Municipal Finance: Innovative Resourcing for Municipal Infrastructure and Service Provision

Report prepared by Mr Ilias Dirie
for the Commonwealth Local Government Forum in cooperation with ComHabitat

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Foreword

By Carl Wright, Secretary-General, CLGF

In a message to the 2005 Commonwealth Local Government Conference held in Aberdeen, Scotland, UK Prime Minister Tony Blair stated:

"…Effective, elected local government is an important foundation for democracy. Legitimate and well-functioning local democracy is key to the delivery of the basic services – water, sanitation, education, health, transport and so on – which are vital to tackling poverty and helping Governments deliver the Millennium Development Goals".

The important role of local government in helping to deliver the Millennium Development Goals (MDGs) in local communities is being recognised increasingly by the UN, the Commonwealth and international development agencies such as EuropeAid, AusAID, DFID and NZAID, as well as by national governments. The role of local government and the need to strengthen its capacity was further underlined in the Commission for Africa report which was taken up at the 2005 G8 meeting in Gleneagles.

In many countries decentralisation of responsibility for key services to local government is well underway. A recent example is the Government of India's National Urban Renewal Mission (NURM), which aims to improve urban infrastructure, including provision of services to the urban poor, and the resource implications of this.

While recognition of the importance of local service delivery and the decentralisation of responsibilities to local government is to be welcomed, it is important that there is equal recognition that this must go hand-in-hand with financial empowerment of local government. Unless local government has adequate resources to deal with its new tasks, it will not be able to deliver the quality of services expected.

The issue of municipal and local government finances is thus fundamental to the debate on local democracy, good governance and effective service delivery through public-sector decentralisation. This is why the CLGF *Aberdeen Agenda: Commonwealth Principles on Good Practice for Local Democracy and Good Governance*, adopted unanimously by CLGF members in March 2005, has 'adequate and equitable resource allocation' as one of its key principles, stating that 'local government must have adequate financial resources to fulfil its mandate and ensure significant autonomy in resource allocation'.

This publication, prepared with the support of ComHabitat, makes a valuable contribution to the debate about municipal finances and resource allocation, and looks at how the *Aberdeen Agenda* can be taken forward. There are many different paths and innovations including private–public-sector partnerships, municipal bonds, direct access to international development agency funds, all of which are increasingly being considered. The key to the way forward is close cooperation between all spheres of government – local, central, state/provincial and intergovernmental – as well as cooperation between local government, the private sector and civil society. Financial resources are always likely to be tight. It is essential that these scarce resources are put to the most effective use in a transparent and accountable way, and that they help promote a pro-poor development strategy which addresses the real needs of the local community.

CARL WRIGHT, SECRETARY-GENERAL, CLGF

Introduction

"It is a paradox that the lowest level of government increasingly has to provide the most comprehensive response to the most complex developmental challenges. Yet the policy-making process and institutional arrangements are often deeply flawed. To meet these challenges, cities need to be transformed from passive service providers to more proactive facilitators of infrastructure and services. However, this transformation cannot occur without imparting real authority, responsibility and resources to local government through a process of empowerment. A vital component of this is strengthening the city's ability to raise resources, create and maintain infrastructure and pay for these costs over time".

Professor Jeffrey Sachs of Columbia University in his contribution to the Cities Alliance Annual Report 2005

The challenge of meeting the Millennium Development Goals (MDGs) is placing an increasing emphasis on local government as the delivery agent for key basic services including: water, sanitation, primary health care, housing, economic and community development. However, the devolution of service-delivery responsibility poses significant difficulties for local government if it is not coupled with sufficient financial resources, greater autonomy and increased capacity.

Addressing this will require:

- Central government commitment to meaningful decentralisation, including the financial and political empowerment of local government.
- Local governments increasing their competency, accountability and ability to work in partnerships with other organisations to deliver innovative and sustainable solutions to basic services, especially for the poor.

The Commonwealth Local Government Forum (CLGF) has been actively helping to strengthen local democracy in the Commonwealth by promoting aspects of good governance such as transparency, public participation, due process etc. These essential principles provide the basic foundation for democratic local government and contribute to more responsive and efficient provision of basic local services. As a result of embracing such principles, the quality of programmes formulated and implemented through public-private-community and donor partnerships have shown encouraging results in several (developing) Commonwealth countries. However, there remains the challenge of how to upscale and replicate such interventions in the face of limited flows of private capital into local schemes. For this reason CLGF commissioned a study to review innovative options for municipal resource mobilisation to meet the MDGs at the local level.

This review sets out the context in which local government is operating; analyses patterns and gaps in local government financing in (developing) Commonwealth countries which presents key lessons and challenges; and proposes innovative resourcing options for municipal service delivery.

SCOPE OF THE STUDY

Resourcing is defined as "the total means available to local government to meet local developmental objectives aimed at increasing the quality of life for its citizens". These includefinancial resources; municipal land and buildings; extensive networks with community, private and international organisations; planning instruments; knowledge of markets; business and financial management expertise; and linkages to the international donor community and finance institutions.

In identifying resources to fund municipal services, financing in the form of central government transfers or through domestic borrowing is critical, but is only one ingredient towards expanding service provision to rapidly growing urban centres.

Even with good data, no single framework can take full account of the highly complex issues involved in assessing an appropriate fiscal role for local governments. Great variations in the internal situation of (developing) Commonwealth countries can influence significantly the ideal assignment of public service responsibilities and revenue generating powers among levels of government, as well as the types of reforms required to deal with existing system deficiencies. Thus, many of the statistics on local government finance are not readily comparable across countries.

Given the scanty quantitative evidence on global trends in local government finance, we have found it more useful to present in this paper some of the key lessons and challenges that global experience suggests should be taken into account by countries wishing to establish sound local finance systems. We also highlight some of the innovative means local government in the Commonwealth has developed to raise and efficiently utilise local, national and international resources to meet local objectives, while also bearing in mind the global MDG targets.

2 CONTEXT FOR LOCAL GOVERNMENT

2.1 Rapid urban growth

The United Nations (UN) estimates that the population of cities in developing countries will increase by 2.4 billion between 1995 and 2025. This impressive scale of urbanisation is such that it will have a significant impact on the already taxed urban infrastructure of cities and towns, and further strain efforts of local governments to address present and future demands for local services.

In Sub-saharan Africa, for example, main cities have typically experienced continued annual population growth of 5 to 6 per cent in the last 20-30 years, while secondary towns have seen population growth of more than 10 per cent – a doubling of the population every decade. Over a similar period the urban population in the Asian and Pacific region has increased by 560 million people (or 260 per cent) and in the next 30 years it is expected to increase by about 1,450 million people (or 250 per cent). This contrasts sharply with rates in more developed countries which have witnessed stabilisation and even reversal.

This unprecedented urbanisation in developing countries presents a challenge to government authorities to meet the needs of modern society.

2.2 Political decentralisation

Political decentralisation means the transfer of policy and legislative power to citizens and their democratically elected representatives at the local level. It is often associated with pluralistic politics and representative government and may require constitutional or statutory reforms, development of pluralistic political systems, strengthening of legislatures, the creation of local political units and encouragement of effective public interest groups.

A number of Commonwealth countries have included local government in their constitutions, formally assigning more functions and greater autonomy to local government.

The extent of decentralisation may depend on central government motives and objectives, primarily political and economic. For example, central government may retain policy-making power while decentralising delivery functions to the local level. Alternatively, it may prefer to decentralise administratively (i.e. deconcentrate central government departments) rather than devolve responsibilities to local government.

Economic motives for decentralisation include reducing demand on national revenue. Political motives may be to maintain political stability by preventing challenges to the ruling party if opposition parties are given a political platform locally. (Urban local governments in developing Commonwealth countries are often a power-base for opposition groups).

Decentralisation and the ability of local governments to carry out their obligations may be hampered by the inadequate transfer of resources, discouragement to fully exploit potential resource options, and failure to develop local technical and administrative capacity.

Such unequal power relationships and lack of coordination at the local level are at the heart of tension between decentralisation and the distribution of resources, so it is important to highlight them for this study.

2.3 Democratisation

Democratisation is about empowering people to participate in and influence the decisions made within their locality. In a politically decentralised system, the policy-making process is brought closer to the people and, at least in theory, is better able to respond to local conditions, and enable implementation.

This requires an effective decision-making process at the municipal level in which local citizens can participate and for which decision-makers can be held accountable. However, in many developing countries the institutional structures and processes for participatory decision-making are either absent or weak. Where locally elected governments have the political and financial powers to pursue and deliver the agenda mandated by voters, encouraging citizen participation in decision-making helps to cultivate a culture of democracy, accountability and transparency.

Thus, designing mechanisms to encourage citizen participation in decision-making is an important part of democratisation. Examples of effective mechanisms include: regular elections, local referendums, community representation in key committees, and other institutional structures. Such mechanisms help local governments to identify and act on citizen preferences.

One way in which some local governments have extended their democratic processes has been through citizen participation in local government planning and budgeting. For some cities this has resulted in significant improvements in the urban environment.

2.4 Increasing role of local government in poverty reduction strategies and meeting the Millennium Development Goals

In recent years there has been a move towards national governments developing poverty reduction strategy papers (PRSPs) with an increasing focus on meeting the 8 UN agreed Millennium Development Goals (MDGs).

Poverty Reduction Strategy Papers (PRSPs) describe a country's macroeconomic, structural and social policies to promote growth and reduce poverty, and associated financing needs. The PRSP approach aims to provide the crucial link between national public actions, donor support, and the development outcomes needed to meet the UN Millennium Development Goals (MDGs).

The Millennium Development Goals (MDGs) are a set of development targets agreed by the international community, which aim to reduce poverty and improving the welfare of the world's poorest by 2015. Urban poverty/MDG focused strategies are commonly referred to as City Development Strategies.

Given global demographic trends, it is inevitable that local governments will have a greater responsibility in the preparation of long-term strategies for investments in health, education and infrastructure to reduce poverty and achieve the MDGs. However, the local sphere and the role it plays in national poverty reduction is often overlooked when determining these policies. Local government is important in the achievement of the MDGs as:

> *"In Asia and Africa 50 per cent of urban residents lack adequate water and 60 per cent lack adequate sanitation"*

- Many of the responsibilities for addressing multi-dimensional aspects of poverty are devolved, or being devolved, to the local level and are, at least, a shared responsibility.
- Diverse spatial conditions require poverty diagnosis and solutions at local level.
- Decentralised planning and budgeting can bring a local strategic approach to policies and budget-making.

