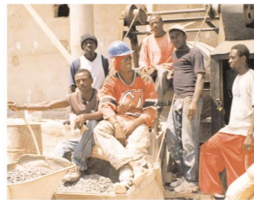
Commonwealth Secretariat
Local Government Reform Series No.2

Municipal Infrastructure Financing

Innovative Practices from Developing Countries

Edited by Munawwar Alam



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Foreword

Municipal Infrastructure Financing is the second title in the Commonwealth Secretariat's Local Government Reform Series. Books in the series offer guidance on various aspects of local government reform to public sector policy-makers, senior managers at central and sub-national levels, as well as students and researchers in public administration with an interest in local government issues. Each volume distils contemporary thinking and good practices from around the Commonwealth, in a readable and accessible form.

This title on municipal infrastructure financing appears at a time when a global economic crisis presents unprecedented challenges to governments. Many countries, despite fiscal constraints, are considering some form of stimulus package in response to the crisis. These packages are meant to stimulate economies via significant increases in public spending. Investment in infrastructure is recognised as an effective measure to deal with the economic downturn and this, in turn, will have important bearing on the quality of services provided by government.

This book is based upon a study commissioned by the Commonwealth Secretariat in 2007. The study acknowledged and analysed the key constraints in financing municipal infrastructure and services in Commonwealth developing countries, and presented infrastructure-funding options based upon illustrative success stories globally. The growing trend to mobilise private sector financing and participation in order to develop infrastructure projects, particularly at the sub-national level, is evident in the approaches adopted in a number of countries.

In many Commonwealth countries, decentralisation has resulted in greater local government responsibility for provision of municipal infrastructure and public services. In parallel, increasing urbanisation and fiscal constraints have prompted governments to seek innovative infrastructure financing from the private sector. These developments present new challenges for governments, challenges that include developing appropriate legal and regulatory frameworks, preparing bankable infrastructure projects, developing capital and credit markets to access long-term infrastructure finance, and attracting private sector financing and participation.

As is known, infrastructure projects typically have a long gestation period and require huge capital investment that, initially at least, do not yield substantial revenues. The current adverse economic environment and fiscal constraints demand, even more than before, stringent minimum levels of performance and reinforce the

importance of appropriate policy and legal frameworks in infrastructure spending. Municipal governments traditionally lack technical and financial capacity to finance infrastructure projects. Public–private partnerships in provision of municipal infrastructure that will improve efficiency are all the more relevant in the current environment.

This book focuses on the trends and gaps in municipal infrastructure financing and assesses credit and capital markets in selected Commonwealth countries. I sincerely hope that policy-makers and managers entrusted with local government service delivery will be encouraged to explore the issues and alternatives to conventional municipal infrastructure financing through the case studies. Our aim is to strengthen local government reform strategies and processes, so that Commonwealth governments can make more informed policy choices about decentralisation. The Secretariat will continue to support Commonwealth member governments by advancing knowledge of these and other public sector reforms.

Ransford Smith
Deputy Secretary-General
Commonwealth Secretariat
London

Introduction

Today cities and municipal governments all over the world are faced with the same primary challenge: where to find the money to meet the growing demand for infrastructure development? As urban populations grow, the deficit between the demand for services and the ability of governments to supply those services gets wider. Our greatest challenge in the twenty-first century must be to try and build sustainable cities. In order to do this, we need to better understand what it will take to deliver sustainability. To date this has not been done particularly well. This publication sheds a very important light on the urban development canvas. Namely, how are some cities and municipalities in the Commonwealth dealing with the challenges of finding the resources to meet their infrastructure development needs?

In the twenty-first century, the world faces challenges unlike any in human history. New conflicts, climate change and rapid industrialisation in the developing world are placing unparalleled pressures on our planet's resources. To compound matters, the current global economic meltdown demonstrates how inter-connected the world has become, but at the same time, vulnerable. As the world's population grows rapidly, there is one single unequivocal truth. More people want to live in cities now than ever before. Harnessing and managing the forces of urbanisation in a way that does not undermine our planet's resources is now our greatest challenge. In that challenge, institutions charged with the responsibility of building a sustainable future come under greater scrutiny than ever before.

We know that in the next 20 years, most of the world's population will be absorbed by urban areas in Africa and Asia. Predictions of people moving from rural areas into urban agglomerations are startling. The Asian Development Bank (ADB) forecasts that by 2030, half of the Asian region's population will live in cities. Faced with this reality, how do our cities, their leaders and policy-makers intend to meet the challenges ahead? Governments of all kinds from Kampala to Ulaan Baatar will have to address the impacts of hyper urbanisation on economic, social and environmental conditions in their respective regions.

Cities of all sizes face major service delivery challenges, which require mobilising resources. In Asia alone, the ADB estimates the need for $250 billion per annum for the next 25 years. How to finance such requirements is a key issue facing many developing countries. Municipal governments, often faced with deficit budgets, lack the resources to finance infrastructure provision. Co-financing through regional

and national governments, government grants and subsidises contribute to infrastructure funding in many developing countries. However, this also falls short of meeting demand for delivering infrastructure and service needs. In recent years, municipal governments in developing countries have explored other ways and means of overcoming this – namely drawing on private sector resources.

If we believe that municipal governments lack the wherewithal to finance infrastructure, then it would seem natural for the public sector to seek out new forms of financing. That said, municipal governments all over the developing world have done little to help themselves or inspire confidence for a number of reasons. First, the governance and financial health of municipal governments remains weak. Second, the lack of technical capacity to structure projects has undermined the ability of governments to successfully implement large-scale infrastructure. Third and most critically, the lack of desire to modernise the public sector by introducing elements of new public management means governments are configured in the traditional Weberian mould. So, we ask ourselves, how can municipal governments help themselves and free much-needed resources before turning to other options?

Many municipal governments lack good governance and fiscal management. Though it is fair to say that the lack of autonomy to raise and use their resources is a contributing factor, poor public expenditure management exacerbates the problem. Traditional budget-making processes, lack of fiscal control and inadequate expenditure management leave governments with limited resources. Equally important is the need to develop basic skills in finance, accounting, auditing and institutional capacity in strategic human resource and performance management. In recent years, successful fiscal reforms attempted in cities like Faisalabad (Pakistan) and Ahmadabad (India) show how municipal governments can move from being cash strapped to healthy fiscal positions.

The capacity to structure strategies, plans and projects is woefully poor in municipal government in developing countries. In recent years, while initiatives like the World Bank's Cities Alliance have been assisting cities to prepare medium- to long-term urban development frameworks, there are hundreds that have yet to embrace the tenets of strategic management. This inability to define projects conceptually and in terms of their potential financing should be addressed. In India, the Jahwarlal Nehru Urban Renewal Mission (JNNURM) an urban development policy framework incentivises small and medium-sized cities to prepare city-level plans in exchange for infrastructure financing. Though the response of cities has been significant, the plans are little more than infrastructure project 'wish' lists, supported by inadequate financial analysis. Municipal governments should invest in building their capacity to strategise, plan and structure projects effectively.

Critically, municipal governments in developing countries (including Commonwealth countries) are traditional administrations. The lack of strategic management and unwillingness to embrace information and communication technologies and

new public management helps explain why public service provision remains poor. The inability to innovate through new strategic partnerships in delivering public services is one reason why many municipals governments lag behind in delivering quality services. Similarly, the unwillingness to reform, moving from the old to the new, undermines the ability of municipal governments to respond to a new global environment and public service orientation. If municipal governments could commit to a new kind of organisational and institutional configuration, one more akin to the private sector, they might be better placed to finance and supply infrastructure provision. Despite these lacunae, significant efforts are being made in managing and developing cities in developing countries through public and private sector means.

Even with these weaknesses, there is no reason why municipal governments shouldn't embrace new modes of financing infrastructure. The journey is not likely to be easy and previous results from developing countries are mixed. Experience thus far points to the need to develop capacity and 'know-how' in accessing market-based options and domestic or international lending sources. This will not be achieved alone, and many municipal governments in the Commonwealth and outside will need greater support in accessing expertise in these areas. This is where institutions like the Commonwealth Secretariat, ADB and the World Bank could do more to assist. Nevertheless, the onus must be with developing countries and their municipal governments to ask for this assistance and then demonstrate the commitment needed to implement sustainably financed infrastructure provision in cities across the world.

Hence, the publication of this book is timely. It arrives at a juncture when the debate about finding resources for sustainable city development this century is at a zenith. As a collection of case studies across Commonwealth cities and countries in Africa and South Asia in municipal infrastructure development, through private sector means, this book catalogues the experiences of cities like Karachi and Kampala in securing financial resources for effective public service provision. What emerges is a story of common challenges and issues, but very different strategies and approaches. This very much tells the tale of the degree to which decentralisation has occurred in each of the case study countries examined.

Critically, the book presents an important running theme. Namely, that the key bottleneck to private sector investment in many developing countries and cities is the poor physical infrastructure and investor perception of local government efficiency. This raises the spectre of reforming public sector management in Commonwealth and other developing countries before significant private sector participation in urban service delivery can take place. Dar es Salaam's attempts to reform the management of the transport sector for private sector involvement is heartening. However, the broad experience based on the evidence of this book is that private sector participation activities will remain incoherent and sector specific until investor confidence can be improved. That is unlikely to take place unless cities and the institutions that run them change.

The other significant point to emerge from this publication is the notion of bankable projects. Municipal governments and cities across Asia lack the ability to structure commercial and bankable projects. Typically, the process of prioritising investments with suitable financing plans tends to be inadequate. This deters private financiers, who perceive local government authorities as not being creditworthy and hence highly risky. One among many reasons for this is the lack of good governance. Often, in many Commonwealth municipal governments the responsibility for preparing bankable projects rests with different stakeholders. This lack of co-ordination and co-operation scatters investment possibilities, administrative and functional jurisdiction. This is especially true of South Asia.

Notwithstanding these challenges, the book traverses the potential of market-based financing citing several successful examples from India, South Africa, South East Asia and Latin America. The book presents successful case studies of local governments raising funds through municipal bond markets, finance intermediaries and public-private partnerships. This should give practitioners, policy-makers and officials the confidence that alternatives to traditional financing for infrastructure development exist. However, this calls for innovation in government.

What emerges is the need for wholesale policy, regulatory and institutional reform if cities in the Commonwealth are to fill the funding gap in infrastructure provision. Notably, it is the view of this author that this must start with systemic reform of key public sector institutions responsible for delivering urban services. Unless there is change in the way our governments are configured at the national, regional and local levels, we can expect still to be looking for ways to improve urban service delivery 20 years from now.

Let me congratulate the Commonwealth Secretariat and authors of this study in addressing the key challenges in improving municipal financing and also shedding light on how they can be overcome practically. This is a relevant piece of work for all those interested in sustainable urban development.

Mr Nadir Ehsan[1]
Senior Municipal Development Specialist
Cities Development Initiative for Asia (CDIA)

1. This introduction reflects the views of its author and not the Cities Development Initiative for Asia (CDIA) or the Asian Development Bank as an institution. CDIA is a multi-donor programme based in Manila, supported jointly by the governments of Germany, Sweden, Spain and the Asian Development Bank.

Abbreviations and acronyms

ADB	Asian Development Bank
ADP	Annual development programme (or plan) grants
BMDF	Bangladesh Municipal Development Fund
BOO	Build, own and operate
BOOT	Build, own, operate and transfer
BOT	Build, operate and transfer
CEPA	Cambridge Economic Policy Associates
CDGK	City District Government of Karachi
CDIA	Cities Development Initiative for Asia
DAWASA	Dar es Salaam Water and Sewerage Authority
DAWASCO	Dar es Salaam Water and Sewerage Corporation
DBSA	Development Bank of Southern Africa
DCA	(USAID) Development Credit Authority
DCC	Dhaka City Corporation
DSM CC	Dar es Salaam City Council
FDU	Paraná State Urban Development Fund (Brazil)
GDP	Gross domestic product
GIS	Geographic Information System
GO	General obligation (bond)
IADB	Inter American Development Bank
IDFC	Infrastructure Development Finance Company (India)
IFC	International Finance Corporation (of the World Bank)
INCA	Infrastructure Finance Corporation Limited (South Africa)
KCC	Kampala City Council

KWSB	Karachi Water & Sewerage Board
LDIFs	Local Development Investment Funds (Vietnam)
LGAs	Local government authorities
LGLB	Local Government Loans Board (Tanzania)
LGO	Local Government Ordinance (Pakistan)
LGUs	Local government units
LGUGC	Local Government Unit Guarantee Corporation (Philippines)
MDF	Municipal development fund
MLGRDC	Ministry of Local Government, Rural Development and Co-operatives (Bangladesh)
O&M	Operation and maintenance
OECD	Organisation for Economic Co-operation and Development
OZT	Octroi and zila tax
PFC	Provincial Finance Commission (Pakistan)
PFI	Private financing initiative (UK)
PPP	Public–private partnership
PSP	Private sector participation
SADC	Southern Africa Development Community
TNUDF	Tamil Nadu Urban Development Fund
ULBs	Urban local bodies
USAID	US Agency for International Development
WASA	Water and Sanitation Authority
WPA	Water project account (India)
WSPF	Water and Sanitation Pooled Fund (India)

Currency equivalents

Exchange rate as of 15 September 2007, when the publication was drafted:

Bangladesh taka (BDT or Tk), US$1 = Tk69.9

Indian rupee (INR or Rs), US$1 = Rs40.46

Pakistan rupee (PKR or PRs), US$1 = PRs60.58

South African rand (ZAR or R), US$1 = R7.18

Tanzanian shilling (TZS or TSh), US$1 = TSh1,275

Ugandan shilling (UGS pr USh), US$1 = USh1,726

Editor's Acknowledgements

As the principal architect of this project, I have an obligation to acknowledge and give recognition to all of those who have supported me in making it a success. I owe gratitude and appreciation to a number of people for their contribution and assistance in one form or the other, and I am grateful to all of them.

