.1 Balancing national and local perspectives in fiscal decentralization: The experiences of Brazil and Bolivia ..... 12*
*2.1.2 Reconciling development and equalization policies in fiscal decentralization ..... 14*
*Box 2.1 Development & equalization strategies under adverse economic conditions: Indonesia's fiscal decentralization process ..... 14*
*2.1.3 Restructuring the frameworks for regional/local fiscal relations ..... 15*
*2.1.4 Dealing with economic marginalization and social hardship ..... 16*
2.2 Evolution of financial systems to enhance transparency and accountability ..... 18
*2.2.1 New trends in local financial management: Performance based budgeting and accrual accounting ..... 20*

3 PATTERNS AND TRENDS IN MUNICIPAL BUDGETING ..... 23

3.1 Reliance on central transfers ..... 24
3.2 Control of local revenue generation by provincial/regional governments ..... 25
3.3 Building local capacity to raise and manage own revenue sources in West Africa ..... 29
3.4 Mandating responsible municipal financial management ..... 30
*Box 3.1 Brazil's Law of Fiscal Responsibility ..... 31*
3.5 Lack of funds for maintenance of existing assets ..... 31
3.6 Capital investment programs & budgets ..... 32
*Box 3.2 Multiyear Capital Investment Planning, Szczecin, Poland ..... 32*
3.7 The impact of popular participation on the allocation of capital investments: Participatory Budgeting in Brazil ..... 35

4 PERFORMANCE OF KEY SOURCES OF MUNICIPAL REVENUE ..... 37

4.1 Taxes on property and businesses ..... 37
4.2 Challenges constraining the improvement of municipal revenue ..... 39
4.3 Taxes on Income ..... 41
4.4 User fees ..... 41
4.5 Betterment taxes and development exactions ..... 41
4.6 Borrowing and debt service management ..... 42

*4.6.1 Management and control of short term borrowing ... 43*
*4.6.2 Credit enhancement, access to financial institutions and capital markets 44*
*4.6.3 Income-generating enterprises ... 45*
*Box 4.1 The role of Special Purpose Vehicles (SPVs) in China ... 46*
4.7 Municipal financial management under adverse economic conditions & structural adjustment ... 47
*Box 4.2 Botswana ... 48*
*4.7.1 Tax increment financing ... 49*

5 SPECIAL FUNDING SOURCES AND TARGETED FUNDS ... 50

5.1 Municipal Development Funds ... 50
*5.1.1 Public Works Loan Board, UK ... 51*
*5.1.2 FINDETER, Colombia ... 52*
*Box 5.1 FINDETER, Colombia ... 52*
*5.1.3 Municipal Development Fund of Georgia ... 54*
*Box 5.2 Municipal Development Fund of Georgia ... 54*
*5.1.4 Alberta Capital Finance Authority, Canada ... 55*
*5.1.5 Development Bank of Southern Africa (DBSA) ... 56*
*5.1.6 Philippine Municipal Development Fund ... 56*
5.2 State funds for urban and regional development ... 57
*5.2.1 Tamil Nadu Urban Development Fund (TNUDF), India ... 57*
*Box 5.3 Tamil Nadu Urban Development Fund (TNUDF), India. ... 57*
*5.2.2 The role of the states financing urban development in Brazil ... 58*
5.3 Local Partnerships for the establishment of Development Funds ... 59
*5.3.1 The Kommuninvest Corporation, Sweden ... 60*
*Box 5.4 The Kommuninvest Corporation, Sweden ... 60*
*5.3.2 Nejapa Local Development Fund, El Salvador ... 60*
*5.3.3 Czech-Moravian Guarantee & Development Bank (CMZRB) ... 61*
*5.3.4 Virginia Resources Authority (VRA), USA ... 62*
5.4 Local Development Banks & Funds offering credit to both public & private borrowers ... 62
*5.4.1 Bank for Socioeconomic Initiatives (BISE), Poland ... 63*
5.5 Special Funds ... 63
*5.5.1 Bolivia's experience with Social Investment Funds ... 63*
*5.5.2 Special Funds financed by Debt Swaps and discounted debt under the HIPC initiative ... 64*

6 PRIVATE FINANCE OF MUNICIPAL INFRASTRUCTURE AND SERVICES ... 66

6.1 Privatization of Municipal Service Delivery ... 66
*6.1.1 Overview and key features ... 66*
*6.1.2 Impact on local financial management ... 67*
6.2 Key Issues in Different regions ... 68
*6.2.1 Granting Concessions for the operation of revenue earning services: the experience of Abidjan, Cote d'Ivoire ... 69*
6.3 Joint funding of infrastructure and urban services ... 69

*6.3.1 Linking formal and informal systems and providers* ............................. *70*
*Box 6.1 Cotonou, Benin* ........................................................................ *70*
6.4 Joint Funding of community-based initiatives for the delivery of basic services ........................................................................................................71
*Box 6.2 Genesis Empresarial, Guatemala* ...................................................... *71*
*Box 6.3 Parivartan Program, Ahmedabad, India* .............................................. *72*
6.5 New trends in Partnerships for local development ..........................................73
*6.5.1 Alliance of stakeholders to drive local development: San Andres Valley, El Salvador* ........................................................................ *73*
*6.5.2 Decentralizing investment in urban development in Central America: Honduras' PRODDEL program* ............................................................ *74*
*Box 6.4 Valle de Sula Region, Honduras* ........................................................ *75*
6.6 Tapping migrant remittances............................................................................75
*Box 6.5 Cuenca, Ecuador, Improve your Neighborhood Program* ................... *76*
6.7 Building the capacity of Municipalities and improving local financial management ........................................................................................76
*Box 6.6 Municipal Development Program (PDM)* ............................................. *77*

7 CONCLUDING REMARKS ..........................................................................79

7.1 Decentralization, Municipal Performance and Accountability.............................79
7.2 Ability of Municipalities to provide Serviced Land and Basic Services ................80
7.3 Local Capacity to Meet the Goals of Sustainable Development ......................82
7.4 Privatization of Municipal Services and the Need to Link Formal and Informal Providers in the Poorer Countries ..................................................................83
7.5 Building the capacity of municipalities to finance local development...................84

8 ANNEXE ......................................................................................................85

8.1 List of Cases Reviewed by Region ...................................................................85

9 ENDNOTES ..................................................................................................87

10 LIST OF REFERENCES…………………………………………………………… 89

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# 1 INTRODUCTION

Part B of the Global Report, Municipal Finance, Conditions and Trends, 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 them 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 in 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 to them the support infrastructure and services they need, orderly development will be impaired. In emerging economies, 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 decade of the 80's and 90's amid fiscal deficits, financial crisis and political unrest, eroding local revenue and disrupting access to funds for capital investment.

Through Part B the emphasis is placed on emerging economies and poor countries where the challenges are the greatest and the resource constraints the most acute. They are the areas targeted by the Millennium Development Goals (MDGs), and associated 2015 targets adopted in 2001[i]. Reaffirming the world commitment to address the growing disparities in income and wealth among countries and within countries, multilateral and bilateral development organizations are placing a priority on poverty reduction. 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 economies, 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 programs. 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 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 the global economy. The sequencing of the reforms affecting legal and institutional framework 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 initiate jointly funded programs with residents and developers to improve infrastructure and housing.

Leading 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 the 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 key projects.

In emerging economies, 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 emerging economies lack the supportive framework enjoyed by local governments in advanced economies. They have to be creative and experiment with innovative approaches to meet their economic and social objectives, particularly in generating employment, expanding service delivery, upgrading the urban environment and improving living conditions in poorer communities.
Government sponsored Municipal Development Funds have provided them with resources for specific categories of projects, including revenue producing services and infrastructure. Social programs 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. They are learning to seek partners and alliances. The best managed municipalities have managed 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 the poor countries, local authorities are heavily dependent on central transfers to cover 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 projects to upgrade and expand infrastructure and urban services.
Decentralization policies have devolved to them functional responsibilities without providing them with 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, 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 programs. Municipalities can benefit directly and indirectly from these financial resources. Lack of technical and managerial capacity hampers their ability to use efficiently the funding they receive let alone leverage the funds.

### 1.2 Organization of the section

Part B is organized as individual chapters that look at the major issues and trends affecting municipalities, with an emphasis on their ability to provide services and finance improvements:

2) Municipal Finance for Urban Development
3) Patterns and Trends in Municipal Budgeting
4) Performance of Key Sources of Municipal Revenue

5) Special Funding Sources and Targeted Funds
6) Private Finance of Municipal Infrastructure and Services

Global and regional statistics do not exist on the experience of municipalities to manage their finances under these circumstances due to the wide differences in the degree of fiscal decentralization and financial autonomy that exist among countries in any particular region. With few exceptions presented in Part B, national statistics on municipal finance are also lacking. This dearth of statistics dictated a structure for Part B 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 highlighting creative initiatives in the different sections of Part B. 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 emerging, transitional and advanced economies, 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 and 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 important 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 FOR URBAN DEVELOPMENT

Decentralization, globalization, and the priority placed on poverty reduction as a key objective of sustainable development have highlighted the critical role of local governments and the importance of building up their technical, managerial and fiscal capacities.

Globalization has also impacted 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 the state. In the poorer countries, government expenditures on social programs, 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 compromising 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 labor rights. It advocated fostering opportunities for national and cross-border networking, cooperation and exchange among local authorities, and instituting policies that support and empower local communities. These recommendations have implications for local development policies, social inclusion programs and municipal finance.

Two key emerging issues are affecting the performance of local authorities in both industrialized and emerging economies. First, is the progressive decentralization of the responsibility for infrastructure investment and the delivery of services to local governments, 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. Second, is the rapidly evolving relationship between local and regional fiscal relations. 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 emerging economies, with the exception of India and Russia where the state and provincial governments exercise 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 governments 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 economies, most local sources of revenue are still determined and collected by the central government, leaving little opportunity for local governments to assess often significant local economic activities to fund improvements in social services or invest in the infrastructure necessary to achieve sustainable urban development strategies.

### 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 considerations, decentralization has become a worldwide trend underlying the different approaches. Where progressive planned devolution has taken place, as in Europe, the reallocation of functions among levels 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 governments are taking a lead role stemming from their statutory powers and their ability to act cross-sectorally in a defined geographic space.

Assembling comparative information on municipal finances is a difficult task. The Government finance statistics compiled by the International Monetary Fund only give aggregate figures on revenues and expenditures for all sub-national entities combined. Studies of decentralization and intergovernmental fiscal relations were undertaken by The World Bank, regional development banks and other international organizations in the late 90's, mostly in 1997 and 1998. These comprehensive studies have not been updated because of the difficulties and high cost of assembling data for several hundred thousand municipalities. Recent statistics are only available in countries where decentralization and municipal development programs are currently under implementation and 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 channeled through local authorities testifies to the expanding scope of their responsibilities. In Indonesia, local government expenditures jumped from 17% in 2000 to 28% of public expenditures in 2001 following the enactment of decentralization laws[ii]. However, wide variations in levels of decentralization and fiscal capacities among regions and within regions prevail: from under 5% to over 15% in Latin America; from less than 10% to more than 50% in Asia; and from around 10% in North Africa to under 10% in Sub-Saharan Africa, exclusive of South Africa, where provincial and local governments account for 29% and 21% of public expenditures respectively [iii]. Incomplete fiscal data and uneven geographic coverage within sub-regions precludes 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 emerging economies, municipalities lack the sophisticated supportive framework from which their counterparts in the advanced economies 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 proving difficult, 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 intergovernmental fiscal relations, the development of municipal credit markets and access to long term credit, and the rationalization of expenditure patterns and the improvement of municipal financial management. Major challenges that must be addressed include:

- Large numbers of smaller, financially weak municipalities.
- Asymmetrical decentralization.
- Retrenchment of central transfers.
- Weakness of 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 investments.
- Lack of funds for the maintenance of existing assets.

Despite these constraints, democratic local governance has enabled local governments to address problems of poverty and exclusion, institute participatory processes, implement multi-sectoral programs 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 governments and civil society.

### 2.1.1 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. Intergovernmental transfers to municipalities increased accordingly, accounting on the average for 51.3% of total revenue in 1989 and 66.7% in 2003. The volume of central transfers declined following the 1998 financial crisis, and has gradually recovered since. However, their relative importance as a percent of total local revenue is a function of the locality's size. An estimated 50% of Brazil's 5,559 municipalities have populations below 10,000 and are economically very weak (see Table 2.1).

**Table 2.1 DISTRIBUTION OF BRAZILIAN MUNICIPALITIES' AVERAGE REVENUES BY POPULATION SIZE**

| Population (in thousands) | Total revenues (MM R$) | | 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 | 1,349.0 | 28.8 | 25.0 | 46.2 | 52.3 | 25.0 | 22.7 |
| More than 5000 | 2,946.4 | 9,240.6 | 22.6 | 37.8 | 32.4 | 42.7 | 45.0 | 19.5 |

*Source: IBAM 2002, IBAM 2004.*

The Fund of Participation for the Municipalities (FPM) receives from the central government 22.5% of the revenue collected from income and industrial products taxes. The distribution formula favors smaller municipalities which receive a higher amount of resources on a per capita basis. Transfers from the FPM are the prime revenue source in 81% of the municipalities, and in 28% of them account for over 50% of all current revenues. In 2003, FPM distributed a total of RS. 22.9 billion (US$ 8.4 billion[iv]). The central government also transfers to the municipalities 50% of the Tax on Rural Property (ITR) but this amount represents a small percentage of total revenue.

The states transfer to the municipalities 25% 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% of the total transferred. This allocation method favors larger and stronger municipalities. The remaining 25% is computed according to a formula based on population size and other criteria. In 2003, ICMS transfers totaled RS. 30.6 billion (US$ 11.2 billion). The States also transfer to the municipalities 50% of the Tax on Vehicles (IPVA) they collect (see Table 2.2).

**Table 2.2 DISTRIBUTION OF REVENUE AND TAX COLLECTION IN BRAZIL 2003**

| Government Level | Total Revenue | | Collected Taxes | |
|---|---|---|---|---|
| | Rs$ billions | % | Rs$ billions | % |
| Central government | 918.5 | 72.9% | 470.0 | 67.4% |
| State government | 209.3 | 16.6% | 189.2 | 27.2% |
| Municipal government | 132.2 | 10.5% | 37.4 | 5.4% |
| TOTAL | 1,260.0 | 100.0% | 696.3 | 100.0% |

*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 out migration to southern cities, particularly Sao Paulo deprive the northeast of its working age population. The main household sources of income 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[v].

Bolivia's Decentralization Law illustrates an ambitious attempt to coordinate intergovernmental fiscal relationships within the context of poverty reduction efforts. Bolivia's per capita income is approximately US$ 1,000. About 50% of the poor live in urban areas. Their numbers were swelled by migratory flows during the economic crises of the 1980's and 1990's. This rapid urbanization of poverty is putting pressure on municipalities to deliver basic services.

In 1994, the 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% of the total national tax collection is transferred to municipalities. The transfer is based on population size according to the 1992 census. The lack of actualized population counts penalizes areas experiencing high demographic growth.

In municipalities with a population over 50,000 transfers account for 50% of total revenue while in municipalities with a population under 15,000 they account for 95%. The financial weakness of the smaller Bolivian municipalities is underscored by the fact that 70% of the total local taxes are collected in 10 municipalities. The smaller municipalities are unable to meet the demand for social services and typically have the additional challenge of supporting impoverished rural populations.

The National Policy of Compensation regulates capital transfers targeting them to support priority sectors for social development and strengthen municipal capacity to fund capital investments that improve local services. Concomitantly, controls over the municipal debt were instituted. The eight priority sectors are defined through consultation with stakeholders from all the regions in the country and include healthcare, education, basic services, productive infrastructure (such as irrigation), rural access roads, rural electrification, environment, natural resources management, and institutional strengthening[vi].

### 2.1.2 Reconciling development and equalization policies in fiscal decentralization

The difficulty in 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 citizens. Indonesia's experience with fiscal decentralization demonstrates that it is possible to undertake a phased national reform program of national policies that reflect national disparities and modulate the central government's role to address inequalities and national priorities (see Box 2.1).

*Box 2.1 Development & equalization strategies under adverse economic conditions: Indonesia's fiscal decentralization process*

Starting in 1997, Indonesia suffered economic recession, financial crisis and political disturbances that eroded the improvements in living standards achieved over the previous decades. The currency was devalued by over 80 %, the GDP contracted by 13.8 %, the level of poverty doubled and political strife erupted. Prior to 2000, the country, despite its diversity and size, had a highly centralized administrative and fiscal system. The central government collected 94 % of general government revenue and financed 60 % 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 channeled through local governments rose from around 17 % to over 30 %; two-thirds of the central government's civil servants were reassigned to the local level; 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 the imbalances and addressing major concerns as it proceeds. Decentralization laws in 1999 devolved wide responsibilities to local governments in urban and rural districts. Cities and villages are now responsible for providing health, education, public works, communications and the management of land and other environmental resources, as well as support agricultural, manufacturing and commercial activities. Further regulations enacted in 2000 mandated the provinces to undertake functions that localities are unable to perform. Nevertheless, local governments 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 that were largely used to pay the salaries of local civil servants, along with general development transfers, have been replaced by the General Purpose Grants (DAU) presently set at 25.5 % of net central government domestic revenues, and divided between local governments and the provinces on a 90:10 basis.[1] The allocation formula is based on fiscal needs and capacities. Expenditures needs are based on an index of 4 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 % of total local governments' revenues in 2001, is the most important equalization mechanism.

The Specific Purpose Grants (DAK) are matching grants for certain regions based on urgency

[1] This share is set to rise to 26 % in 2008.

of need and national priorities. The allocation formula is still in the process of finalization. The shared revenues (SDA) 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% 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, profit of local-government-owned enterprises and other levies. In 2001, the own revenues of urban localities were estimated at around 9.7 % of total revenues. In 2004, local governments were empowered to institute new taxes upon satisfying certain "good tax" criteria and to set local tax rates within the ceiling stipulated by the regulations.

Two major impediments impair local revenue development, 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 continue to flow to the central government before being redistributed to the provinces and regions, local governments have resorted to levying 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 state decided to reinstate in 2003 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 localities 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 and on adopting provisions ensuring that communities participate as full partners in decisions regarding the allocation of funds.

Source: The World Bank, "*Sub-Sovereign Credit Access and Infrastructure Financing In Four East Asian Countries: China, Philippines, Indonesia, and Vietnam-Phase One: A Reconnaissance",* June 30, 2003; Menon, Balakrishna et al, 2003; Chakeri and Lewis, 2004. Research on this case was undertaken by CUDS team member Balakrishna Menon.

### 2.1.3 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 governments have to align their plans to regional strategies in order to access funding for a wide range of support programs.

In emerging economies, provinces trend to function as an intermediate level with varying degrees of authority over local governments. In transitional 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.

| Table 2.3 RUSSIA: LOCAL GOVERNMENTS' 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, A.V., *Review of Financial Municipal Development in Russia 1992 – 2002*

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 framework is still in a state of flux. New laws and regulations can alter intergovernmental 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 VAT, profit and income taxes (see Table 2.3).

Successive reforms have limited 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 different levels of government in Russia. Ad hoc assignment of functions to municipalities persisted until the structure of governments' responsibilities was codified in the late 90s. Federal and regional expenditures grew as they took over some of the local responsibilities. In practice, local governments have little autonomy in decisions regarding service delivery[vii].

India has experienced rapid economic growth since 1990 at an average annual rate of 4.3 % in real terms. Constitutional amendments in 1992 and subsequent decentralization laws have given urban local bodies (ULBs) substantial political autonomy. However, political decentralization has not been matched by fiscal decentralization. The states are still heavily favored fiscally while the local level comprising 3,682 ULBs and 247,033 rural 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 of 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 have to obtain prior approval of their state government to issue 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 (NSSO) estimates that only 45.8 per cent of urban households have tap water within the premises; 25.5 per cent of households do not have access to latrine, and only 18% of households are served by municipal garbage collection[viii].

2.1.4 Dealing with economic marginalization and social hardship

Largely marginalized from the global economy, Sub-Saharan African countries, with the notable exception of South Africa, 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 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 80's. In the countries of the West African Economic and Monetary Union (UEMOA), despite their lack of adequate technical, managerial and fiscal resources, local governments have become the prime providers of services and investments 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% in Côte d'Ivoire to a high of 80% in Niger, a marked improvement over previous years (see Table 2.4).