2.5 Rising demand for basic services and housing: the challenge at local level

UN-Habitat statistics estimate that in Africa as many as 150 million urban residents (up to 50 per cent of the urban population) do not have adequate water supplies, while 180 million people (about 60 per cent) in urban areas lack adequate sanitation. UN-Habitat also estimates that more than 60 per cent of the urban population live in slums – overcrowded and congested areas and housing, lacking adequate provision of water supply and sanitation, healthcare and education facilities, electricity and adequate shelter without proper tenure rights.

In urban Asia, 700 million people (half the population) do not have adequate water, while 800 million people (60 per cent of the urban population) does not have adequate sanitation. For Latin America and the Caribbean 120 million urban dwellers (30 per cent of the urban population) lack adequate water and 150 million (40 per cent of the urban population) do not have proper sanitation.

2.6 Spending needs of local government to meet rising demand

Whereas political and administrative decentralisation has been commonplace in the Commonwealth, fiscal decentralisation – the control over the local budget – is often inadequate or not clearly defined. This has obvious implications for local government attempts to meet infrastructure and service requirements in their areas. (See Section 4 on Local Government Financial Frameworks.)

Where local government is responsible for infrastructure – such as roads, rail, water supply pipelines, IT infrastructure – it faces a number of challenges and constraints:

- Maintaining and replacing existing infrastructure
- Expanding the network of services improving revenue collection to boost funds for infrastructure spending
- Exploring alternative methods of raising funds for capital expenditure
- Creating constructive alliances with poor communities and commercial finance institutions.

Table 1. Local government spending in selected Commonwealth countries (2003)

Country	Expenditure per person
UK	2,797.97
Canada	1,984.86
India	799.18
South Africa	692.64
New Zealand	588.74
Australia	480.43
Namibia	402.06
Mauritius	180.37
Uganda	107.08
The Bahamas	45.85
The Gambia	19.78
Tanzania	18.11
Ghana	12.22
Kenya	8.69
Zambia	6.14
Swaziland	2.30

Source: CLGF

Table 2. Comparative budgets of selected Commonwealth cities (2003)

City	Population	Total expenditure	Expenditure per person
Dhaka CC, Bangladesh	7,000,000	218,540,000	31.22
Calgary CC, Canada	922,315	1,270,000,000	1,377.00
Toronto CC, Canada	2,418,495	5,420,000,000	2,184.00
Ho, Ghana	235,351	1,371,521	5.83
Sunyani, Ghana	203,267	3,908,835	19.23
Solapur MC, India	873,000	132,200,000	151.00
Surat MC, India	2,755,200	344,800,000	125.00
Wellington CC, NZ	182,600	167,800,000	919.00
Auckland CC, NZ	420,000	246,000,000	586.00
Dodoma, Tanzania	324,347	2,012,141	6.20
Lushoto, Tanzania	419,970	974,300	2.32
London Borough of Ealing UK	300,948	503,072,741	1,671.63
Sheffield City Council, UK	512,000	1,558,023,790	3,043.02
London Borough of Tower Hamlets, UK	196,106	544,446,287	2,776.29
Waveney District Council, UK	112,342	95,733,992	852.17

Source: CLGF

All figures in the comparative spending tables are expressed in international dollars based on purchasing power parity.

Tables 1 and 2, which show local government per capita spending and budgets for selected cities, highlight the severe financial constraints for local government. Meeting the shortfall in the capacity and resources to deliver both current services and future demand for expanding urban services is a clear challenge requiring imaginative and innovative solutions.

Table 3 shows the amount of spending that is recurrent revenue expenditure against spending on capital projects. It shows that expenditure is clearly skewed to recurrent expenditures (and primarily salaries) rather than capital investment. This is another limiting factor on the possibilities for infrastructure and service provision development.

2.7 Other sources of capital funding

More and more it is becoming accepted that local government cannot continue to depend indefinitely on central government and traditional taxes for capital expenditure. Continued declining central transfers will force local government to explore other sources, especially from domestic capital markets and to look at how they can use the resources they have access to and influence over more effectively.

In addition to market-based financing, many poorer Commonwealth countries will require significantly increased official development assistance to meet the MDGs, potentially linked to HIPC/debt relief.

Thus, particularly for developing and emerging countries, a key concern for central and local government is: how to relieve the pressure from slow-growth economies (e.g. Sub-saharan Africa), from increasing urbanisation and urban growth, from declining grants and loans from central government and escalating local government responsibilities without a similar rise in resources?

Table 3. Local government expenditures – recurrent and capital

Countries	Recurrent expenditures %	Capital expenditures %
Zambia (1997)	95	5
Uganda (1997/1998)	84	16
Swaziland (1998)	96	4
Ghana (1996)	31	69

3 A STRONG FINANCIAL FRAMEWORK FOR LOCAL GOVERNMENT

Numerous research programmes on decentralisation and municipal finance have identified the basic ingredients for a strong local government financial framework. They include:

- Clear assignment of responsibilities.
- Authority to adjust revenues to the needed expenditures
- Authority to generate sufficient local government own revenue sources and to develop strong positive incentives to strengthen this
- Strong financial management and accountability systems and procedures.
- Developing an appropriate mix in expenditures and in revenues
- Efficient, democratic and accountable budget procedures
- Appropriate financial relationships between central and local governments
- An appropriate level of redistribution
- Efficient and timely transfers from central to local government
- Effective revenue collection.

International development agencies are supporting public reform policies in some Commonwealth countries as a means of improving local government finances, financial management, and performance in service delivery.

As part of this study, we analysed financial frameworks for local government in a number of Commonwealth countries to see how closely they meet the above framework and are able to meet their service delivery responsibilities.

4 LOCAL GOVERNMENT FINANCE FRAMEWORKS: REVIEW AND KEY LESSONS AND CHALLENGES

4.1 Local financial autonomy

A key mark of local self-government is the ability for a local authority to control its own finances. For this study, a number of Commonwealth countries were examined to look at the extent of their local financial autonomy and the effect of this on local government and services.

Of the Commonwealth countries considered, New Zealand gives local authorities the most financial control. Under its new financial management legislation, local government has greater flexibility and discretion to choose what services it will provide. It also sets greater requirements for accountability of both revenue and expenditure, including explaining to the public why they are incurring the expenditure.

Some countries, Bangladesh for instance, have power for local determination, but lack the financial resources to provide locally determined services. In Malaysia local governments have considerable discretion, but have insufficient funds to carry out few discretionary projects. Local governments in some African countries are reluctant to take on the greater responsibility and accountability that comes with greater autonomy, preferring to leave it to higher levels of government.

The key issue is how finance is distributed between spheres of government. There are three basic questions:

- Who does what? (Expenditure assignment)
- Who levies what taxes? (Revenue assignment)
- How to resolve the imbalance between the revenues and expenditures – vertical imbalance.

Vertical imbalance causes severe financial problems for local government, exacerbated by the increasing reduction in central government transfers combined with the lack of assignment of new revenue sources and restricted autonomy to adjust the present sources.

This section looks at expenditure and revenue assignment, vertical imbalance and concludes with examples of legislative frameworks for local government finance which have tried to address the challenges raised.

There are three key instrumental components of intergovernmental fiscal relations in any country: expenditures, revenues and transfers.

4.2 Matching expenditure and revenue

A basic requirement for efficient and effective local government is the matching principle – where expenditure needs match revenue and revenue capacities match political accountability.

Typical services that local governments are expected to deliver include:

- Water and sanitation
- Drainage
- Solid waste management
- Urban roads and transport
- Housing services (including slum upgrading, land development, site planning, land use, zoning and building regulations)
- Planning
- Local economic and community development
- Primary health care
- Primary education
- Disaster management.

An example of typical responsibilities is given in the inset box below.

Box 1. The Constitution (74th Amendment) Act 1992 of India provides an illustrative list of municipal functions.

These include:

- Urban planning including town planning
- Regulation of land-use and construction of buildings
- Planning for economic and social development
- Roads and bridges
- Water supply for domestic, industrial and commercial purposes
- Public health, sanitation, conservancy and solid waste management
- Fire services
- Urban forestry, protection of the environment and promotion of ecological aspects
- Safeguarding the interests of weaker sections of society, including the handicapped and the mentally retarded
- Slum improvement and upgrading
- Urban poverty alleviation
- Provision of urban amenities and facilities such as parks, gardens, playgrounds
- Promotion of cultural, educational and aesthetic aspects
- Burials and burial grounds; cremations, cremation ghats/grounds and electric crematoria
- Cattle pounds; prevention of cruelty to animals
- Vital statistics including registration of births and deaths
- Public amenities including street lighting, parking lots, bus stops and public conveniences
- Regulation of slaughter houses and tanneries.

The constraints on local government expenditure include:

- Lack of autonomy to set local priorities
- A large proportion of expenditure goes on general public services (administration) and salaries
- A poor relationship between central and local government leading to a budget approval process which is cumbersome, lengthy and often not based on any formally defined procedural guidelines.

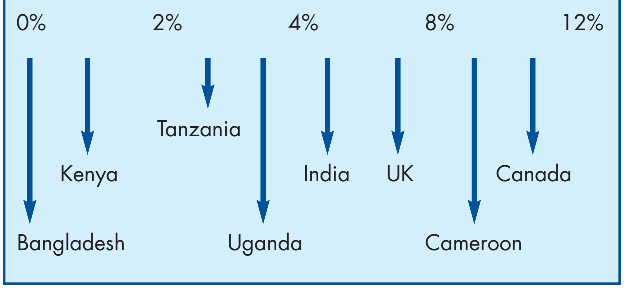
Whilst local government Acts outline clear lines of responsibility as to the types of services municipalities are assigned to deliver, they do not always give them sufficient authority in terms of the ability to manage expenditures and to determine (within limits) revenues to deliver these services.

In most countries there is a fundamental imbalance in the vertical assignment of expenditures and revenues and hence a need for intergovernmental fiscal transfers to close the gap. Even so, limited national funds do not always make sufficient impact in closing this gap.

The key factors in matching expenditure and revenue are:

1. The share of local government expenditure of GDP – for selected developing Commonwealth countries it averages just 2.1 per cent, compared with the unweighted average of 21 OECD countries of 11.1 per cent (see Chart 1).