To begin with, I am thankful to the CEPA team for their valuable contribution. Daniel Hulls, a Director of CEPA, had overall responsibility for the project and deliverables. He is an expert on public–private partnership (PPP) financing issues, including structuring of PPP transactions. Pritha Venkatachalam, a CEPA Principal, undertook substantive fieldwork and was the project manager. Pritha's particular specialty is in municipal and urban infrastructure finance, and she has worked on PPP policy and transaction advisory mandates. Also included in the team was Stefan Rattensperger, an economist by training. Stefan worked on economic analysis, as well as providing policy advisory support in municipal finance and infrastructure development of developing countries.

I am also grateful to Nadir Ehsan, Senior Municipal Development Specialist, Cities Development Initiative for Asia (CDIA) under the auspices of the Asian Development Bank. Nadir not only provided valuable advice on the selection of countries, but also agreed to contribute an introduction for this book. I hope that in future CDIA/ADB and the Commonwealth Secretariat will partner to work strategically in Commonwealth cities, where quality urban infrastructure is a distant prospect.

Within my own organisation, I am indebted to many colleagues. Jacqui Wilson, Director of the Governance and Institutional Development Division (GIDD) provided strategic direction. As head of a division that is mandated to implement public sector development programmes in the Commonwealth countries, she is an ardent proponent of non-conventional means through which local governments in developing countries must attempt to tackle their infrastructure gaps. She wanted the Commonwealth Secretariat – through me and this book – to offer some choices to member countries to bridge the wide gap in supply and demand in the provision of basic municipal services.

John Wilkins, Head of the Thematic Programme Group in GIDD, has guided me throughout this project. He champions the cause of alternative service delivery. On several occasions he prevented the study from diverting or losing focus, whenever

I was enticed by the huge amount of knowledge in this emerging area of municipal infrastructure financing.

The third 'J' on my list is Jasimuddin, Regional Adviser for Asia in GIDD. He helped enormously in carrying out field research in Pakistan and Bangladesh. Similarly, my colleague Dunstan Maina, Adviser, East Africa region in GIDD, assisted me and the team in Uganda and Tanzania. Their insight into these countries and rapport with the government agencies greatly facilitated the fieldwork and provided valuable regional and country context.

Last, but of course not the least, I am indebted to Guy Bentham in the Communications and Public Affairs Division, for encouraging me to publish this report of the study and for assisting me throughout. His patience in dealing with a novice like me is commendable.

1

Overview and Outline

This book is based on a study commissioned by the Commonwealth Secretariat on municipal infrastructure financing in selected Commonwealth countries. The study was undertaken by the Cambridge Economic Policy Associates (CEPA). It was intended to inform the policy community on the key constraints in financing municipal infrastructure and services in Commonwealth developing countries, and present some alternative infrastructure funding options based on illustrative success stories globally.

Decentralisation is taking place in most countries of the world, including the Commonwealth, albeit at a varying pace. According to an estimate, about 80 per cent of the developing countries have introduced some form of decentralisation over past decades.[1] Consequently, local governments now have greater responsibility for service delivery and also for achievement of the Millennium Development Goals. One of the crucial issues for local governments is the availability of adequate finance to provide quality services to their constituents. This not only involves the ability to mobilise financial resources, but also to use those resources effectively and efficiently. It is a known fact that there is a chronic shortage of money in local governments. Sometimes the situation worsens to acute when local governments are assigned the delivery of devolved services, without being given adequate matching resources by central government.

Another related issue is rapid urbanisation, which puts the service provision capabilities of local governments – who are already finding it difficult to keep pace with the rising demand – under even greater pressure. The mounting fiscal constraints and infrastructure-financing gap in most countries have together resulted in governments seeking to mobilise alternative financing for infrastructure from the private sector. Consequently, governments are facing new challenges in terms of attracting private sector financing and participation. These challenges include issues such as developing appropriate legal and regulatory frameworks, preparing 'bankable' infrastructure projects, and developing capital and credit markets to access long-term infrastructure finance.

As stated above, faced with ongoing urbanisation and the mounting gap in financing municipal infrastructure, the typical options for local governments are borrowing from financial institutions and development banks, accessing capital markets or soliciting private sector participation through contracts, leases and

concessions. According to World Bank estimates, between 1990 and 2006, privatisation attracted more than one trillion dollars worth of investment in infrastructure in developing countries.[2] However, basic urban services such as water supply and sanitation, sewerage and solid waste management are unattractive to the private sector for a number of reasons, including limited cost recovery, high risk and long gestation investments. At the same time, in the context of developing countries, liquidity and financial products are typically limited in availability, while loans from banks and financial institutions are often of short tenure (up to 5 to 7 years), and may require sovereign guarantees. Hence, many developing countries are trying to develop domestic and international capital markets to mobilise private savings for urban infrastructure involving lengthier payback periods.[3] Access to capital markets by sub-national governments is important for another reason. Infrastructure investments benefit future generations, so equity requires that future generations should also bear the cost of financing.[4]

The situation of (municipal) infrastructure financing in developed countries, including Commonwealth countries, is quite different. In Anglo-Saxon countries, there is a significant history of drawing on the private and voluntary sectors to deliver public services. Countries such as the UK, New Zealand, Canada and Australia have led the way in the development of public–private partnerships (PPPs) over recent decades. Today, PPPs play an important part in expanding public infrastructure throughout the European Union. This book provides a succinct review of international practices, including developed countries of the world.

An overview of municipal infrastructure financing in Commonwealth developing countries

Against this backdrop, the book seeks to provide an overview of municipal finances and the extent of private sector involvement in the delivery of municipal services in selected Commonwealth developing countries. This includes a review of the current market for infrastructure financing at the sub-national level, across the Commonwealth developing countries. It also looks at the specific patterns and gaps in municipal infrastructure financing, based on the demand for infrastructure projects and the available sources of financing. The analysis of the current financing sources covers public, private and donor funding of infrastructure projects. As part of this review, an assessment of the extent to which the capital and credit markets in these countries are developed to provide financing for infrastructure projects, has also been attempted.

Given the varying degrees of fiscal decentralisation, capital markets development and the economic base of municipalities across countries, as well as the diverse infrastructure financing approaches, it was decided to adopt a case study approach to this overview. In order to provide a representative sample, two Asian Commonwealth developing countries and two African Commonwealth developing

countries were selected for the study – these are Bangladesh, Pakistan, Tanzania and Uganda.

An understanding of alternative options for innovative municipal infrastructure financing

Given the rapid urbanisation of cities and the constraints in public financing of their growing infrastructure needs, several countries are exploring alternative means to mobilise additional municipal financing, particularly by attracting private sector participation in infrastructure services. In this book, an attempt has been made to present various innovative municipal infrastructure financing initiatives that have worked across other developing and developed countries. Examples of such options include the issue of municipal bonds, pooled financing initiatives across municipalities, and the establishment of municipal funds or different forms of public–private partnerships, with the objective of attracting private sector financing or donor support for infrastructure projects.

Challenges

The book also aims to identify the key challenges and constraints in municipal infrastructure financing, including any broad institutional and financial strengthening measures that are required to tap alternate sources of financing for infrastructure investments. While the report of the study focuses on drawing lessons relevant for the case study cities/countries, some of these suggestions will apply across developing countries that face similar challenges with regard to infrastructure development.

In terms of methodology, the study commenced with desk-based secondary research of relevant literature and municipal data. However, given that the area of local government finances in developing countries has not been extensively researched, the desk study was supplemented with primary research involving semi-structured interviews with key stakeholders in the municipalities and relevant private infrastructure investors in the selected case study countries. The statistics stated in this book are based on the 'best available' estimates provided by the respective government agencies. Where there are gaps or inconsistencies in the data or reporting formats thereof, the researchers have tried to reconcile the figures and present them as coherently as possible.

Structure of the book

Following this overview, chapter 2 sets out the broad context and background of the study. It has been argued that although 'finance follows function' is a cardinal principle of decentralisation, in practice fiscal decentralisation has not taken place along with administrative and functional decentralisation in most developing

countries. As a result of the varied pace of fiscal decentralisation, and the differences in size and economic prospects, there is a significant difference in sub-national fiscal structures across developing and emerging market countries. This chapter touches upon various sources of municipal finance across emerging market and Organisation for Economic Co-operation and Development (OECD) countries. It also sets out the international experience in accessing alternate sources of financing, such as through issuing municipal bonds.

Chapters 3 to 6 present the detailed case studies on Dar es Salaam, Kampala, Karachi and Dhaka respectively. Briefly, in Dar es Salaam (Tanzania), private sector participation (PSP) is fairly nascent, both at the national and municipal levels, and is limited to the contracting out of specific municipal services such as solid waste collection, bus terminals and parking services. Municipal borrowing for infrastructure investments has not taken hold, and local governments need central government permission to borrow. Although the Local Government Loans Board acts as a specialised public municipal lender, borrowing is negligible.

Similarly, in Kampala (Uganda), the city council has been contracting out services like solid waste management; however, a regulatory framework to strengthen PSP at the national and sub-national levels is yet to be established. Private sector capacity to provide and finance infrastructure services has been harnessed to a limited degree in the city. Borrowing is allowed by law, but confined to a maximum of 25 per cent of own-source revenues. Kampala has yet to access market finance. The financial sector is evolving and long-term government bonds have been taken up comfortably. However, market financing has not been pursued at the municipal level.

This study shows the situation in the (selected) Asian cities to be similar. In the case of Karachi (Pakistan), the level of PSP is limited to the private contracting out of services such as solid waste and markets. Through a donor- (the Asian Development Bank) funded infrastructure development project, the Karachi Megacity Development Project, it is expected that the institutional environment for private sector participation will improve, as the project is also poised to set up a special finance vehicle to harness private sector finance. In parallel, although the banking sector has experienced growth, there is a liquidity gap for infrastructure finance.

In Bangladesh, private sector capacity and willingness to engage in infrastructure projects, particularly at the local government level, remains weak. In Dhaka, PSP activities are limited to the contracting out of services such as solid waste management. Dhaka City Corporation is legally entitled to borrow for its capital investments, but it has only done so largely for working capital purposes. In this context, the government-owned Bangladesh Municipal Development Fund (BMDF) was set up under a World Bank credit to provide financial support for municipal infrastructure projects. Local financial markets are nascent, which constrains access to market finance for infrastructure projects. Moreover, municipal borrowing entities

are not considered creditworthy enough to tap private debt and ensure its timely servicing.

Chapter 7 sets out some innovative municipal financing approaches that have been successful across developing countries. These include examples of mobilising financing from the capital markets and attracting private sector participation in the provision and financing of municipal infrastructure.

Chapter 8 concludes by summarising the challenges of municipal infrastructure financing, and discusses some of the key financial and institutional strengthening measures required to mobilise alternate sources of financing.

Finally, chapter 9 provides references, both primary and secondary sources.

Conclusion

Infrastructure constraints are a major obstacle to human and economic development. The governments of the developing Commonwealth countries lack financial resources to meet current and future infrastructure needs. It is within this broad context that this book has been written. It is sincerely hoped that these four case studies and review of the literature will provide the 'pros' and 'cons' of borrowing by local governments to public sector policy-makers. I hope that readers will appreciate that borrowing by sub-national entities is not that simple, that it is a complex issue which can sometimes have a serious impact on macro-economic management. For example, in Argentina, public banks provided loans to finance the deficits of sub-national governments, contributing to macro-economic imbalances, as well as stifling incentives to change inefficient service delivery mechanisms.[5] This book therefore argues for more stringent technical and financial scrutiny on projects that are to be financed from loans, as compared to projects financed out of the recurrent budget. Decentralisation and attempts to finance municipal infrastructure through non-conventional means should be accompanied by stronger project preparation and development capabilities of local governments.