**Table 2.4 STRUCTURE OF MUNICIPAL OPERATING REVENUE AND EXPENDITURES IN SELECTED WEST AFRICAN COUNTRIES**

| | Benin | | Burkina Faso | | Mali | | Cote d'Ivoire | |
|---|---|---|---|---|---|---|---|---|
| | 1996 | 2000 | 1996 | 2000 | 1996 | 2000 | 1996 | 2000 |
| **Operating revenues** | | | | | | | | |
| 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% |
| Other | 49% | 49% | 47% | 45% | 44% | 42% | 63% | 62% |

*Source: PDM 1996; PDM 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 Intercommunal Solidarity Fund is to promote the balanced socioeconomic development of municipalities.

Generally, financial autonomy is related to the size of the municipality. In Burkina Faso, for example, smaller municipalities tend to operate at a deficit while larger cities of 50,000 inhabitants or more (exclusive of the capital) balanced their budget and had per capita investment rates roughly twice that of smaller municipalities (1999 data).

Although fiscal decentralization also started in the 80's in East African countries, it only acquired momentum from the mid 90's on. Wide variations prevail throughout the region. In 2000, Ethiopia's state governments accounted for 31.2% of total public expenditures and raised 18.9% of revenue, while Uganda's local governments accounted for 28% of expenditures but raised less than 8% of revenue. South Africa's provincial governments accounted for 46% of total expenditures but raised an average of only 4% of their revenues, while local governments accounted for 25% of public expenditures, but raised 92% of their revenues.

Functional responsibilities also vary. In Ethiopia and South Africa, state/provincial governments are responsible for health and education and in the case of South Africa, welfare. In most other countries, these functions are still discharged by central governments and NGOs have stepped in to fill the gaps left by inadequate delivery systems.

The local revenue bases also differ. Ethiopian states rely predominantly on shared taxes (personal income, business, excise and sales). Kenyan local governments rely on the property tax, and since the late 1980s on local payroll and business taxes. In Uganda, the most important sources of local revenue are income, wealth and poll taxes; the property tax is only significant in the larger urban centers. In South Africa, provincial governments generate revenue from motor vehicle fees, hospital charges and more recently, gambling. Local governments depend on

surpluses from services mainly electricity and water supply, property rates and, in large metropolitan jurisdictions and district councils, a business tax.

In all countries, central transfers provide the main source of local finance. In Ethiopia there is a single block transfer program based on a complex formula. In Kenya, a transfer system to distribute 5% of the income tax revenues to local governments was adopted in FY2000. In South Africa, the national government transfers to provinces and municipalities an unconditional block grant the "equitable share" based on the size of the population living below the poverty line. This transfer funds more than 95% of provincial expenditures, but less than 10% of municipal expenditures on average. The Municipal Infrastructure Grant program and other conditional transfers, some of which are off budget, fund capital expenditures on infrastructure and urban services[ix].

The Municipal Infrastructure Grant Program[x] was instituted in 1995 by the national government to "ensure that all communities have access to at least a basic level of service." The program funds all categories of infrastructure, some community facilities and devotes a percentage of each project's cost to build the technical and managerial capacity of municipalities.

The program offers household's grants to cover basic services costs. It aims to reach the poor urban and rural communities. The allocation formula combines three indicators to assess needs: number of families earning less than R800/month, lack of water supply, and level of unemployment in the community. To ensure community involvement, the communities must initiate all funding requests, and municipalities have a key role. They prioritize the requests and provincial governments review their eligibility and submit the proposals to the national government. The grants are disbursed to the community through the municipality. Structured for geographic outreach and speed of delivery, the program has completed over 2,500 projects.

In 1998 the government expanded the program's scope to reinforce links with local economic development the budget has steadily grown reaching R 2,357 million in 2003/04. at this time, it is the largest and most ambitious programs of its kind in the world[xi].

## 2.2 Evolution of financial systems to enhance transparency and accountability

Whether based on principles of subsidiarity and concertation or enacted through decentralization laws and subsequent adjustments local governments have become the major providers of public services. In nations as big and diverse as China, India, Brazil and Russia it cannot be otherwise.

Accountability for performance is a cornerstone of good governance and a major tool in financial management. 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 qualities of the services they deliver and the projects they implement. Democratic local governance has fueled 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 oversight regarding their actual application.

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

As recurring expenditures have increasingly dominated budgets, techniques for determining expenditures and measuring actual performance have been developed and incorporated into budgetary processes. 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 covering temporary cash-flow shortages. These principles of financial management are increasingly incorporated in legislation on national finance systems relating to state and local budgeting and 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 recent years, practices have varied in their application and enforcement among different countries. Accounting systems for activities to be funded from general revenues are often much simpler in form but cover a large variety of activities. Unfortunately, in many countries particularly in emerging economies and poorer nations, 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 investment decisions. With many accounting systems currently in use in state and local governments in different countries, incompleteness is typically the state of affairs. Therefore, unit costs and other indicators derived from these accounts will not usually account for the totality of the resources committed or consumed.

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

The Public Sector Committee of the International Federation of Accountants has only recently begun to issue standards for the public sector: the International Public Sector Accounting Standards (IPSAS). Adoption of 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 activities require sophisticated systems of financial accounting that tend to overwhelm the capacity of their finance and budget staff. Local governments, experience even greater difficulties in implementing the new systems.

Municipal financial accounting systems use two main formats. For revenue producing activities the financial accounting systems are often quite similar to those used in private sector enterprises, particularly when the activities are performed by an entity legally separate from core functions, funded from budgeted general revenues. Fostered by 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 provincial and local governments on the financial autonomy, as happened in China and is now happening in India and elsewhere[xii].

### 2.2.1 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 been adopting performance monitoring, although national mandated systems have largely been avoided. No matter how tight the definitions, the indicators used have to take into consideration differences in the way that service delivery is organized. Data variations will sometimes arise that are caused only by different interpretations, rather than by 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 was done by Sao 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 on hand. When performance measurements are based on unit costs, their utility for performance-based budgeting depends on the degree to which cost computations for both budgetary estimates and reported final results are consistent and account for total economic resource consumption. 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 correlate to development goals and objectives and that all critical inputs and services are covered.

Municipal finance is increasingly focused on the sources and modalities of securing funding for programs and projects to leverage scarce local resources. Accounting practices are increasingly shifting away from addressing the manner in which fixed assets are financed and concentrating on the financial costs of the resources consumed by the use of these assets in service delivery.

Plans, programs, and budgets are primarily concerned with inputs, whereas the public is concerned with outputs. For example, in the supply of water, plans, programs, 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 (services and products delivered) and outcomes i.e. the extent of user satisfaction with the outputs. Performance budgeting has to be complemented by a participatory assessment of policies and programs. This requires instituting 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 relating outputs to the municipality's development objectives. In more developed budgetary 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 utility 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 to 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, more recognition is being given to the need for comprehensive cost analysis and accounting for fixed assets. Depreciation costs are charged in operating statements. The net worth of fixed assets are 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 requires specialized personnel that local governments may not necessarily have in house. They must either build this capacity or procure the services by contracting out.

Worldwide progress is being made on the institution of more transparent systems in local financial management. For example, two of the world's largest countries, Russia and Indonesia, have very different cultures and histories. Yet, in each one, in the past few years, laws have been promulgated that will require the use of full accrual accounting in state and local governments. In Russia, St. Petersburg and a few other major cities started this reform in the 90's. As housing and shelter are among Russia's most pressing social concerns, financing and budgeting for this sector needs to 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 has conducted in 2003 a series of national seminars sponsored by UNDP on "Strengthening Local Self-governing Institutions in Macedonia, through Capital Development, Transparency and Financial Accountability", to build capacity as a first step in the reform of local financial systems. In the poorer countries, donor sponsored fiscal decentralization includes the development and

institutionalization of accounting reforms to insure 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[xiii].

# 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. It 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 impede the preparation of accurate and complete budgets. In many countries, local budgets are just lists of cash receipts and payments that are not usefully categorized. Often, there is no clear distinction between operating and capital expenditures. Budgets respond primarily to the mayor's priorities, requests by councilors, potential funding from higher levels of government and outside sources, and electoral promises.

In spite of their continued reliance on central government transfers, there has been a steady rise in locally generated revenues. 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 the VAT, entitlement grants for recurring expenditures, and grants for specific projects. They 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, followed by taxes on economic activities, including the sales tax, and fees for services. Although locally based and therefore reflecting the range of economic activities found in a locality, they are often set at the national or regional level (as is the case in India), and may be collected by a central administration on behalf of the municipality. In several West African countries, a portion of the tax collected is retained by the central government. A variety of low yield local taxes are also to be found, often the holdovers from the colonial era.

The efficient collection of taxes is a daunting problem, particularly in parts of the world that are experiencing rapid urbanization. A lack of up to date records, inadequately trained personnel and the prevalence of informal housing and of unstructured floating economic activities are major obstacles to an increased financial self-reliance of local governments. This has prevented the preparation of multi-year capital investment strategies that are indispensable to ensure an adequate supply of serviced land, the delivery of improved services and, generally, meeting the goals of sustainable urban development. There are notable exceptions where municipalities have been steadily increasing the efficiency of collection of local taxes. In Brazil, a series of reforms culminating in the enactment of the 2000 Fiscal Responsibility Act redefined the responsibilities of state and local governments by imposing fiscal management standards, spending limits on personnel expenditures and mandating the preparation of capital improvement programs. In countries of the West African Economic and Monetary Union, significant progress has been achieved in increasing the yield of local taxes, including assessments on property improvements and on informal economic activities.

Salaries, wages and supplies are the principal local expenditures and leave few resources for the maintenance of existing assets and the capital investments required for municipalities to finance urban development. In most countries in Africa, Asia, or Latin America municipalities are not able to borrow long-term funds on the capital markets and have to rely on targeted transfers for their capital investment. This may be due to legal constraints or a lack of the needed technical and managerial skills to identify potential funding sources. As a result, most local capital budgets reflect immediate needs or political expediency rather than a long-term development strategy. Brazil's participatory budgeting, first instituted in Porto Allegre in 1989, is a notable exception and is being widely emulated. Thanks to a transparent process, it addressed immediate as well as strategic needs and provided 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. The rolling four-year capital investment program of Szczecin, Poland, allowed the city to improve its financial management standards to a level that enabled to attract local and foreign investors, and obtain a credit rating and borrow from commercial financial institutions.

### 3.1 Reliance on central transfers

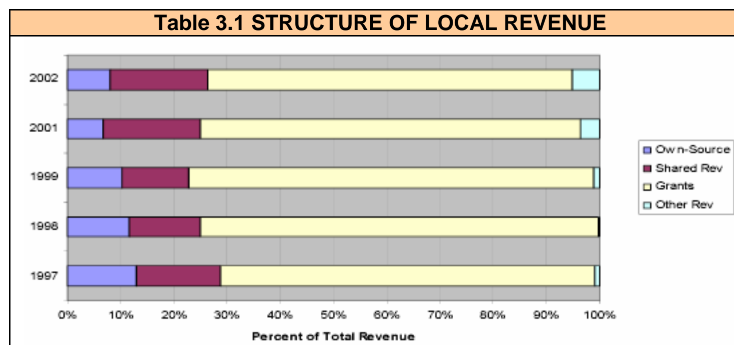
Inter-governmental fiscal transfers include three components: shared taxes, such as income and VAT taxes that are more efficiently managed at the national or regional level; distributional grants to somewhat equalize mismatched needs and resources among local governments; and specific purpose grants.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

In most emerging economies, local authorities have little understanding of redistribution formulas and rules governing central transfers. Hence, the tendency to consider them grants to balance the local budget irrespective of their economic or social purpose. Operating expenditures, once fixed, are relatively inflexible of adjustment to meet adverse short-term changes in financial circumstances, hence, the tendency to cut back or defer outlays on maintenance and capital expenditures. Environmental and social impacts of delayed maintenance of infrastructure and neglect 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 governments 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 equity in distribution, central funding will usually be accompanied by some measure of control or supervision over the local activities funded. Cumbersome controls encourage corruption and politicization of allocation decisions. They can also become stifling of local initiative and negate some advantages of decentralization and democratic governance.

**Table 3.1 STRUCTURE OF LOCAL REVENUE**



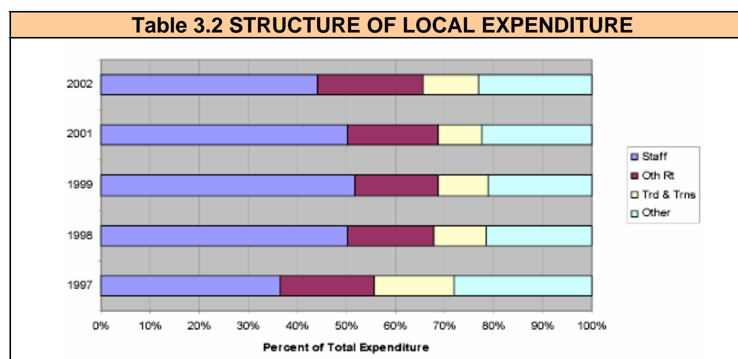

*Source: Chakeri and Lewis (2004) in Notes on Decentralization prepared for the World Bank.*

In Indonesia, decentralization has increased local government current revenue [xiv]. Between 1999/2000 and 2002, current revenue in nominal terms grew by a factor of 3.4 at an average annual rate of 57%. Central government grants contribute a dominant but slightly decreasing share from 76% in 1999-2000 to about 69 % in 2002. Meanwhile, the contribution of shared

revenue grew from under 13% to over 18% in 2002. The contribution of local revenue sources declined steadily from about 13% in 1997-98 to less than 7% in 2001 (see Table 3.1).

From 1999 to 2002, local government expenditures have risen by a factor of 3.3 at an average rate of 55% annually, in nominal terms. Capital spending increased by 60% annually, slightly outpacing operating expenditure that rose by about 52%. However, the structure of local government expenditure has barely changed. Wages still constitute the most dominant component although its share has decreased slightly from over 50 % to less than 45 % of total expenditure. Conversely, other recurrent expenditures have increased somewhat from 17 % to about 21 % of the total (see Table 3.2).

**Table 3.2 STRUCTURE OF LOCAL EXPENDITURE**




*Source: Chakeri and Lewis (2004) in Notes on Decentralization prepared for the World Bank.*

In 2004, the five key 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 regions and communities in the jurisdiction; (d) reserve funds; and (e) development expenditures.

Among development expenditures, the most notable categories are trade and transportation (about 11% of total expenditure in 2002), regional development (6.4%), state apparatus (5.7%) and education (5.0%)[xv].

## 3.2 Control of local revenue generation by provincial/regional governments

Despite the wide differences in their economic, demographic, social and cultural contexts India, a rapidly emerging economy, and Russia, a country in the midst of a difficult transition, have both opted to give provincial/state governments control over the taxes that municipalities can levy and collect.

In India, octroi (a traditional tax on the entry of goods into a local area for consumption, use or sale) is appreciated as a buoyant source of revenue by municipal governments but is viewed as a barrier to free trade and is being phased out. Only Gujarat, Maharashtra and Punjab permit municipalities to levy octroi. The latter state has taken a decision to abolish it and is exploring the possibility of replacing it with 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 Rs 272 in 1997/98 to Rs 80 in 2001/02. Other local taxes include taxes on land and buildings**;** animals and boats; tolls; professions, trades, employment and entertainment, but few municipalities have the capacity to levy all the revenue sources that they are empowered to levy.

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 transfers are a key component of municipal revenue, contributing an average of 31.7% in 2001/02, and include assigned revenues, compensatory grants, revenue-sharing arrangement and grants-in-aid. They have increased by a factor of 1.7 from 1997/98 to 2001/02. Unlike Brazil, India does not have 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 accounts for only 2.43% of their budget. The allocation criteria include indicators of size, equity, need and efficiency (see Table 3.3).

**Table 3.3 INDIA: ROLE OF TRANSFERS IN MUNICIPAL FINANCES 2001/2002**

| State | Transfers (in Rs.) | % of Total Municipal Revenue | Per capita transfers (in Rs.) |
|---|---|---|---|
| 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, Om, Thakur, Sandeep, India's Municipal Sector. A Study for The 12th Finance Commission (TFC). National Institute of Public Finance and Policy, New Dehli, September 2004*

The expectation that functional devolution will be accompanied by a corresponding transfer of fiscal powers has not been realized. Intergovernmental relations continue to be characterized by unpredictability and instability. Lack of distinction between the capital investment account and the general revenue account in transfers add to the confusion that is caused by transfers put under the same headings irrespective of having or not been previously included in the plan. Total per capita revenue and per capita local revenues in selected states illustrate the wide variations existing across regions.

Since 1991, tax reforms have reduced income tax rates, custom duties and excises, and simplified the tax system ahead of efforts to institute a value-added tax. These reforms did not extend to the municipal level. Municipal revenue has risen at an average annual growth rate of 10.0% but it is still insufficient for the delivery of services at acceptable levels as evidenced by an average expenditure level estimated at Rs.577 per capita in 2001/02.

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 Rs.39.5 compared with Rs.1,493 in Maharashtra and a country-wide average of Rs.482. Many states have posted high annual growth of own revenues. Between 1997/98 and 2001/02 Kerala, Karnataka, Maharashtra, Gujarat, Punjab and Tamil Nadu were among the better performing states, while Assam, Bihar, Haryana, and Rajasthan lagged. In the stronger states, the municipalities contributed 82.2% of the total increase in public revenue. Overall municipal revenues rose in parallel with the increase in the state's GDP.

Disparities among municipalities are extraordinarily large and have increased in the first phase of the decentralization process. In 2001/02, municipalities in Mahasrashtra with a share of 14.4% in total urban population account for 48.5% of the total municipal revenues in India: in Gujarat 12%, in Tamil Nadu 7.6%, in Andhra Pradesh 6.2%, in Karnataka 5.9% and in Punjab 4.6%. The remaining states, with over 50% of the country's urban population account for only 15%. 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: water supply, sewerage, hospitals, transport and other services. Octroi taxes provide them with the revenues needed to operate these services[xvi].

In Russia, municipalities accounted for fewer than 10% of revenue in the consolidated Federal budget.

The increase in the share of the Federal government is in part due to the discontinuation of the VAT transfer and the restructuring of the debt of some enterprises and 'organizations'.

**Table 3.4 DISTRIBUTION OF REVENUES BETWEEN BUDGETS OF 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: Freinkman et al., Russian Economic Trends (1988,2); RF Ministry of Finance; Russian Statistical Yearbook, Goskomstat, 2001* quoted in Chernyavsky, A.V., *Review of Financial Municipal Development in Russia 1992 – 2002*, IUE, 2002.

While the budget of regional governments increased, municipalities' revenues were sharply cut back falling from 10.9% in 1997 to 6.5% in 2002 as the 1998 financial crisis substantially reduced public receipts and led to a shift of revenues from local to provincial budgets (oblast) (see Table 3.4).

Local governments are legally allowed to impose and collect 22 different taxes and fees, considered own revenue sources but including shared taxes with federal and regional governments, in addition to local fees and the sale of assets. Transfers as a budget heading covers: Shares of federal and regional taxes annually negotiated and assigned to local budgets and equalization grants for redistribution purposes. The structure of municipal revenue over the last seven years is shown in Table 3.5:

**Table 3.5 STRUCTURE OF RUSSIAN MUNICIPAL REVENUES IN 1996 – 2002 (%)**

| 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 (excluding individual property tax, but including land tax) | 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 |

*Source: RF Ministry of Finance quoted in* Chernyavsky, A.V., *Review of Financial Municipal Development in Russia 1992 – 2002*, IUE, 2002.

The available data is neither complete nor uniform. In 2000 reports were given for only 48 cities. Overall, from 1996 to 1999, the share of tax revenues grew while the share of transfers declined. However, from 1999 to 2001 the share of transfers from the federal budget grew to 80% 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 Komi-Permyatsky autonomous Okrug 80 % of municipal expenditures are funded by transfers.

The individual income tax has been the main source of transfer revenue for municipalities from 1997 to 2002. However, the Law *On Financial Principles* stipulates that at least 50% must be transferred to local budgets but does not specify the allocation among sub-national entities. These allocations are negotiated with regional governments in the annual budget cycle. The importance of the profit tax as a source of local revenue grew after 1998 when the VAT transfer was discontinued. However, the local share in the tax is also set by negotiations with regional governments. Given these uncertainties, municipalities have to contend with instability and lack of predictability in their fiscality.

As shown in the table, the municipalities' own revenues include property taxes, sales tax, local taxes (including the land tax), shares of VAT, corporate profit and individual income taxes set by federal law. These revenues declined sharply after 2001 due to the abolishment of the housing and communal service tax.