Chart 1. Local government expenditure as a percentage of GDP



2. The local government share of the general public expenditure – this is also small at less than 10 per cent, compared to 10-30 per cent in Council of Europe countries.
3. The composition of expenditure – for most developing countries this is highly skewed to recurrent expenditure (on average more than 50 per cent goes to wages), and so has a big impact on the scope for development of infrastructure and service provision. An exception to this is Ghana, where central government transfers from the Common Fund are dedicated to capital investments and therefore have a major impact on disbursements at the local level.
4. Dilution of central government allocation – when a small central government budget for infrastructure is allocated to individual local governments on the basis of a formula, each local government will only receive a very small amount annually – not enough to implement any infrastructure projects.
5. Understaffing of local government.
6. There is often a lack of financial monitoring capacity within local government and Ministries of Local Government .
7. Excessive earmarking of funds for particular spending (such as the 'mandating' of local government to spend in accordance with central preferences) – this significantly reduces the scope for effectively managing expenditures by local government, even if they have both the will and the capacity to do so.

4.3 Setting local budgets

Most local governments have the basic authority to adopt and amend their own budgets. The issue, however, is to what extent the authority is constrained by other considerations such as:

- If the local budget depends on the national budget and national sources of funding it would be subject to review and possible amendments.
- Is a local government constrained or limited in its budget implementation? For example, does it have control over local cash management? Is local government authorised to decide where to keep cash deposits? Is it allowed to earn interest on these deposits, or to invest them?
- Are local expenditures subject to prior review and approval by central government before any payments are made?

Evidence from several developing Commonwealth countries in Sub-saharan Africa shows that the budget is often subject to late approval, due to lack of inter-governmental coordination, lack of principles for the approval, lack of central government administrative capacity or other reasons. In some countries, such as Swaziland and Zambia, budgets are often not approved until several months into the financial year. This has severe consequences for medium-to-long-term planning, priority setting and financial management.

A solid local government framework for local budget law and regular external auditing can help combat these difficulties. This framework would not require local government budgets to be subject to prior approval of the Ministry of Local Government as is the case in numerous developing countries, or much of the point of decentralising in the first place is lost.

There are good reasons for central government to work with local government in developing a strong local government budgeting and financial system as it satisfies two essential requirements of good government. First, it will establish the basis for financial control. Second, it will provide reasonably accurate, uniform and timely financial information.

4.4 Local government revenue

A sound local government revenue system is even more important to sound local government finance than a robust expenditure system.

There are two basic principles for assigning revenues to local government:

- 'Own-source' revenues – these should be sufficient to enable at least better-off local governments to finance the locally provided services primarily benefiting local residents
- Local government revenues should be collected only from local residents, businesses and service users.

These groups of tax and user-fee payers should have avenues to input into their local government representatives and spending priorities.

If local governments do not have a significant degree of freedom to set the level and composition of their revenues, neither local autonomy nor local accountability are meaningful. In particular, local government must be able to set tax rates (albeit within limits). Few local governments in developing or transitional Commonwealth countries have this ability at the moment.

Local government should not only have access to those revenue sources that they are best equipped to exploit – such as residential property taxes and user charges for local services – but they should both be encouraged and permitted to exploit other sources. (See Section 5.)

The development of responsible and responsive local government is thus dependent on local government having at least some degree of freedom with respect to local revenues, including the freedom to make mistakes and be held accountable for them. This means that local government must have control over the rates of some significant revenue source if they are to be fiscally responsible and able to innovate as to the way they finance basic services.

Traditional sources of local government revenue are:

- User charges – water, sewerage, refuse, market fees, property taxes etc.
- Tax revenues – local taxes or shared national taxes.
- Central government development loans and grants.
- Overdraft facilities and short-term loans from banks and building societies.
- Long-term borrowing and other sources of revenue for capital expenditure – local government can use relatively well-

developed financial markets to raise funds (e.g. stocks, bonds and loans). This requires a legislative and policy framework for local government borrowing and access to capital markets.
- Municipal property assets (e.g. buildings, land etc).
- Donor funding – grants, loans, and more recently HIPC funds.

Table 4 shows the main internal and external sources of local government revenue.

Table 5 gives more detailed information on the major sources of local government revenue in selected Commonwealth countries.

There are two models that are typical for local government revenues in developing countries of the Commonwealth:

1. Local governments rely very much on their own source revenues, especially taxes and user charges/fees (e.g. Zambia and Swaziland).
2. Local governments are heavily dependent on transfers from central government and/or donor contributions (e.g. Ghana).

Local taxes, user charges and fees are a significant local government revenue source, whereas shared taxes are uncommon and borrowing is an insignificant source of finance in most developing Sub-saharan African countries (Table 6a).

Table 6b shows the composition of local government revenue for more developed Commonwealth countries, which is more diverse especially in relation to investment income and trading surpluses.

The legislative framework created by central government is another important factor. Box 2 below shows an example of local government revenue legislation which defines the authority that local government has over its revenue.

Developing countries in the Commonwealth face a number of challenges in terms of local government revenue:

- Weak local government revenue base – the local government revenue base is weak relative to central government and the tasks assigned to local government.
- Lack of own revenue sources – the composition of revenues is inappropriate, especially the balance between grants and own revenue sources and the way these sources interact. Most of the own revenue sources are seen as unstable.
- Autonomy for revenues – strong central control is imposed on local government revenues; the control is irregular and not

Table 4. Sources of local government revenues

Internal sources			External sources	
Land-based revenues	**Non-land-based revenues**	**User charges**	**Inter-governmental transfers/grants**	**Borrowing**
• Property taxes	• Taxes on households, vehicles, animals etc	• Service charges (water, parking, sewerage etc)	• General purpose grants – regular transfers or formula-based shared taxes	• From governmental sources
• Land fees	• License fees for various businesses and occupations	• Administrative fees, such as building permits, registration, market fees etc	• Grants for specific purposes	• From private capital markets (including international markets)

Table 5. Local government revenue sources in 12 Commonwealth countries

Country	Sources of local government revenue
Australia	Grants and general or special purpose payments of federal and state governments comprise 23 per cent of local government revenues. Other sources include tax on immovable property, fees and fines, net operating surplus of trading enterprises and interest.
Bangladesh	Taxes, rates, fees and charges levied by local bodies, rents and profits accrued from their properties and money received through its services. Government grants, international project funding and loans raised by local bodies are additional sources of income. Taxes are the most important source of income, while loans and voluntary contributions are rare.
Cameroon	Council taxes, business levy and licenses.
Cyprus	Municipal taxes, duties and fees.
Fiji Islands	Revenues from land tax (town rate) and other local incomes such as grants-in-lieu, rental fees, market and bus station fees, business license fees, building fees and parking fees. Most councils also raise loans from the local capital market. Grants from central government are rare.
Ghana	Taxes, user fees and charges.
India	Tax revenue – properties, octroi, professions and vehicles, non-tax revenue – licenses and service charges, grants-in-aid, and state/central government loans and borrowings.
Kenya	Fees and charges, water and sewerage fees, local property taxes and business permits.
New Zealand	Property rates, user charges, fees, fuel taxes and returns on investments. Some central government financial assistance. The rating and charging powers have been provided for in law since 1988 and are an important source of local tax revenue.
Malaysia	Local taxation (assessment rate, rents and fees for services, grants/subsidies given by state or central government. Some local authorities receive grants-in-lieu of rates. Other sources include miscellaneous forms of charges and fees (licenses, payment for various forms of services, rental penalties and compounds and interest).
Pakistan	Tax and octroi (comprising 60 per cent of local governments revenues) and non-tax sources. Property related taxes (such as local rates or leases on all land assessable to either rent, land revenue or use). Tax on the transfer of property and octroi are the largest sources of revenue.
Sri Lanka	Rates, taxes, duties, fees, fines, penalties and other charges as well as money from sales, leases or other transactions, revenues derived from properties and grants from other government spheres.

Source: Kevin Sproats, Local Government in Asia and the Pacific: A comparative analysis of fifteen countries; and CLGF (2005).

transparent; and there is a general lack of flexibility to adjust local revenues to meet expenditure needs.

- Central government transfers: the transfers are not stable or transparent; criteria for their distribution are not objectively defined; and there is a lack of a legislative basis to guide and ensure equitable distribution of transfers.
- Less than full use of the existing local revenue potential – the potential for increases is often more than 30-50 per cent.
- Lack of incentives to generate own revenues.

Table 6a. Composition of local government revenue in five Sub-saharan African Commonwealth countries

Revenue %	**Ghana**	**Uganda**	**Swaziland**	**Zambia**
Own taxes	22	15	67	21
Shared taxes	0	0	0	0
User fees/charges	23	5	5	23
Single source revenues	18	0	1	18
Central government transfers	3	66	17	3
Donor contribution	0	11	0	0
Other non-tax revenues	34	4	5	34
Borrowing	0	0	5	0
Total	**100**	**101**	**100**	**99**

4.5 Intergovernmental transfers

Regardless of the revenue sources made available to local government, transfers from the centre will undoubtedly continue to be an important feature of the financing of local government in many countries. This is because:

- In most countries, the national government retains the major tax bases, leaving insufficient fiscal resources to local governments for covering their expenditure needs (vertical fiscal imbalance).
- Central government has the obligation to maintain a minimum standard of public service in all the local government units. Regions without sufficient resources to reach this minimum level should be subsidised (horizontal fiscal imbalance).

Experience also tells us that no simple, uniform pattern of transfers is suitable for all circumstances. However, the three key factors in the design of intergovernmental fiscal transfers are: the size of the distributable pool; the basis for distributing transfers; and conditionality.

There are three ways in which the amount of money that is to be distributed through intergovernmental fiscal transfers can be determined:

1. As a fixed proportion of central government revenues (e.g. Ghana, Uganda) or some other 'macro' basis, for example, as a percentage of Gross Domestic Product (GDP)
2. On an ad hoc basis, that is, in the same way as any other budgetary expenditure
3. On a formula-driven basis (e.g. Australia, UK). A formula grant uses some objective, quantitative criteria to allocate the pool of revenues among the eligible local government units (for example, population, proportion of families living below the poverty line, infrastructure needs).

In most countries central government transfers money to local government through grants. The type of grant allows the local authority a greater or lesser degree of autonomy in its spending depending on the amount of discretion given. Grants are defined by their purpose and the amount of discretion local authorities have in using them, from general grants, designed and distributed by objective criteria (indicating a higher degree of autonomy), to specific grants made on a discretionary basis and without objective criteria for calculation and distribution (low autonomy).

There are three main types of grant:

1. Specific grants – to ensure local government compliance with national objectives and control
2. General grants – often transferred as unconditional block grants, for local governments to determine the distribution of resources according to their own priorities. These grants are comparably smaller in developing Commonwealth countries
3. Capital grants – earmarked for capital purposes; these are generally modest but are increasing.

If there is no adequate legislative basis to guide and ensure equitable and timely distribution of transfers, such a process is open to manipulation by central government interests.