It is increasingly argued that when developing countries want to try non-conventional modes of financing service delivery, or where more responsibility is devolved to local bodies, then care must be taken to ensure that appropriate arrangements exist, or are created where they do not exist, in order to ensure the stewardship of public money. It must be remembered that such 'innovations' cost, in terms of both money and time, and carry their own overheads.[6]

Notes

1. Commonwealth Secretariat (2009).
2. Gomez-Ibanez (2008).
3. Venkatachalam (2007).
4. Ahmad et al. (2005).
5. Ahmad (1996).
6. Chartered Institute of Public Finance and Accountancy (CIPFA) (2005).

2

State of Municipal Finance in Commonwealth Developing Countries

Background

It is expected that most of the increase in the world's population until 2030 will be absorbed by urban areas. In sub-Saharan Africa, the urban population, 270 million at the time of writing, has increased at an annual rate of about 5 per cent since 1980 and is expected to reach 630 million by 2030. Over a similar period, the urban population in Asia will rise from 1,570 million to 2,670 million. As urban growth continues unabated, an increasing number of Commonwealth (developing) countries have assigned greater autonomy and responsibility for infrastructure and service provision to local governments. The unprecedented urbanisation coupled with the growth in population presents a challenge to government authorities in providing adequate infrastructure facilities and services.

Where local governments are mandated with infrastructure provision such as roads, water, sanitation, primary healthcare and education, they face a number of constraints in maintaining and expanding the network of services. Growing fiscal deficits at all levels of government constrain the funds available for the provision of infrastructure and public services. The infrastructure demands as a result of decentralisation and urban growth often overpower the local authorities' financial and institutional capacity. For example, in Africa and Asia, up to 50 per cent of the urban population do not have adequate water supplies and about 60 per cent lack adequate sanitation. A concerted effort is needed by local governments to address present and future demands for municipal infrastructure financing and service provision.[1]

Sources of municipal finance

The concept that 'finance follows function' is enshrined in political decentralisation mandates across the world. However, in practice, the extent of fiscal decentralisation has not kept pace with administrative and functional decentralisation in most developing countries.

The theory of fiscal federalism assigns the public finance role of resource allocation to local governments, while retaining the roles of economic growth and income distribution at the federal level. Accordingly, only immobile tax bases such as property taxes are typically assigned to local jurisdictions.[2] These tax bases, by definition, are less elastic to economic growth and are hence limited in their expansive ability. The matching principle of local finances emphasises that the financial capacity of local authorities should be harmonised with the functional responsibilities assigned to them. To that effect, operational expenditures are typically expected to be met by locally raised revenues, and capital expenditures are financed by intergovernmental transfers, grants and external funds.[3] Historically, borrowing at the local level has not been favoured, as the traditional thesis of capital financing professed that local government borrowing is irresponsible and not viable and sustainable given its poor income generation capacities.[4] This thinking was embedded in donor policies of lending to sovereigns and not to local bodies.

However, these conventional theories have been challenged by the recent trends of urbanisation and globalisation, which have heightened the pressure on cities' growth and infrastructure. Simultaneously, political decentralisation strategies have pushed downwards to city governments the responsibility for coping with the explosive demand for urban services.[5] In comparison, financial authority is being devolved gradually, owing to political unwillingness to delegate power to local entities, as well as genuine fiscal inability at all levels to finance the spiralling urban infrastructure requirements.[6]

The varied pace of fiscal decentralisation across countries and the differences in sizes and economic prospects of cities have resulted in a wide diversity of sub-national fiscal structures across developing and emerging market countries. Some cities that are engines of economic growth generate a high degree of own-source revenues and in turn contribute to the central exchequer. However, as a general principle, the own-source revenues of most cities are not very substantial and primarily comprise immobile tax sources such as property tax. Table 2.1 summarises the typical tax bases by level of government.

Globally, local revenue sources include tax and non-tax charges, and transfers from the higher levels of government. Depending on the country being examined, tax

Table 2.1. Tax base

Level of government	*Tax base*	*Tax base mobility*
Central	Capital income	High
Intermediate (state/provincial)	Consumption/labour income	Medium
Local/municipal	Real property	Low

Source: Ebel and Vaillancourt (2001)

revenues include personal and corporate income tax, property tax, and tax on goods and services. Non-tax revenues comprise fees, fines and user charges.

Table 2.2 provides an un-weighted average summary of local revenues across groups of countries or regions over the period 1991–2001.[7] The key observations are:

- Developing countries in Asia and Africa are still lagging behind in terms of percentage contribution of local revenues to overall government revenues as well as the percentage of own revenues (vis-à-vis transfers and grants) in total local revenues. This indicates that the pace of financial decentralisation in developing countries is as yet gradual.
- Also, income taxes typically constitute a large proportion of local revenues in the OECD, East European and transition countries. Developing countries across South and Central America, Asia and Africa, on the other hand, derive most of their own local revenues from property taxes and taxes on goods and services.
- Local governments in South and Central America in particular derive almost a quarter of their tax revenues from transactions, especially in goods and services. These tax sources are economically more buoyant than property taxes.
- Non-tax sources such as fees, fines and charges supplement the local government's own revenues.

The efficient administration and collection of the assigned local revenue sources depends, in part, on the strength of the institutional structures of the local governments. Several local governments in developing countries that enjoy some degree of administrative and financial strength have been trying to increase their traditional revenue sources as well as to mobilise alternate, including private, financing.

Table 2.2. Local government revenues (un-weighted average across sampled countries)

Countries	*% local revenues*	*% own revenues*	*% tax revenues*	*% income taxes*	*% property taxes*	*% goods and service taxes*	*% non-tax revenues*
OECD	14.8	63.8	42.2	20.7	13.1	5.2	9.9
Eastern Europe and transition countries	19.6	70.2	55.4	33.9	6.8	11.3	7.3
South and Central America	7.1	68.8	47.2	2.3	13.4	22.7	5.3
Asia/Africa[8]	6.9	58.5	32.8	3.0	13.7	13.8	7.6

Source: Ebel and Vaillancourt (2001), IMF (2002)[9]

International experience on alternate sources of financing

Several developing country governments are trying to bolster their traditional sources of municipal finance by mobilising alternate market-based sources of funding. The typical options exercised have been borrowing from financial institutions and development banks, accessing capital markets, or soliciting private sector participation through contracts, leases and concessions. However, municipal urban services like water supply and sanitation, sewerage and solid waste management do not prove attractive to private financiers given their characteristics of time and space externalities, limited cost recovery, high risk and long gestation investments. Furthermore, few municipal governments in developing countries have a strong financial position, and their projects are most often not commercially viable. On the supply side, banks and financial institutions are constrained by their balance sheet and are willing to offer only shorter tenure loans, typically up to 5–7 years, and often require sovereign guarantees for local lending.

In contrast, sub-national governments of North America and Western Europe hold a long-standing record of harnessing private debt for urban infrastructure. The credit models championed by these blocs are instructive in their diversity – while North America relies mainly on municipal bonds, Western Europe has developed its home-grown municipal banks. Emerging markets are attempting one or a hybrid of the above models, either directly or through specialised financial intermediaries or municipal funds.[10]

The US municipal bond market originated to cater to the urban boom of the 1850s. Specific purpose revenue bonds have matured into the primary source of funding capital projects, but general obligation bonds issued against the full faith of local government revenues are also prevalent. The federal government has endorsed decentralised financing by conferring tax-free status to municipal bonds, and contributing to State Revolving Funds and Bond Banks. These intermediaries pool the borrowing needs of marginal local entities that are unable to individually access capital markets.[11] A mature federal system comprising strong sub-national governments matched with an enabling investment environment has promoted the growth of US municipal debt markets.

Western Europe, on the other hand, leveraged its historic preferential access to long-term saving deposits and government contributions to establish municipal banks and financial institutions. Examples of municipal banks include Dexia Credit Local of France, BNG of Netherlands, Banco de Credito of Spain and Credit Communal Belgique of Belgium. With financial deregulation, some of these banks are also converging into the competitive capital markets to raise funds.[12]

Developing country governments have attempted to access market-based financing by creating municipal development funds (MDFs), often with the backing of international agencies and development finance institutions. However, developing

self-sustaining local credit markets has proved challenging. The pioneering MDF in Brazil provides loans to municipalities and special utility companies and enjoyed over 30 years of commendable loan recovery rates and less than 5 per cent non-performing loans.[13] The Infrastructure Finance Corporation Limited in South Africa also provides loans to municipalities and other statutory boards and utilities. Similarly, since 1996 Vietnam has established several provincial Local Development Investment Funds (LDIFs), in order to develop infrastructure and enable mobilisation of private capital and participation in these projects. India has also successfully established several state-level municipal or urban development funds that have raised market financing for sub-national infrastructure projects.

Several Indian municipalities have also raised bond financing in the recent past, and some of them, such as the Ahmedabad Municipal Corporation in the western state of Gujarat, have obtained investment grade credit rating to reduce the cost of bond issues. Zimbabwe has also issued municipal bonds with sovereign guarantees.[14] Low domestic savings have motivated some cities like Sofia in Bulgaria and Moscow and St Petersburg in Russia to float foreign bonds.[15]

The other successful model has been that of a contingent financier, which provides products such as guarantees or insurance that are contingent to the main project financing. FINDETER in Columbia, established in 1989 as a second-tier government financial intermediary, rediscounts bank loans to local borrowers. It has motivated commercial banks to be responsible for municipal credit risks across sectors such as transportation, water and sewerage, and education.[16] Another example is the Local Government Unit Guarantee Corporation (LGUGC) in the Philippines. Initiated as the brainchild of the Department of Finance in 1997, LGUGC provides insurance to municipal investors. It is uniquely structured as a jointly owned public–private entity, supplemented by a 30 per cent US Agency for International Development (USAID) backed credit guarantee. It has also instituted a proprietary credit rating system to identify creditworthy issuers.[17]

Some of these examples are described in greater detail in chapter 7 of this book. Nonetheless, the above summary indicates that no decentralised municipal system is dependent on a single borrowing option for all infrastructure needs. While many governments have instituted MDFs to front-end inexperienced local borrowers, several have matured into a multi-tiered municipal credit system. Larger creditworthy local entities access cheaper bond finance against their own balance sheet, while small and medium entities continue to leverage financial intermediaries, development banks, and government grants. Often, a line of credit or credit enhancement from a contingent financer and/or an international financial institution has proved instrumental in extending the maturities of local debt instruments.

Against this overview, the following chapters of the book provide detailed case studies on municipal finances in four selected Commonwealth cities. This is then

followed by a description of some alternate techniques of innovative financing of municipal infrastructure and services.

Notes

1. United Nations (2006); Dirie (2006).
2. Musgrave (1959); Oates (1993).
3. Bird (2001).
4. Bahl (1981).
5. Vera and Kim (2003).
6. Bird (1980); Bahl and Linn (1992).
7. The percentage of local revenues in the second column of the table refers to the contribution of locally raised revenues in the national revenues. All other percentages in the table represent that particular source of income as a proportion of the total local revenues.
8. India and China are not included in the countries studied. Average excludes Zimbabwe.
9. Incorporates own calculations using base data, Netherlands Antilles has been excluded as it is non-representative of the rest of the region.
10. Peterson (2003).
11. El-Daher (1997).
12. Peterson (1996); El-Daher (2000).
13. Peterson (2003).
14. Phelps (1997).
15. Marfitsin et al (1997); Epstein et al (2000).
16. Kehew et al (2005); Peterson (2000).
17. USAID (1997); Orial (2003).

3

Tanzania – The Case of Dar es Salaam

This chapter considers the state of municipal finances in Tanzania, focusing in particular on municipal infrastructure finance in Dar es Salaam. It first sets out the country or macro-economic context, then provides the background on the framework for decentralisation and local government finances. The chapter goes on to analyse the municipal finance situation and the approach to infrastructure financing in Dar es Salaam, concluding with a summary of the key findings of the case study.

Macro-economic context

Tanzania is located in Eastern Africa bordering the Indian Ocean and covers a land area of 945,000 square kilometres. The current population of 39 million is projected to reach almost 60 million by 2025. The country's economic growth has averaged 6 per cent in the period of 2000 to 2006 and the economic outlook remains robust, with growth projections of 6–7 per cent of gross domestic product (GDP) for 2007 and 2008. Notwithstanding the recent economic surge, with a GDP per capita of less than US$340 in 2005, half of Tanzania's population remains poor.[1]

Tanzania's development vision aims for a high quality of life for all people by 2025. Among the principal macro-economic policies to sustain growth, price stability is a central objective of the Bank of Tanzania. The inflation rate is expected to be 6 per cent in 2007. The Tanzanian Shilling (TSh) is now freely floating at an exchange rate of TSh1,275 to the US$.[2] With macroeconomic stability and growth, the levels of public and private sector investment are gradually increasing.[3]

Urbanisation and underlying economic trends

A quarter of Tanzania's population live in urban areas. However, with urban growth rates twice the rural ones, UN projections estimate that the urbanisation rate will increase from 24 per cent in 2005 to 38 per cent by 2030, with more than 20 million Tanzanians living in urban areas.[4]

Depending on different estimates, Dar es Salaam accommodates about 30–40 per cent of the national urban population and functions as the locus of economic activities. Urbanisation is expected to drive the country's economic transformation. While 46 per cent of economic activity continues to be based on agricultural activities, industrial and services sectors are growing at a rapid pace. Tanzania's development vision anticipates a transfer to a more knowledge based, semi-industrialised economy, with particular focus on investing in sound infrastructure as an economic underpinning.[5] The main contributors to economic expansion are the manufacturing and construction sectors with growth rates of about 12 per cent and 9 per cent in 2006. The service sector grew at 7 per cent in 2006, with tourism leading the growth.[6]

Decentralisation framework

The government's policy agenda recognises the local government's critical role in providing an environment conducive to economic growth and poverty reduction. In this context, decentralisation ranks high on the national policy agenda.