The distribution of budget revenue highlights the wide variations that prevail due to the combined effect of regional economic strength, the particularities of the situation in each city and the uneven system of inter-governmental fiscal transfers applied in each region. Similarly, municipal expenditure patterns reflect successive adjustments in devolution policies.

Their functional structure over the1996-2002 period is shown in Table 3.6:

**Table 3.6 FUNCTIONAL STRUCTURE OF LOCAL EXPENDITURE BUDGETS IN THE RUSSIAN FEDERATION (%)**

| Expenditure items/years | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| Expenditures, total | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Local administration | 3.3 | 4,3 | 5,3 | 5,7 | 6,0 | 6,5 | 6,7 |
| Branches of economy (manufacturing, power production, construction, farming, transport, roads, communication, etc.) | 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 |

*Source: RF Ministry of Finance quoted in Chernyavsky, A.V., Review of Financial Municipal Development in Russia 1992 – 2002, IUE, 2002.*

Expenditure patterns exhibit greater stability than might be expected. Emerging trends include increases in expenditures on administration and leveling of expenditures on housing and communal services due to new federal codes that have increased residents' payments.

Spending patterns remained constant from 1999 through 2001 in such major categories of municipal expenditures as 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 investments in the housing and utility sectors were recorded as spending in the

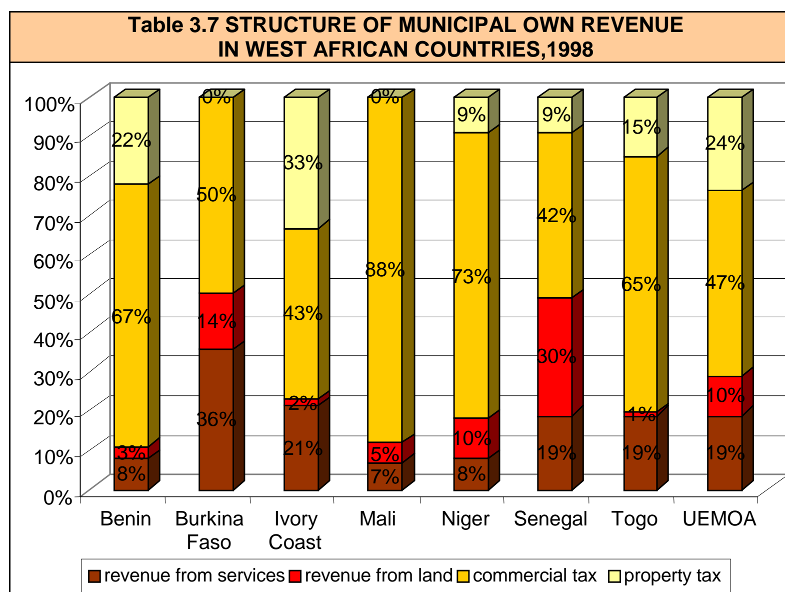
industrial, energy and construction sectors, artificially increased local expenditures on these categories.

More than 120 federal laws passed since 1999 call for providing subsidies to specific population groups. Regional and local governments 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 % GDP, or 20-25 % of the consolidated regional and local budgets of the Russian Federation. The most onerous mandate is the regulation on public servants' salaries. In November 2002, a long overdue resolution was passed increasing salaries by a factor exceeding 1.7. Regions were to be compensated for the additional expenses incurred but the Federal transfers covered only about 10% of the cost, forcing regions and municipalities to trim their expenditures on other budget items starting with deferring badly needed maintenance of existing assets and curtailing capital expenditures[xvii].

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

In sharp contrast to the situation prevailing among emerging economies in East Asia and East Africa, municipalities in the West African Economic and Monetary Union (UEMOA) have to rely on locally collected revenue that ranges from 45% (Côte d'Ivoire) to 85% (Niger) of municipal budgets. The two principal revenue sources are the commercial tax (47%) and the property tax (24%). Other sources are charges for public services (19%) and revenues derived from leasing public lands (see Table 3.7). In the case of the commercial and property taxes, national legislation and not local government determine the assessment rate, and the central administration is responsible for their collection. The central administration is therefore responsible for the preparation and periodic update of tax rolls, the sending out of tax bills and the enforcement of collection. This system was instituted as a result of a lack of local capacity, particularly in smaller municipalities, but tends to lag behind changing conditions, often resulting in under taxation in municipalities experiencing rapid economic development or spatial expansion as cadastral records rarely keep up with new development.

The 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 6% to 12% in Senegal and 2% and 6% in Togo; 5% for the premises, 6% for heavy machinery and 10% for other equipment in Benin; and a uniform rate of 10% in Burkina Faso, Mali and Niger with some modulations of the rate in certain cases.




*Source: PDM, 2003*

Various criteria are used to assess the output value: volume of sales in Senegal, Togo and Burkina Faso; volume of sales, location of the activity and the 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, some national governments retain part of the yield: 64% in Côte d'Ivoire and 50% in Togo. In Mali, 40% in redistributed to the regions and to rural areas.

All UEMOA countries assess a 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 level of comfort 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 the commercial tax, some national governments retain a share of the property tax yield: 10% in Benin, 40% in Niger, 50% in Togo and 72% in Côte d'Ivoire.

A recent evaluation of local revenues by the Partenariat pour le Développement Municipal[xviii] points out a number of weaknesses in local taxation practices that impede the ability of local governments to undertake necessary public investments:

- The complexity of a system that is based on a multitude of taxes, often difficult to collect, and that places the burden on a limited number of activities.
- The inability of local governments to set their own tax rate, thereby retarding their initiative to undertake improvements.
- Inadequate or obsolete information on taxable activities that allows a significant proportion of the population to escape local taxes.

As a result, local governments 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[xix].

### 3.4 Mandating responsible municipal financial management

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

In South Africa and Brazil, municipalities have constitutionally defined authority and fiscal resources. This privileged status gives them wide decision-making powers and discretion in the use of their revenues.

In Brazil, dynamic mayors used their new constitutional authority to institute 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 Andre, Belo Horizonte and Recife among others. Unfortunately, many more did not manage their affairs responsibly, forcing the Federal government to intervene and reign in their runaway finances (see Box 3.1).

*Box 3.1 Brazil's Law of Fiscal Responsibility*

In Brazil, the privileged status of state and municipal governments under the 1988 constitution strengthened the role of mayors and governors in the national administrative framework. However, these same constitutional guarantees provided an impetus for municipal mismanagement and the multiplication of municipalities through fragmentation to reach 5,559 in 2003. Dependency on central transfers and shared revenue and excessive politicization of local governance accounts for a focus on the short term and a general lack of coherence and continuity in municipal management. The constitutional amendment, enacted in conjunction with the fiscal stability program adopted in October 1998, established rules for responsible fiscal management and the passage of the "Fiscal Responsibility Act" in May 2000 established rules and standards for responsible fiscal management. For the three levels of government, the law mandates multiyear budgeting with fiscal targets, contingent liabilities and cost controls and introduces balanced-budget principles and incentives for mobilizing own resources.

The law caps expenditures on personnel at 60% and relates them to tax revenue. It mandates expenditures on education at no less than 25%. It 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 and mandated regularization of informal settlements and upgrading of the living environment in areas housing lower income communities. These national priorities are in turn reflected in the municipal budgets.

Source: Serageldin, M. et al, *Assessment of Participatory Budgeting In Brazil,* 2003

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

In emerging economies, asymmetrical decentralization has led to serious imbalances. In many emerging countries 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.

Because they immediately impact on day-to-day activities, operating expenditures are almost always perceived as the most urgent. Invariably, priority is given to the meeting of payroll expenditures. Next are supplies and services considered to be urgently needed. Priority operating expenditures and financial constraints frequently lead to deferment of expenditures on 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 centers, authorities have to 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 environmental and social

consequences of the deferred maintenance and neglect of existing assets have been highlighted in the cases reviewed.

### 3.6 Capital investment programs & 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 have to acquire the technical and managerial capacity to tap external sources and identify strategic partners to help finance different 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 governments. 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 urgency of need, political importance, economic efficiency, availability of funding, implementation capabilities, operation and maintenance costs of the completed assets or, life-cycle costing, to ensure that the assets and related activities will continue to operate over longer time periods. In many infrastructure projects, the relation between capital investments and operation and maintenance costs in not adequately considered and hardly ever accounted for in choosing among options (see Box 3.2).

*Box 3.2 Multiyear Capital Investment Planning, Szczecin, Poland*

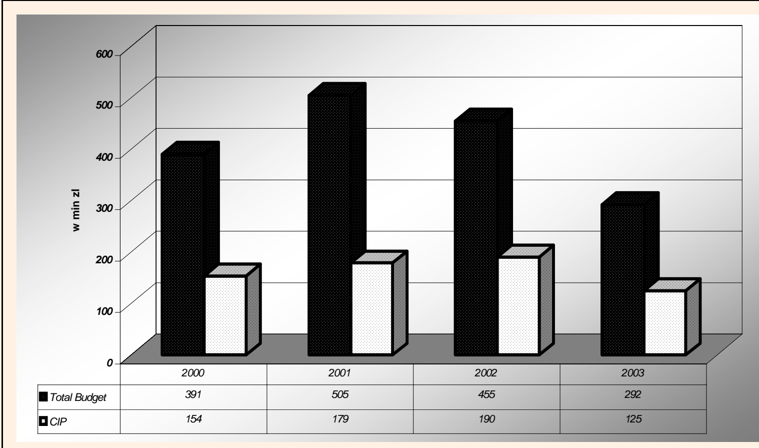
During the transition, a priority was placed on capital investments that structure and support the local economy and enhance local development including: road construction and maintenance, water supply and sewerage systems, revitalization of communal housing and improving education and healthcare facilities. Szczecin was the first Polish city to link its city development strategy to a four year capital investment program (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.

The first four-year CIP (1997-2000), coincided with the rapid expansion of the responsibilities of local governments as a result of devolution. In March 1998, the City Council adopted a resolution detailing the principles governing the preparation of the CIP and established procedures and criteria for prioritization and selection of projects to be funded. These 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 program identified each capital expenditure by year, disaggregated by project, program and responsible department, and funding sources for each category, and proposed methods of financing. The rolling four years, CIP is submitted to the City Council for approval annually. The year one capital investment program is integrated in the city budget.

Financial analyses and forecasts are presented and include a detailed analysis of revenues and expenditures and a forecast of capacity to finance investments for the next 10-year period. Credits and debt service requirements needed to cover short term borrowing from commercial banks for cash flow management and loans for longer term capital investments increased as municipalities had to cope with an expanding scope of devolved responsibilities for which transfers did not cover the costs.

**Table 3.8 SZCZECIN CAPITAL INVESTMENT PROGRAM 2000-2003**

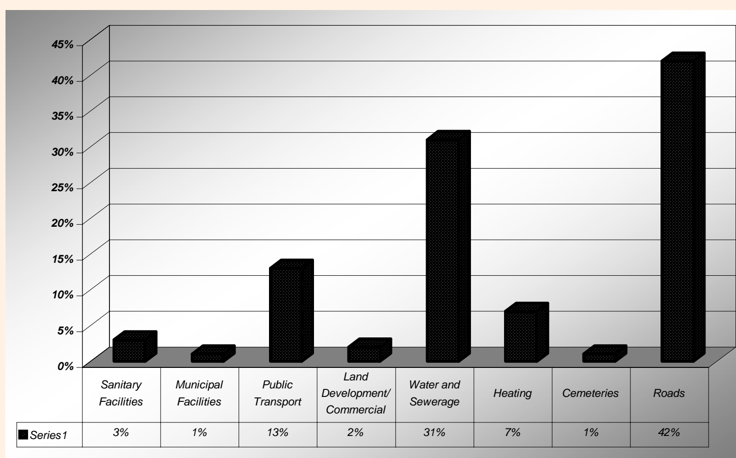



Capital investment accounted for 39% of the municipal budget in FY 2000 and 43% in 2003 (see Table 3.8). Large investments on infrastructure, primarily highways, and roads were required for the expansion of the urbanized area, the regeneration of obsolete industrial zones, and greenfield housing developments. These investments could no longer be financed from budget surpluses. Borrowing from commercial banks to finance priority projects progressively increased the debt service burden to unsustainable levels, reaching 25% of revenues. In 2000, the city had to curb borrowing and sharply reduce expenditures.

The transfer of the responsibility for education to local governments further strained their operating budgets as the funds shifted to the localities to cover the costs of running the facilities were totally inadequate. Municipalities had to scramble and reshuffle budgets to operate the existing system, and faced even greater fiscal challenges to upgrade and modernize it to the standards prevailing in the European Union. Cities that decided to spend and invest 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.

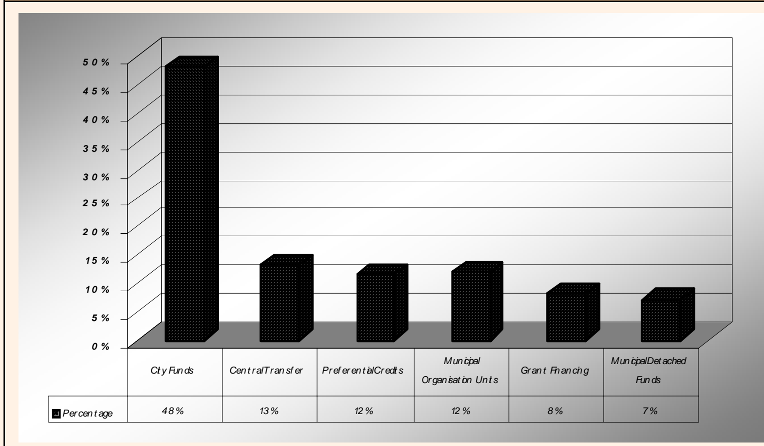
Investments in environmental infrastructure, which includes water supply, sewerage and treatment plants, are becoming important as Eastern European countries gradually move towards compliance with EU guidelines. The public investment in housing is mostly for new residential land development. Affordable 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 municipality can access loans on favorable terms from the National Housing Fund to build, renovate and manage affordable housing.

**Table 3.9 SZCZECIN - PERCENTAGE DISTRIBUTION OF CIP INFRASTRUCTURE INVESTMENTS**




Communal housing repairs and modernization are managed by an independent budgetary unit and funded by rent collection. The Capital Investment Program's budget currently exceeds the city's capacity to finance it. Mobilizing and leveraging non-municipal resources in the form of credits, grants and private investments has become a necessity to sustain the city's economic development and quality of the living environment (see Table 3.9).

**Table 3.10 CAPITAL INVESTMENT PROGRAM - SOURCES OF FUNDING**




The city has been successful in obtaining competitive central grants and credits. Partnerships between the municipality and private developers, homeowners associations, street associations, educational groups and cultural associations allowed the city to launch community based programs to improve the living conditions of residents (see Table 3.10). The private partners contribute 35 % for public works, housing, culture, social care and close to 83% to improve health care and educational facilities.

The CIP provided Szczecin with a formal mechanism for decision-making, an instrument of financial management, and a strategic tool for reporting and monitoring the performance and impacts of its investments. It has improved cooperation and communication among departments and agencies, involved citizens in the selection and prioritization of projects and promoted partnerships with citizens and the private enterprise.
Sound financial management contributed to earn 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, Center for Urban Development Studies, *The Capital Improvement Program, City of Szczecin, Case Study*, 2002.

### 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 the legal mandate requiring popular participation in local decision-making. Municipalities introduced mechanisms ranging from the presentation of budget proposals for public comment to the actual involvement of residents in decision-making. Participatory budgeting was first instituted by the city of Porto Alegre in 1989, and gave the city international recognition as a leader in "popular democracy" in local governance. The concept has now been adopted by about 180 Brazilian Municipalities and is spreading beyond Brazil in Latin America to cities in Argentina, Uruguay, Peru, Ecuador, Colombia, Bolivia, Mexico and Chile. More recently, cities in other parts of the world are also experimenting with adapting the process to their own situation.

Participatory Budgeting (OP) allows residents to have a voice in the annual allocation of capital investments. It is based on the delegation of statutory executive powers regarding the preparation of the municipal budget and has to be initiated by the Mayor. There is no similar delegation of authority from the legislative branch and the city council remains the statutory authority approving the municipal budget.

The OP concept embodies 4 key features:

1) It ensures representation of residents in each sub-area within the jurisdiction in the decision making process.
2) It requires municipal officials to report on what has been accomplished with the previous year's budget and to provide estimates of revenues and expenditures for the upcoming year in order to determine the budget envelope for capital investments.
3) It is structured to ensure transparency through direct popular participation and an open voting system.
4) It ensures objectivity through the use of quantitative criteria for the prioritization of funding requests and the allocation of resources.

The OP is primarily an instrument of empowerment and social inclusion. Participation and social impact are its most important dimensions. It covers all capital investments, which range from 5% to 15% 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 but cannot be changed during the cycle.

Popular assemblies are the cornerstone of the OP 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, the mobilization efforts of groups who want to press for specific demands and the degree of coordinated action at the community level. Outreach at the community level is needed to foster participation of lower 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. Belo Horizonte and Santo Andre 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 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 investments serving lower income communities has increased.

Belo Horizonte has instituted a two-year participatory capital investment budget (OP) interlinked with a parallel process for the housing component of the budget (OPH). Fifty percent of the city's capital investment budget is divided equally among its nine districts (referred to as regions) (see Table 3.11). The other half, also allocated through the OP, is targeted to improve conditions in communities where the quality of life is low. The Housing Secretariat has developed a quality of life index (IQVU) combining 6 quantitative indicators (2 each for economic, social, and environmental quality) and delineates priority areas for investment in social inclusion.

There are technical criteria, guidelines and regulations including development standards that must be met in order for a project to be submitted for OP funding. Documentation, demonstration of need and approval of concerned local agencies are pre-requirements.

Allocation procedures are generally based on a two-step process. The capital investments are first allocated among sectors and then redistributed among the different sub-areas in the municipality by a formula combining voting patterns, indicators of service deficiency and population size. The 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 favor smaller size communities. In the quest for comprehensiveness and objectivity, the formulas for the computation of deficiency can be complicated. Despite its complexity, OP rules are viewed as fair and objective and its workings are accepted. The benefits of popular participation in local governance far outweigh any lack of scientific rigor in the methodology.

**Table 3.11 PRIORITY AREAS FOR URBAN AND SOCIAL INCLUSION**

| IQVU | Population | % of regional population | weight |
|---|---|---|---|
| Barreiro | 26,002 | 9.9% | 30% |
| Centro-Sul | 38,875 | 14.9% | 40% |
| Leste | 29,340 | 11.5% | 30% |
| Nordeste | 21,478 | 7.8% | 20% |
| Noroeste | 17,349 | 5.1% | 20% |
| Norte | 19,792 | 10.2% | 30% |
| Oeste | 28,201 | 10.5% | 30% |
| Pampulha | 7,680 | 5.4% | 20% |
| Venda Nova | 13,714 | 5.6% | 20% |
| TOTALS | 202,431 | 9.0% | |
| Belo Horizonte Population = 2,238,526 | | | |

*Source: Belo Horizonte Municipality*

Participatory Budgeting has built trust and fostered cooperation 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 as a mechanism of social inclusion depends on the resources that can be mobilized for capital investment so that people have hopes that their living conditions will improve in the not too distant future[xx].

# 4 PERFORMANCE OF KEY SOURCES OF MUNICIPAL REVENUE

Locally generated municipal revenues fall into three broad categories: taxes on property and on economic activities; levying user fees for the delivery of services and the improvement of infrastructure; borrowing to finance long-lived investments, generally infrastructure. While well-managed municipalities maintain a proper balance among them, the rapid urbanization that is taking place in most of the world, institutional constraints and weak local management has slowed the efforts of local governments to increase their financial autonomy as part of the devolution of responsibility from the central to the local level. Increasing the yield of locally generated taxes is therefore the key challenge faced by all emerging economies. The inability to do so is manifest in the fact that almost all 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 source of local revenue. A combination of factors, ranging from technical issues such 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 often dramatic changes in their property values as a result of investments in infrastructure and urban projects. With the exception of North America and the European Union, most municipalities do not have adequate records that reflect changing property values. In emerging economies, data on the informal urbanization of the fringe is lacking. As a result, collection rates in these settlements are often disappointing or non existent and registered properties and formal businesses bear a disproportionate share of the tax burden.