Table 6b. Composition of local government revenue in four developed Commonwealth countries

Revenue %	**Australia**	**Canada**	**New Zealand**	**UK**
Own taxes	38	41	54	16
Investment income		3	7	
User fees/charges			9	12
Other government transfers	13	41	11	46
Other non-tax revenues	15			
Trading surpluses	32			
Sales of goods and services		15	19	
Redistributed business rates				16

Box 2. Legislation regarding local government revenue, India

To strengthen the urban local bodies with adequate sources of revenues, the Constitution (74th Amendment) Act 1992 provides that a State Legislature may, by law:

- Authorise a Municipality to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedure and subject to such limit.
- Assign to a Municipality such taxes, duties, tolls and fees levied and collected by the State Government for such purposes and subject to such conditions and limits.
- Provide for making such grants-in-aid to the Municipalities from the Consolidated Fund of the State
- Provide for the constitution of such Funds for crediting all moneys received, respectively, by or on behalf of the Municipalities and also for the withdrawal of such monies therefrom, as may be prescribed by law.

4.6 A legislative framework for municipal finance

Policy imperatives point to the need for clear legislation on municipal finance to ensure the effective performance of local government in the delivery of basic municipal services to all communities – urban and rural.

The purpose of legislation on local government finance is to:

- Regulate municipal financial management
- Set requirements for the efficient and effective management of the revenue, expenditure, assets and liabilities of municipalities and municipal entities
- Define responsibilities with regard to municipal financial management
- Determine a financial management governance framework for municipal entities
- Put in place a municipal borrowing framework
- Entrench legal rights for municipalities to access transfer funds that are due to them.

Box 3 shows the legislative framework for municipal finance in South Africa, developed through efforts of strengthened relations between national and city governments.

The South African Municipal Finance Management Act is a reflection and outcome of local government undergoing a major restructuring and transformation in South Africa. The overall objective of such reforms has been to seek to give municipalities sufficient resources and capacity to deliver the services for which they are accountable.

The Act also demonstrates the government's recognition that, in order for local government to deliver and manage basic services, access by municipalities to private capital markets is an important element of ensuring an efficient system of local government. Part of the Act also defines the policy framework in respect of the borrowing powers and procedures of municipalities.

Box 3. Outline of the Municipal Finance Management Act of South Africa 2000

1. Interpretation, object, application and amendment of this Act.

2. National and provincial supervision deals with the intergovernmental aspects of local government financial management. It defines the major relationships between the different spheres of government as they relate to municipal financial management.

3. Municipal revenue sets out conditions for municipal revenue and investments.

4. Municipal budgets defines a process of annual budgeting for municipalities (within a framework of multi-year budgeting), including provisions for regular reporting to their councils and the national and provincial governments.

5. Debt deals with the borrowing of money by municipalities. It limits short-term borrowing to bridge operating cash shortfalls or capital requirements, on the basis of anticipated income streams, grants or long-term debt in waiting. It requires that short-term debt is paid off annually. Long-term borrowing is limited to funding of capital investment. It also sets requirements for the authorisation of municipal debt, without national or provincial approval, and spells out the conditions for providing security. It rules out guarantees of municipal debt by national and provincial governments, other than what is provided for in the Public Finance Management Act. Disclosure requirements for the borrowing of money by a municipality are also set out.

6. Responsibilities of municipal officials defines the responsibilities of officials involved in municipalities' financial management.

7. Municipal budget and treasury offices requires that the municipalities establish Treasury and Budget Offices, under control of a chief financial officer.

8. Municipal entities allows municipalities to retain or establish a variety of corporate entities in terms of other relevant legislation, but also makes it possible for statutory and regulatory limitations and requirements to be imposed on such entities.

9. Financial statements and auditing outlines requirements and procedures for local governments' financial statements and auditing.

10. General treasury matters assigns powers to the National Treasury to make regulations or issue instructions relevant to the Act or specific aspects of the municipal financial management in general and for borrowing by municipalities. Provisions are also set for the creation of audit committees.

11. Financial misconduct is concerned with financial misconduct within municipalities and defines the concept of financial misconduct.

Source: Government of South Africa Ministry of Finance

5 INNOVATIVE RESOURCING FOR MUNICIPAL INFRASTRUCTURE

Given the context described in previous sections, what innovative options are there for local government to mobilise the needed resources to finance and deliver infrastructure and service provision?

5.1 Resources available to local government

Local government owns or controls or has access to a variety of resources that can lever in revenue. Yet, many local governments are unaware as to how much freedom of choice they have over their handling of such resources or how best to utilise them to deliver much needed basic services. Local government resources include:

- Financial resources
- Municipal land, buildings, and other assets for development
- Planning instruments
- Linkages to other levels of government and the international donor community
- Extensive networks with community and private organisation
- Technical capacity to deliver basic services
- Investment finance, knowledge of markets, and business and financial management expertise.

Given this resource-base, the key challenges facing local government in meeting the rising demand for basic services are how to:

- Become more innovative in the way they can tap into long-term private capital from banks and investors to finance infrastructure
- Be more imaginative in the efficient use and leverage of resources for better public service delivery.

This section looks at the prospects for local government borrowing, and gives a review of (non-financial) assets that could be better utilised by local government to generate additional revenue.

5.2 Capital market borrowing

Gone are the days of traditional methods of financing via ad hoc grants and government guarantees. Policy-makers must embrace a paradigm shift for financing basic services today. In order to bridge the recognised financing gap in meeting the MDGs at the local level, central and local government should carefully consider the options for becoming more innovative in identifying and utilising various resources. Broad-ranging local government reforms (e.g. restructuring local authority revenue sources, greater autonomy to revise taxes, deregulation and privatisation, greater community support and participation) have paved the way for cities to mobilise domestic capital, create infrastructure through joint public–private-community ventures, and take responsibility for repayments.

Is borrowing an appropriate and viable option for local government investment financing in the developing world? On the one hand, where there are no institutional, fiscal, and financial frameworks or they are inefficient or there is no financial accountability and thus low creditworthiness, as is the case with many local governments, there must be caution in making the case for local government to take on debt.

On the other hand, local government borrowing is needed to enhance the flexibility of long-term local investment planning. If central government holds local government fully responsible for their investment decisions, local government borrowing can provide local governments with strong incentives for improving project design, cost-recovery practices, budget transparency, and financial management.

Increasing demand for local capital investment is stimulating innovative approaches to expanding local government access to private credit markets, as illustrated by the case study on municipal bonds from Ahmedabad, India (see Box 4).

5.3 The case for local government borrowing

In industrialised countries, local governments often manage 70 per cent of resources for local public infrastructure projects whereas in developing countries it is nearer 30 per cent. Nevertheless, the role of local government in developing countries in planning and implementing capital investment projects is projected to increase as a consequence of four factors:

- Urbanisation and rapid urban growth
- Decentralisation
- Fiscal adjustments to reduce central budget deficits, which have cut back central subsidies for infrastructure financing
- Intergenerational equity considerations – spreading the contributions of capital investments over time so that future residents contribute to capital (recognising that present and future residents will consume the services provided). These investments are best financed through borrowing.

5.4 Constraints to local government capital market borrowing

Local government in developing countries have very limited borrowing powers, even to finance investment projects with a long time-span. A medium- or long-term loan is justified for the financing of investments that will yield benefits in the future, in terms of services to the citizens and revenues (user payment/charges) to local government. On the other hand, too many and large loans might lead to insolvent local government and unstable financial situations. The challenge is to strike the right balance.

Lack of creditworthiness has been one problem. Another has been the inability to develop bankable projects. A third, but to a minor extent, are the strict regulations and cumbersome procedures on local government borrowing. To date few countries have introduced clear rules on local government borrowing. It should be stressed that local government borrowing should mainly be regulated by lenders/the market, based on the creditworthiness of councils.

Some countries use pension funds as credit facilities for the local government, (e.g. Zambia) but generally this source is also limited. Countries differ in the way the center controls local government to ensure that they are acting in conformity with the national objectives. Some countries have developed ceilings and clear and transparent general rules on borrowing (e.g. Ghana) but all countries need more developed and detailed regulation of the purpose of the borrowing, the amount and the conditions, the timing, the procedures for handling borrowing, the sources of borrowing and other technicalities.

5.5 Accessing capital markets

Local authorities can be put into three groups based on their "readiness" to access domestic capital markets for infrastructure financing. Financial condition, managerial skills, and, to a certain extent, size all contribute to the estimation of credit worthiness and possible private market access.

1. The first group is those local authorities that already have access, but could enjoy more and better options given a supportive policy and regulatory environment.
2. The second group are those that do not currently have access to domestic capital markets, but could with various forms of help.
3. A third group are those local authorities that cannot access the market, even through market-oriented intermediaries.

A central question is how to assist those authorities which cover areas that do not have the resources to be self-financing or have an inadequate tax base. Central government assistance to such authorities, through a predictable and stable system of intergovernmental transfers, allows even smaller municipalities to have adequate local revenues. Revenue streams from both local

Box 4. Ahmedabad Municipal Corporation bond issue

In 1996, Ahmedabad Municipal Corporation (AMC) was the first urban authority in India to request and receive a rating for a municipal bond issue for water and sewerage expansion. Ahmedabad's water and sewerage projects were subsequently financed through proceeds from the bond issue.

In late 1994, Ahmedabad Municipal Corporation (AMC) launched a major effort to improve collection of octroi (a tax on various good brought into a town or city) and property taxes and upgrade the skills of its workforce. USAID (the United States Agency for International Development) provided targeted technical assistance to the city and helped build capacity in municipal accounting and financial management, project management and non-tax revenue generation. These measures were designed to improve the AMC's overall financial position.

USAID in association with Mumbai-based Infrastructure Leasing and Financial Services Ltd. (IL&FS), worked with AMC to prioritise its investment proposals, conduct detailed financial analysis of proposed investments, and assist in the technical and financial aspects of a water supply and sewerage project.

As a result, in 1996 Ahmedabad requested and received a rating for issuing a municipal bond to fund water and sewerage expansion. AMC's own revenue, a loan from IL&FS using funds made available through USAID's Urban and Environment Guaranty Programme and other financial institutions including the Housing and Urban Development Corporation and the Life Insurance Corporation of India helped to expand services.

Through the project, Ahmedabad's local government has learned to use bonds as a financial tool to raise investments for its capital investment priorities.

Source: PADCO (2003)

sources and intergovernmental transfers can be used for capital investment in infrastructure.