Local government legislation and organisation structure

The Local Government Act of 1982, setting out the framework of functional and fiscal decentralisation, has become a central theme of government policy. The government's vision of the local government system, based on 'decentralisation by devolution', is set forth in the Policy Paper on Local Government Reform of 1998. A number of amendments to the Local Government Act in 1999 gave more authority to district and urban councils to approve their plans and budgets.[7] In accordance with the Public Finance Act 2001, the Ministry of Finance (MoF) is responsible for co-ordinating intergovernmental fiscal relations. The Prime Minister's Office – Regional Administration and Local Government (PMO-RALG) oversees the local government system and the decentralisation process, and the line ministries are responsible for regulatory and sectoral policies.

Tanzania has adopted a two-tier structure of decentralisation – through both central government and local government authorities (LGAs). The LGAs have been awarded legal status enabling them to contract services and, subject to ministerial approval, raise borrowing. LGAs are comprised of 22 urban councils and 92 (rural) district councils that have autonomy in their geographic area. The urban councils comprise two city, twelve municipal and eight town councils. District councils co-ordinate activities of township authorities and village councils.[8]

Functional and fiscal devolution of powers

The devolution policy of local government functions and expenditures to the LGAs is enshrined in the Local Government Act and is based on the principles of subsidiary and that 'finance should follow function'. LGA activities include a list of public

services including general administration, education, social welfare, public health, housing and town planning, transport, environment, culture and economic affairs. The expenditure responsibilities range from concurrent functions, subject to central government policy, to purely local government services. It is expected that each of these will be funded through different identified sources of financing.[9] Table 3.1 below sets out, at a high level, the detailed expenditure assignments, and their planned source(s) of financing. These are described in further detail in the following sections.

Table 3.1. Assignment of LGA expenditure responsibilities and financing sources

Type of local government function	*Local government activity*	*Planned source of financing*
Concurrent functions (locally provided 'national' public services)*	• Primary education • Local health services • Water supply • Local roads and works • Agriculture extension and livestock	• Sectoral block grants
Exclusive local government functions	• Land use planning • Sewage and sanitary services (including solid waste collection and street cleaning) • Local parks and markets • Community centres • Other local amenities	• General purpose grants • Own-source revenues
Delegated central government functions	• Outbreak of infectious diseases	• Ministerial subventions
Local government administration	• Council operations • Local planning • Local financial management • Village and street neighbourhood (*Mtaa*) administration	• General purpose grants
Local capital development activities	• Construction of new and rehabilitation of existing infrastructure in various sectors including education, health, water, roads, etc.	• Own-source revenues • Local borrowing • Capital development grants

Source: United Republic of Tanzania (2006)
* Central government sets policies, regulation and norms and controls financing

Overview of the provision of municipal services

This section provides an overview of the state of the key municipal services in Tanzania, including education, healthcare, roads, water supply and sanitation services, based on desk-based research. The combination of rapid urbanisation, unplanned settlements and pervasive urban poverty has confronted the central government, as well as LGAs, with serious challenges in public service provision:

- Among concurrent local government responsibilities, primary education stands out as the only public service rated as satisfactory. This is seen as a result of strong growth in school enrolment in recent years, following the abolition of school fees in 2001 and the launch of the Primary Education Development Plan, which aimed to increase the affordability and accessibility of primary schooling.[10]
- In contrast, the majority of citizens are not satisfied with health services, as accessibility and affordability remaining serious problems.[11]
- Roads, both urban and rural, remain under-funded and are generally in poor condition. Municipalities in Tanzania manage more than 56,000 kilometres of local roads with funding from sectoral block grants as well as from a 30 per cent share of the separate road fund financed by the proceeds of a fuel surcharge.[12]
- Water supply is largely operated by 19 urban water and sewerage authorities (UWSAs), established as autonomous bodies under the Urban Works Order of 1998. The water sector suffers from several issues, including low, non-cost-reflective tariffs, poor governance, and lack of resources for maintenance and capital investments. Fifty-four per cent of people in rural and 74 per cent in urban areas had access to safe drinking water in 2005. However, to meet the country's development vision's target of a countrywide 90 per cent coverage by 2025, a further 24.6 million will need improved water supply.[13]
- Sewerage operations, to the extent they exist, are under the control of the UWSAs. Due to poor maintenance, few wastewater treatment facilities are functioning. Seventeen per cent of the urban population is connected to an improved sewerage system and an estimated 50 per cent of the households have access to basic sanitation services. The government's objective is to increase the proportion of the urban population with improved sewerage services to 30 per cent and to allow for 95 per cent of the population to have access to basic sanitation by 2010.[14]

Urbanisation has contributed to the rapid growth of informal and unplanned settlements that make up 60 per cent of the total urban housing stock in Tanzania. This has aggravated the municipal infrastructure financing gap.[15]

Local government revenues

Local governments in Tanzania finance their assigned expenditures from three main sources:

- intergovernmental transfers,
- own-source local revenues, and
- borrowing.

Table 3.2 provides an overview of the revenues across local governments in Tanzania for the period 2002–06. The key points to note are:

- The total amount of local government revenues has doubled since 2002, with the increase primarily driven by growth in intergovernmental transfers.
- Government transfers or grants account for nearly 90 per cent of local government revenues.
- Own-source revenues have declined in absolute and relative terms since 2002.
- Local borrowing, although provided for in the law, remains negligible.

Table 3.2. Local government revenues in Tanzania, 2002–2005/06 in TSh million

Revenues	*2002**	*%*	*2003**	*%*	*2004/05*	*%*	*2005/06*	*%*
Local grants (transfers)	247,027	81.0	313,873	86.5	386,768	89.9	452,831	89.9
Own-source revenues	57,740	18.9	48,344	13.4	42,871	10.0	49,291	9.8
Local borrowing	225	0.1	443	0.1	549	0.1	1,496	0.3
Total	304,992		362,660		430,188		503,618	

Source: United Republic of Tanzania (2007b)
*Prior to 2004, revenue collections were reported based on calendar years and not fiscal years

Intergovernmental transfers

Transfers from the central government currently amount to around 90 per cent of local government revenues. Following from the detailed expenditure responsibilities, these transfers include:

- Formula-based *recurrent (conditional) block grants* for grant-aided sectors, including primary education, local health services, water, local road maintenance, and agricultural extension.
- Formula-based, *equalising general-purpose grants* (GPG). Such grants combine the former 'current administration grant' and the 'compensation grant'

(provided in compensation of own-source revenues abolished in 2003/04). The size of GPG is largely dependent on population and the number of rural residents.

In total, recurrent block grants account for about two-thirds of all intergovernmental transfers. It is worth noting that 75 per cent of the total recurrent government transfers in 2005/06 were allocated to the health and education sectors, 18 per cent to administrative expenses and 7 per cent to roads, water and agriculture.

In addition to formula-based grants, local governments receive two additional sources of transfers:[16]

- Formula-based 'local government capital development grants' (LGCDGs). LGCDGs have been implemented since 2005/06 and provide discretionary funds to LGAs. Funding is linked to local government performance in key areas of financial management, participatory planning and issues of transparency and accountability. LGCDGs have become the main funding modality for local capital infrastructure and amounted to about TSh100 billion in 2005/06.[17]
- Ministerial subventions. These are routed around the available formula-based grant allocation modalities.[18] In 2005/06, LGAs reported receiving TSh77 billion in recurrent subventions from line ministries.

Own-source revenues

Besides intergovernmental transfers, own-source revenues raised by local governments are limited and include:

- property taxes and rent,
- charges from solid waste collection, vehicles, markets etc.,
- fees, including taxi registration, bus stands etc. and
- licences, including road and liquor.

Various amendments to the Local Government Acts in 2003 and 2004 significantly reduced the revenue-raising authority of local governments.[19] In 2003, the Ministry of Finance announced the abolition of the development levy, as well as a number of additional 'minor' local revenue sources, while also limiting the local rate-setting discretion for other local revenue sources. To compensate for the fall in own-source revenues, the general-purpose grant was introduced. Consequently, local revenue collection declined since 2003, and has only recovered since 2005/06 with a number of reform measures instituted to transform the current system of local government revenues. These include measures to strengthen administration of revenue collection and improved revenue mobilisation.[20]

Table 3.3 presents a summary of own-source revenues across local governments in Tanzania. The key observations are:

- Licences and permits, user fees and charges constitute about 28 per cent of own-source revenues.
- Local rates on business-related activities in form of service levies and agricultural cesses are further significant revenue sources.
- Local rates on property and land, although gradually growing as a source of revenue, are a minor component of local revenues.[21]
- The development levy, an earlier significant revenue source, was abolished in 2003. As a result, local revenue sources are yet to reach pre-2003 levels.

Table 3.3. Local government own-source revenues, 2002–2005/06, in TSh million

Revenues	*2002**	*%*	*2003**	*%*	*2004/05*	*%*	*2005/06*	*%*
Licenses, fees and charges	17,174	29.7	17,313	35.8	11,801	27.5	13,621	27.6
Service levy	9,261	16.0	7,787	16.1	10,682	24.9	11,734	23.8
Agricultural cesses	9,251	16.0	9,018	18.7	11,376	26.5	10,862	22.0
Other revenues	6,570	11.4	7,232	15.0	4,234	9.9	7,447	15.1
Property tax	3,548	6.1	3,135	6.5	4,208	9.8	4,857	9.9
Land rent	567	1.0	655	1.4	572	1.3	771	1.6
Development levy	11,369	19.7	3,205	6.6	0	0	0	0
Total revenues	57,740		48,345		42,873		49,292	

Source: United Republic of Tanzania (2007b)
*Prior to 2004 revenue collections were reported based on calendar years

Local government borrowing

As shown in table 3.2, borrowing currently accounts for a negligible 0.3 per cent of local funds and is primarily from the Local Government Loans Board (LGLB), a government-supported financial intermediary.

The LGLB is largely funded from contributions of LGAs and grants from the central government. LGAs are requested to contribute a minimum compulsory reserve equal to 10 per cent of own-source revenues, which serves as a reserve with the LGLB. LGAs are eligible for borrowing only if the requested reserve is maintained. However, with own-source revenues remaining weak and many LGA being unable to contribute their minimum reserve requirement, the LGLB has been unable to cater to the level of loan applications. The level of new loans issued in 2006/07 amounted to only TSh598 million, with loan applications being much higher at TSh1,144 million.[22]

Local government financial management

A series of reforms to strengthen local government financial management have been implemented in order to improve the spending effectiveness of the limited local revenues.[23] These include the following:

- A local government finance statistics reporting system was set up in 2006 to provide regular, detailed reports on local government finances for urban and district councils in mainland Tanzania.
- Recent actions were taken to improve the local government planning and budgeting process, particularly related to the operations and maintenance cost for infrastructure investments. Since 2006/07, all local governments in mainland Tanzania use PlanRep software to prepare their budget plans.
- LGAs in Tanzania are required to prepare their budget plans in a medium-term budget framework, consistent with the national strategy for economic growth and poverty reduction. Recent reforms include the training of local government officials in the medium-term expenditure framework processes, as well as the harmonisation of budget classifications and codes.

The case of Dar es Salaam

Having outlined the decentralisation framework in Tanzania, including a description of local government finances, this section studies the municipal finances and service delivery in Dar es Salaam. It sets out the city context and describes the administrative framework of municipal finances in the city. The section also presents the municipal revenues and expenditures of the city, and goes on to discuss private sector participation in the city's service provision, finally reviewing the current state of and potential for alternate financing sources.