The price structure of user fees has to reflect social considerations and, for the most part, does not cover the recurring costs of delivering the service, much less the amortization of its capital cost. As a result, most developed economies have moved toward more sophisticated means to recover 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 programs. Since the mid 1980's, the proceeds of the linkage program that mandates payments by developers of larger commercial development has financed both the construction of affordable housing and job training for residents of lower-income neighborhoods in San Francisco and Boston, USA.

The financing of capital investments by issuing long-term bonds is a well-established practice in the developed economies 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, both domestic and international, requires efficient municipal financial management and skills. In instances where municipalities are not allowed to borrow, often-ingenious alternative mechanisms have been used by separating revenue producing activities from the general budget and allowing them to borrow against future revenue, as is the case with China's Special Purpose Vehicles. Similarly, many US cities use tax increment financing that designates the tax revenue induced by new development to finance the bonds issued by the municipality to construct the necessary public improvements.

## 4.1 Taxes on property and businesses

The real estate property tax is likely to be among the major sources of local revenue. Its administration demands a good real estate valuation capability to perform periodic revaluations of all taxable property over a period of not more than about five years. Setting up a computerized

system capable of maintaining property and valuation records greatly facilitates this task. Where these capabilities exist, it is possible to apply factors that ensure that the assessed valuation of all properties maintain a realist relationship to each other and to market trends.

In many countries among emerging economies, property records are kept manually and valuation experts have a hard time keeping up with rapid urbanization. Tax valuations do not fully keep pace with actual values, and an increasing proportion of the urbanized area is not covered. In cities experiencing fast-paced growth cadastral records are obsolete and only cover a limited zone, and are unable to keep with formal change in the use of land. Except for some regularized settlements, informal areas and squatter settlements are not covered; properties are not titled or registered and therefore not taxed. There are exceptions to these general patterns. In Egypt, a long tradition of quasi-autonomous management of the tax administration allows the agency to tax real estate whether it is regularized or registered or not. In Indonesia, an occupancy tax is levied and ensures some revenue in situations where property ownership is unclear or complex. In 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 and 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. In some cases, as in the USA, the 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 financial support through transfer of shared and redistributed revenues and directly manage the high yield tax bases and revenue collection for major revenue producing taxes including property and commercial taxes. Because of the importance of the informal economy and the prevalence of uncontrolled urbanization, the formal real estate and business sectors are heavily burdened by taxation. Productive and beneficial use of the property as well as its capital appreciation is taxed. Owner-occupied and rental housing, commercial premises and locales used for workshops and other production activities as well as 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 emerging economies due to a combination of factors:

1) 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 centers and older neighborhoods compound the problems of updating records, identifying tax payers and billing and collecting taxes.
2) 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 and increase the cost of updating 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 coordination among levels of government, central government officials are reluctant to work with municipal departments.
3) In many countries, the central allocation, including grants, shared taxes and targeted transfers, are not related to locally raised revenues but redistributed according to population

size, social equity, geographic balance and development potential. The relative weight assigned to these criteria varies among countries and within the same countries at different times in response to changes in the macro-context and political climate.

4) Taxation systems based on real or imputed rental value rather than capital value understate the value of the assets while 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 of the splitting of the property's capital value among an ownership component transacted on the formal market and an occupancy component settled with key money shared by owners, renters and brokers.
5) Tax rebates and exemptions granted to encourage specific segments of the housing market (multifamily rental units, cooperative, etc…) or new urban development. In North and West African countries exemptions from one or more taxes are granted for periods ranging from 3 to 15 years.
6) The treatment of informal development on the urban fringe. In most countries, these settlements are not taxed until they are regularized. In a few countries, including Egypt, they are assessed by the tax administration, a central agency, independently of their status since regularization is a local function. Property owners readily pay these taxes which are not onerous and can be used to document occupancy and possession of urban land and buildings.

Because of their buoyancy and their importance to local revenues, taxes on commercial activities also tend to heavily burden formal private enterprise. 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. Market stall holders usually pay a flat rate and except in some West African countries hawkers and other informal activities escape local taxation.

### 4.2 Challenges constraining the improvement of municipal revenue

India, Morocco and Cote d'Ivoire exemplify the challenges encountered by emerging economies in enhancing the performance of municipal revenue sources. In Morocco, shared and redistributed taxes cover close to 70% of the revenue allocated to local government, principally from the value added tax and commercial and occupational taxes. Property taxes, service fees and market taxes provide the bulk of locally raised revenues. Metropolitan and provincial governments collect charges for the services they provide and have separate taxing powers on market activities. Moroccan local governments raise about 20% 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 utilities companies. This outstanding debt is usually consolidated into short term loans. Budgets documents 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 are running operating deficits covered by central transfers that consist of tow 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 the economically more buoyant localities.

Capital investments are almost entirely dependent on transfers from central ministries and international donor funding, resulting in an opportunistic approach to project finance that undermines rational development strategies and plans to improve the functional efficiency and livability of cities. The capital expenditure part of the municipal budget is often left blank in the budget submitted for approval to the Ministries of Interior and Finance. The Municipal Development Bank (FEC) allows localities an annual debt service burden of 40% of recurrent revenue. It is a very liberal limit

compared to the ceiling prevailing in the advanced economies where a maximum of 15% to 20% is the usual level. Most of the debt incurred is for infrastructure, transport terminals, road construction, markets and urban development[xxi].

Since 2000, India initiated 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 (URIF); the City Challenge Fund (CCF), and the Pooled Finance Development Facility (PFDF). The objective was to provide municipalities with the capital needed to improve services and enhance the functional efficiency of urban centers. The Urban Reforms Incentive Fund encompasses incentives to undertake structural reforms and includes the following measures: repeal of the Urban Land Ceiling and Regulation Act; rationalization of the Stamp Duty; reform of Rent Control Laws to remove controls on new leases; computerization of property registration; reform of property tax so that it may become a major source of revenue for urban local bodies.

In West Africa, the reliance on central government authorities in all matters of tax assessment and collection does not allow communes to significantly improve real estate tax yields. Central authorities are particularly unwilling to collaborate with them in updating tax rolls and improving collections, a similar situation as the one encountered in North Africa and in the Middle East.

In Abidjan, the real estate sector is overburdened. There are no less than nine direct taxes on urban property, exclusive of the taxation of rental income. Four basic taxes are levied and collected by the Ministry of Finance's Direction Générale des Impots (DGI), which transfers to the communes a portion of the receipts according to a separate 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 development corporations and building societies. Municipal councils can levy supplemental charges not to exceed 20% 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: the sanitation tax is collected by the state and the tax for roads and refuse removal by the municipality. 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 unbuilt property; and a tax on the rental value of premises subject to the commercial license fees (patentes) paid to the state.

The expansion of the urbanized area in the 70's and 80's has not been matched by a commensurate expansion of the tax base. Three factors contribute to the erosion of the tax base: Temporary exemptions granted to new construction for overly long periods ranging from 5 to 20 years; central control of tax roll and rates; and the proliferation of informal development on the urban fringe through the unauthorized subdivision of tribal land. 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 and failed to keep up with the pace of urbanization. DGI estimates the performance of real estate taxes to range between 20% and 30%. High rates discourage compliance and the hardships created by structural adjustment, prolonged recessions and civil strife promote widespread evasion. In lower income communities, absentee landlords typically live in higher income neighborhoods and ignore tax bills sent to other addresses. A regulation mandating tenants to pay the tax if landlords cannot be identified or located is not enforced. Furthermore, in the 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% of local revenue. There are two main taxes: The "patente" levied by the DGI

on larger businesses with annual sales volume 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 Adjame commune, the "taxe forfaitaire" generated 57.8% of the 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 to other forms of taxation. Yet, their contribution to local fiscal revenue cannot be overlooked. In the event they are abolished, a substitute and equally buoyant locally controlled tax must be instituted[xxii].

### 4.3 Taxes on Income

At local government levels, taxes on income are not nearly as common as taxes on property, although in some instances provincial governments are authorized to do so and local governments may be allowed to levy a surcharge on the income tax levied by provincial and national governments. Alternatively, there may be a fixed proportion of the national income tax that is transferred to the local level.

### 4.4 User fees

Pricing of user fees is a matter of public policy. In many cases, charges will be levied at less than their financially efficient prices. Balancing financial and social considerations, governments at all levels have instituted measures to alleviate the hardships suffered by the poor. The most commonly used are: (1) Allowing a minimum consumption level per capita or household free of charge, as in South Africa; (2) Subsidizing charges for lower income populations; (3) 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 considerations and, in many cases, the reassertion of pre-colonial traditions and/or religious beliefs have thwarted the attempts to raise prices to financially sustainable levels since the 80's. Under structural adjustment programs, 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 the NGOs led movement to assert the 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 fo the developing world at this time. Nevertheless, there is some consensus regarding the desirability of charging for a public service even when the charge cannot cover full financial costs. In most circumstances, user charges are not structured 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, and political pressure and rapid urbanization weigh heavily in these decisions.

### 4.5 Betterment taxes and development exactions

In advanced economies, an array of impact fees and betterment taxes compensate local authorities for the additional expenditures incurred to extend urban 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" to leverage funds from the profits derived by developers of real estate projects in the city's growth nodes. Linkage programs focus on tapping private capital to fund social projects.

Linkage authorizes the city to impose impact fees on developers requiring zoning approval of proposed urban projects in the form of either a payment or an in-kind contribution to the City. The concept was first introduced by San Francisco in 1982 and adopted in Boston in 1983 where it was institutionalized by the Massachusetts State legislature in 1987. The program requires that 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. In Boston, the fee was dedicated to subsidize the construction of affordable housing elsewhere in the city and provide job training with a requirement that 20% of any linkage payment be reserved for use in the area surrounding the development project. The rationale for the program 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, generated by 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 $m^2$) 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 equaled 8.62$ per square foot out of which $7.18 subsidize affordable housing and $1.44 job training. This rate can be adjusted every three years to follow inflation. The schedule of payments is spread out over seven years for downtown projects and twelve years for projects in other areas and the fees are deposited in a Special Fund for Affordable Housing and Training. Alternatively, developers may choose to build affordable housing projects or create a job training program. Between 1987 and 2004, US$ 79.6 million were generated for housing through linkage, adding 7,604 units to the city's housing stock, 6,116 of which were affordable. The program generated US$ 15.2 million for job training and awarded US$ 12.9 million to 190 different job programs, such as school-to-work, family literacy or workplace-based education, creating over 1,000 jobs[xxiii].

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 to prevent the program from being a disincentive to development.

Many countries with rapidly emerging economies 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 mechanism to redistribute the benefit of growth during periods of rapid economic development.

### 4.6 Borrowing and debt service management

Funding for capital expenditure requires access to long-term borrowing, broadly related to the working lives of assets to be financed. Debt service can then be annually financed, either from internally generated funds for revenue-earning services or from general revenues for tax-borne

services. Users of 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 emerging economies or in many advanced economies 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, 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[xxiv].

Several countries have indexed some of their debt instruments and other accounting information, such as asset valuation, in a variety of ways. In the 1970's, 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 1970's, it was a common practice for countries of 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 acceleration of inflation in the 1980s and early 1990s as inflation worsened dramatically. Brazil lost its access to foreign capital markets while domestic borrowing to finance the growing public-sector deficit became increasingly expensive[xxv].

#### 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 if the option was available to them. Short-term borrowing by municipal governments is normally limited to covering capital investments. In many countries, attempts have sometimes been made to continuously roll over, short-term debt used to finance capital expenditure. Debt has sometimes been used to cover recurrent budgetary deficits or for short term cash flow management. Accumulated debt has to be brought under control and refinanced, otherwise it can lead to financial crisis.

In the mid 90s, a series of Russian laws established rather liberal borrowing rules for subnational entities and authorized municipalities to issue bonds and lottery tickets, extend and take out loans, and open municipal accounts with banks and other financial and credit institutions. Municipalities borrowed from regions to cover deficits, issued municipal bonds and contracted short-term loans from banks. Municipal financial mismanagement and indebtedness led to the revocation of these laws. Following the 1998 financial crisis, the law *On Specificity in Issuance and Circulation of State and Municipal Securities* and the Budget Code prohibit municipalities from contracting external debt or debt obligations exceeding 10 years. The issuance of debt obligations is limited to the financing of capital expenditures. These restrictions, while justified to curb runaway municipal finances, constitute a constraint on the financing of local public infrastructure projects[xxvi].

In Indonesia, in the aftermath of the 1997 financial crisis, widespread defaults on outstanding loans from the National Development Fund 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, the Regional Development Account extends credit to regional governments and their enterprises and the subsidiary loan agreement on-lends donor and sovereign loan funds (primarily from the World Bank and the Asian Development Bank) for regional infrastructure projects. Despite favorable loan terms, arrears reached 40% in 1998. Regional and local governments were 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 BOT (Build/Operate/Transfer) contracts fueling a risky reliance on off shore financing.

With the central government engaged in a restructuring of a massive public debt of US$132.2 billion, amounting to 80% of the GDP, the financial markets have to absorb recapitalization bonds. The weakness of local governments finances and their reliance on transfers and shared revenue, with own source revenue contributing on the average 5% of their 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 been yet authorized to levy new sources of revenue their financial situation remains weak[xxvii].

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 such as South Africa's DBSA. 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 governments need sophisticated debt management capability to draw on the range of financial options and instruments to finance their 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 governments can withhold them from municipal governments and authorize lenders to intercept the transfers in order to settle arrears of 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 rebounding from the 1997 financial crisis[xxviii]. These countries, however, offer sharply contrasting financial environments.

The Philippines was one of the first Asian countries to devolve functions and resources to local government units. 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 governments 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 to function and a limited domestic bond market to operate. A specialized bond insurance company provides coverage to enhance the creditworthiness of borrowing municipalities. A limit on debt service ceilings set at 20% of revenues and the restrictions on the issuance of bonds prevent excessive borrowing. Since

1991, 13 local government units have issued bonds for housing projects and the rest funded public markets, ports and port terminals[xxix].

By contrast, Vietnam is barely starting on the transition path and local authorities have little fiscal autonomy. Borrowing is restricted to capital expenditures and the state bank can extend loans to localities for up to 30% of project cost[xxx].

In India, the Ahmedabad Municipal Corporation became the first municipality to issue bonds of Rs.100 crore at 14% interest payable semi-annually. A number of municipal entities and parastatals have since accessed the domestic capital market, with the back-up of credit rating agencies. The nine municipalities have accessed the capital market have thus far been able to issue bonds without requiring a guarantee from the state government or a bank, as traditionally required by lenders to municipal entities. They raise capital on the strength of their own credit rating.

The States Finance Commission recommended several measures to shore up financially weak municipalities, focusing on the rationalization of intergovernmental fiscal relations by: the transfer of specific amounts of revenue to municipalities, as in Himachal Pradesh; transferring designated shares of taxes raised locally but collected by state governments, including motor vehicle taxes as in Tamil Nadu; sharing of a pool of state revenues excluding loans, as in Karnataka, Madhya Pradesh, and Tamil Nadu; increasing the participation of the private sector in improving service delivery and collection of user charges, as in Andhra Pradesh where the share of local bodies in state revenue increased from 39.2% to 40.9%. The Eleventh Finance Commission issued guidelines in 2004/05 recommending a municipal grant program to strengthen decentralization and provide incentives for local resource mobilization[xxxi].

4.6.3 Income-generating enterprises

Local governments can establish separate income generating enterprises to enhance their overall revenue-generation capability. The advantage of using an income-generating enterprise lies in the fact that its 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. It is, instead, to remove open-ended reliance upon such revenues. It also highlights the full costs of operation, so that these may be more appropriately covered from user charges and carefully targeted subsidies.

In China, formal government budgets account for only half of local government financial activity due to the importance of off-budget finance. Own-revenue sources consist of special fees, taxes, profit distributions from locally owned enterprises, land leases and taxes on business enterprises (VAT and income). The property tax on urban and rural land generates a meager 2% of local revenue while the business tax contributes 34% but exacts a heavy burden on businesses representing about half their profits. Having no borrowing power, municipalities have resorted to the ingenious mechanism of creating independent wholly owned companies whose activities are off-budget to finance the capital financing of development projects, particularly infrastructure. These so-called Special Purpose Vehicles are allowed to borrow on the capital markets and use their revenue to amortize their debt. They have become a key instrument in the implementation of large scale urban development projects (see Box 4.1).

*Box 4.1 The role of Special Purpose Vehicles (SPVs) in China*

The People's Republic of China presents striking contrasts. It is a highly centralized state where 60% of public expenditures are channeled through subnational entities and provincial governments are given a major role in all aspects of economic and social development (see Table 4.1). The fiscal decentralization enacted in 1994 gave separate taxing powers to central and subnational authorities on the same tax bases. The subnational share of revenue is around 50% while about 70% of public expenditures are channeled through the provinces and the municipalities. This gap is widening and is covered by central transfers consisting of rebates of shared taxes and earmarked grants for specific purposes and projects. As a result of wide variations in development potential, some localities have surpluses while others are struggling with growing deficits.

Municipalities have no borrowing power and rely on off budget entities to obtain the capital they need for investment primarily in infrastructure projects. These Special Purpose Vehicles (SPVs) 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 5 to 10 years and from commercial banks for terms of 3 to 5 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 becomes a significant actor on the international capital markets.

**Table 4.1 CHINA: TOTAL BUDGETARY REVENUES AND EXPENDITURES WITH CENTRAL AND LOCAL GOVERNMENTS SHARES**

| Year | Government Revenues | | | Government Expenditures | | |
|---|---|---|---|---|---|---|
| | Total (100 M RMB) | Central (%) | Local (%) | Total (100 M RMB) | Central (%) | Local (%) |
| 1980 | 1,159.93 | 24.5% | 75.5% | 1,228.83 | 54.3% | 45.7% |
| 1985 | 2,004.82 | 38.4% | 61.6% | 2,004.25 | 39.7% | 60.3% |
| 1989 | 2,664.9 | 30.9% | 69.1% | 2,823.78 | 31.5% | 68.5% |
| 1990 | 2,937.1 | 33.8% | 66.2% | 3,083.59 | 32.6% | 67.4% |
| 1991 | 3,149.48 | 29.8% | 70.2% | 3,386.62 | 32.2% | 67.8% |
| 1992 | 3,483.37 | 28.1% | 71.9% | 3,742.2 | 31.3% | 68.7% |
| 1993 | 4,348.95 | 22.0% | 78.0% | 4,642.3 | 28.3% | 71.7% |
| 1994 | 5,218.1 | 55.7% | 44.3% | 5,792.62 | 30.3% | 69.7% |
| 1995 | 6,242.2 | 52.2% | 47.8% | 6,823.72 | 29.2% | 70.8% |
| 1996 | 7,407.99 | 49.4% | 50.6% | 7,937.55 | 27.1% | 72.9% |
| 1997 | 8,651.14 | 48.9% | 51.1% | 9,233.56 | 27.4% | 72.6% |
| 1998 | 9,875.95 | 49.5% | 50.5% | 10,798.18 | 28.9% | 71.1% |
| 1999 | 11,444.08 | 51.1% | 48.9% | 13,187.67 | 31.5% | 68.5% |
| 2000 | 13,395.23 | 52.2% | 47.8% | 15,886.5 | 34.7% | 65.3% |
| 2001 | 16,386.04 | 52.4% | 47.6% | --- | --- | --- |
| 2002 | 18,903.64 | 55.0% | 45.0% | --- | --- | --- |

*Source: China Statistical Yearbook, 2003*

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 by assets transferred to the SPVs by the municipality or by the revenue stream of a self-sustaining project. While nonperforming loans have not yet been adequately dealt with due to continued lending to unprofitable state-owned enterprises by the four National Banks, yet the domestic capital market finances SVPs and the companies they own.

In China's booming economy, dynamic cities can use the SPV concept in creative ways to finance larger scale development projects. The Shanghai Urban Development Investment Corporation (UDIC), owned by the city, has directly issued bonds to finance infrastructure and transportation projects on the financial strength of the municipality. The implicit guarantee is that the city will not

allow UDIC to fail. The city has also created an on-lending facility within UDIC to assist suburban units in meeting their share of regional projects starting with projects to control water pollution. The Municipality has financed US$ 3.5 billion out of total capital investments estimated at US$ 4.85 billion. UDIC is creating a fiduciary institution to issue bonds to cover the balance. Although the strength of 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, M. et al, 2004; World Bank, 2003.
Research on this case was undertaken by CUDS team member Shannon Bassett.