If a local government has reliable revenue streams, then access to borrowed capital should, in principle, be available. However, private markets may still not be accessible if their financing needs are small, if they do not have the ability to do analysis and planning, or if they do not have the capacity and experience to deal with capital markets concepts and practices, or to design and develop creditworthy urban infrastructure projects. In these cases, market intermediaries and technical assistance could be made available to help bridge these gaps. An example of how this can be achieved is given in the Municipal Infrastructure Investment Unit case study (see Box 5).

Once the municipalities have acquired the necessary technical skills in developing bankable projects, the focus shifts on how to access private capital. An interesting case study is the Infrastructure Finance Corporation Limited, (INCA) of South Africa (see Box 6). This case highlights how enabling policies and actions by national government (such as legal framework for local government reform, financial framework for municipal budgeting, accounting and borrowing, and intergovernmental finance framework) have managed to attract private financing for municipal infrastructure.

Box 5. Municipal Infrastructure Investment Unit (MIIU)

Setting up municipal infrastructure partnerships typically is expensive and requires considerable technical expertise. The South African government realised that, in order to facilitate such partnerships, something was needed to guide the process of preparing and negotiating public-private partnerships (PPPs) at the municipal level across the country and set up the Municipal Infrastructure Investment Unit (MIIU) to do this.

The MIIU manages a grant fund capitalised by the South African national government and a small contribution from the US Agency for International Development.

Local government budgets typically cannot cover the necessary but often costly investigations on the viability of PPP projects. Without such investigations local officials cannot structure bankable projects or negotiate effectively with potential private partners. MIIU's fund provides resources for local governments to carry out feasibility studies, develop project specifications and contract negotiations.

Using an extensive array of decision-making criteria drawn from similar work in other countries, the MIIU provides grants to PPPs that it considers have greatest potential for success. The projects are selected from a nationwide list of projects proposed, on a demand-driven basis, by any of South Africa's towns and cities.

Source: The Municipal Infrastructure Investment Unit: The Government's PPP Enabling Strategy

5.6 Conditions for a successful local government finance system

Central governments have a key role in creating the right conditions for a successful local government finance system. Central governments can provide an environment to promote marketability of local authorities' debt through:

- Appropriate macroeconomic and regulatory policies – especially those which are conducive to the accumulation of resources to invest through long-term savings pools – to help municipalities have access to borrowing
- The removal of the bottlenecks to private banks lending to local government units and levelling the playing field with government finance institutions
- Devolving sufficient powers to local government.

Central government can also contribute to addressing the fundamental challenge of developing comprehensive financing programmes that will allow local government to meet infrastructure needs without putting unnecessary stresses on tax payers through public subsidies. Access to central loans, loans subsidies and other types of financial assistance can aid local utilities to structure and restructure their debt to achieve low-cost, low-risk debt and to minimise debt service costs over the long-term. Without such financial support, private debt through issuing municipal bonds can be expensive and ultimately will be sustained only by substantial local tax increases which are politically undesirable.

Local government can create an enabling environment through:

- City development strategies
- Capital improvement plans
- Improvements in financial management and accounting
- The development of a comprehensive public information system on local government finances and local government debt

Box 6. The Infrastructure Finance Corporation Limited (INCA), South Africa

INCA is an infrastructure debt fund in South Africa that is 100 per cent privately owned and operated. It was established following a call by the South African government for increased private-sector involvement in infrastructure funding.

It draws on local and international market funds, raised through a series of INCA bond issues and long-term loans. Shareholder capital is another source of funding. It also has a commitment to have funding available from the issue of Junior Bonds in the future.

INCA's borowers include municipalities, water boards and other statutory institutions to establish social and economic infrastructure in South Africa. Funding has mainly been in the form of long-term fixed interest rate loans.

INCA's loans vary between five to 13 years, depending on the repayment profile of the funds that INCA has itself raised on the local and international capital markets. Normally INCA would have a number of different sources of funding available, and the most suitable option would be offered to the borrower. Typical long-term funds available on the capital markets require six-monthly interest payment with a bullet capital repayment. INCA loans can also be amortized (regular payments that pay off both interest and principal sufficient to pay off a loan by maturity).

INCA is actively involved in work to build capacity in local government. With assistance from the government of France, INCA established the French Fund to finance capacity-building on a grant basis. INCA also assists local authorities with long-term financial planning, and has a forecasting model to assist municipalities to calculate maximum levels of affordable borrowing.

- Effective procurement procedures;
- Increasing own-sources of revenue (by improving billing and collections, improving operating efficiency etc)
- Sustainable partnerships with the private-sector, NGOs and organisations of the urban poor.

5.7 A policy framework for municipal borrowing

Local governments in many (developing) Commonwealth countries are undergoing a major restructuring and transformation process. The overall objective is to give municipalities sufficient powers, resources and capacity to carry out their extensive responsibilities in respect of the development and management of the services for which they are accountable.

Governments are becoming increasingly aware that private finance will need to form an important source of funding for capital investments in the municipal sector. However, unlike the past local government borrowing will no longer be guaranteed by the central counterpart and will now have to raise private finance on their own books and bear the responsibility for servicing the debt.

This now requires the introduction of a legal and regulatory framework that clarifies the rights and obligations of borrowers and creditors. It would further provide municipalities with the incentives to perform their functions effectively and manage their fiscal and financial affairs prudently in order to be able to attract significant investment from the private sector.

In South Africa the policy framework – highlighted in the Municipal Finance Management Act (see Box 7) – clarifies the rules in three areas:

- Municipal borrowing powers and procedures
- Information disclosure and market regulation
- Executive, administrative and legal procedures when municipalities encounter financial difficulties.

From the private-sector/investor perspective, the conditions for borrowing for central and local government to tap into domestic capital markets are:

- Revenue flows to local governments, including transfer payments, that are predictable over time, which involve significant local control, and which allow long-term budget forecasts and loan repayment forecasts to be made.
- Good management systems including well-designed, transparent procedures for investment planning, procurement, operations, maintenance, budgeting, financing and reporting, and trained professional staff to implement the management systems.
- Modern accounting, auditing and disclosure standards.
- The timely provision of comprehensive public information about budgets, finances, and debt in a format that is uniform across local governments.
- Policies that promote private and corporate style operation of public services and which carefully manage the contingent liabilities assumed by local governments.
- Policies, and a legal, regulatory and tax system that promotes a competitive, level playing field among private and public financial institutions, that promotes competition between bonds and bank loans, and that is flexible in accommodating the needs of new financial products.

If these basic conditions are in place, supporting institutions will emerge over time including private credit-rating agencies, bond insurance companies, and secondary trading institutions.

International development institutions can also assist local government in accessing private capital markets.

Beside continued reforms aimed at improving local government finances and financial management, the need to create bankable infrastructure projects is key to facilitating the development of viable capital markets for municipal finance.

Municipalities in developing countries require more extensive technical assistance for capacity-building, feasibility studies, project development, procurement, political, environmental and social analyses, and monitoring. Given the financial constraints, these should be supported by donor grants. They also require a range of financial instruments (loans, bridging finance, or other credit enhancements) to enable municipal projects to be viewed as a viable investment opportunity by private finance institutions.

Local governments in emerging and developing economies are increasingly seeking ways to raise debt on private credit markets to finance local investments. Municipal credit assessment has become an important topic for investors and policy makers. Therefore, municipal credit evaluation needs to respond specifically to the concerns of potential domestic and foreign lenders and investors as they evaluate credit demand and investment proposals by local governments. To this end, there is a need to build and improve the municipal information systems upon which ratings are predicated.

The need for commitment from the donor community to stay the course over the mid- and long-term to support technical assistance is critical to generating a functioning municipal finance system accessible to cities who want to improve their financial, technical and operational capacity to deliver basic services. Such assistance would include, for example, project preparation, partial guarantees, bridging loans, and grants.

Box 7. South Africa's policy framework on borrowing powers and procedures of municipalities:

- Gives all municipalities equal borrowing powers in law.
- Allows municipal entities to borrow; the extent of such borrowing remains a decision of the municipality itself. Insofar as the borrowings of municipal entities are underwritten by the municipality, the issuing of any and all such guarantees constitutes an act of municipal borrowing and the resultant liabilities are recorded on the municipal balance-sheet.
- Allows municipal borrowers and lenders broad leeway to craft security provisions to meet their needs (including revenue bonds, tariff covenants etc), provided that minimum essential services – which need to be clearly defined – are maintained at all times.
- Ensures that existing debtholders are not unfairly prejudiced by a deepening of municipalities' rights to enter into new security covenants.
- Requires that borrowing is authorised by municipal councils at the recommendation of the chief executive, without the need for national or provincial approval.
- Provides that short-term borrowing may be authorised either by council resolution in each individual instance or by a general resolution that the chief executive may borrow up to specified limits.
- Allows municipalities to determine their own debt levels.
- Ensures that borrowing is not used as a source of funding for current budget deficits.
- Limits short-term borrowing to the amount required to bridge operating cash shortfalls in anticipation of specific and realistic future income streams to be realised within the fiscal year and/or to bridge capital requirements in anticipation of specific grants to be received or long-term debt to be issued within that fiscal year.
- Prohibits the borrowing of money in foreign currencies.
- Requires short-tem debt to be paid off annually, and remain paid off for a reasonable period, with both borrower and lender responsible for enforcement.
- Limits long-term borrowing to funding of capital investment in property, plant and equipment.

Source: Municipal Finance Management Act (2000) South Africa Department of Finance

5.8 Non-financial resources available to local government to generate additional revenue

Developing and managing urban development (shelter and services) requires human and financial resources. Such resources are generally domestically sourced and mobilised, at the national and local levels, in all countries.

Most cities and towns in Commonwealth countries have substantial fixed-capital assets (land, buildings etc). If these are properly surveyed, mapped, documented, registered and appropriately exploited, they could finance a substantial part of their investment on infrastructure and services development.

Local governments also have 'soft' assets in the form of business and financial management expertise, extensive networks, and adequate capacity which can contribute to efficient basic service delivery. These create opportunities for local governments to leverage private investment through partnerships with the private-sector and community groups. The challenge remains as to how they can find creative ways to utilise resources such as land to generate much needed revenue for infrastructure provision.

5.8.1 Innovative planning instruments for land and real estate development

While central government often imposes rigorous limitations on the right of local governments to establish their own taxes, set tax rates or borrow from the credit market, there are often less limitations on the rights of local governments to own, operate, acquire or dispose of discretionary assets. The examples from India and the United Kingdom (see insets) provide interesting examples of planning instruments for land used for social objectives.