City context

One of the fastest growing cities in sub-Saharan Africa, Dar es Salaam is Tanzania's industrial, commercial and governmental centre. With an estimated 3 million people, Dar es Salaam is seven times larger than the country's second largest city. Some estimates place the population as high as 5 million at daytime. Dar es Salaam comprises three municipalities, Ilala, Kinondoni and Temeke, which are in parallel districts of the Dar es Salaam region. Based on the 2002 Population and Housing Census, Kinondoni had the highest population, followed by Temeke and Ilala. Population figures and recent urban growth estimates are shown in table 3.4 below.[24]

The city population is growing at about 4 per cent and attracts 100,000 migrants annually. Although there is a strategy aiming to achieve 'a city without slums' by 2015, some 70 per cent of the population currently live in unplanned and

Table 3.4. Municipalities in the Dar es Salaam region, current and projected population

Municipality	*2002*	*2003*	*2005**	*2007**
Kinondoni	1,083,913	1,130,520	1,229,835	1,337,875
Ilala	634,924	662,225	720,401	783,687
Temeke	768,451	801,493	871,904	948,498
Dar es Salaam	**2,487,288**	**2,594,238**	**2,822,140**	**3,070,060**

Source: DSM CC (2004)
*Projected population figures

un-serviced settlements.[25] The urban sprawl in the city as a result of this unplanned growth increases the burden of providing infrastructure services.

City administration and allocation of responsibilities

Dar es Salaam has a regional administration headed by the Dar es Salaam regional commissioner. In addition, Dar es Salaam has a city council, headed by a mayor. Each of the three municipal councils has been given an administrative jurisdiction area in the city.

Table 3.5 sets out the split of responsibilities between the city council and the three municipalities. Dar es Salaam City Council (DSM CC) only performs a co-ordinating role and attends to issues cutting across the three municipalities. In contrast, each of the three municipal councils is responsible for providing the bulk of infrastructure and public services outlined below.

Table 3.5. Responsibilities of Dar es Salaam City Council and municipalities

Dar es Salaam City Council (DSM CC)	*Municipalities of Ilala, Temeke and Kinondoni*
• Co-ordinate the functions of the three municipalities regarding infrastructure. • Prepare a coherent citywide framework for the purpose of enhancing sustainable development. • Deal with matters of interdependency among the municipalities – such as inter-district roads. • Provide peace, security and emergency services such as fire prevention, and control ambulance and auxiliary police.	• Primary education • Local health services • Solid-waste management • Transport infrastructure including roads • Informal sector development • Culture and community development • Water supply – municipal councils are responsible for supporting the construction of wells on demand[26]

Source: DSM CC (2004); Interview DSM City Council

Municipal revenues

Based on the devolution of powers and responsibilities to the municipalities, this section describes the revenues of the city council and the municipalities. Overall, own-source revenues in the Dar es Salaam region amounted to a total of TSh17,300 million in 2005/06, equal to 30 per cent of total local government revenues. A further increase to about TSh21,000 million is expected in 2006/07.

Dar es Salaam City Council

The Dar es Salaam City Council has limited revenue powers, given its role as a primarily co-ordinating institution, and limited expenditure responsibilities. Table 3.6 describes the composition of its revenues.

- The city council does not raise its own taxes like the municipalities. The bulk of its own-source revenues are from parking and bus stand fees.
- Intergovernmental transfers comprise the majority of the council's revenues and are mostly general purpose grants for recurrent expenditures. The 2006/07 budget indicates a nearly three-fold increase in general purpose grants to the city council.
- The city council has not raised any borrowing.

Table 3.6. Revenues of Dar es Salaam City Council, in TSh million

Revenues	*2005/06 actuals*	*%*	*2006/07 budget*	*%*
Own-source revenues, of which	**2,004**	**47.1**	**2,371**	**29.9**
Fees and charges	1,607	37.8	1,892	23.9
Service levy	99	2.3	80	1.0
Other revenues	298	7.0	399	5.0
Intergovernmental transfers, of which	**2,249**	**52.9**	**5,553**	**70.1**
Total recurrent grants	2,219	52.2	5,297	66.9
General purpose grants	1,634	38.4	5,031	63.5
Roads	246	5.8	146	1.8
Health	75	1.8	120	1.5
Local admin	264	6.2	0	0
Development grants	30	0.7	256	3.2
Local borrowing	–	–	–	–
Total revenues	**4,253**	**100.0**	**7,924**	**100.0**

Source: United Republic of Tanzania (2007c) and Local Government Information, Monitor Local Government Finances, Budgets 2006/07

Municipalities in Dar es Salaam region

The core revenue raising powers and expenditure responsibilities at city level are assigned to the three municipalities of Ilala, Kinondoni and Temeke. Table 3.7 sets out the aggregate revenue sources of the three municipalities. The key lessons are described further below.

Table 3.7. Revenue sources, municipalities in Dar es Salaam region, in TSh million

Revenues	*2005/06 actuals*	%	*2006/07 budget*	%
Own-source revenues, of which	**15,383**	**28.7**	**18,820**	**22.3**
Service levy	8,201	15.3	8,361	9.9
Property taxes	2,723	5.1	5,031	5.9
Fees and charges**	3,095	5.8	3,005	3.6
Hotel levy	187	0.3	212	0.3
Licenses	76	0.1	101	0.1
Produce cess*	30	0.1	2	0.0
Land rent	0	0.0	50	0.1
Other revenues	1,071	2.0	2,058	2.4
Intergovernmental transfers, of which	**38,298**	**71.3**	**65,736**	**77.7**
Total recurrent grants	29,215	54.4	41,407	47.3
Education	15,536	28.9	21,954	26.0
General purpose grants	4,842	9.0	8,996	10.6
Health	5,066	9.4	7,824	9.3
Local admin	900	1.7	1,390	1.6
Agriculture	1,147	2.1	592	0.7
Water	496	0.9	359	0.4
Roads	1,229	2.3	292	0.3
Subventions and basket funds	4,995	9.3	9,192	10.9
Development grants	4,088	7.6	16,528	19.5
Local borrowing***	–	–	–	–
Total revenues	**53,681**	**100.0**	**84,556**	**100.0**

Source: United Republic of Tanzania (2007c) and Local Government Information, Monitor Local Government Finances, Budgets 2006/07

*Charges on agricultural and livestock produce, **includes parking fees, billboard fees, bus stand fees, ***no municipal borrowing, other than a small loan to Ilala municipality from the LGLB has been reported

In contrast to other local governments, the urban municipalities in Dar es Salaam mobilise greater levels of own-source revenues. These constitute 29 per cent of local revenues, and are relatively three times higher than the national average. The key factors determining own-source revenues are outlined below:

- The primary source of revenue in the three municipalities is service levy, which constitutes more than 40 per cent of own-source revenues. The service levy, raised as a 0.3 per cent charge on business turnover, has risen from TSh3,000 million in 2000 to more than TSh8,000 million in 2006/07.[27]
- Property taxes are collected by each municipality.[28] Properties in Dar es Salaam were however last fully valued in 1994 and there is a need to strengthen administration of local property rates in order to improve local resource mobilisation.
- Similar to the national trend, the three municipalities have lower own-source revenues following the abolition of the development levy and other 'nuisance' taxes in 2003.
- Miscellaneous fees and charges are a growing source of own revenues, with parking and billboard fees being a significant source of income.

With respect to intergovernmental transfers, similar to the countrywide level, recurrent grants constitute about 50 per cent of total local government revenues and are largely sector specific. Education and health are the sectors that receive most of the funding.

As for capital investments, all three municipalities fulfilled the eligibility criteria for development grants in 2006/07. These grants are largely discretionary and are the main sources of finance for infrastructure investments.[29] Funding amounted to more than 7 per cent of local revenues in 2005/06 and is expected to increase to about 20 per cent of total local revenues (TSh16,500 million) in 2006/07. The grants include funds from the community infrastructure-upgrading window of the World Bank's Local Government Support Project.[30]

Revenue enhancement plans

As part of the ongoing Local Government Support Project, Dar es Salaam is implementing a revenue enhancement plan to strengthen its own-source revenues. The city aims to increase its own-source revenues by TSh28,900 million in the coming years from the current level of TSh21,000 million. A major focus is on widening the revenue base. Key strategies for revenue enhancement aim at:[31]

- *Strengthening the tax administration system.* A tax increase of TSh12,000 million is expected from improved tax administration. Reform measures include a wider identification of taxpayers and improved assessment of tax liability, capacity building of councillors and staff, better enforcement of tax collection, and follow up on debtors. It is also proposed to better utilise technology for tax administration and undertake a public awareness campaign on taxpayers' responsibilities.
- *Realising the potential of property related taxes.* The total potential increase from property taxes is estimated at about TSh20,000 million by 2011 from a level

of about TSh5,000 million in 2006/07. The project aims at the valuation of all taxable properties in Dar es Salaam, including using aerial mapping to identify unassessed properties. This includes a large number of high-value properties not captured under the current valuation. Furthermore, reform will include improvements in the techniques of valuation and assessment of properties, as well as improved enforcement and collections of property taxes.

Municipal expenditures

This section outlines the expenditure patterns of Dar es Salaam LGAs. Tables 3.8 and 3.9 show the expenditures of the DSM CC and the three municipalities (aggregated) respectively. Since the city council mainly plays a co-ordinating role, its expenses are limited and essentially comprise recurrent expenditure such as salaries and local administrative expenses.

The aggregate expenditure of the municipalities is much higher in comparison. With municipalities being autonomous, their expenditure control makes up more than 90 per cent of the local government funds in the Dar es Salam region. The main observations that can be drawn from their budgets are:

- Development expenditures, including funds for infrastructure developments and rehabilitation, constituted only about 15 per cent of the 2005/06 expenditure.[32] However, for 2006/07 a strong rise in the absolute and relative share of capital expenditures is expected, as the modalities and process of the new capital development grant system become established and the capacity of financial management further improves.[33]
- Recurrent expenditure accounts for the majority of the municipalities' expenditure. Since responsibility for most municipal functions are devolved, the bulk of recurrent funds are allocated to payment of salaries in the education and health sectors (in addition to local administration expenses).

Table 3.8. Local government expenditures, Dar es Salaam City Council, in million TSh

Expenditure	*2005/06 actuals*	%	*2006/07 budget*	%
Recurrent expenditures, of which	**3,512**	87.2	**6,263**	79.3
Local admin.	365	9.1	3,241	41.0
Roads	47	1.2	146	1.8
Health	121	3.0	120	1.5
Water	290	7.2	0	0.0
Other local spending*	2,689	66.8	2,756	34.9
Development expenditure	**514**	12.8	**1,638**	20.7
Total expenditure	**4,026**	100.0	**7,901**	100.0

Source: United Republic of Tanzania (2007c) and Local Government Information, Monitor Local Government Finances

*Including part of the salaries of administrative staff

Table 3.9. Local expenditures, municipalities of Dar es Salaam region, in TSh million

Expenditure	*2005/06 actuals*	%	*2006/07 budget*	%
Recurrent expenditures, of which	**34,274**	85.3	**59,498**	64.8
Education	17,013	42.3	25,257	27.5
Local admin.	8,728	21.7	16,461	17.9
Health	5,454	13.6	8,647	9.4
Roads	513	1.3	742	0.8
Agriculture	231	0.6	669	0.7
Water	313	0.8	497	0.5
Other local spending	2,022	5.0	7,225	7.9
Development expenditures, of which	**5,908**	14.7	**32,306**	35.2
Education	1,778	4.4	7,314	8.0
Admin.	92	0.2	5,841	6.4
Roads	2,130	5.3	4,060	4.4
Health	464	1.2	2,836	3.1
Water	29	0.1	100	0.1
Agriculture	11	0.0	96	0.1
Other	1,404	3.5	12,059	13.1
Total expenditure	**40,182**	100.0	**91,804**	100.0

Source: United Republic of Tanzania (2007c) and Local Government Information, Monitor Local Government Finances

Municipal infrastructure services and the framework for PSP

As with other rapidly urbanising cities facing an infrastructure financing gap, Dar es Salaam also faces the following key challenges in delivering an adequate level of municipal infrastructure:[34]

- *Rapid urban migration and unplanned settlements:* The backlog in infrastructure service provision is evident in Dar es Salaam, as infrastructure investments cannot cope with rapid urban growth. The urbanisation process, coupled with the spread of informal settlements, is not co-ordinated with the capacity of the respective utility systems.
- *Lack of co-ordination across stakeholders:* Studies show a lack of co-ordination among the different urban institutions and stakeholders. Sector-focused planning and implementation has led to overall unco-ordinated city development and investments.
- *Land tenure system further constrains infrastructure development:* While there is progress at the municipal level with geographic information systems and

land use plans,[35] the existing land tenure system constrains the acquisition of land for infrastructure development.

The municipalities in Dar es Salaam are trying to attract private sector participation to bridge the gap for infrastructure financing.

National PSP environment

The local governments' attempts to mobilise private sector participation (PSP) in infrastructure is to be examined in the context of the fairly nascent PSP activity at the national level in Tanzania. As a step towards more vibrant private sector development, the government is making efforts to strengthen the overall enabling environment. These include reforms in the banking sector and the commercial courts, a credit guarantee scheme for small and medium-sized enterprises (SMEs), and a privatisation programme to facilitate development of local capital markets. The Public Sector Reform Commission is in the process of completing the privatisation of the remaining 36 public enterprises in 2007.[36] However, poor physical infrastructure and investors' perception of local government efficiency are still bottlenecks inhibiting private investments.[37]

The government is currently examining new options of private sector provisioning of public infrastructure, particularly in the transport sector. For example, a study exploring options for PSP in the road sectors has been commissioned.[38] Some recent examples of successful PSP activities include a concession contract awarded by the Dar es Salaam port authority for a container terminal,[39] and a 25-year concession contract awarded to operate the Tanzania National Railway.