### 4.7 Municipal financial management under adverse economic conditions & structural adjustment

In East Africa, as in most emerging economies, the taxing powers of local authorities are inadequate to meet their expenditures. The high yield taxes, namely the VAT and taxes on income, sales and business are controlled by central governments while municipal authorities derive their revenue from property taxes and charges on services. They are not empowered to set tax rate structures, and enforcement procedures. Inadequate technical and managerial capacity contributes to obsolete valuations, poor collections and deficient financial management. Central governments and para-statal organizations often owe cities large arrears.

Transfers from higher levels of government lack stability, transparency and predictability and are subject to sudden reductions. Specialized municipal finance institutions have not yet developed, with the notable exception of South Africa. Local authorities are mostly prohibited from issuing 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% of their operating budget as a formula-based block grant and the totality of their capital investment budget from the central government. In Kenya, there are formula-based block transfers; in Malawi, general purpose block grants and specific purpose transfers; in Nigeria, federal transfers include formula-based grants and targeted transfers; in Uganda, the constitution stipulates that localities can receive block grants, specific purpose grants and equalizations grants but the situation on the ground is unclear[xxxii].

Almost all African local authorities receive shares of taxes collected by central government but there are wide variations among countries. In Kenya, 20% of the tax levies on road fees and 5% of the annual income tax; in Uganda, the Local Government Act of 1997 stipulates that 35% of total revenue is to be transferred to districts but it is not evident that statutory transfers have actually taken place in whole or in part; and in Malawi, there is no inter-governmental tax sharing system in operation[xxxiii].

Despite its importance as a key source of local revenue, the property tax is far from providing its potential yield. In Kenya, Uganda, Tanzania and Zambia rolls are incomplete and obsolete. Cash strapped government agencies, already exempted from some taxes, delay payment of transfers and grants while residents are angered by the low quality of the urban services and refuse to pay for inadequate services. Land consuming industrial and commercial projects benefit from tax exemptions as do greenfield housing estates. The use of an income tax as a source of local revenue is limited. Where it exists, as in Uganda and Tanzania, its performance is crippled by the proliferation of informal activities forcing authorities to resort to charging flat rates on self-employed individuals. Trade licenses and fees are an important source 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 badly needed increases in charges for urban services for fear of angering politically potent constituencies or triggering civil disturbances and local authorities are often unwilling to enforce collections of politically sensitive taxes. Providing services to impoverished populations is 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 structure a more equitable schedule of fees[xxxiv] (see Box 4.2).

*Box 4.2 Botswana*

Botswana is a rather interesting case displaying the difficulties encountered in implementing fiscal decentralization policies under adverse economic conditions. Local Authority reforms 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 6-year development plan concurrent with the 6-year National Plan. Once a plan is approved, funds are guaranteed by the central government, ensuring that 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 the Public Debt Service Fund (PDSF) that are frozen at the present time. Local councils charge a flat fee for urban services accounting for 1.2% to 3% 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.
Local governments are not empowered to borrow on the domestic capital markets. Furthermore, local authorities are required to seek authorization from the Minister to spend any amount exceeding 10% of the balance in their General Fund Account. This creates a paradoxical situation where cash strapped municipalities are accumulating surpluses in their General Fund Account and the national government is using 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 income.

Gaborone exemplifies the challenge cities face in meeting the requirements of rapid urban growth with their limited resources. Transfer grants cover approximately 60% 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 programs. The revenue from rates and property taxes account for around 25% of total revenue as squatter settlements represent 53% of the total housing stock in the city. Valuation rolls are incomplete and obsolete records impair billings and collections. Furthermore, central government and para-statal organisations do not pay the taxes they owe the municipality and their arrears rose from US$ 2.4 million in FY1999 to US$ 6.4 million in FY2000 plus an accumulated interest of US$ 0.7 million. The city taxes commercial premises and levies business taxes on licences, market stalls and food vendors, and entertainment. These taxes are either annual flat rate taxes or payable on use of services. Low assessments, high default rates, the size of the informal economy, the proliferation of unregistered businesses and inadequate records erode revenue potential.

The Water Utilities Corporation operates the city's water supply system but the council is responsible for sanitation, including extending the water-borne system to lower income

communities at a cost of over US$ 20 million. Even the sharp increase in sewer connection rates will not cover this cost. The city's solid waste collection and disposal system is to be privatized. The city has launched an ambitious upgrading program 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 money from the central government through the Capital Account. In FY2000 it owed US$ 7 million payable over 25 years at an interest rate of 14.6%.

Source: Mosha, A.C., 2004

#### 4.7.1 Tax increment financing

Tax increment financing (TIF) is a mechanism introduced in the USA that has become increasingly popular among local governments eager to find off budget sources to finance urban development projects. TIF applies to economically and financially viable projects and has been extensively used to finance mixed use projects and industrial and office parks. It is a revenue generating strategy for buoyant economies and can become dysfunctional during downturns when receipts plummet and tend to collapse during prolonged recessions.

Tax increment financing allows state and local governments to fund the front end costs incurred for capital investments in infrastructure and other improvements needed to bring idle assets, particularly vacant land, into productive use by borrowing. The TIF bonds are repaid from the revenue generated by the additional tax receipts on real estate, personal property, and businesses developed by the private sector through the use of the 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 the new developments are speculative. They may not materialize to the extent, or in the time-frame, anticipated. In this case the local government is forced to issue general obligation bonds to cover the shortfall, thereby incurring new debt to service its off-budget borrowing. The new activities will place demands on public services: education, health, solid waste management, policing, and recreational facilities, implying further capital and operation and maintenance costs that cannot be covered by the TIF bond proceeds and may not be covered by the additional tax revenue. Imposing impact fees or exactions on developers and investors will work at cross purpose 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 fixed assets purchased or constructed. Yet, financing of adequate maturity continues to be a scarce commodity in emerging economies. Available funding has been largely confined to:

- Grants or occasional long-term loans from central governments.
- Loan funds sponsored or partially funded by central governments.
- 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 still limited when compared to the needs of local governments but tend to be allocated primarily to a few important municipalities or specific categories of infrastructure. Except for loans from central governments, most other sources draw on foreign funding that in addition to normal interest costs, carry foreign exchange risks that cannot easily be borne by local units of government.

Many countries have established Municipal Development Funds (MDF) to provide regional and local governments with 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. Most MDFs were started under the sponsorship of central governments, often with the encouragement and initial participation of international development organizations. Some poorly managed MDFs have imploded; others have been sustained and continue to finance development projects. Some have managed to leverage local capital contributions. A few have evolved into such noteworthy institutions as Columbia's FINDETER and the Development Bank of South Africa.

Alternatively, groups of municipalities have been able to obtain pooled financing as members of specialized sub-national entities (Sweden's Kommuninvest Corporation, for example) or by virtue of their regional location (Virginia's Resources Authority in the US). Both approaches are based on a financial intermediary whose size and managerial capacity allow it to access financial markets on better terms than its individual members. The resulting savings are passed on to the municipalities. Initially developed in Europe and the US, this model has been successfully adapted in the case of India's Tamil Nadu Urban Development Fund.

The growing importance of the private sector as a partner in urban development projects has also led some lending agencies to extend their activities to finance targeted private sector components, particularly those involving job creation. Even though still an exception, targeted funding of poverty reduction and environmental projects is growing in importance, in Latin America in particular. Financing tends to be funded either through external donations or through debt swaps under the 1996 World Bank's Heavily Indebted Poor Countries initiative.

## 5.1 Municipal Development Funds

Municipal Development Funds (MDFs) have been often established to provide regional and local governments with needed capital. The cases described in the following sections show that most MDFs have begun under the sponsorship of central governments. International development organizations have encouraged and initially participated in the creation of these institutions. Some MDFs have been poorly managed and have imploded. Others have been sustained and continue to finance development projects. Some have managed to leverage local capital contributions. A few have evolved into credible and notable Municipal Finance Institutions.

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. If it is provided in the form of debt, eventual repayment of this debt 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 agreeing to their retaining earnings rather than paying dividends. Capitalization of a fund can sometimes be achieved by using the contributed capital as collateral for long term borrowing. Unless a robust relationship of equity to debt is maintained, the risk of instability and eventual implosion remains.

#### 5.1.1 Public Works Loan Board, UK

The UK Public Works Loan Board (PWLB), established in 1793, 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. It has a Board of twelve Commissioners appointed by the Crown, holding office for four years; they review loan applications from local authorities and other bodies and collect the repayments. At present, nearly all borrowers are local authorities. The Commissioners are legally required, before making a loan, to satisfy themselves that an authority is able to service and repay the loan. 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 1945, the Local Authorities Loans Act required virtually all borrowing to be from the Public Works Loans Board (PWLB). This restriction was lifted in 1952 and by 1955 the PWLB became lender of last resort as only the largest local governments are able to borrow on the private capital markets.

Tightening of access to the PWLB, combined with the inability of smaller local authorities to obtain long term credit resulted in local governments relying upon excessive short-term borrowing by the use of loans pooling or sinking funds. When loans became due, they were simply rolled over. Minimum revenue provisions based on asset lives and included in annual budgets ensured that loans were being gradually repaid, over their maturity periods.

By 1963, the British Treasury alarmed by the amount of local debt held in short-term instruments, limited temporary borrowing to no more than 25% of each local government's debt portfolio. Access to the PWLB was relaxed and more local government units were permitted to issue bonds.

During the 1980's new controls on the fiscal discretion of local governments were introduced to curb overspending. In 1981 capital expenditure was required 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 that the minister considered to be "overspending." In the 1990's, the Housing Revenue Account was treated as a separate fund and no transfers are allowed from local taxes and revenues to subsidize the rents of tenants. In 1995, capital controls were extended to companies controlled or influenced by local authorities and until 1998 some capital receipts were required to be set aside as "provisions for credit liabilities". However, in 1999, the earlier capping limits on rate levies were replaced by multi-year reviews of local budgets, with limiting of taxes as a last resort. Funding capital investment solely by 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[xxxv].

### 5.1.2 FINDETER, Colombia

Providing long-term funding sources accessible to municipalities to finance capital improvements requires more than the creation and capitalization of an institution. Its long-term viability depends on its stability as a borrower on the domestic and, perhaps, international financial markets and thus on it's ability to recover the loans it makes to individual borrowers. The lack of experience of local governments in debt management has often resulted in delayed repayment or default. The success of a MDF therefore depends on the availability of credit being matched by building the financial management capacity of the borrowing municipalities. The activities of FINDETER, combining credit to both public and private entities, the assessment of their borrowing capacity and building their managerial ability has enabled Colombia's subnational governments to access the private markets to finance most of their capital investments needs under favorable terms and conditions (see Box 5.1).

*Box 5.1 FINDETER, Colombia*

In Latin America, decentralization has fostered creative initiatives involving intermediary institutions and NGOs. In Colombia, decentralization has given municipalities strong revenue generation powers and allocated to them the responsibility for urban services including water and sanitation, streets, education and health. Despite increases in the local share of national taxes, boosting central transfers and improvements in local revenue generation, municipalities are unable to access long-term credit for capital investments on the domestic capital market. Financial intermediaries holding mostly short-term liabilities 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 FINDETER (Financiera de Desarrollo Territorial), sponsored by the Inter American Development Bank (IDB) and the World Bank. Unlike conventional MDFs, FINDETER is a second tier lender operating through the banking sector by rediscounting loans granted by private banks to municipal borrowers for capital projects.

Since 1990, FINDETER approved loans totaled Pesos 4.18 trillion while the amount disbursed did not exceed Pesos 2.61 trillion (62.4%). Throughout the 1990-1999 decade the relationship between approved loans and disbursements remained steady as the total volume of approved credits grew from Pesos 37 billion to 413.5 billion. Unfavorable national economic context and financial instability aggravated the difficulties experienced by local governments. The financial crisis of 1999-2001 resulted in a sharp reduction of FINDETER's loan approvals to Pesos 229.0 billion. In 2001, new laws were passed that streamlined intergovernmental transfers and freed up extra revenues to address the fiscal imbalances. FINDETER's operations were restructured and streamlined to improve its efficiency and effectiveness. FINDETER has evolved from a municipal development fund that disbursed credit at subsidized rates to a bank 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 6 months. Recognizing the growing scope of 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 approved loans totaled Pesos 1.02 trillion, an increase of 64.1%. This significant

growth was made by the Law 795 of 2003 that expanded the categories of capital investments that FINDETER could finance to include the environmental field, the range of borrowers, and extended credit to leasing operations. Furthermore, the "Modality of Automatic Rediscount" authorizes intermediary banks to directly approve credits to finance education and services projects. FINDETER will typically lend the entire project cost. Loans maturities are much longer, up to 12 years, and grace periods of up to 3 years are often built into the amortization schedules.

As shown in Table 5.1, basic services account for the bulk of municipal borrowing from 1990 to 2004, with urban services accounting for 37% of disbursements, roads and transport 30% were for roads and educational facilities 13%.

**Table 5.1 FINDETER: CREDITS APPROVED / DISBURSED BY SECTOR 1990-2004**

| SECTOR | Total Approved (Million Pesos) | Total Disbursed (Million Pesos) | Total Approved | Total Disbursed |
|---|---|---|---|---|
| Services to Households | 1,648,400 | 968,549 | 39.39% | 37.15% |
| Roads / Transportation | 1,236,852 | 792,812 | 29.56% | 30.41% |
| Education | 484,171 | 346,533 | 11.57% | 13.29% |
| Machinery and Equipment | 133,895 | 94,839 | 3.20% | 3.64% |
| Debt Substitution | 126,471 | 92,856 | 3.02% | 3.56% |
| Housing | 107,962 | 48,404 | 2.58% | 1.86% |
| Fiscal Adjustment | 92,323 | 36,557 | 2.21% | 1.40% |
| Sports, Recreation and Culture | 92,151 | 55,047 | 2.20% | 2.11% |
| Health | 85,853 | 68,367 | 2.05% | 2.62% |
| Local/Regional Commercial Centers | 78,025 | 57,167 | 1.86% | 2.19% |
| Tourism | 27,387 | 8,953 | 0.65% | 0.34% |
| Heritage Conservation, Renovation & Equipment | 24,001 | 16,621 | 0.57% | 0.64% |
| Environment | 23,621 | 5,490 | 0.56% | 0.21% |
| Telecommunications | 11,119 | 10,572 | 0.27% | 0.41% |
| Development Plans | 7,901 | 3,537 | 0.19% | 0.14% |
| Capitalized Interests | 3,745 | 0 | 0.09% | 0.00% |
| Undefined | 565 | 500 | 0.01% | 0.02% |
| Institutional Development | 17 | 0 | 0.00% | 0.00% |
| **TOTALS** | **4,184,459** | **2,606,803** | **100.00%** | **100.00%** |

*Source: FINDETER, 2004*

As a second tier lender, FINDETER rediscounts up to 100% of loans made to subnational governments by commercial banks but it does not assume 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 operating costs, foreign exchange and credit risks, and produces a positive return on investment. Several measures substantially reduce risk. Commercial banks are liable to FINDETER if their borrowers default, and municipal revenue, pledged as loan guarantee to the banks, can be used to repay FINDETER. Furthermore, the percentage of municipal revenues which 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 %, and a municipality which defaults on a FINDETER-backed loan cannot access new funding through FINDETER.

Improvements in borrower performance have demonstrated, publicly that they are willing and able to be the credit-worthiness of its customer base and enable them to receive a more willing and acceptable reception from private lenders, should they wish to raise capital on the open markets, an outcome that FINDETER encourages. Lately, some local governments are reaching their limits of borrowing capacity and commercial banks are now competing more aggressively against FINDETER for medium-term funds, because of nationally-imposed liquidity requirements.

Despite owning 86% of FINDETER's shares, the national government does not guarantee its bond issues and unlike its predecessor FFDU, local governments and financial intermediaries are not compelled to buy them.

FINDETER's financial strength has been shored up by the recent changes in the management of intergovernmental 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. In the period between August 2002 and June 2004, 64.75% of FINDETER's resources originated in the public sector (Pesos 954,281 billion) and 35.25% in the private sector (Pesos 519,579 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 it refinances.

Source: FINDETER, 2004; Freire, M. and Petersen, John, 2004.

### 5.1.3 Municipal Development Fund of Georgia

Development fund and government departments often share competence and authority, to appraise and approve projects, and should work collaboratively to support sound financial management of the MDF and the localities. Established in 1997, the Municipal Development Fund of Georgia was part of a broader Municipal Development and Decentralization initiative to fund expenditure on the capitalized repair and rehabilitation of municipal infrastructure and service equipment. Its successful activities demonstrate that with adequate appraisal of projects to be funded, a well-managed MDF can be sustainable without additional capitalization even under the difficult adjustments experienced by former CIS countries (see Box 5.2).

*Box 5.2 Municipal Development Fund of Georgia*

The difficulties local governments and local utilities encountered to get access to financing emerged as a critical constraint on initiatives to reverse the decline in the quality of life arising from the breakdown of basic urban services including water supply and sewerage, solid waste collection and disposal, road repair, and building maintenance. MDF's supervisory board is appointed by the 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 US$ 1.5 million IDA loan. Repayments by borrowers and limited financing from government are expected to cover MDF's debt service.

A preliminary assessment in 2002 showed that MDF funding of 83 investment projects for a total cost about US$ 17 million resulted in significant improvements in the quality of municipal service delivery in the twelve participating local governments. Around 55% of MDF financial resources were used for the rehabilitation of urban roads and another 20% for the improvement of water supply and sewerage systems. The assessment highlighted the link between the performance of MDFs and the technical and managerial capacity of local governments. To gain access to MDF financing, local governments have to identify feasible investments and demonstrate their capacity to repay the funds borrowed. The MDF assists them in the preparation of their proposals. On their part, they have to improve revenue collection, budgeting and financial management. Between 1998 and 2000, budgetary income increased by 30% and debt capacity by a factor of 2.5 by trimming administrative costs, adopting competitive procurement procedures and instituting financially autonomous local utility enterprises.

Even under optimistic assumptions there were only about 30 local self-government units and local utility enterprises that could borrow from MDF in the short-and medium-term and their total borrowing capacity was unlikely to exceed GEL 4 million or (US$ 2.0 million). To maintain as large as possible a customer base, address the accelerating deterioration of municipal infrastructure and services and simultaneously expand its customer base, MDF offers financing combining loans and matching grants made possible by access to IDA funding. MDF loans can only be used for the rehabilitation of existing infrastructure including replacement of equipment. They cannot be used for land acquisition, purchase of vehicles, budget support including working capital or commercial enterprises.

A new IDA credit provided US$ 13.1 million towards additional capitalization of US$ 24.8 million; US$ 6.7 million is to be covered by the re-flows from loans (principal and interest, net of operating expenses) which in FY 2002-2003 totaled US$ 5.7 million and US$ 5 million will be provided by borrower local entities in the form of upfront contributions. MDF extends financing in local currency for a maximum amount of US$ 600,000. Borrowers are expected to cover 20% of project cost. MDF provides 40% as a grant approved by the Government of Georgia and funded through IDA. The remaining 40% is extended as a loan over 10 years at a fixed interest rate of 15% per annum with a one-year grace period. Eligibility requirements are that debt service not exceeds 25% of prior year operating surplus and total debt 60% of ordinary income. Arrears on salaries must not exceed 10% of total income and transfer payments to cover unplanned budget deficit must be less than 25%. This structure is expected to ensure MDF's financial sustainability, promote local development, foster sound municipal financial management and improve the quality of the living environment.

Source: Medlock, S. "Municipal Development Fund of Georgia", in International Association of Development Funds Bulletin (IADF), Vo. 1, Issue 4, June 2004.

### 5.1.4 Alberta Capital Finance Authority, Canada

The Alberta Capital Finance Authority (ACFA) was established in 1956 as a non-profit Authority. Its enabling legislation provides for a statutory guarantee of its debt by the Province. The Board of Directors includes the Lieutenant Governor of the province and five appointed representatives of the Class A shareholder. Each of the other four classes of shareholders – borrowers – elects one director to the Board.

On December 31, 2003, the Assets of ACFA totaled US$ 4.05 billions. Its loan portfolio was US$ 3.94 billions; its own outstanding debt was US$ 3.97 billions. It has a credit rating of AAA and raises capital in Canadian and foreign financial markets.

The majority of ACFA borrowers are the municipalities. Their financial constraints include balanced budgets and debt service limits. Borrowing terms range from 3 to 30 years. Loans must be for terms of amortization and maturity related to the working life-cycles of projects including water and sewer facilities; roads and bridges; transport utilities; land purchase; buildings, vehicles and machinery and equipment as well as airport infrastructure; irrigation works; energy efficiency projects and parking[xxxvi].