5.8.2 Innovative partnership approaches to service delivery: community contracting

The experiences on Public–Private-Partnerships (PPPs) from around the world show that with committed governments and an experienced private sector it is possible to address the needs of the poor. The experience also shows that involvement of the private-sector, even foreign contractors, does not guarantee success. However, even where there have not been immediate improvements in service to the poor, the introduction of the private sector is undoubtedly a powerful force to 'unfreeze' the existing situation and to overpower the 'restraining forces' which have limited the results from the existing government providers.

There are many factors to be taken into account in the development of PPPs but perhaps the most important is that serving the poor is one of the prime objectives. In such a case the most appropriate partnerships able to deliver have to be devised. An interesting example that has sought to do just that is Public-Community Partnerships in Mumbai (see inset).

The institutionalisation of partnerships is another concern. Research on local politics and performance highlights that political decisions are strongly influenced by the short-term horizons of the political process, with short-term visible impacts taking precedent over the long-term tasks required for sustainable service delivery. A political cycle dictated by short-term interests is not conducive to innovations. Hence, there is a need to develop partnership mechanisms and processes that sustain innovations into the longer-term.

The Indian Alliance dealt with these difficulties by being non-political and developing a complex affiliation with whoever is in power at the federal and state level, and within the municipality of Mumbai. This approach is based on the Alliance's ingrained culture of accommodation, negotiation and long-term pressure rather than of confrontation or threats of political reprisal. Unlike limited political cycles (e.g. mayor term in office) it calls for patience, long term asset-building and cumulative successes.

Box 8. Planning Gain in the United Kingdom

Planning Gain is defined as:

"The arrangements whereby local authorities, in granting planning permission, achieve planning and other community gains at the expense of developers".

The intended outcomes of planning gain are seen as:

1. Removal of obstacles to the implementation of planned development
2. Paying for the provision of infrastructure and other public services
3. Paying towards the provision of infrastructure and other public services
4. Mitigation of development impacts
5. Compensation for development impacts
6. Recovery of "betterment" (i.e. any increase in the value of land as a result of the development).

Planning gain has resulted in many circumstances in social housing and improved infrastructure in deprived neighbourhoods. Typically developers are permitted to build housing for higher range private sales on the condition that they also build a percentage of low-cost housing.

Box 9. Slum Rehabilitation Act and transferable development rights in Mumbai, India

The Slum Rehabilitation Act states that:

"A slum landowner, a cooperative society of slum dwellers, an NGO or any real estate developer having individual agreements with at least 70 per cent of eligible slum dwellers is entitled to become a developer. Under the Act, every family is entitled to a unit whose floor space is 225 sq ft (21m^2), and developers implementing slum rehabilitation projects must provide this unit free of cost to slum dwellers occupying the land".

The Act gives incentives to developers to develop in slum areas of Mumbai. They can make a profit by selling for-sale units permitted for development (i.e. plots where the slum population density is low) and/or Transferable Development Rights (TDR) on the open market. TDR is awarded and sold per square foot; the amount generated by a development is dependent upon the location of the plot and building design – for instance the size of tenements, number of tenements and for-sale units. TDR can be used by the holder for development on other lands in specified areas of the city, the location of which depends on where the development that generated the TDR took place.

Dharavi, a suburb of Mumbai, is reputedly Asia's largest slum. More than half a million of Mumbai's 14 million inhabitants live there. The Bharat Janata Scheme is a community-led scheme to upgrade 147 slum dwellings in the middle of Dharavi. The Scheme received financing from the Community-Led Infrastructure Finance Facility (CLIFF) – a multi-donor programme to facilitate the demonstration of community-driven solutions to slum development – which could then be replicated and scaled up. The Scheme consists of five buildings containing 197 residential units (of which 50 are for sale) and 8 commercial units. Construction began in 2003 following four years of planning and site clearance.

The Bharat Janata Scheme demonstrates that it is possible to develop viable housing schemes in areas of Dharavi that do not have the commercial advantages of a road-side location, and that slum communities can manage them. It shows that sales from residential and commercial units, in combination with Transferable Development Rights obtained under the SRA, can produce enough revenue to fully cross-subsidise such housing schemes.

5.9 Financial management expertise
The need to tap into several forms of financing for infrastructure development, whether it is for initial feasibility and project initiation financing through construction and longer-term project operations, necessitates the development of a broader range of skills for local government employees. Local government is increasingly developing the skills of its finance managers, particularly in budget management, financial analysis and borrowing/credit evaluation (to evaluate credit-worthiness and debt carrying capacity). They are further becoming more knowledgeable of the various sources and types of infrastructure financing. They are learning how to borrow prudently and successfully from capital markets by making use of new concepts and analytical techniques. This enables government officials to select the best projects and develop appropriate investment priorities; understand what they can realistically afford in future years; and compare the cost and risk of alternative strategies to finance capital improvements.

The following section highlights innovative programmes that local governments have been able to tap into thanks to the development of the skills and public-sector reforms.

Box 10. Mumbai sewerage disposal project
Historically in Mumbai (formerly known as Bombay), the provision of toilet blocks has been through public agencies without any involvement of communities in the designing, planning, building and maintenance of these facilities. However, public toilet blocks have been poorly managed and maintained, and the service rapidly becomes defunct. Up to 900 people use a single toilet, and surveys suggest that up to 75 per cent of existing facilities are not functioning. As a result, people are forced to defecate in the open, which is a particularly difficult situation for women and results in dangers to public health.

The Indian Alliance (a partnership between women's savings groups, National Slum Dwellers Federation and the NGO SPARC) offered an alternative. The Indian Alliance's suggested a new division of roles: the City should pay for the capital cost of toilet construction (no more than the cost of contractor-built toilets that the municipality was used to funding), and the communities would manage and maintain the toilets themselves and generate the funds to do so. Thus, the sanitation programme would be implemented through NGOs and Community Based Organisations already active in those slums. The relationships involved in the construction of toilets challenged all the institutions concerned, particularly as, for an initial project, the scale was huge.

5.10 Knowledge of international donor programmes
International development agencies (e.g. World Bank, United Nations, etc.) are actively supporting Public-Sector Reform Programmes with a view to developing the necessary human resource base to effectively and efficiently deliver public services. They are also providing a range of technical assistance facilities focused on addressing the policy and regulatory constraints to private-sector participation in infrastructure service delivery (e.g. Public-Private Infrastructure Advisory Facility, Public–Private Partnerships for the Urban Environment etc).

Other facilities geared to attracting private-sector financing for infrastructure include Emerging Africa Infrastructure Facility, GuarantCo, USAID Development Credit Authority, Community-Led Infrastructure Finance Facility and the Slum Upgrading Facility. Others focus on assisting local governments in developing city development strategies and city-wide upgrading programmes (eg Cities Alliance and UN-Habitat). For more information see ComHabitat's overview of existing International Financing Facilities for Slum Upgrading and Infrastructure Provision in developing countries.

The aforementioned donor-sponsored facilities have a role in supporting capacity-building within central and local government in (developing) Commonwealth countries. Now that local governments in emerging Commonwealth countries such as India have more capacity, they are now better able to identify domestic capital sources and utilise various types of financing for infrastructure projects. An overview of public-financing instruments available is given in Annex 1.

5.11 Extensive networks with community, private and international organisations
Developing networks and partnership arrangements that can contribute to sustained improvements in municipal service delivery is often a neglected or unappreciated task in local government.

Providing services for the poor requires the involvement, at some level, of all stakeholders including: community based organisations, non-governmental organisations and other civil society entities; public government bodies at ministry, regulatory and municipal level; international public bodies, the donors and multi-laterals; small and medium enterprises, as well as larger private-sector organisations; the media, lobbying NGOs, international NGOs and the academic or knowledge community.

With so many disparate interests, formal agreements between the stakeholders to promote efficiency and effectiveness can be beneficial, but informal relationships, which ensure recognition and representation, are also valuable. The power of these partnerships – contractual, institutional and relational – is critical to the success of the ongoing reform and universal service.

Local governments that have developed and maintained strong networking and partnerships arrangements have benefited from increased knowledge and managed to effectively utilise the valuable contributions that each partner brings towards realising a shared vision to city development.

6 SUPPORTING INNOVATIONS IN FINANCING MUNICIPAL INFRASTRUCTURE

The lessons and challenges outlined in this paper on how local government can muster various resources for infrastructure delivery suggest that countries in the Commonwealth should give serious consideration to:

1. Full commitment to decentralisation: without a complete commitment towards meaningful decentralisation local governments will remain severely constrained in their ability to fulfil their mandate, in turn affecting central government's ability to fulfil its full role.

2. Given global knowledge on decentralisation, municipal finance and service delivery central government should think outside the box and create an appropriate framework combined with the right incentives for local government to be more innovative and accountable in the way basic services are funded and delivered.

3. Central and local government need to be more aware of donor-sponsored initiatives geared to attracting private finance for municipal infrastructure; the various sources of domestic capital for long-term investment;

and be realistic about the options. However, for many local governments in developing Commonwealth countries, knowledge of such finance facilities like the Slum Upgrading Facility (SUF) and the Community-Led Infrastructure Finance Facility (CLIFF) is limited.

There is an opportunity here for councils to work with their local government associations (LGAs) to identify their specific needs and demands, to be made aware of the operations of donor-sponsored facilities and whether they would be accessible, and to ascertain whether there is a need for other type of initiatives. As part of the follow-up work CLGF will explore in greater detail and with the direct cooperation of LGA (in possibly four countries) what assistance, information, access to support and resources their members require.

4. CLGF should investigate options for local governments affected by natural disasters. Local government is looking to increase its role in reducing the risk of disasters by developing risk reduction strategies and undertaking specific actions and measures to mitigate risk, for example surveying the vulnerability of existing building stock and enforcing compliance with construction and building codes.

5. Central and local government must make better use of its networks to identify innovative best practices in municipal infrastructure financing from partner Commonwealth countries and encourage learning exchanges. They should also review how local government finance is being treated through training. (See Annex 2 for examples.)

6. Central government must encourage and give local government adequate capacity to pilot innovative infrastructure financing schemes. This should complement reforms to improve service delivery.

7. Central and local government should seek technical assistance from international donor, finance and non-governmental organisations in developing pilot infrastructure projects geared to accessing domestic capital markets. They should further encourage better donor coordination as to information on and access to finance facilities.

7 CONCLUSION

The trend towards decentralisation throughout the Commonwealth has often been characterised by the transfer of responsibilities to local government without the commensurate resources to deliver adequate services. This paper has highlighted a number of challenges facing local government in the field of resourcing and has shared several examples of how local government has been able to raise finance, lever-in extra resources and make the most of its limited financial capacity. It also highlights a number of steps that government ministries can take to enable local government – whether through legislation or by supporting central advisory bodies.