PSP at sub-national level

At the sub-national level, successful practices of private sector activities in infrastructure provision have so far been limited to contracting out specific municipal services. The most notable examples of contracting out municipal services include solid waste management, parking services, a bus terminal and the operation of local markets. However, an attempt to operate the local water supply system under a leasing agreement was terminated with the management of water services reverting back to the state-owned operator DAWASCO.

These experiences with outsourcing municipal services are discussed in turn below.

- Since 1992, the city's solid waste management system has been reformed and contracted out to private sector operators. The programme, focusing on the privatisation of waste disposal and community waste collection, is considered a notable success. Solid waste collection has been fully contracted out by the municipalities and is tendered competitively. There are currently 23 different operators and the collection rate of solid waste has increased from

2–4 per cent in 1992 to currently 45 per cent of the city area. The DSM CC monitors the quality of services and manages the disposal facilities.[40]

- Similarly, the city's central bus terminal is managed by a private operator. Not only does the bus terminal raise more than TSh600 million from fees annually but it creates more than 1,000 jobs. In addition, parking services in Dar es Salaam are privately operated, and the city council receives a certain percentage from fees collected. The operation of local markets is also tendered on an annual basis and successful contractors pay the council a fee.[41]
- On the contrary, the city's experience with PSP for water and sanitation services was not successful. This sector in Dar es Salaam has been particularly constrained with limited capital investments for 30 years. In 2002, a British-German-Tanzanian joint venture – 'City Water Services' – was awarded the tender for a 10-year lease contract to manage the technical and commercial operation of the water and sewerage system in the city. The infrastructure assets remained in government hands and the consortium entered the contract for the implementation of the 'Dar es Salaam Water Supply and Sanitation Project' with DAWASA. The World Bank and other donors awarded US$143 million for repairs, upgrades and expansion of the water and sewerage infrastructure. However, in May 2005, the government, accusing the operator of failure to deliver on its contractual investment obligations and settle the lease fee, terminated the contract and transferred the responsibilities back into the public sphere. The city's water supply and sewerage has since then been managed by DAWASCO.[42]

Going forward, the city is planning some of its future new infrastructure developments in the form of public–private partnerships:

- Urban transport in Dar es Salaam is generally considered inefficient, and of poor quality and safety. Public sector operators only hold a 10 per cent stake in the market, while transport is largely run by private bus operators on an ad hoc basis. The World Bank is currently spearheading the implementation of the Dar es Salaam Rapid Transport Project to improve public transport in the city. Under the auspices of the Dar es Salaam Rapid Transit Agency, a separate lane rapid bus system modelled after the successful Bogotá TransMilenio[43] project is being envisioned. Key project characteristics are:[44]
    - o Total planned investments are US$125 million and operation should start in 2009.
    - o Funding for infrastructure investments will be co-ordinated by the city council, and investments in vehicles to operate the system will be largely privately financed. Two operators are expected to invest US$15 million.
    - o The private sector operator will run the fare collection, management and operation. The project will be operated under a 10-year concession

contract awarded to the operator with ticket prices similar to those of private operators who will be banned from the market. Small subsidy payments are budgeted for the introductory phase.

- Similarly, several new properties are being developed for commercial and residential purposes, with the explicit objective of attracting private sector developers and financiers. Box 3.1 provides a summary of a new property development planned in Kinondoni municipality.

Box 3.1: New property development in Kinondoni municipality

Kinondoni, one of the three municipalities in Dar es Salaam, has attracted private sector developers to invest on a joint venture basis with the municipality, in the development of a new business district accommodating office and residential buildings. As one of the main financiers, the National Social Security Fund will provide seed capital for the project. The plan is that the municipality contributes the plot of land and the investors shall bear the construction cost. While the exact share and management of the development project are still to be agreed, it is expected that the revenues from rents and sales of units will be shared between the municipality and the investor.[45] The rapid urbanisation and tourism potential are driving up land prices in priority areas of the city, which is anticipated to attract private property developers and other financiers seeking to invest in long-term, high-return avenues.

Alternative sources of municipal financing

As noted, the budgets of Dar es Salaam municipalities are largely supported by intergovernmental transfers. The revenue enhancement plans largely focus on strengthening own-source revenues such as property tax and improving financial management.

Currently, the municipalities do not access any alternative financing to the traditional revenue sources. There are several demand and supply side issues constraining the development of market-based financing.

The Local Government Finance Act of 1982 allows LGAs to borrow with ministerial permission. However, borrowing has been negligible. Given the limited resources and financial strength of the municipalities, lenders are not confident to provide financing to the municipalities, unless supported by bankable projects, and/or guarantees from the government or donors. Private sector financiers perceive local government authorities as not being creditworthy and hence highly risky. Also, the PMO-RALG and the Ministry of Finance currently oppose providing loan guarantees for local government borrowing.[46] Hence, despite a substantial level of liquidity in the market, no market lending activities on the sub-national level have evolved.

There appears to be an interest within the Government of Tanzania to expand the possibilities for LGAs to use borrowing as a tool to finance local capital

infrastructure, as long as the framework ensures prudent borrowing in the context of a 'hard budget constraint'. Several measures have been proposed to reform the existing Local Government Loan Board.[47]

As regards the sources of financing, the Tanzanian financial sector is evolving but remains nascent.[48] With the ongoing macro-economic and financial sector reforms, the overall business climate is expected to improve substantially, resulting in the growth of local capital markets and new corporate listings.

The general observation is that there is a lot of liquidity in the economy, but a shortage of local investment-grade and long-tenor assets. Pension funds and insurance companies have excess liquidity and are not allowed to invest offshore. In prior studies, pension funds and insurance companies indicated that they would welcome alternative investment options, like creditworthy infrastructure bonds.[49] There continues to be a strong demand for government securities and bond issues are usually oversubscribed.[50]

Summary

Tanzania has experienced strong economic growth over the last decade. Urbanisation drives the country's economic transformation, with 30–40 per cent of the urban population living in the commercial and industrial capital Dar es Salaam, a city of 3 million. Decentralisation is high on the government agenda, and municipalities are responsible for providing the bulk of infrastructure and municipal services. Dar es Salaam comprises three municipalities, to which the core of revenue raising powers and expenditure responsibilities have been assigned. Overall, the municipalities control 90 per cent of expenditures in Dar es Salaam. The city council only performs a co-ordinating role.

While other local governments in Tanzania depend almost exclusively on government transfers (90 per cent), Dar es Salaam municipalities mobilise a greater level of own-source revenues (about 30 per cent of their budgets) than at the national level. The main sources of own revenues are service levies and property taxes. Revenue enhancement plans are being implemented that aim to strengthen own revenue sources, largely business service levies and property taxes, which are expected to double by 2011. Nonetheless, budgets are still largely supported by government transfers, including the discretionary capital development grants that are expected to increase significantly. An increase in capital investments is very much needed, since the city's infrastructure provision is found to be inadequate and 70 per cent of the population continue to live in informal settlements.

As regards alternate provision and financing of municipal infrastructure, PSP activity is fairly nascent both at the national and municipal level. PSP has so far been limited to contracting out of specific municipal services like solid waste management system, bus terminals and parking services. An attempt at PSP in the water and

sanitation sector failed in 2005. Future projects to attract private participation include a World Bank funded mass urban transit system with private operators and large-scale property developments for commercial purposes, for example, in Kinondoni municipality in the Dar es Salaam region.

Municipal borrowing for infrastructure investments has not taken hold, and local governments need central government permission to borrow. Although the Local Government Loans Board acts as a specialised public municipal lender, loans to local governments remain negligible at 0.3 per cent of total revenues. Several reform measures to expand lending have been proposed, but have not been implemented yet. At the same time, the financial sector is evolving and demand for government securities is strong. Private sector lenders, however, still perceive local governments as not creditworthy and, hence, lending too risky. Potential lenders could be insurance companies and pension funds, which have the appetite for long-term investments and have indicated potential willingness to invest in creditworthy municipal infrastructure bonds.

Notes

1. Organisation for Economic Co-operation and Development (OECD, 2007); International Monetary Fund (IMF, 2007a); United Republic of Tanzania (2004).
2. Bank of Tanzania, 17 September 2007.
3. OECD (2007); IMF (2007a); United Republic of Tanzania (2004).
4. United Nations (2006).
5. United Republic of Tanzania (2004); OECD (2007).
6. World Bank (2006g).
7. See Tanzania – Local Government Laws Amendment Act 1999.
8. CLGF (2007a).
9. Function and expenditure responsibilities are assigned in the Local Government Acts.
10. Braathen et al. (2005).
11. Braathen et al. (2005).
12. Interview with World Bank Tanzania Office, transport specialist in July 2007. The current fuel surcharge is 16 US cents per litre and was doubled some years ago.
13. World Bank (2007a); OECD (2007). The total cost for improving access to safe drinking water and sanitation in accordance with the Millennium Development Targets is estimated at US$2 billion. WaterAid (2005).
14. World Bank (2003); OECD (2007).
15. World Bank (2006a).
16. United Republic of Tanzania (2007b).
17. United Republic of Tanzania (2007a).
18. The allocation process is widely flagged for reform in order to develop the transfer system towards a more efficient, transparent and equitable one. United Republic of Tanzania (2007b).

19. Prior to 2003, each local government was generally allowed to define its own revenue structure, including determining its own tax base and rates. However, the system of local taxes and revenues was widely considered inefficient, inequitable and poorly administered. As a consequence, local discretion in setting own-source revenues was significantly constrained in 2003.
20. For an example, see the case of Dar es Salaam below. United Republic of Tanzania (2006b).
21. The specific case of Dar es Salaam, where a concerted effort is made to better tap into potential sources of property tax, is discussed further below.
22. Interview with PMO-RALG and Local Government Loan Board.
23. United Republic of Tanzania (2006b, 2007b). Interview with Dar es Salaam City Council.
24. DSM CC (2004).
25. Ibid.
26. The provision and management of water and sewerage services is in the responsibility of a separate entity – the Dar es Salaam Water and Sewerage Corporation (DAWASCO), which has been contracted by the Dar es Salaam Water and Sewerage Authority (DAWASA). Once the construction of wells by the municipality is complete, the responsibility is handed over to the water authority.
27. Business-related taxes have a stronger economic base in an urban context. In contrast to a national trend where own-source revenues constitute a mere 10 per cent of local government revenues, the Dar es Salaam region is better off and is able to tap on its more vibrant local economy and property market.
28. A current bill is due in parliament, which will centralise taxation power for local revenue sources like property tax and the service levy (Interviews DSM City Council, PMO-RALG).
29. United Republic of Tanzania (2007b); interview Dar es Salaam City Council, Kinondoni municipality.
30. Funds benefit 31 communities in basic infrastructure provision.
31. Interview with Dar es Salaam City Council.
32. This was much less than the 30 per cent budgeted for development expenditure.
33. Interview with Dar es Salaam City Council and Kinondoni Municipality.
34. Megacities (2007).
35. Interview with Kinondoni Municipality.
36. Some of the public enterprises to be privatised include the National Insurance Corporation, the Tanzania Zambia Railways Authority, commercial units of the Tanzania ports authority and the power utility TANESCO.
37. Infrastructure Finance Corporation Limited (INCA, 2005).
38. Interview with World Bank Transport Specialist. Road development is increasingly administered by TANROADS, which became an autonomous agency by 2005. Most new contracts for road construction and maintenance are performance based and awarded to private contractors.
39. Its main objective was to improve the efficiency of operation, which was successfully realised with decreased dwell time of containers and a doubling of container volumes since start of

operation in 2000. The private operator is responsible for the maintenance of the infrastructure and pays a fixed fee and royalties depending on the volume of containers.

40. Interview with Dar es Salaam City Council.
41. Ibid.
42. IPP Media (2005); World Bank (2003); WaterAid (2003).
43. See chapter 7 for details on the PSP arrangement of the TransMilenio project.
44. Interview with World Bank Office Tanzania (transport specialist) and DSM City Council (finance officer). The bus system shall operate with a total of 142 trunk and feeder buses and 20.9 km of special lanes will be set in place for the rapid transit system with 29 bus stops. The DSM CC will own one of the bus companies, but private operators are encouraged to compete for the second licence. The project further includes investments for five bus terminals and will bring positive externalities in terms of adjacent businesses.
45. Interview with Kinondoni Municipality and the National Social Security Fund.
46. United Republic of Tanzania (2006c, 2007b).
47. Interview with Local Government Loan Board.
48. INCA (2005); private sector demand for commercial lending has grown significantly in recent years.
49. INCA (2005).
50. United Republic of Tanzania (2006a); OECD (2007); interview with National Social Security Fund. Eight companies were listed at the Dar es Salaam Stock Exchange (DSE) by July 2007, of which two were foreign companies. There are still very few corporate bonds listed at the DSE, and trading volumes in corporate bonds are minimal.