### 5.1.5 Development Bank of Southern Africa (DBSA)

The Development Bank of Southern Africa (DBSA) was established in 1983. It is wholly owned by the Republic of South Africa and reoriented after 1994 with a mission to mobilize and provide finance and expertise and by establish partnerships to develop infrastructure to improve the quality of life of the people of southern Africa. DBSA has total assets of US$ 3.41 billion, total borrowings of US$ 1.57 billion and excellent credit ratings. With a net surplus since creation, its total capitalization now stands at US$ 1.71 billions. DBSA does not pay taxes or dividends to the government. Its present funding is mainly through bond issues in local currency. It also receives loans from international development financial institutions. It has assets valued at US$ 3.41 billions.

DBSA makes grants, lends, invests, underwrites capital issues and arranges other types of funding. As a partner, it acts as a catalyst, and provides assistance to borrowers. Total loan approvals to date are US$ 4.45 billions. Disbursements are US$ 3.93 billions and investments in Debt and Equity Funds R902 million. Approximately 75% of the DBSA lending is within South Africa, with the remainder in other countries of the region. About 60% of its lending is for water, energy, and roads and drainage projects; 15% for commercial projects; and the remainder are for education, sanitation and social infrastructure[xxxvii].

### 5.1.6 Philippine Municipal Development Fund

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

Local government water and sanitation projects are required to be privately managed and under design, build and operate arrangements, and lease payments of operators will service the local government debt service on the capital investments required for the projects. A parallel initiative, undertaken with the Land Bank of the Philippines, added sewerage components to some of the water projects. The initiative has experienced difficulties in raising the revenue needed to cover debt services, as sewerage charges, were difficult to enforce.

An important stated purpose of the Municipal Development Fund was to attract private capital for local infrastructure funding. Program administrators sought sound projects and credit-worthy localities where governments were reluctant to risk damaging their credit rating by borrowing from 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 been concerned about insuring its members against the credit risks associated with lending to local governments. A Local Government Unit Guarantee Corporation was created to guarantee loans and perform credit ratings for local governments. In Mid-2003 it had insured loans valued at about US$ 33 million. Its capitalization, of about US$ 7 million, is still quite small, but is supplemented by uncalled capital, pledged by over 20 participating banking entities. However, debt instruments that are appropriate to the life cycle of public infrastructure projects are still lacking[xxxviii].

### 5.2 State funds for urban and regional development

In countries where the regional/state governments have broad competences and a role in governance with commensurate financial resources they can create special funds to support municipalities within their jurisdictions. Federal states have led this trend, as illustrated by the outstanding examples of Tamil Nadu, India, Paranacidade and Para Urbe, Brazil.

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

In India, fiscal responsibilities have remained significantly controlled by the central government, as state and local expenditures are not matched by their own-source revenues. Until very recently, only the largest local government units (municipal corporations) had significant borrowing powers while smaller local governments had virtually no power to borrow for capital expenditure and very little authority to raise local revenues. In Tamil Nadu State, the Urban Local Bodies Act of 1998 brought all of the state's urban local governments under common legislation with respect to their powers to borrow. Such borrowing may be by 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.

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 5.3).

*Box 5.3 Tamil Nadu Urban Development Fund (TNUDF), India.*

The Tamil Nadu Urban Development Fund has evolved from a municipal trust fund to one established and managed by the public and private sectors. The initial fund 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 with the aim of achieving managerial efficiency and attracting private capital for urban infrastructure it was converted into an autonomous financial intermediary. Established as a trust fund with private equity participation it was the first public-private partnership in India that provided long-term municipal financing for infrastructure without guarantees. Instead of merely channeling public funds its purpose is to attract financing from the private sector. It also manages a separate grant fund owned by the state government to finance poverty alleviation projects (see Table 5.2).

**Table 5.2 TNUDF Portfolio (2003)**

| Private Sector | Large ULBs | Small ULBs |
|---|---|---|
| 15% | 35% | 50% |

*Source: The World Bank, March 2003*

The Fund is managed by a private corporation, Tamil Nadu Urban Infrastructure Financial Services Ltd. Financial institutions have committed to contribute an amount equal to 44% of the initial contribution of the Tamil Nadu State Government. The Fund's Management Board comprises representatives from the State Government and participating financial institutions. Borrowers are required to follow 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 TN-UDF is making an important contribution to capital investment needs for large, lumpy and non-revenue-generating projects (see Table 5.2 and Table 5.3). For many small local governments that are unable to access the markets directly, the Fund provides a pooling mechanism and indirect access to the market together with enhanced credit. Such arrangements can be especially useful for sewerage projects which require substantial funds over repayment periods of 20 years or more.

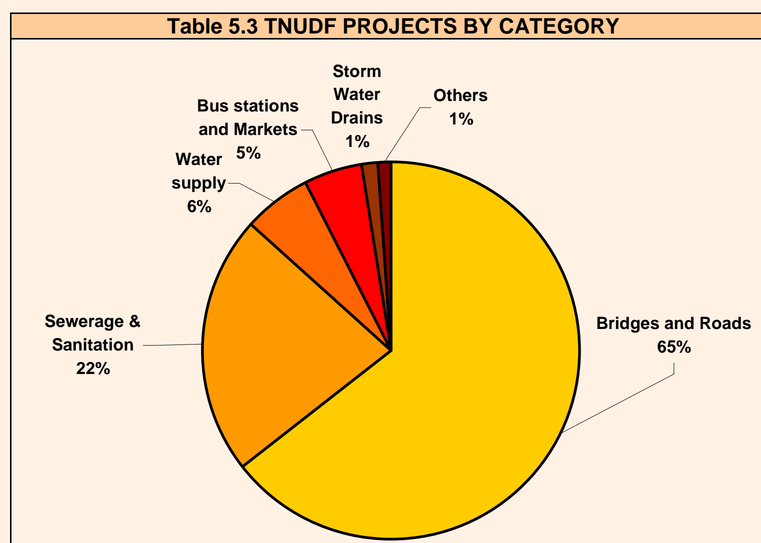
**Table 5.2 TNUDF FINANCING – MARCH 2003 (Rs. in Crores)**

| Category | 2000 | 2001 | 2002 | 2003 (Projected) |
|---|---|---|---|---|
| Total contribution | 176 | 177 | 196 | 285 |
| Term debt | 209 | 411 | 433 | 816 |
| Loans and advances | 230 | 437 | 418 | 518 |
| Investments | 129 | 150 | 210 | 222 |
| Debt-equity | 1.19 | 2.32 | 2.20 | 2.86 |
| Ownership pattern<br>- GoTN | 71% | 70% | 71% | 57% |
| - FIs | 29% | 30% | 29% | 44% |

*Source: The World Bank, March 2003*

Despite these constraints, the Fund is quite creative, launching new financial products to tap the capital market for special purposes such as the "Water and Sanitation Pooled Fund". A municipal bond issue for a road development initially funded by TN-UDF was re-financed from the bond proceeds, thus releasing funds for other capital investment.

**Table 5.3 TNUDF PROJECTS BY CATEGORY**




*Source: The World Bank, March 2003*

Sources:
The World Bank, *Concept Memoranda (CM) Proposed Repeater Project, Third Tamil Nadu Urban Development Project (TNUDP 111)*, May 7, 2004; Singh Maini, T., "Tamil Nadu Urban Development Fund", in IADF Bulletin, Vo. 1, Issue 1, March 2004; The World Bank, "Tamil Nadu Urban Development Fund (TNUDF)-A Presentation", power point presentation graciously contribute by program officers, March 2003; INTA, 2004;Freire, M. et al, 2004. Research on this case was undertaken by CUDS team member Shannon Bassett.

## 5.2.2 The role of the states financing urban development in Brazil

Their preeminent role in a federal system gives Brazil's states the responsibility and power to assist municipalities in their transition to a growing fiscal autonomy. Two recent developments in Paraná State illustrate the evolution of a municipal development fund from a strictly 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 FAMEPAR (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 the municipal level. Specific areas of assistance include administrative management, human resource management, tax and financial management, urban planning and information systems. Paranácidade is supervised by the State Secretariat of Urban Development, and is accountable to the State legislature. Municipalities are assisted in their project identification and implementation. This has increased operational efficiency and fostered a sense of ownership on the part of the municipalities.

The FDU funds an urban development program (Paraná Urbano), financed 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 projects account for 84% of projects, with street paving, water and sewerage and purchase of heavy equipment as the dominant funding requests. Overall, 380 out of the 399 Paraná state municipalities have benefited from Paraná Urbano. Paraná Urbano also funds public agencies operating at the regional and city level. The Sanitation Company of the State of Paraná (SANEPAR), established in 1963, provides water supply to about 98% of the population. It covers its costs, including capital depreciation costs without direct subsidies from the government. It obtains loans from public financial institutions including FDU/Paranácidade. Under Paraná Urbano, SANEPAR received a loan of R$60 million to increase the coverage of the sewerage system

Paranácidade has developed its own software to compute the borrowing ceiling for each municipality under the Law of Fiscal Responsibility. Municipalities must agree to put up their mandated state transfers as collateral in case of default. This guarantee and the active involvement of the regional municipal associations ensure that there are practically no non performing loans.[xxxix]

The State of Pará also established an Economic and Development Fund to finance programs and projects that promote economic development and mitigate regional disparities. The Fund transfers approximately US$ 25 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 program to support municipalities undergoing institutional adjustment, and to enable the implementation of Institutional Action and Investment Plans in all municipalities. The State of Pará provides a discretionary transfer aimed at promoting municipal tax revenue, rationalizing municipal spending and helping municipalities comply with the Law of Fiscal Responsibility. The program is administered by the State of Pará Department of Urban and Regional Development (SEDURB), and receives 40% 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 intent is for Pará Urbe program to become a permanent system of non-mandated matching grant type transfers to municipalities for capital investments in infrastructure and local and regional services, with a view to promoting inter-municipal compacts and collaborative action[xl].

### 5.3 Local Partnerships for the establishment of Development Funds

When macro-economic conditions allow, opportunities will almost certainly exist for joint action and partnerships to access funds for capital investment. In emerging economies, central government leadership, guidance and participation can enhance the capacity of local authorities to obtain funding on favorable terms and is critical to the ability of smaller municipalities to finance their capital

investments. In poorer countries, strong external technical and financial support mostly from donors is needed to help mobilize stakeholders to set up a development fund. Local governments must also be legally empowered to create the fund. Alternatively, the fund can provide the mechanism needed to overcome regulatory constraints hampering the municipalities' ability to finance capital investments. The examples described below illustrate the potential of these local partnerships.

In Europe, municipalities are empowered to structure intermunicipal initiatives. Swedish municipalities used this approach to establish a cooperative association through which they could raise funds on the capital markets (see Box 5.4). The pooled financing concept has been transferred and adapted by leading municipal development funds in emerging economies, as in the case of India's Tamil Nadu Urban Development Fund.

### 5.3.1 The Kommuninvest Corporation, Sweden

*Box 5.4 The Kommuninvest Corporation, Sweden*

The Kommuninvest Corporation is a cooperative association of municipalities established in 1986 by 10 municipalities and the Örebro County Council in Sweden. All Swedish municipalities can join the association.

Wholly owned by its member municipalities, Kommuninvest provides funding for a range of investments, including infrastructure and educational improvements. Lending terms are the same for all member municipalities, irrespective of the size of the loan. Kommuninvest raises funds by borrowing on the European, Swedish and Japanese capital markets. By working in a cooperative fashion, overheads are kept to a minimum. In 2000, Kommuninvest was able to issue a €500 million bond, its largest single issue to date. The average interest rate on loans granted in 2003 was 4.2%, down from 4.84% in 2002. Kommuninvest provides member municipalities with 35% of their total loan portfolios. It is the largest municipal lender in Sweden.

The members of Kommuninvest Cooperative Society are required to sign both joint and separate guarantees to cover all of the credit market company's obligations. Its solid financial situation is strengthen by the municipalities' right to levy taxes, a constitutionally guaranteed right that contributed to Kommuninvest's AAA credit rating for borrowing in foreign currencies.

Swedish municipalities are currently limiting their investments in new projects and most borrowing is used to refinance old loans. Membership, is conditioned by the municipalities' ability to meet fiscal criteria for five key parameters: liquidity preparedness, financial flexibility, financial capacity, obligation and commitments, and external factors.

Source: Winter, P., "Kommuninvest", in International Association of Development Funds Bulletin (IADF), Vo. 1, Issue 2, April 2004.

In Central America, national economic constraints, the general poverty of the population and the weakness of the municipal institutions entail the participation of outside partners in setting up development funds.

### 5.3.2 Nejapa Local Development Fund, El Salvador

Nejapa, a municipality of 30,000 inhabitants located in the San Salvador metropolitan Area, is experiencing a very rapid urbanization; 79% of the residents considered "poor" and 48% were

classified as living in "extreme poverty". The majority of the populations lived in slums and squatter settlements where 38% were overcrowded, 84% lacked water supply, and 49% lacked 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 role of key stakeholders and to foster consensus and collaboration for sustainable development. A Compensation Fund was set up to provide seed capital to enable the municipality to initiate economically viable projects. This fund helped overcome national regulations that constrain the local governments' ability to pre-finance investments.

The Local Development Fund is managed by a board of members representing different stakeholders: one central government official; two municipal officials; four representatives of the two key local enterprises, the Nejapa Power Company and EMBOLSAVA representing Coca-Cola; two representatives of the Association for development of Nejapa (ACDN) which groups different CBOs; two members of FUSAI and FUNDE NGOs; and two representatives of FIA (Inter American Foundation) and SIDA (Swedish International Development Agency). It has mobilized US$ 814,297, the bulk of which are grants from International Cooperation (64%), the private sector (17%), other local actors (12%), the Municipality (4%) and the community (3%). The Municipality intends to be able to contribute about 20% as central transfers to local governments are expected to increase substantially under the recently adopted decentralization program.

The Fund has developed 12 projects requiring investments of US$ 368,682. The projects directly benefit 53,753 persons and organizations in the public, private and social sectors. Over the past two years, the fund financed projects for environmental recovery (reforestation and water-related projects), infrastructure (bridge construction and electricity), housing, and social services[xli].

5.3.3 Czech-Moravian Guarantee & Development Bank (CMZRB)

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 the Program Agreement signed between the Czech Republic and the United States to introduce a Housing Guarantee Program (HGP) in the Czech Republic. The Housing Program has been implemented as a Program of Municipal Infrastructure Finance. CMZRB owns 49 % share of MUFIS, the Ministry of Finance (49 %) and the Union of Towns and Communities of the Czech Republic (2 %). 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 program, 112 loans in excess of 1.4 billion CZK (some US$ 45 million) have been provided to finance 122 housing related projects. Borrowers are municipalities or associations of municipalities and local utility entities where a municipality still owns a majority stake. Credit terms are loans of up to 100 million CZK at fixed interest rate over a maximum of 15 years with a negotiable grace period.

Eligible projects have to be housing related and include the following:

- Construction and reconstruction of technical infrastructure networks for housing projects;

- Construction and 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 seniors and disabled citizens;
- Construction or improvement of in situ roads and public transport infrastructure[xlii].

5.3.4 Virginia Resources Authority (VRA), USA

In 1984, the Virginia General Assembly, recognizing a growing need for environmental infrastructure throughout the Commonwealth, passed legislation to establish the Virginia Water and Sewer Assistance Authority to finance infrastructure projects. In 1988, it became the Virginia Resources Authority to reflect its expanded range of infrastructure finance options.

VRA was initially created to issue bonds for solid waste projects but is now authorized to finance water, sewer, solid waste, aviation, public safety and brownfields remediation projects through the Virginia Pooled Financing Program. It has issued over US$1,500 millions in bonds to fund projects throughout the Commonwealth.

VRA legislation was further amended to allow it to serve as financial administrator and manager for Virginia's federally-funded revolving loan funds: the Virginia Water Facilities Revolving Fund (VWFRF) in 1986, the Virginia Water Supply Revolving Fund (VWSRF) in 1987, and the Virginia Airports Revolving Fund (VARF) in 1999. The three funds have generated over US$ 1.1 billion to finance over 350 wastewater, drinking water and airport projects. In addition, VRA co-administers the Combined Sewer Overflow Matching Fund with the Department of Environment Quality Funding for the VWFRF and the VWSRF is provided US Environmental Protection Agency grants that require state matching funds. Funding for the VARF comes from the General Assembly.

VRA's Board of Directors comprises seven members appointed by the Governor and confirmed by the General Assembly and four ex officio members, representing the concerned agencies. The Board sets administrative policy and approves loans for borrowers of VRA bond programs. VRA completed its third issue of the Virginia Pooled Financing Program (VPFP) on November 17, 2004. Nine localities and service authorities have borrowed US$ 57,970,000 to finance water, sewer and public safety projects, taking advantage of a blended "AAA/AA" rating from both Moody's and Standard & Poor's rating agencies.

For most localities, the program offers among the most attractive interest rates in the market in addition to savings in issuance costs. Savings, on average, exceed 70 % or more, compared to single-project financing. VRA passes along to local governments its own savings from the pooled approach. It does not impose an up-front bond issuance fee. Moreover, annual loan servicing fees are reduced by about 20 %. 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 established[xliii].

### 5.4 Local Development Banks & Funds offering credit to both public & 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 fully commercial institutions, similar to investment banks. In the case of fully commercial

institutions, capital is raised by issuing shares on the commercial market and shareholders expect to receive either dividends or enhanced share values. Borrowing is on commercial terms. Supported by good credit ratings, interest rates will be 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 to the creation of the International Association of Development Funds (IADF), established in 2000, and headquartered in Washington D.C., USA. It has a current membership of over one hundred and fifty institutions listed in Annex 4.1. IADF provides linkages between the funds and well-known financing institutions, as well as with credit-rating agencies. It is assembling a very useful library of operating techniques on sub-national capital funding and related financial management.

#### 5.4.1 Bank for Socioeconomic Initiatives (BISE), Poland

In the face of asymmetrical fiscal decentralization and economic restructuring, Polish municipalities raise their funds to meet their 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 Banks, the EBRD, 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 of European institutions in Poland. BISE is a private bank that finances projects that create new jobs. It specializes in financing both small and medium size enterprises as well as municipalities and local authorities. Since 1993 BISE has financed over 1,200 projects: water supply; solid waste collection and disposal technology; school construction and modernization and other facilities. Typically, lending is short term and BISE carries no substantial long-term liabilities.

BISE obtains its funds from several international financial institutions including the World Bank; the Development Bank of the Council of Europe for loans to small and medium 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.

BISE is subject to national controls on the lending operations of banks and the rules for public procurement and competitive bidding. The bank works mainly with smaller local governments, a group that comprises 2,800 townships and 300 towns. Its largest municipal client is a town of 150,000 people. The Bank's focus on this special market accounts for an average loan size of about US$300,000 on a project size of around US$800,000 in towns with a population of 30,000[xliv].

### 5.5 Special Funds

Social Investment Funds were introduced in several countries in Latin America, Asia and Africa over a decade ago 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.

#### 5.5.1 Bolivia's experience with Social Investment Funds

Bolivia has tried to improve the performance of its Social Investment Fund (FIS) by integrating it into the system of inter-governmental fiscal transfers aimed at promoting decentralization and

redistributing fiscal revenues to the poorer areas. External donations and credit are the main source of capitalization of the funds that co-finance an estimated 30% of municipal investments.

International Cooperation funds are administered by a new entity, the FPS (Social and Productive Investment Fund) which consolidates two national investment funds, the Social Investment Fund (FIS) and the Local Development Fund (FDC). FPS pools international cooperation funds and distributes them among the municipalities to finance projects in national priority sectors. These grants are generally non reimbursable. Municipalities have been divided into five groups according to an urgency of need index (NBI). For a particular municipality, the higher the NBI for a 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 (DUF) guides FPS policy and coordinates the grants provided by the social and local investment funds, and the loans provided by the National Fund for Regional Development (FNDR). Municipalities submit projects that are ranked by reference to their Institutional Adjustment Plans (PAI), 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 Grant funds are distributed according to a compensation policy formula and included in the annual budget. FNDR loans are provided for eligible projects on the basis of municipality's credit worthiness. FNDR monitors the projects' finances and has developed an interesting database to assess the performance of municipal finance.