The Commonwealth comprises an array of local government arrangements. In some the fiscal and political autonomy is high, while in other it is quite limited. The question that this research leads us to ask is whether those limitations are having an adverse impact on local development or not? The paper highlights that controls such as annual auditing can exert control without imposing developmental limitations. They can in fact, enable local government to access private-sector funds that require demonstrably secure financial management.

Whilst raising the issue of local fiscal autonomy, it also recognises that a level of financial redistribution is critical, particularly in those countries where development has been quite uneven. However, this may be implemented – grants, redistribution of the national income, formula-based mechanisms – predictability is vital in order to make planning possible and effective. This predictability of revenue – both locally-raised and through intergovernmental transfers – is critical for local government seeking to engage in more innovative forms of financing.

Accessing capital markets is a relatively new idea in many Commonwealth countries. The role central government plays in supporting its local government to make use of these markets is essential to their success. A number of options have been pursued successfully.

As international development agencies give increasing recognition to the role of local government it is vital that local government associations are provided with up-to-date information on how to access those agencies' funds for their members.

There are several issues highlighted here that CLGF can take forward in consultation with its members and partners to support more innovative financing of local government services and to make private and international funds more available to local government to boost its developmental role.

ANNEX 1: INFRASTRUCTURE FINANCING SOURCES AND STRUCTURES

(Reproduced from an article by Dr Michael Cobb – 2002)

For infrastructure project development, several forms of financing can be sought, from initial feasibility and project initiation financing through construction and longer-term project operations. An overview of various public-financing instruments available is presented.

Sources and types of financing:

1. **Feasibility Studies and Demonstration Projects**
   Loans or grants provided by governments and donors for financing the costs of preparing feasibility studies, business plans and in limited very defined cases, demonstration projects.

2. **Venture Capital and Infrastructure Funds**
   Start-up financing from traditional venture capital groups for new enterprises is not usually available for infrastructure projects due to the high cost of due diligence and limited exit options for these firms.

   Typically, high rates of return, often 25-50 per cent, are also required. However, a number of special purpose international investment funds have been created by large insurance companies and other major corporations for investing in major infrastructure projects.

3. **Non-recourse or Project Finance**
   This refers to projects financed on the basis of projected cash flows of the project rather than on the credit-worthiness of the borrowers or project's sponsors.

   Understanding and allocating risks among all parties are key components in project finance, and extensive project preparation and documentation regarding purchase or supply contracts and other documentation is required.

   Also, because of the lack of collateral, lenders require substantial equity participation by project developers.

4. **Corporate Finance**
   Corporate finance, in contrast to project finance, bases debt and equity financing on a corporation's project earnings and balance sheet, with its asset base as collateral for the debt financing. This form of financing is only available to financially strong established companies.

   Equity Financing involves providing funding in return for an ownership interest in the project or enterprise. Returns are in dividends on equity shares and in appreciation in share values.

   Debt Financing involves loans secured by the assets of a corporation or project. Lenders typically require substantially more collateral than their exposure, which usually means that major portions of a project, often 25-50 per cent, be financed through equity.

5. **Export Credit Finance**
   Export credit finance, also termed trade financing, can be available to finance the export of goods and services from countries. It usually requires letters of credit from qualified local banks to assure repayments to the lenders in the exporting country.

6. **Public Finance and Bond Funding**
   Public finance, often termed municipal or special authority borrowing, addresses public-sector projects, and increasingly public–private integrated projects. Resulting project debt is usually based on overall tax revenues (general obligation bonds) or targeted revenues streams from specific projects (revenue bonds).

   Until recently, the distinction between public- and private-financing was mostly clear; in recent years integrated public–private revenue and cost-risk sharing arrangements are creating hybrid structures where public- or private-financing distinctions are not completely separate.

Public Finance Instruments

There are many types of public-finance instruments used in industrialised, emerging and developing countries. These include:

- General obligation, tax increment, sales tax and assessment bonds
- Revenue bonds related to industrial power supply, water supply-wastewater treatment, airports, ports, solid waste disposal, parking, mass transit and other revenue producing projects or programs.

Other types of public-finance instruments include:

- Refunding bonds
- Grant and bond anticipation notes
- Commercial paper
- Variable rate demand notes
- Leveraged leases
- Sale/leasebacks
- Lease financing certificates of participation
- Swaps
- Installment sale contracts and other secondary market derivative products.

7. **Guarantees or Credit Enhancement Programmes**
   Multilateral agencies, national governments and other sponsors often provide insurance, guarantees or other forms of credit enhancement mechanisms, such as subordinated debt, in order to make projects more attractive to investors, project lenders or investors. These credit enhancement mechanisms help reduce and reallocate project risks among lenders and investors in order to make a project more attractive.

ANNEX 2: EXAMPLES OF GOOD PRACTICE IN MUNICIPAL FINANCE

1. Accessing domestic capital markets for water and sanitation

*Case study 1: Ahmedabad Municipal (*Corporation Bond Issue, India)

In late 1994, the Ahmedabad Municipal Corporation (AMC) launched a major effort to improve collection of octroi and property taxes while at the same time taking an important step to professionalise its workforce. USAID began to provide targeted technical assistance to the city and build its capacity in municipal accounting and financial management, project management and non-tax revenue generation that would improve the AMC's overall financial position.

USAID, in association with Bombay-based Infrastructure Leasing and Financial Services Ltd (IL&FS), worked with AMC to prioritise its investment proposals, conduct detailed financial analysis of proposed investments, and assist in the technical and financial aspects of a water supply and sewerage project.

In 1996, Ahmedabad became the first urban authority in India to request and receive a rating for a municipal bond issue for water and sewerage expansion. The capital raised from this bond issue. Along with AMC's own revenue, a loan from IL&FS using funds made available through USAID's Urban and Environment Guaranty Program and other financial institutions including the Housing and Urban Development Corporation and the Life Insurance Corporation of India, financed Ahmedabad's water and sewerage projects.

As a result of this project, Ahmedabad's local government has learned to use bonds as a financial tool to raise investments for capital investment priorities.

Case study 2: Tamil Nadu water and sanitation pooled fund, India

To facilitate small and medium towns' and cities' access to the domestic capital market, a Water and Sanitation Pooled Fund (WSPF) was set up as a pure debt fund. WSPF acts as a bond bank with a reserve fund coming from the state government. Funds are raised by bond issues and disbursed as sub-loans to the participating municipalities. An asset management company, Tamil Nadu Urban Development Infrastructure Financial Ltd., 51 per cent owned by private investors and 49 per cent by the state government, manages the trust.

For servicing the debt, the WSPF requires municipalities to maintain an amount equivalent to their one-year debt service payments in short term fixed deposits of AAA-rated corporate or highly liquid investments, such as government securities or treasury bills. The local authorities' cash flow/bank account (or current account) will be escrowed to the extent that, at a minimum, an amount equivalent to one-year principal and interest is available in the escrow account 90 days prior to the due date of debt servicing.

Apart from this escrow, a separate Debt Service Reserve Fund (DSRF) has been established and maintained by the state government in the form of low risk, short term fixed deposits. The amount of the DSRF will be equivalent to 1.6 times the principal and interest payments due to bondholders. In case of default of the escrow mechanism, the DSRF will be automatically triggered for servicing the bondholders. Through a government order, state government will replenish the DSRF, if necessary, by intercepting state disbursement of transfer funds to the municipalities.

As a final means to ensure repayment to bondholders, up to 50 per cent of the outstanding principal and interest payments are guaranteed by one or more Indian financial institutions, while up to 50 per cent of these payments are guaranteed by USAID's Development Credit Authority. With up to 50 per cent of the bond issue repayments guaranteed by a strong, private-sector financial institution, and up to another 50 per cent guaranteed by the full faith and credit of the US Government, Indian credit rating agencies and institutional investors view these bonds as attractive investment opportunities.

2. Mobilisation of capital funds by urban local authorities

Case study 3: Zimbabwe urban councils raise capital

A section of the Urban Council Acts of Zimbabwe provides that urban councils can have the following as optional sources of revenue:

- Loans from the Local Authority Pension Fund
- Loans from the Municipal Provident Fund
- Loans from the Municipal Medical Aid
- Loans from another Local Authority
- The issue of stocks, bonds debentures or bills.

The cities of Harare and Bulawayo have raised funds through bond issues in the capital market. Bulawayo City Council raised $100m in 1996 and another $100m in 1997 from the issue of stocks. This was used for the construction of factory shells, fire stations, refuse disposal tipping sites, bridges, roads, schools, sewerage and water reticulation among others. Mutare City Council also raised money from its Pungwe water project from the same source.

Between 1997 and 2001 Gweru City Council depended on external funding as an option for capital expenditure. The $72m borrowed from the money markets in 1997/1998 was derived from the issue of stocks for $32m and a $42m loan from the Local Authority Pension Fund.

3. Issuing bonds with a partial credit guarantee

Case study 4: Johannesburg bond issuance with a partial credit guarantee

South Africa's reforms created a sound legal framework for municipal governance and finance, through:

- Integrated metropolitan cities, enabling the provision of services to formerly disadvantaged areas.
- Clear delineation of expenditure and revenue responsibilities among three tiers of government.
- Predictable intergovernmental transfers, no central government guarantees for municipal borrowing, a clear framework for resolving events of municipal financial distress.
- A high degree of transparency, disclosure, and stakeholder consultation.

Johannesburg had large capital expenditure plans to address service backlogs, deferred maintenance, and population growth. The city's borrowing requirements were too large for traditional bank loans (single obligor limits) and there was a need to diversify financing sources, and extend maturity of debt to match asset life.

Capital finance was needed to:

- Finance the capital expenditure plans of the City and its utilities (capex program focused on water, urban streets and electricity distribution).
- Retire some existing, high-cost debt.

To raise this money, the City of Johannesburg created a 'Central Treasury' bond issue, backed by its aggregate revenues (general obligation), with a negative pledge clause on 'major assets'.

The bond issue was in two tranches:

- April 2004 – six-year bullet bond without enhancement. ZAR 1,000m = US$150m)
- June 2004 – 12-year enhanced bond with three-year amortization. ZAR 1,000m = US$150m (*Municipal Fund)*

Partial guarantee

The City successfully issued a six-year bullet bond in April 2004, without enhancement. However, the City was also looking for funding beyond 10 years – but they could not issue beyond six or seven years at an acceptable price without credit enhancement.