4

Uganda – The Case of Kampala

This chapter reviews the state of municipal finances in Uganda, focusing on municipal infrastructure financing in Kampala. In particular, it sets out the country macro-economic context, outlines the framework for decentralisation and local government finances and assesses the municipal finances, and the approaches to service provision and infrastructure financing in Kampala.

Macroeconomic context

Uganda is a landlocked East African country with a population of 28 million, covering an area of approximately 241,000 square kilometres. The country's macro-economic performance over the past decade has been outstanding and per capita GDP growth exceeded the average in sub-Saharan Africa. Savings, exports and foreign direct investment continue to rise and sound macro-economic management with low inflation, stable exchange rates and foreign reserves have arguably supported economic growth. Overall, economic growth averaged 5.5 per cent between 2000 and 2005 and growth rates were higher than in the 1990s. The country's economy was expected to grow at 6.2 per cent in 2007. Urban areas have experienced particularly strong economic growth and poverty reduction. Nonetheless, with an estimated GDP per capita of US$316 in 2006, Uganda remains a least developed country.[1]

In terms of employment, Uganda is still predominantly an agricultural economy. However, the sector's contribution to the economy declined from 53 per cent in 1995 to 34 per cent in 2005. The industrial sector, based mainly on agricultural processing and manufacture of consumer goods, has grown an average of 8.4 per cent annually since 1995 and accounts for 21 per cent of economic activity. The main economic contributor is the service sector, at about 46 per cent of GDP. With the shift in economic activity, Uganda's urban population is expected to increase from 3.6 million (13 per cent) in 2005 to 15 million (21 per cent) in 2030.[2]

Decentralisation framework

Local governments play a key role in local public service provision. The Ministry of Local Government oversees the local government's administration. The following sections outline the functional and fiscal decentralisation framework in Uganda.

Local government legislation and organisation structure

Decentralisation in Uganda was first enshrined in the Local Government Statute of 1993 and later in the 1995 Constitution. The basic structure is laid out in the 1997 Local Government Act[3]. The Act provides a clear and legally based distinction between the roles of central and local governments. There are five basic tiers of local governments in Uganda. Figure 4.1 shows these tiers diagrammatically.

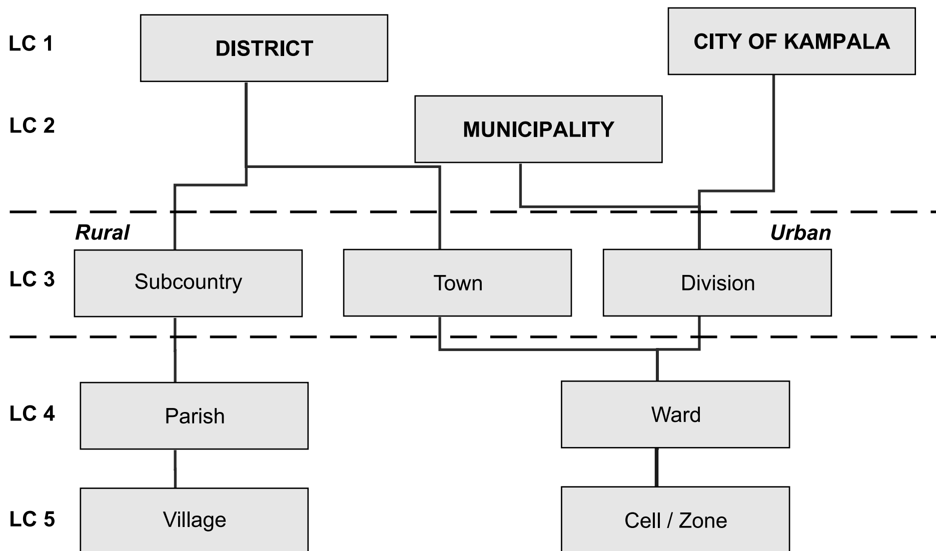

Figure 4.1. Decentralisation in Uganda – tiers of local government
Source: World Bank (2004a) Country Integrated Fiduciary Assessment

The various tiers of local government are linked through administrative arrangements. There is no formal subordination or hierarchical control across the different local government layers.[4]

- The highest level of local governments (LC1) comprises the districts and the City of Kampala. Urban areas are divided into municipalities (LC2) and towns (LC3).
- Only the LC1 and LC2 levels are considered local governments with legislative powers – subsequent levels are for administration purposes. Below LC2, Kampala City and the municipalities are split into divisions and, subsequently, wards and zones.[5] The five divisions of Kampala City Council (KCC) constitute lower local governments.
- In rural areas, the districts are split into subcounties (LC3).

Functional and fiscal devolution of powers

In Uganda, a significant amount of the national budget is spent through the local government system. Local governments are assigned sectoral expenditure responsibilities to deliver basic services that affect their communities directly.[6]

The functions and expenditure responsibilities devolved to the various levels of local governments are set out in table 4.1 below. The provision of most infrastructure services is the mandate of local government. Most of the key functions/expenditure responsibilities are allocated to the KCC, the districts and municipalities. Generally, only the upper government tiers execute significant expenditures on their own.

Table 4.1. Uganda, assigned local government functions and expenditure responsibilities

Level of government	*Responsibility*
City council/districts	• Primary and secondary schools • Primary healthcare and district hospitals • Maternal and child welfare • Construction, rehabilitation and maintenance of feeder roads • Water and sanitation • Land administration and planning • Issue standards and policy guidelines to lower councils
Divisions/subcounty level	Upon devolution by the district/city council: • Nursery and primary schools • Community based healthcare • Maintenance of community roads • Provision and maintenance of local water sources • Social, cultural and sporting activities • Control of soil erosion and protection of wetlands • Monitor administration and service provision in parishes and villages

Source: Ministry of Local Government

Overview of the provision of municipal services

This section provides an overview of local government service provision and expenditure policies across key municipal services. Table 4.2 shows sector expenditures of local governments, with the percentages indicating the magnitude of municipal expenses as a share of the total national public expenditures for the sector. The sector expenditures include donor project funding, which is a significant revenue source for local governments.

The key observations are:

- Local government expenditures peaked in 2001/02 at 35 per cent of the national budgets and have declined since to 26 per cent of budget allocations.

- The *education sector* has consistently had the highest share of local government expenditures, comprising about half of the local government budget over the years. This is a result of primary education being a responsibility of local governments. Also, as indicated by the percentages, local government incurs a majority of the national public education expenditure.[7]
- The *health sector* attracts the next highest financing. While the absolute level of expenditure is much lower than the education outlay, the local spend is a substantial percentage of the national allocation for the sector. However, this has declined significantly from 60 per cent in 2001/02 to around 37 per cent in 2004/05.
- Uganda's spending for *water services* at the local government level has been modest compared to that in education and health and stands at about 3 per cent of local government budgets. The share of local expenditure in these sectors has declined from 50 per cent of total public expenditures in 2001/02 to 27 per cent in 2004/05. These funds are allocated by the centre in the form of a conditional grant to the local governments.[8]
- The other sectors that received funding include agriculture, roads and other local government services.

Table 4.2. Local government expenditures, in billion Ugandan shillings (USh), and as % of total national public expenditures for sector

Sector expenditure	*2001/02*	%	*2002/03*	%	*2003/04*	%	*2004/05*	%
Education	330	73	363	65	393	67	432	68
Health	98	60	104	34	118	31	135	37
Water	25	50	26	29	27	29	29	27
Agriculture	7	18	15	13	20	18	22	18
Roads and works	23	15	18	8	21	8	22	6
Other expenditures	128		147		165		180	
Total expenditure	**611**	**35**	**673**	**26**	**744**	**26**	**820**	**26**

Source: Ahmad et al. (2006)

Local government revenues

This section sets out the sources of revenue of local governments in Uganda. Overall the main trend shows that:

- Intergovernmental transfers, the main source of local government revenues, are gaining further importance.
- Own-source revenues are declining, both in absolute and relative terms.

Further details of each of these revenue sources are presented below.

Intergovernmental transfers

Government transfers exceeded 90 per cent of local government revenues in 2004/05. Table 4.3 presents the trend of government transfers until 2006/07. The key points to note are:

- Conditional grants, which are sector specific, amount to about 90 per cent of the total transfers. Eighty per cent of these grants are allocated for recurrent expenditures.
- Unconditional grants are, in theory, fully discretionary and can be used to delivery direct services to the citizens. In practice, however, unconditional grants are mostly used to cover necessary local administration costs, including councillor wages and allowances.
- Other transfers include compensation for the abolished graduated tax (G-tax), and a limited amount of equalisation grants.[9]

Table 4.3 Transfers to local government, in million USh

Revenues	*2002/03*	*2003/04*	*2004/05*	*2005/06*	*2006/07*
Unconditional grants	77,436	83,037	87,530	98,755	94,396
Conditional grants, of which	588,178	654,896	714,483	733,885	839,291
Recurrent grants	445,957	481,782	544,477	558,075	674,685
Development grants	142,222	173,114	170,006	175,810	164,606
Equalisation grants	4,334	3,534	3,535	3,480	3,494
Compensation for G-tax*				34,860	25,000
Total transfers	**669,948**	**741,467**	**805,548**	**870,980**	**962,181**

Source: Ministry of Local Government, Local Government Finance Inspectorate
*The graduated tax was abolished in 2004, and the central government provided transfers to compensate for the budget gap.

Own-source revenues

Compared to the devolution of responsibilities, local authorities in Uganda have limited own-source revenues. Own-source revenues include property tax, fees and fines, licences and permits, interest on investments, rent from lease of property, market dues, donations, contributions and endowments, and parking fees (graduated tax is now suspended).[10]

Table 4.4 sets out the own-source revenues of local governments until 2004/05.[11] The key points to note are:

- The share of revenues mobilised locally has fallen in 2004/05, and has since dropped further as a result of the suspension of graduated tax. The graduated tax, which represented half of local tax collection, was suspended for a

10-year period in 2005, depriving local governments of their largest revenue source. To compensate for the loss of revenues, a number of new tax sources such as local government service tax, a hotel tax and a local motor vehicle tax, have been put forward in a bill for cabinet approval.

- Other than graduated tax, the main own-source revenues include property tax and user fees/charges. Income from property taxes has been growing gradually. With rapid urbanisation, urban authority permits are a growing source of revenue.
- However, the magnitude of other fees is limited, since local authorities have limited ability to modify tax bases and rates.

Table 4.4. Local government own-source revenues, in million USh

Revenues sources	*2002/03*	*2003/04*	*2004/05*
Graduated tax	44,116	45,134	25,675
Property tax	13,563	10,625	24,666
User fees/charges	17,801	22,005	16,783
Urban authority permits	7,054	9,933	11,327
Other revenues	16,150	23,136	8,586
Revenue from departments	2,178	2,554	3,036
Total own-source revenues	**100,862**	**113,387**	**90,073**

Sources: Ministry of Local Government, Local Government Finance Inspectorate

Overall, local authorities have poor administrative capacity and lack strong enforcement practices for tax collection. Furthermore, own-source revenues are subject to political manipulation.[12] The revenue-sharing arrangements within local governments are complex. Local revenues are redistributed within districts and municipalities, after being collected at the lower local government units. This redistribution takes place through a complex transfer system that has often generated incentives for underreporting revenue collections.[13]

Local government borrowing

In principle, borrowing by local governments is allowed by law, but is limited to 25 per cent of locally generated revenue by the Local Government Act. In addition, any type of lending activity is subject to central government approval. Thus far, local government borrowing has been limited to working capital management. There are also deficiencies in the financial reporting and accounting practices of local governments. For example, International Monetary Fund (IMF) reports show that borrowings are often not included in budget documentation and there is currently no comprehensive information on the debt or contingent liabilities of local governments.[14]

Local government financial management

The public financial management of local governments in Uganda was found to be coherent, but has a number of flaws in capacity and institutional design. Some issues related to budgeting and planning include:[15]

- The link between the specific policies and plans to the actual budgets is weak. Strategic development plans are often not properly linked to local budgets.
- Local budget implementation and expenditure controls are weak, reflecting capacity constraints and institutional loopholes.
- Local authorities lack an effective cash planning system. Most sub-national governments do not forecast their intra-year disbursements or plan their use, with cash received from the local government's own revenue collections being disbursed in an ad hoc manner.

The case of Kampala

This section studies the municipal finances and service delivery in Kampala. It sets out the city context and describes the administrative framework guiding municipal finances in the city. The section goes on to discuss the sources of municipal revenues and expenditures respectively. It then discusses private sector participation in the city's service provision before finally examining the current state and potential of market finance.