During the 1990's, municipalities extensively used their borrowing powers, often imprudently. By 1997, the Ministry of Finances had to impose constraints on borrowing: The debt ceiling set at 200% of the municipal revenue of the previous year and the annual debt service not to exceed 20% of the prior year revenue. Two years later, many Bolivian municipalities either exceeded this limit or were close to surpassing it. This situation led the Ministry to introduce in 2001 a Program of Local Development and Fiscal Responsibility in the re-adjustment for the financial situation of indebted municipalities. Funded through an IADB loan of US$ 87.3 million, the program finances social and productive projects through FPS and other urban projects through FNDR credits. To access these funds, municipalities are required to prepare a fiscal adjustment and investment plans identifying their weaknesses and assessing their needs.

By blending grants and loans, the program seeks to implement strategic actions that support decentralization, increase local resources and foster a sound fiscal management, and to promote the involvement of the private sector in municipal finance. To achieve these objectives, the program helps build the technical and managerial capacity of municipalities with a special emphasis on fiscal management and administration of property cadastres and tax rolls. It is also sponsoring a credit rating for the major municipalities in preparation to allow them to issue bonds[xlv].

#### 5.5.2 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 very burdensome or totally unsustainable under changed macro-economic circumstances.

To further their international development aid goals and assistance to poorer countries, governments to whom debt is owed 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 investments or promoting strategic social and environmental objectives. One of the first such "swaps" involved Costa Rica's debt and helped preserve the rich ecosystem of the national rainforest reservations. More recently, "swaps" have been used to fund poverty alleviation initiatives in accordance with the Country Poverty Reduction Strategy (PRSP) in Heavily Indebted Poor countries (HIPC)[xlvi]. 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 was 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[xlvii].

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 that has been cancelled to date is estimated at US$ 36.3 billion or less than 10% of the total[xlviii].

The Bolivian Strategy for Poverty Reduction, within the HIPC initiative gives an important role to local authorities as a way to increase the efficiency in services delivery to impoverished populations and to promote local development. It relies on municipalities to develop and implement action plans to reduce poverty. Approximately US$ 20 million annually are transferred to local authorities to invest within the eight national priority sectors. The redistribution formula for the allocation of HIPC funds underscores the program's poverty alleviation intent. To ensure geographic coverage, 30% of the resources are evenly distributed among the second tier of government, the departments, and within these among the municipalities according to an index of urgency of need (NBI). The remaining 70% is directly distributed among municipalities according to their NBI ranking. While the investment sectors are predetermined, the municipalities are not obligated to present specific projects to obtain funds. HIPC resources are thus considered as an integral part of the system of non-conditional intergovernmental transfers. The allocation process included extensive consultation with key stakeholders and focused on the potential role of CBOs, "productive groups" and indigenous populations.

The success of the strategy has been undermined by structural impediments: (1) The politization of the national strategy resulted in lack of continuity as successive revisions led to changes in approaches and instruments; (2) Systematic monitoring of the PRSP was halted in 2003; (3) Even though HIPC initiative reduced Bolivia's debt service burden to about US$1.57 million annually for 15 years, the relief was not sustained. Both the domestic and foreign debt has risen and is reaching levels similar to their pre-HIPC intervention levels. These structural impediments hamper Bolivia's ability to meet the 2015 targets of the Millennium Development Goals[xlix].

# 6 PRIVATE FINANCE OF MUNICIPAL INFRASTRUCTURE AND SERVICES

## 6.1 Privatization of Municipal Service Delivery

### 6.1.1 Overview and key features

Starting in the 1980s, “privatization” became an international trend embraced by countries all over the world, prompted by international and bilateral development organizations advocating the greater use of private sector entities as the means by which efficiency and effectiveness in the delivery of public services could be improved. 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 in question, 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.

First, there were massive privatizations of public utilities, in the electric power, telephone, transport, gas and other industries throughout the world, with little regard to the impact of these transfers on the poor or to the fact that some utilities were natural monopolies where the discipline of competition, a major justification for privatization, was substantially absent. Most of these outright privatizations concerned industries that were controlled by national or sometimes state governments. In many instances, along with its service delivery capability, the private sector has been able to supply much needed capital investment raised by using practices that were closed to the public sector or methods that the public sector was legally barred from using, such as borrowing. Unfortunately, in some cases, the outcomes have not always matched the 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 engendered by 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 underfunding or deferring expenditures on replacement and preventive maintenance. When the private contractor walks away from essential services, the public sector has to pick up the operations.

Privatization of local services entailed modifications in 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 (but far less commonly encumbered by sewerage and sanitation); solid waste management; and, a number of activities including janitorial and cleaning services; information processing and accounting; landscaping; and, vehicle and plant maintenance. The success of the outcomes depends on the particularities of each situation and the viewpoints of key stakeholders.

In both emerging and advanced economies, privatization has resulted in revenue producing services, including water supply and solid waste management, being gradually taken over in the larger urban centers by specialized multinational firms serving many local government units[l]. Although not complete monopolies, the sizes of many firms allow them to resort to predatory pricing to secure contracts in new locations and to exact costly 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 the cancellation of the contract for unsatisfactory performance carries heavy political and financial risks. The contractor must usually be indemnified 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 modifying a particular mode of service delivery: public, privately provided or contracted out is not simple. Many activities are capital-intensive or have significant institutional implications. These entry or exit costs can be quite high and make it difficult for potential competitors to compete against entrenched interests, as happens in many concession situations in emerging economies. Privatization and, in particular, the awarding of concessions have not been devoid of corruption, including lower initial bid prices to win, 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 existed. Perceived economic efficiency contrasting to the wasteful use of labor in many public sector activities facilitated savings in costs, together with improvements quality. However, a portion of these expenditures as wages and salaries previously recorded under administration were shifted to expenditure on services in budgets and accounts and recorded as "payments to contractors."

Privatization has, to some extent, shaken local government financial management from an earlier complacency about budgetary rigor and accountability. It has forced a much greater attention upon cost recognition and control, leading to improved accounting practices and a greater concern with the recovery of costs and the collection of payments when it was previously assumed that 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 improved 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 introduced useful new products, more successful activities and labor-saving technologies to gain a greater "return" on the huge sums of money invested in public services. While privatization has forced governments to examine entrenched practices and to consider alternatives for their modification or replacement with considerable success, it is not a 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 provided successful means for empowerment and social inclusion. Solid waste management and recycling have become prime mechanisms to simultaneously promote environmental and social objectives.

There are numerous award winning schemes worldwide such as Santo Andre, in Brazil, and the Scavenger communities, in the North-West Province, in South Africa. Furthermore, in the poorest countries labor intensive activities are important to provide productive employment to impoverished populations. Partnerships between local governments, communities and micro-enterprises can help achieve these objectives.

## 6.2 Key Issues in Different regions

Local government boundaries evolved over time, shaped by history and tradition. Often, their boundaries have been adjusted in ad hoc ways 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 and technical and managerial capacity. There is hardly ever congruence between optimal sizes and locations of jurisdictions for purposes of service delivery and revenue generation. Sometimes, the characteristics can contribute to increasing disparities among localities. This is particularly the case when large assets, such as stadiums, shopping centers and transport stations and airports, fall within one local jurisdiction that derives important tax revenues from them and delivers limited services to accommodate them.

It becomes incumbent upon each locality to consider – for each of the services it delivers – whether it should manage it on its own, or combine some services with one or more of its neighboring units. Local authorities, separately or jointly, 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 cooperation in the larger urban centers[li]. In transitional countries and in 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 emerging economies 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 locality 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 to jointly contract out combined service packages to a private sector entity, which might be either publicly or privately managed or supervised. The organizational structure, the representation of partners in decisions regarding all aspects of management and finances will always be key concerns.

The experience of formal privatization in many cities has not benefited lower income communities, pointing to the need for the public sector to have a role in the delivery of essential services. The abolition of social rates and other forms of subsidization of minimum consumption levels for basic services is very troubling. Even more troubling is the evidence advanced by NGOs that poor urban families are unable to pay even the minimum charges required for access to basic infrastructure and services, prompting 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.

### 6.2.1 Granting Concessions for the operation of revenue earning services: the experience of Abidjan, Cote d'Ivoire

Abidjan, Cote d'Ivoire, has a long history of concession having retained privately operated utilities and services. Before the disruptions and chaotic environment brought about by wars and civil strife, Abidjan's services functioned remarkably well compared to the situation prevailing in neighboring countries. Communes within Abidjan's administrative boundaries payed 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 system. 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 program and the vast majority of lower income renters now purchase their water from property owners, shopkeepers and water vendors. Despite the fact that its contract contained a clause entitling the company to compensation for any discrepancy between actual consumption and the estimates developed by the Water Directorate (the basis for the negotiation of concession contracts), the company contended that the maintenance of underutilized systems is 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 out of business the water vendors.

The company's performance regarding the maintenance of the sanitation network was highly inadequate. Frequent obstructions, mainly due to defective solid waste management, were not attended to promptly despite the fact that 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 was also privatized. The different companies that were contracted covered the primary road network system and the main market areas. Their trucks were ill adapted to the high organic content of the wastes. They collected trash and garbage deposited in bins and dumpsters. The service was too infrequent for an equatorial country. Garbage spilled from overflowing dumpsters was not collected[lii].

## 6.3 Joint funding of infrastructure and urban services

Local governments have been major participants in capital development projects. In transitional countries, privatization became a strategic objective since the early transition years. By now, private sector entities are 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 (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). They also contribute repayable equity or loans. The private partners provide equity and shareholder loans. Concessions and BOOT agreements are more attractive to private investors, and foreign investors in particular, because 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, and preferential loan

repayment terms. Provincial authorities can use assets and revenue-backed securities to finance their share of the investment.

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

Of special interest to poorer countries are solutions based on partnerships between municipalities, NGO's and CBOs. In these countries, integrating poorer communities into the city fabric and giving the poor access to basic services is hampered by the spread of chaotic urbanization; the mounting 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 in the underserviced communities, systems and networks using different technologies and serving different population groups and geographic areas must be somehow 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 also an issue that can benefit from this approach. Cotonou (Benin) award winning programs demonstrate the importance of linking formal and informal service providers (see Box 6.1).

*Box 6.1 Cotonou, Benin*

In Cotonou, the institution of a solid waste management program was conceived as an environmental initiative. The service is run by an NGO that employs local youths to collect waste. Subscribers pay monthly fees for the service. Two committees composed of community residents formulate plans and define the responsibilities of each partner, and monitor the operation of the service with technical support from the NGO. The municipality assumes the responsibility of transporting waste from dumping stations to the disposal sites. It operates conforming environmentally sound practices.

The NGO is promoting recycling activities by community groups, mostly women, using ecologically sound practices including biological treatment of polluted run off water and composting of organic wastes to reduce the number of dumpsites from 30 to 5. Bilateral aid (GTZ-MEHU) provided start up funds for the program in 1995. In the first 5 years of operation, 80% of the population subscribed to the service. Collection rates were on the order of 95% and 200 permanent jobs were created. A community bank enables women recyclers to access micro-credit to expand their activities[liii]. The Partnership for Municipal Development (PDM), a regional organization, provided the municipality with capacity building and technical support and facilitated the initiation and institutionalization of the program.

In 1998, the piped water supply system operated by "Benin Water and Electricity Company" (SBEE) covered less than 50% of Cotonou. Only 16% of the households were directly connected and 32% purchased potable water from neighbors and public water fountains. 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 lived. This entailed reaching and organizing the vendors and building up their capacities. A formal Association of Water Vendors (AREB) was created grouping 300 vendors, a core group representing 20% of potential members.

The Municipality and the SBEE recognize AREB as a formal partner and SBEE 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 settlements that are not regularized and AREB members will operate the new public fountains. The PDM acts as a mediator and a facilitator to overcome the conflicts and distrust prevailing between small vendors, SBEE and the municipality. It is planning to transfer this partnership concept to other West African cities to improve the delivery of services to the poor.

Source: PDM, « Renforcement du partenariat tripartite collectivités, entreprises concessionnaires et petits opérateurs pour un accès a l'eau des populations urbaines défavorisées », Cotonou, Bénin. Unpublished updated information graciously contributed by the project officers. Quoted in Serageldin, M. et al, *Local Authority Driven Interventions and Processes*, Cambridge, 2003.

## 6.4 Joint Funding of community-based initiatives for the delivery of basic services

Microcredit 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, they started to offer loans for housing. They progressively expanded their lending to help poor families access land and basic infrastructure services. Today, they have become key partners in municipal initiatives to improve the living conditions of poor households in both urban and rural areas. The experiences of Guatemala's Genesis Empresarial, PROMUNI program and the partnership between the Ahmedabad Municipal Corporation and SEWA Mahila Trust to upgrade slums through the Parivartan program illustrate the potential of these partnerships (see Box 6.2).

*Box 6.2 Genesis Empresarial, Guatemala*

Genesis Empresarial was established in 1988 to improve living conditions for low-income rural communities by providing them with microcredit to finance their access to infrastructure services. Genesis loans are not subsidized and the interest rates charged reflect the costs of the funds obtained from different sources of capital. Current rates range from 21 % on funds from the Central American Bank for Economic Integration (BCIE) to 30 % on funds from commercial banks and Genesis' own funds. The range of Genesis lending is shown in the following table:

**Table 6.1 ACTIVE LOANS DEC. 2002 (IN THOUSAND US$)**

| Program | # of Clients | Active loans | % of participation |
|---|---|---|---|
| Micro-enterprise | 17,751 | 8,746 | 50% |
| Women Enterprises | 13,023 | 3,520 | 20% |
| Small Enterprise | 669 | 2,375 | 14% |
| Services in Rural areas | 2,037 | 1,965 | 11% |
| Housing | 1,972 | 731 | 4% |
| **TOTALS** | **35,452** | **17,337** | **100%** |

Source: Bucaro Rosales, 2003

In 1993, Genesis 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 program requires that at least 90 % of residents agree to request the service. The program is implemented through groups of four to twelve families with loans ranging from US$ 120 to US$ 450 per household and loan amortization periods from 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 %. Genesis assists in organizing borrowers, registering the project committee with the local authorities, preparing the technical reports, applying for matching grants and credit, interacting with contractors, and managing the group loan accounts. Because of the financial burden of technical assistance, PROMUNI did not achieve a positive return on investment (1.2 %) until 1998.

From 1993-2000, the program supported the development of 79 projects reaching 143 communities with a population of 8,994 inhabitants in the different departments of Guatemala. Total funding was over 32 M Quetzals (US$ 4.1 M). From 1988 to 2002, Genesis worked with close to 83,000 clients and originated 129,000 loans amounting to US$ 184 million. The average loan amount is US$ 489 and the default rate is around 8%. As of December 2002, there were 35,452 active clients carrying loans of US$ 17.3 million (see Table 6.1).

San Juan Sacatepéquez Municipality (population 137,136) is located 31 km from Guatemala City. Génesis extended credit of US$ 323,600 to introduce electricity to 23 of its 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: Genesis Empresarial, « Haciendo realidad sueños de desarrollo » Genesis Empresarial and BCIE 40 aniversario, n/d; Búcaro Rosales, Edgar R., “Fundación Génesis Empresarial”, Power-Point presentation graciously contributed, Tegucigalpa, Honduras, 2003; Serageldin et al, 2001.

In Ahmedabad, the major commercial, industrial and financial center in the state of Gujarat, India, 45% of the population of 3.5 million lives in slums and under serviced areas. The Ahmedabad Municipal Corporation (AMC) was running budget deficits and had to improve its financial management. It initiated a series of reforms that won international recognition for their achievements. It then launched the Parivartan program to address the issue of living conditions in the slums (see Box 6.3).

*Box 6.3 Parivartan Program, Ahmedabad, India*

The Slum Networking Project, referred to as Parivartan, provides basic services in the city’s slums. Municipal budget allocations and national transfers and grants could only cover the cost of the secondary and tertiary infrastructure required. The cost of house connections was divided in three equal parts to be covered respectively by the households, the municipality and private donations.

The AMC sought assistance from the Self-Employed Women’s Association (SEWA), an NGO established in Ahmedabad in 1992 as a trade union to empower low-income women working in the informal sector (that accounts for 96% of employed women). SEWA, at the request of its members, had established a microcredit bank owned by shareholding members and the Mahila Trust (MHT) to finance housing improvements. As a partner in Parivartan, SEWA assumes responsibility for community outreach and organization, acts as financial and technical intermediary assisting households in meeting the program’s technical requirements and negotiating with AMC on the community’s behalf, and extends micro-loans to enable households to pay their share of the costs and working with AMC to raise matching grants from local businesses and philanthropies.

The municipality designates the slums for upgrading and regularizes tenure. All participating households are provided with written documents ensuring security of land tenure for a minimum renewable period of ten years. Participation is optional but conditional on a commitment to pay their share of the program’s costs: US$ 48 towards the infrastructure package and US$ 2.3 towards the cost of its maintenance.

Within 5 years, Parivartan reached 9,435 families with 56,610 people in over 40 slums. It is being

expanded to include 59 more slums reaching an additional 15,431 households. Death rates in the upgraded slums have declined from 6.9 per 1000 to 3.7 per 1000. The proportion of children immunized against disease rose from 31.25% to 51.35% and include 100% of newborns. General illness incidence has been lowered from 24.4% to 16.5%, reducing health related expenditures by 4.4%.The program has enhanced the ability of families to generate income and increase their monthly expenditures by 33%. Literacy rates have also increased from 30% to 45%.

Source: Harvard University Graduate School of Design, Center for Urban Development Studies, *SEWA's participation in infrastructure improvement initiatives in urban areas: The "Parivartan" Slum Networking program, Ahmedabad, India*. Cambridge, 2000. Additional unpublished updated information. Quoted in Serageldin et al, *Local Authority Driven Interventions and Processes*, Cambridge, 2003.

### 6.5 New trends in Partnerships for local development

In developing countries, where decentralization is a recent or ongoing reform, municipalities are particularly reluctant to delegate authority or share revenue with their 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 Sao Paulo, Brazil, where 7 municipalities have to cope with economic restructuring and the rebuilding of the local economy based on new growth sectors following the decline of the automotive industry[liv].

The difficulties encountered in mobilizing and structuring alliances of stakeholders to promote local development is illustrated by the experiences from Central America. In poor regions bypassed by development, programs promoting development must also foster social inclusion. Inter-municipal initiatives can significantly enhance the effectiveness of these efforts as in the case of 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 initiated. 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.

#### 6.5.1 Alliance of stakeholders to drive local development: San Andres Valley, El Salvador

San Andres Valley is located 4 km from the San Salvador metropolitan area and has 11 municipalities and a population of 368,358. It has archeological resources, large areas of agricultural land and industrial activities, particularly "*maquiladoras*" (sweatshops), and has the potential to develop new agro-industries and tourism. It is a migrant receiving area, where sustained growth generates a strong pressure on land, leading to chaotic urbanization. There are around 1,000 firms in the area, of which the majority are micro-enterprises employing up to 4 workers.

In 1993, the San Andres Foundation (FUSANDRES) launched a participatory process to prepare a plan for the Development of the region and created an alliance of stakeholders to drive the development of the valley. Representatives of 200 organizations participated in the preparation of the plan, which was completed in 2000. Key issues addressed include: regional planning;

education, culture and recreation; environment, and public health; and, local economic development.

A Management Group for the development of the Santo Andres Valley brought together the different actors active in the area to implement the plan. FUNDE (National Foundation for Development) and FUSAI (Salvadorian Foundation for Integral Support) facilitated the process. The Management Group comprised representatives of ten local governments, 25 government institutions, 13 NGOs, 12 CBOs and 18 firms located in the valley who signed an agreement committing them to take on responsibilities for plan implementation in accordance with the guidelines established by a general assembly. A Coordination Commission which acts as the board of directors was created to ensure the smooth functioning of the alliance and facilitate multi-sectoral activities. 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 Andres Valley Office of Planning (OPVSA) 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 US$ 66,000 were 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 the rating of the area as a location for private investment, and created attractive conditions for environmentally sensitive investors. An Environmental Committee grouping 23 enterprises balances income generation and the protection of the environment. Local governments' management is being strengthened and four municipalities are implementing a joint action plan for local and regional development. Including citizen organizations in governance, gave the area a social vision that it sorely lacked. It also allowed the management to foster micro-enterprises and to curb housing projects that violated the environmental regulations[lv].