Structure and amount

- Irrevocable guarantee of due and punctual payment of principal or interest up to the Guarantee Amount ('first pay-out' guarantee).
- 40 per cent of Bond principal, reduces by the amounts paid by Guarantors, but can be reinstated on cure of default.
- Issued by IFC (AAA International) and the Development Bank of Southern Africa (DBSA – AAA Local).
- Guarantee payout results in a one-year loan between Guarantors and the City.

Structuring the guarantee this way meant that for bondholders the probability of default decreased and there was an increased chance of recovery in the circumstances of a default.

Outcome

- Enhanced bond rated AA-.za (Fitch), a three notch upgrade from Johannesburg's standalone rating of A-.za.
- Issue over-subscribed 2.3 times, showing strong market endorsement of both the issuer and the enhanced structure.
- Strong investor demand allowed for tightening the spread (164 basis points above Treasury benchmark = 71 bp less than the non-guaranteed six-year bond issued in April 2004 – in spite of the longer-tenor.
- Long-tenor improves the City's debt service profile.

In the longer-term, this type of capital fund-raising has created a new asset class as a benchmark for long-tenor municipal debt in South Africa, and become a model for the Development Bank of Southern Africa, with potential replication in other cities.

4. Tax sharing between central and local government

Case study 5: Uganda transfer system

Uganda has recognised that effective local governments must have adequate resources to meet their responsibilities under decentralisation. Rather than reducing local claims on the national budget, the government developed very significant, rule-based intergovernmental transfer programmes that account for a substantial proportion of total central government revenues.

In 2000 in Uganda local governments accounted for 28 per cent of expenditure, but they raised less than 8 per cent of revenues.

The most important source of local revenue (and outside the capital Kampala the dominant source, accounting on average for 70 per cent of local revenues) is the graduated personal tax (GPT), an unusual and complex hybrid of a pay-as-you-earn income tax, a presumptive income tax, a wealth tax and a poll tax.

Uganda's transfer system is designed to provide three types of grants: block, equalisation and conditional. The system is not yet fully implemented, but it is already significant, representing nearly 24 per cent of the central government budget and nearly 80 per cent of local government revenues (less in the larger urban municipalities).

More emphasis has been given in Uganda to the development of intergovernmental transfers than to improving local sources of revenue, and there are not adequate incentives in the transfer formulas to encourage local revenue generation. Local revenue yields have not increased significantly under decentralisation, and grants still account for the bulk of local revenues (typically greater than 80 per cent outside a few larger municipalities) and increasingly substantial portions of central revenue. In addition, there are serious questions about the clarity of objectives and the accuracy of the data in the transfer formulas being used.

5. Increasing local government revenue through reform

Case study 6: Local government reform in Tanzania

The local government reform programme (LGRP) in Tanzania has contributed to positive changes in local authorities' provision of basic services to the public, enhanced capacity for financial management and revenue enhancement, improved governance, including accountability and responsiveness of the local government. The main components of the programme are:

- Governance – establishing broad-based community awareness and participation, aimed at promoting principles of democracy, transparent and accountable government.
- Restructuring – enhancing the effectiveness of local government authorities in delivering quality services in a sustainable manner;
- Finance – increasing the resources. available to local authorities and improving the efficiency in their use.
- Human resource development – improving accountability and efficiency of use of human resources.
- Legal – establishing an enabling legislation to support the effective implementation of local government reforms.
- Programme management – supporting the effective and efficient management of the overall reform programme.

The World Bank's Local Government Support Program is supporting the ongoing LGRP in Dar es Salaam by:

- Further strengthening fiscal decentralisation, improve accountability in the use of local government resources, and improve management of intergovernmental transfers.
- Increasing access to infrastructure and services in unplanned and under-served areas of Dar es Salaam and to improve revenue performance for sustainable operations and maintenance.

6. Public–private-community partnerships for slum upgrading

Case study 7: Community-Led Infrastructure Finance Facility (CLIFF)

The Community-Led Infrastructure Financing Facility (CLIFF) is a finance mechanism that helps to address the constraints imposed by the non-availability of substantial medium and long-term loan finance for community-driven housing and infrastructure initiatives. It has been set up in some countries in Asia and Africa – including India and Kenya.

CLIFF is an alternative approach to meeting shelter needs by helping organisations of the urban poor to carry out and scale up community-driven infrastructure, housing and urban services initiatives at the city level, in conjunction with municipal authorities and the private-sector (including banks and real estate developers). CLIFF is unusual in that it provides funds for projects on a larger scale than is usually available to NGOs and people's organisations, and also in a form that helps leverage funds from other groups and, where possible, to recoup the capital investment.

CLIFF is currently being piloted in India. Its objectives are:

- Improved housing and infrastructure for many thousands of the urban poor by working in partnership with CBOs/NGOs who have, or can be assisted to have, a track record in delivery of urban rehabilitation.
- An operational mechanism for extending loans, guarantees, and grants to organisations of the urban poor undertaking urban infrastructure and housing initiatives.
- To attract increased local market financing for further schemes thus accelerating or scaling up the response to the challenge of urban renewal.
- An improved policy, regulatory and legislative environment in countries where CLIFF is implemented.

It is envisaged that further CLIFFs will be established in Africa and Asia.

ANNEX 3: A GLOSSARY OF FINANCIAL TERMS

AMORTIZATION OF DEBT
The process of paying the principal amount of an issue of securities by periodic payments either directly to security holders or to a sinking fund for the benefit of security holders.

BOND
Evidence of the issuer's obligation to repay a specified principal amount on a date certain (maturity date), together with interest at a stated rate, or according to a formula for determining that rate. Bonds are distinguishable from notes, which usually mature in a much shorter period of time. Bonds may be classified according to maturity structure (serial versus term), source of payment (general obligation versus revenue), method of transfer (bearer versus registered), issuer (state versus municipality versus special district) or price (discount versus premium).

BONDHOLDER
The owner of a municipal bond. The owner of a bearer bond is the person having possession of it, while the owner of a registered bond is the person whose name is noted on the bond register.

DEBT SERVICE RESERVE FUND
The fund in which monies are placed which may be used to pay debt service if pledged revenues are insufficient to satisfy the debt service requirements. The debt service reserve fund may be entirely funded with bond proceeds, or it may only be partly funded at the time of issuance and allowed to reach its full funding requirement over time, due to the accumulation of pledged revenues. If the debt service reserve fund is used in whole or part to pay debt service, the issuer usually is required to replenish the funds from the first available funds or revenues.

A typical reserve requirement might be the maximum aggregate annual debt service requirement for any year remaining until the bonds reach maturity. The size and investment of the reserve may be subject to arbitrage regulations. Under a typical revenue pledge this fund is the third to be funded out of the revenue fund.

GENERAL OBLIGATION BOND or **G.O. BOND**
A bond, which is secured by the full faith and credit of an issuer with taxing power. General obligation bonds issued by local units of government are typically secured by a pledge of the issuer's ad valorem taxing power; general obligation bonds issued by states are generally based upon appropriations made by the state legislature for the purposes specified. Such bonds constitute debts of the issuer and normally require approval by election prior to issuance. In the event of default, the holders of general obligation bonds have the right to compel a tax levy or legislative appropriation, by mandamus or injunction, in order to satisfy the issuer's obligation on the defaulted bonds.

ISSUER
A state, political subdivision, agency or authority that borrows money through the sale of bonds or notes.

JUNIOR BOND
A revenue bond issued, or to be issued, with a claim on the sewer utility revenues or water utility revenues that is junior and subordinate to the claim of one or more other revenue bonds.

MATURITY or **MATURITY DATE**
The date upon which the principal of a municipal security becomes due and payable to the security holder.

MUNICIPAL SECURITIES
A general term referring to securities issued by local governmental subdivisions such as cities, towns, villages, counties, or special districts, as well as securities issued by states and political subdivisions or agencies of states. A prime feature of these securities is that interest on them is generally exempt from federal income taxation.

PLEDGED REVENUES
The moneys obligated for the payment of debt service and other deposits required by the bond contract.

RATING AGENCIES
The organisations which provide publicly available ratings of the credit quality of securities issuers.

RATINGS
Evaluations of the credit quality of notes and bonds usually made by independent rating services. Ratings are intended to measure the probability of the timely repayment of principal of, and interest on, municipal securities. Ratings are initially made before issuance and are periodically reviewed and may be amended to reflect changes in the issuer's credit position. The information required by the rating agencies varies with each issue, but generally includes information regarding the issuer's demographics, debt burden, economic base, finances and management structure. Many financial institutions also assign their own individual ratings to securities.

UNDERWRITE or **UNDERWRITING**
The process of purchasing all or any part of a new issue of municipal securities from the issuer, and offering such securities for sale to investors.

All the above definitions on financial terms have been taken from PADCO paper on 'Innovations and Solutions for Financing Water and Sanitation' 2003.

ANNEX 4:
Fiscal Decentralisation in Eastern and Southern Africa in 2000

	South Africa	Kenya	Uganda
Structure of local government	Provincial – municipal (Type A, B and C)	Local (municipal, town, urban and county)	Local (districts and four levels below)
Size of local government	• Provincial and municipal > 60% of total public expenditures < 15% of total public revenues	• 5% expenditure • 6% revenue (prior to recent reforms)	• 28% expenditure • 8% revenue
Local government expenditures	• Social services (provincial) • Local services (municipal)	• Local services • Some infrastructure	• Social services • Some infrastructure • Local services
Local government own-source revenues	• Road tax/fees, gambling (provincial) • User charges, property rates and RSC levy (local)	• Property rates • User charges • Agricultural cess (rural)	• Graduated personal tax • Property rates • User charges
Intergovernmental tax sharing	Provided for provinces (not yet used)	Income (newly instituted fiscal year 2000)	None
Intergovernmental transfer programs	• Equitable Share (formula-based distribution of an annual ad hoc allocation) • Various capital transfer programs	• Block Transfers (formula-based distribution of income tax share, but reform conditions placed on a portion)	• Unconditional, equalization, conditional (separate formulae)
Local government borrowing	Once substantial in metros, then declined – new framework in development	Once substantial, now virtually gone	None
Central government oversight	• National Treasury • Department of Provincial and Local Government	• Ministry of Local Government • Ministry of Finance	• Ministry of Local Government • Ministry of Finance • Planning and Economic Development
Local government autonomy	Relatively strong legally and in practice	Relatively strong but some control	Strong legally, but weaker in practice
Local government capacity	Mixed (stronger metropolitan)	Mixed across urban and rural	Mixed, generally better in urban

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