### 6.5.2 Decentralizing investment in urban development in Central America: Honduras' PRODDEL program

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

The National Program for Decentralization and Local Development (PRODDEL) has expanded the scope of municipalities' responsibilities from administrative and managerial tasks to promotion of social and economic development. PRODDEL formulates a strategy of municipal decentralization adapted to the degree of development and the local circumstances of each municipality or association of municipalities while reinforcing efficiency and transparency. In 1998 only 8% of the municipalities were considered "developed", the remainder being classified as under-developed or lagging. Only 25% of the municipalities are able to assume the functions and responsibilities implied in the transfer of competences and resources by PRODDEL but the fundamental premise is that the "vicious circle of not to decentralize because of the lack of local capabilities" can be broken. The program has identified 40 municipalities able to handle a decentralized program of public investments in the short run. The rest require capacity building actions to implement projects funded by the Honduran Fund for Social Investment. The

Mancomunidades are associations of municipalities facing common challenges while respecting the principle of subsidiarity. Today there are approximately 48 Mancomunidades in Honduras addressing basic services delivery, environmental management, cultural and ethnic issues and other activities of common interest. They have become a new intermediate level of government but are still vulnerable to political pressures, social changes, and limited to the local capacities (see Box 6.4).

*Box 6.4 Valle de Sula Region, Honduras*

The Valle de Sula Region houses 25% of the national population and generates 55% of the country's GDP and 40% of its exports. Economic development is concentrated in specific areas and many municipalities, including San Pedro Sula, do not benefit from it and are unable to deal with the influx of low income migrants and the increased demands on housing, infrastructure, services, and 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. It is a permanent self-managed non-profit organization whose goal is to promote balanced regional development and to improve the quality of life of residents. The 17 municipalities in the ZMVS (11 funding members in 1993 were joined by 6 other in 2000) have different levels of institutional development, budgetary resources and fiscal capacity.
The Mayors Assembly formulates policy. The Executive Direction is the executive arm. A Decentralization and Municipal Development project funded by SIDA (Swedish International Development Agency) and implemented by UNDP 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 financed through a 0.5% assessment on each municipality's annual revenues, an amount insufficient to cover its operating costs. The Foro Valle de Sula 2020 strategic plan focuses on access to basic services, an efficient and rational use of public resources in the region, and creating synergies among stakeholders.

Source: Funes, F., 2002.

## 6.6 Tapping migrant remittances

Manuel Orozco's work on immigrant Latino communities in the US highlighted the emergence in the 1990's of hometown associations among expatriate communities. These associations combine social functions in the US with coordinated efforts to support their hometowns in Latin America. Hometown associations are still quite small, private voluntary organizations lacking formal organizational structures. They raised an average of US$10,000 per year to send to their hometowns in 1999. Between 20% to 30% of migrants contribute to these collective remittances. An interesting feature is the evolution of the support they fund from charitable activities, mainly linked to the Church, to investment projects to improve infrastructure and services in their hometowns and villages. They finance infrastructure (potable water, sanitation, street paving) and community facilities (school, health centers, 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 by state, federal, and more recently municipal governments. Zacatecas, Jalisco, and Guanajuato – a region of high out

migration – were the first states to set up such funds to finance “employment generating projects,” mainly garment factories. Jobs were created and relatives of migrants 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 6.5).

*Box 6.5 Cuenca, Ecuador, Improve your Neighborhood Program*

In Ecuador, Azuay is the province with the highest rate of out migration. Between 1990 and 2002 some 249,000 people left the province, accounting for 45.3% of the national total. In 2000, Ecuadorian migrants remitted US$ 1.3 billion of which US$ 600 million went to the Azuay province. The municipality of Cuenca receives around US$ 400 to US$ 500 million annually, that is, US $1.5 million per day and 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 launched the “Improve your Neighborhood” program as an initiative structured to capture migrants’ remittances. The program services “consolidated” neighborhoods (neighborhoods with a high percentage of privately owned housing), providing or improving infrastructure, tree planting and street paving. Neighborhood residents submit a request for improvements to the municipality, directly or through their neighborhood organization. The municipality undertakes the technical studies and calculates the costs for the residents. “Public works packages” of US$ 30,000 to US$ 40,000 are awarded to local engineers and builders who operate as small contractors, hiring the 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 management fee of 12%. A 15% discount is offered for prepayment the full amount. To date, the payment rates are close to 98%. The municipality works with local banks that issue loans at slightly below market interest rates (around 11% in 2003). The funds are used to directly 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 program has achieved impressive results. Between 2000 and 2003, more than 700 small contractors delivered improvements valued at about US$ 21 million. Over 90 km of urban streets have been paved and serviced. The program’s popularity stems from impact on the quality of the living environment and on property values. A house originally valued at US$ 20,000 could sell for US$ 35,000 at a cost of US$ 1,500 to the owner. Furthermore, the city’s attractiveness for external investments and for tourism is enhanced.

Source: Serageldin, M., et al., *Migratory Flows, Poverty and Social Inclusion in Latin America*, presented at the World Bank Urban Research Symposium, Cambridge, December 2003.

### 6.7 Building the capacity of Municipalities and improving local financial management

The lack of experience and a dearth of statistical and spatial information have proved to be the main obstacles to the successful transfer of planning responsibility to local governments. In Central and West Africa, a region grouping impoverished communities affected by desertification, wars and civil strife, the Partnership for Municipal Development 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 units of government.

It provides documentation on development trends, supports institutional reform initiatives, offers technical assistance services and builds the technical and managerial capacities of municipalities. Of the 24 countries in the region, 15 are members (see Box 6.6).

*Box 6.6 Municipal Development Program (PDM)*

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

- Documenting local economic and social conditions in their sub regional context 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. The documentation of these areas is the prerequisite to the formulation of a coherent and sustainable development strategy.
- Establishing 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 study and participate in the elaboration of a Local Development Framework consisting of:
    - A common diagnosis of the recent evolution of the area, its strengths and weaknesses. The emphasis is put 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 the infrastructure and public services.
    - A public investment strategy based on the mobilization of local resources and an equitable sharing of investment costs between the public and private sectors.
- Implementation of the Local Development Framework through a reorientation of municipal investment policies; the mobilization of local resources, including the participation of the private sector and NGOs; identification of and negotiations with foreign donors; solicitation of categorical grants from the central government.

Local development frameworks were prepared for eight cities and their hinterland in the first three years of the ECOLOC program and work on an additional 20 cities was initiated in 2001-02. The PDM provides technical assistance to individual communities monitors municipal finance; publishes the results of its studies; organizes topical workshops and capacity building programs on current development issues in the West African region, including the implementation of decentralization policies in the various countries; and has created a web site that provides access to its growing database. Local governments value PDM's assistance in organizing partnerships to improve the delivery of basic services and in enhancing municipal financial management and performance. Since 2000 it has organized the yearly "Africities" summit that brings together senior government officials, NGOs, private investors, academic institutions and bilateral and international donors. Its activities have supported local initiatives

and assisted municipalities in their effort to meet their new responsibilities under the decentralization initiative.

PDM work is sponsored by French cooperation, the Canadian International Development Agency (CIDA), the World Bank, German cooperation (GTZ), US Agency for International Development (USAID) and the Canadian Federation of Municipalities (FCM).

Source: Canadian International Development Agency (CIDA), 2003.
Research on this case was undertaken by CUDS team member Shannon Bassett.

The achievements of the PDM demonstrate the necessity for building the capacity of weak municipalities to institute participatory processes, improve service delivery and urban governance, mobilize stakeholders, engage citizens and enter into partnerships to improving the living conditions and promoting economic development. It also demonstrates the necessity to provide them with the longer term technical, managerial and logistical support they need to develop and implement and monitor strategic action plans and public investment programs.

Enabling municipalities and small communes to function under adverse economic conditions and destabilizing political disturbances promotes local development, fosters democracy and contributes to poverty reduction. This requires longer term support that can only be provided by a strong locally-based institution networking with organizations worldwide. Sponsoring and sustaining such an institution is the most effective mechanism by which bilateral and multilateral development organizations can help meet the targets of the Millennium Development Goals.

# 7 CONCLUDING REMARKS

Decentralization, democratic local governance, and the economic and social impacts of globalization are the key factors that are affecting municipal finance and reshaping the financing of urban development.

Asymmetrical decentralization has presented local governments with a major challenge: how to finance devolved functional responsibilities in the face of inadequate central transfers and limited access to funding from other sources. Democratic local governance has fueled growing demands for accountability and transparency in municipal management, particularly as regards the allocation of scarce local resources and their performance.

Globalization has aggravated uneven spatial distribution of economic activity and increased disparities in income and wealth among regions, and countries and within countries, and these inequalities affect urban centers. Some benefit from locational advantages while others, sometimes even close by, are bypassed by development. These imbalances are aggravated by the social dimension of globalization that has increased and concentrated poverty and led to massive population movements.

Municipalities are hard pressed to find the resources needed to finance urban development policies fostering 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 retrenchment of governmental expenditures, and the disengagement of the international community from urban issues in emerging economies and poor countries. Municipalities have to learn to tap private resources and access capital markets in order to fund the delivery of urban services and finance urban development programs.

Partnership with the private sector has become as much of a necessity as partnership 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 products, and the emergence and rapid growth of private local development funds have opened up new opportunities that municipalities must tap in order to finance development.

## 7.1 Decentralization, Municipal Performance and Accountability

With the exception of the advanced economies where at least the larger cities have a long experience in 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 European countries, local political autonomy, links to the West and participation in regional and international networks, and hopes of eventual accession to the EU help cushion the burdens of devolution. Grants extended to promote social, economic and environmental objectives have provided needed funding for urban projects. In Africa, Asia and Latin America, transfers from central governments have declined steadily, particularly for larger cities, and charting an appropriate course for decentralization without disrupting the delivery of basic services devolved to the local level has proved to be a difficult task. Only a few countries have formulated successful policies to redistribute resources that are more efficiently collected at the national level and equalized the burden on municipalities that are economically weak or face

higher per capita expenditures. Effective instruments used to foster a smooth decentralization include:

- Local statutory rights guaranteed by the constitution or by national legislation.
- The mandatory transfer of shared tax revenues.
- Formula based redistribution favoring smaller and fiscally weaker municipalities.
- The sharing of fiscal revenue through formulas that take into account concentrations of poverty.
- Intergovernmental agreements and intermunicipal 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 the economic and social life of their citizens. Even municipalities in the poorest countries have made considerable efforts in diminishing their reliance on dwindling transfers from central governments. Despite adverse economic conditions, local authorities in East and West Africa have managed to increase the contribution of locally collected taxes. In the countries of the West African Economic and Monetary Union, these taxes now account for close to 50% of municipal revenue, a significant increase over a relatively short time. In Burkina Faso, "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 by Porto Alegre, to municipalities in Brazil and other Latin American countries[lvi].

Accountability requires some measurement of performance and, since the mid-1980s, local governments in Western Europe, the United Kingdom and the USA have started to measure the real costs of delivering public services[lvii]. Accrual-based multi-year budgeting provides more or less robust indicators of performance and is becoming a more common alternative to the traditional cash flow based local budgets. In emerging economies, most municipalities lack the capacity and resources to implement sophisticated monitoring of financial performance. Nevertheless, publicizing even crude, quantitative and qualitative indicators enhances community understanding of urban management and development challenges and promotes citizen participation in local governance.

### 7.2 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 advanced and transitional economies have both the financial and administrative resources to manage development and provide urban residents with services ranging from adequate to good. Stable or declining populations have facilitated this task. In contrast, the poorer countries have for the most part been unable to keep up with the demand for serviced land or provide adequate basic services to a growing percentage of their rapidly growing urban populations. The major obstacles they face are:

- Shrinking central government transfers;
- Inadequate local tax bases to pay for the delivery of services to a growing population;

- Lack of institutional capacity to prepare mid- and long-term development strategies and the capital improvement programs necessary to implement them; and
- Limited or no access to capital resources to finance investments in infrastructure.

Sources of municipal revenue vary widely from country to country, although the property tax is among the most important, followed by fees for services. Many countries also levy taxes on economic activities according to varying formulas, although taxes on income are rare. Others have a multitude of low yield assessments and fees that contribute little to shore up their finances. The partial redistribution of centrally collected taxes, such as the VAT, entitlement grants for recurring expenditures and designated grants to either equalize disparities among municipalities or carry out specific project are also available, to varying extents, in most countries.

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. Their yield, whether collected nationally or locally, is often problematic. The dearth of up to date cadastral information and the importance of the informal sector are major impediments to collection, particularly in localities that are experiencing rapid development. As a result, an often-disproportionate tax burden is borne by existing properties and formal economic activities while new development escapes taxation. Similarly, rises in private property values, often the result of public improvements, are rarely recaptured due to obsolete tax rolls and inadequate capacity to revalue properties. These conditions erode municipal revenues and deprive local authorities of the funds needed to increase the supply of urban land and extend infrastructure networks. Inadequate local revenue also impairs their ability to access capital markets and enter into partnership agreements with private entities, NGOs, and CBOs to implement urban development initiatives.

User fees form a significant part of municipal revenues, particularly in developed economies. Although widely used, their yield in emerging economies and poor countries has usually been less than the operating and amortization costs of systems as 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 as well as social reasons. In the poorer countries, the NGO-led social movements have been vigorous advocates for free or subsidized services to lower-income populations. Quite apart from its moral merit, this approach would entail a significant increase in central transfers to local authorities and service providers in order to sustain the systems and cover their operating deficits.

A generalized lack of resources and the difficulty in accessing capital markets impedes the preparation of long-term capital improvement programs. Brazil's municipal reforms that imposed fiscal management standards, limited personnel expenditures and mandated the preparation of multi-year capital improvement programs is an exceptional case. Elsewhere, the preparation of multi-year budgets is gradually being introduced as a mandatory requirement in national public finance regulations.

Financial constraints are reflected in two generalized 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, such as South Africa, have provided grants for capital investment in infrastructure, central funds are generally in short supply in most part of the world and are often channeled to larger cities. As a result, it is not uncommon for existing infrastructure to deteriorate as a result of a lack of maintenance.

In emerging economies, medium and small municipalities lack the technical skills to prepare the coherent urban investment strategies required to access grants and loans from donors and municipal development funds. Santo Andre (Brazil) and Szczecin (Poland) stand out as successful examples of a forceful commitment to institute the reforms needed for financial planning and management, and a determined effort to leverage local resources, access credit finance and obtain funding from multilateral and bilateral organizations.

Long-term credit is critical to the ability of municipalities to finance urban development. The performance and impact of municipal development funds such as FINDETER (Colombia) and the Tamil Nadu Urban Development Fund (India) demonstrate that a combination of available credit and technical support provided to borrowing local governments can result in significant improvements in the provision of infrastructure. Where local governments have encouraged citizen involvement in decision-making there has been significant progress in the servicing of lower-income areas as the experience of participatory budgeting in Porto Alegre and Belo Horizonte (Brazil) demonstrate.

To circumvent legal, regulatory and fiscal constraints on their budgets, local governments in both advanced and emerging economies are developing means to finance urban development and public improvements as off-budget expenditures through special purpose vehicles as in China, and assessments and impact fees requiring private developers to pay part of the public infrastructure needed for their projects, a common practice in the USA and some transitional economies. Tax increment financing is another creative concept used by cities throughout the USA to borrow outside the statutory limits set on general revenue bonds. The linkage program first instituted by San Francisco (USA) extends this principle to finance non-infrastructure public programs, namely the construction of affordable housing and job training.

### 7.3 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 both their technical, managerial and fiscal capacity and on their ability to involve local stakeholders in the development process. In many parts of the world, including advanced economies, globalization has affected the financial resources of both national and local governments as taxable economic activities moved to other locations. The situation is further aggravated 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 the localities housing poorer populations or receiving migrants. Households in these under-serviced communities and outlying areas have to pay higher per unit cost 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. Even though local governments are nominally responsible for managing their affairs, their real autonomy is restricted by the dominant role the national government continues to play in determining the local tax base, in setting the tax rates, and in the collection and redistribution of taxes revenue. Municipalities are faced with a mismatch between their newly acquired responsibilities to provide services and fund capital improvements and a lack of control on their revenue sources. The resulting scaling back of public expenditures on both capital investment and social programs is having an adverse effect on urban development and impeding the achievement of the Millennium Development Goals.

In the poorer 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 particularly the case for water supply, in Tanzania, Botswana, Kenya, Mauritania and Benin. NGOs have contributed to the alleviation of hardships endured by the poor and provided them with some services. Their interventions have targeted specific communities selected in accordance with their own objectives and criteria.

Programs 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 Heavily Indebted Poor Countries Initiative are only beginning to be used to finance environmental and social programs, mostly through local NGOs and CBOs. Bolivia is an exceptional case where funds are channeled 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 periodic extension of the systems. Furthermore, making services available to low-income families necessitates substantial subsidies that municipalities have been unable to generate from their own revenues. Unless, the inequities generated by globalization, decentralization, central/local fiscal relations, and the dynamics of urban growth are addressed the sustainability of urban development, particularly in emerging economies, will remain highly problematic.

### 7.4 Privatization of Municipal Services and the Need to Link Formal and Informal Providers in the Poorer Countries

Privatization introduced the expectation that many public functions could be more efficiently performed by the private sector. It can take several forms: spinning off service units, outsourcing or contracting out specialized functions, granting multiyear concessions, entering into Build/Own/Operate and Transfer agreements or outright sale to the private sector. In many countries, revenue generating enterprises –telecommunications, gas and electricity, water supply, and public transport- were sold off to private entities. In emerging and transitional economies, privatization was advocated by international and bilateral organizations as a way to improve the efficiency of delivering public services and to tap 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 emerging economies, the trend is not likely to be reversed when governments have to meet cost saving targets and downsizing requirements. However, the enthusiasm has been somewhat tempered and the momentum slowed down. The weariness stems in part from the fact that privatizations that took place at the national level were associated in some countries with corruption and the transfer of public assets to private elites 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 emerging economies, specialized multinational firms have secured concessions for the management of water supply and solid waste collection. Their size and political influence has allowed them to secure favorable terms from municipalities. Concerns are being voiced and protests have erupted as happened in Latin America. Public authorities are now exercising greater caution in 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 served well populations able to pay the fees demanded by private providers, but lower-income areas are usually under served.

Experience supports widely held views that people are more inclined to pay private operators where they 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 poorer 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 emerging economies, and in particular in the poorer countries, there is an urgent need to address inequities in access to basic services. This is an issue that privatization will not resolve. Disparities result from a legacy of inadequate urban policies and ineffective responses, aggravated by the current dynamics of urban development. Many governments do provide subsidized access to poor families and some, like South Africa, extend these subsidies to cover minimum consumption levels. In the poorer countries, linking formal and informal service providers remains the most effective mechanism by which services to lower income communities can be provided and improved, as the experience of water supply and solid waste management in Cotonou (Benin) demonstrates.

### 7.5 Building the capacity of municipalities to finance local development

Strengthening the capacity of municipalities to plan and manage their economic, spatial and social development, disseminating information on successful approaches, and providing the institutional framework to support reform initiatives remains a major challenge worldwide.

In adverse economic conditions or institutionally fragile environments, building the capacity of weak municipalities requires longer term support that has to be provided by strong locally based institutions. The achievements of the Partnership for Municipal Development, jointly funded by African governments and bilateral and multilateral organizations demonstrate the potential of this approach. Sponsoring local capacity building institutions is an effective mechanism fostering the achievement of the Millennium Development Goals.

# 8 ANNEXE

## 8.1 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: Cotonou's Programs for the Protection of the Environment (Pr.A.P.E.) and Water |
| 2000 Cote d'Ivoire: Abidjan |
| **SOUTHERN AFRICA** |
| 2004 South Africa: Development Bank of South Africa (DBSA) |
| 2003 South Africa: Municipal Infrastructure Program (MIP) |
| **ARAB COUNTRIES** |
| 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: Kommunninvest Corporation |
| 2004 UK: Public Works Loan Board |
| **LATIN AMERICA AND THE CARRIBEAN** |
| **CENTRAL AMERICA** |
| 2002 El Salvador: Local Development Fund of Nejapa |
| 2004 El Salvador: San Andres Valley Management Group |
| 2004 Guetemala: Genesis Empresarial Foundation |
| 2003 Honduras: Decentralization (PRODDEL) |
| 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: Paranacidade |
| 2002 Brazil: Para Urbe |
| 2004 Brazil: Sao Paulo Action Center |
| 2004 Colombia: Financiera de Desarrollo Territorial (FINDETER) |
| 2004 Ecuador: Cuenca Improve your Neighborhood Program |
| **NORTH AMERICA** |
| 2004 Canada: Alberta Capital Finance Authority |
| 2004 USA: The Boston Linkage Program |
| 2004 USA: Tax Increment Financing (TIF) |
| 2004 USA: Virginia Resources Authority (VRA) |
| **TOTAL 43 CASES** |

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