City context

Kampala, the capital of Uganda, is expanding more rapidly than any other city in the country. The city is the hub of the country's economic, political and administrative activities. It is estimated that about 80 per cent of the country's industrial and services sectors are located in Kampala and the city now generates over 50 per cent of Uganda's GDP.[16] Industrial activities are mainly medium-size manufacturing, small-scale agro-processing coupled with an informal small-scale industrial sector. The informal sector employs many people and is also growing rapidly.

Kampala has a population of about 1.2 million growing at 4 per cent per annum, with a day population of about 2.5 million. Table 4.5 shows the rapidly growing population of the city since 1980.

Table 4.5. Kampala population growth

Year	*Population*	*City growth rate*	*National population growth rate*
1980	458,503	3.14%	2.71%
1991	774,241	4.76%	2.52%
2002	1,208,544	4.10%	3.40%

Source: Kampala CDS (2003)

The urban expansion of Kampala is driven by demographic shifts in the form of rural-urban migration, which has led to creation of unplanned settlements and housing pressures in the city.[17] Over 60 per cent of Kampala's population lives in slums and only 20 per cent of the city area has been planned, with effective city planning being limited by existing land tenure systems.[18]

City administration and allocation of responsibilities

The City of Kampala is a district under the 1997 Local Government Act. The mission of Kampala City Council (KCC) is 'to provide and facilitate the delivery of quality sustainable, customer oriented services effectively and efficiently'. KCC consists of five political administrative divisions namely Central, Kawempe, Makindye, Nakawa and Rubaga. Each of the five divisions is divided into parishes, with a total of 100 parishes in Kampala.

Table 4.6. Kampala – administrative units and councillors

Area	*Parishes*	*Villages*	*Population*
Central	20	138	90,392
Kawempe	22	122	268,659
Makindye	22	132	301,090
Nakawa	23	279	246,298
Rubaga	13	131	302,105
Total District	**100**	**802**	**1,208,544**

Source: Kampala City Development Strategy (2003)

KCC is responsible for making policy decisions and by-laws and also monitors the implementation of service delivery programmes and policies. The enactment of the Local Government Act 1997 gives urban authorities autonomy over their financial and planning matters. KCC is responsible for:

- education,
- medical and health services,
- water construction and rehabilitation,
- maintenance of roads and
- all other decentralised services and activities.

While KCC is predicated to devolve the provision of certain services to lower government levels, it remains responsible for providing these key public services.

Municipal revenues

KCC's total local revenue sources have remained more or less stagnant over the last few years. Table 4.7 provides details. While a description of the main sources of revenues are provided below, the key points to note are:

- Of the total revenues of KCC, nearly 50 per cent accrues from own-source revenues and the remainder from transfers.
- Property related taxes amount to 18 per cent of revenue sources. Business-related taxes accounted for about 9 per cent of local revenues in 2006/07. The abolition of the graduated tax has adversely impacted the level of own-source revenues.
- More than 70 per cent of government grants are as earmarked for delegated services or as conditional grants.
- KCC has so far not engaged in any borrowing activities to finance capital expenditures. However, a loan of 1 billion Ugandan Shillings (USh) is expected to be raised in 2007/08.
- Despite not being a part of the official financial accounts, donor financing has increased and amounted to about USh18 billion in 2006/07, which adds funds equivalent to a third of the city's total budget.

Table 4.7. Kampala revenue structure, 2004/05 to 2007/08, in million USh

Revenues	*2004/05*	*%*	*2005/06*	*%*	*2006/07*	*%*	*2007/08**	*%*
Total own-source revenues, of which	**18,384**	46	**19,659**	39	**19,698**	42	**27,481**	51
Total property rate	4,521	12	5,201	10	6,552	14	9,550	18
Licences	3,862	10	3,572	7	3,916	8	4,795	9
Vehicle parks/street parking	3,549	9	3,834	8	2,848	6	4,329	8
Debt realisation	162	0	283	1	519	1	2,936	5
Ground rent	1,683	4	2,466	5	2,160	5	1,502	3
Markets	1,049	3	1,065	2	1,389	3	1,564	3
Building plans	0	0	1,057	2	1,289	3	1,418	3
Advertising	0	0	133	0	275	1	225	0
Housing	38	0	20	0	14	0	35	0
Graduated tax	3,520	9	–		–		–	
Other income	2,247	6	2,030	4	736	2	1,126	2
Capital income	3,646	9	3,782	8	2,844	6	949	2
Total local revenue	**22,030**	56	**23,441**	47	**22,542**	48	**28,430**	53
Total transfers, of which	**17,638**	45	**26,450**	53	**23,985**	52	**24,255**	45
Unconditional grants	2,629	7	4,040	8	4,520	10	3,872	7
Delegated funds	9,236	24	11,005	22	10,012	22	10,012	19
Conditional grants	5,773	15	11,405	23	6,289	14	6,416	12
Compensation for G-tax	–		–		3,164	7	3,955	7
Bank borrowing	–		–		–		**1,000**	2
Total revenues	**39,668**		**49,891**		**46,527**		**53,685**	
Donor financing**	**21,883**		**1,702**		**18,000**		**18,000**	

Source: KCC (2007a,b,c)

*Estimated budget, **the majority of donor funding to KCC is disbursed directly to projects and is not part of the council's financial accounts

Own-source revenues

Local own-source revenues amounted to USh22.5 billion in 2006/07 – about 51 per cent of KCC's total revenues. This is in contrast to the national trend, where own-source revenues are limited to about 10 per cent of local government budgets. However, it is felt that the full potential of own-source revenues has not been realised. Own-source revenue in KCC, as shown in table 4.7, comprise:[19]

- *Property tax:* This is currently the largest revenue source for KCC. Revenues have been growing constantly over the last years, and KCC collected USh6.55 billion in 2006/07.[20] The collection of property rates was contracted out in March 2003 to five private collection firms. However, many properties remain off the property roll and the revenue potential is reduced by many exemptions.
- *Business licence fees:* With revenues from trading licences contributing around 10 per cent to the total budget, KCC appears relatively successful in tapping business-related own-source revenues. However, some business categories are not marked for licensing (e.g. hotels, bank, power, water, telephone companies, etc.) and licence fees in all categories are considered low and have not been revised in a long time.
- *Vehicle parks and street parking:* The collection of revenues from the KCC's two vehicle parks has been contracted out since 1995. The management of street parking is also contracted out. KCC raised a total of USh2.8 billion in funds from the operators of the vehicle park and street parking. However, payments for the vehicle park fell short of the contract sum and substantial potential revenue from street parking remains untapped.
- *Ground rent:* This amounted to USh2.2 billion in 2006/07, equal to five per cent of all local revenues. Ground rents remain limited because of an inadequate database and an ongoing conversion of leased land into freehold land.
- *Market fees:* A total of USh1.4 billion was collected in 2006/07 in current contract sums or arrears from contractors for markets. Overall markets only realised 50 per cent of the contract sums in the budget, on account of illegal markets backed by lower councils and a lack of managerial skills by private revenue collectors.

It expected that in the future, own-source revenues will be raised from the proceeds of the new taxes to be levied in lieu of graduated tax. These include local government service tax, the hotel tax and the local motor tax. The cabinet has already approved the municipal service tax.

Intergovernmental transfers

KCC anticipated receiving USh25.9 billion in central government transfers in 2006/07. It is argued that national transfer policies put KCC at a disadvantage since transfer calculations are based on the census population and do not account for a day population twice as high as census data.[21] Government transfers comprise:[22]

- Conditional grants, which are supposed to fund national priority programme areas,
- Delegated funds, the bulk of which is allocated for salaries of primary and secondary teachers, and
- Unconditional grants, which are limited to about 20 per cent of government transfers.

Revenue enhancement plans

As a core part of the World Banks' Institutional and Infrastructure Development Project, KCC has designed a financial recovery plan.[23] The revenue enhancement component of the recovery plan focuses on medium-term strategies up to 2009/10 on how best KCC could enhance its local revenues. A key element of this programme is capacity building for improved local financial management and enhanced revenue collection measures. Specifically, revenue enhancement measures include:[24]

- *Raising tax awareness amongst the public*: Across most revenue sources, the revenue enhancement strategy aims at sensitising the public about their obligation to pay taxes for service delivery. KCC is building compliance in the community through accountability and transparency using a public awareness campaign, councillor's education programmes on the need to pay taxes, better linking taxes to services, and reducing bureaucracy. These measures will be accompanied by stricter enforcement of prompt payments for all revenues.
- *Effective billing:* KCC aims at privatisation of all revenue sources for which it aims to have efficient and effective contractors for property rates. Measures include stricter monitoring of contractor performance, procurement of new contractors with stronger capacity, and where contractors are adequate, renegotiation of running contracts. KCC plans to award contracts on a 12-month period as opposed to the current three years, which often discourages competition and encourages complacency.
- *Enhancing property tax revenues:* A number of measures are ongoing to improve revenues from property tax. Proceeds are expected to increase to a level of USh12 billion by 2010.[25] Among others strategies, KCC aims for a change in the law on owner-occupied properties, to engage more reputable

companies to collect all property rates, undertake supplementary valuation every two years, and link properties to the GIS system. In addition, measures will be taken to recover property tax arrears.

- *Maximising revenue from trading licences fees.* These measures seek to amend the Licensing Act for new businesses, revise grades and fees and continuously update the licensing database. Further strategies include stricter supervision of contractors, stronger enforcement measures and improved awareness of the need for tax compliance among business owners.
- *Strengthening revenue from markets fees.* KCC aims for a new market law and an improved policy for the management and development of markets. It intends to improve contract management for markets and adopt a hard stance on illegal markets.
- *Widening the tax base.* New sources of revenue are being considered, including taxation of idle land, community and user charges. Further reform measures are planned to strengthen revenues from the ground rent, commercial vehicles, advertising and building plans.

Overall the revenue enhancement plan aims at increasing own-source revenues in KCC from USh19.7 billion in 2006/07 to about USh29 billion by 2010/11.

Municipal expenditures

Following the analysis of KCC's municipal revenues, this section outlines the corresponding expenditures for service provision. KCC's total expenditure has increased since 2004/05 and amounted to about USh47.8 billion in 2006/07. Some general trends in expenditures are:

- Recurrent expenditures amount to more than 80 per cent of KCC's expenditures. Of these, more than 50 per cent of expenditures are spent on paying salaries and wages for employees for delegated activities,[26] to cover related administrative costs, and the recurrent establishment costs for the council (committee).
- Capital expenditure amounts to about 20 per cent of the total spend, half of which is spent on loan repayments and payments to creditors. The remainder of about 10 per cent of expenditures go to sector specific conditional transfers and road maintenance.
- Capital expenditure for donor projects (about USh18 billion in 2006/07) are not channelled through KCC's budget. The budget only shows capital expenditures in form of counterpart funds.

Table 4.8. Kampala expenditure structure, 2004–2007, in million USh

Expenditures	*2004/05*	*%*	*2005/06*	*%*	*2006/07*	*%*	*2007/08**	*%*
Recurrent expenditures, of which	**35,136**	82	**37,988**	80	**38,583**	81	**39,694**	75
Delegated fund activities	9,236	22	11,005	23	10,012	21	10,012	19
Conditional grant activities	5,076	12	4,597	10	5,618	12	5,731	11
Employees	5,153	12	5,153	11	5,411	11	5,681	11
Administration	5,034	12	4,534	10	4,029	8	4,110	8
Health	1,104	3	2,796	6	2,936	6	3,083	6
Council (committee)	1,860	4	1,860	4	1,953	4	2,051	4
Property	1,832	4	1,832	4	1,924	4	2,020	4
Transport and plant	1,736	4	1,736	4	1,823	4	1,914	4
O&M others	1,325	3	1,516	3	1,592	3	1,671	3
Donors activities	920	2	973	2	1,200	3	1,200	2
Others**	1,860	4	1,986	4	2,086	4	2,222	4
Capital expenditures, of which	**7,758**	18	**9,400**	20	**9,183**	19	**13,024**	25
Conditional grant	697	2	2,275	5	671	1	685	1
New investments	35	0	30	0	–		6,000	11
Counterpart funds	1,043	2	814	2	–		–	–
Transport and equipment	295	1	130	0	130	0	300	1
Machinery and equipment	289	1	125	0	125	0	131	0
Land, buildings, etc.	–		–		600	1	800	2
Roads and bridges	1,159	3	864	2	1,850	4	2,000	4
Payment of creditors***	4,139	10	3,980	8	5,160	11	2,929	6
Others****	101	0	1,182	2	647	1	179	0
Total expenditures	**42,894**		**47,388**		**47,766**		**52,719**	
Capital expenditure from donor projects	24,934		5,262		18,000		18,000	

Source: KCC 2007 a,b,c
*Estimated, **Including production and welfare, boards commissions, roads and bridges ***Including loan repayments ****Including furniture/fitting, retrenchment, research

Municipal service provision and local PSP activities

Kampala's rapid urbanisation has increased the pressure on the city's infrastructure facilities. Some key challenges KCC faces in this context include:[27]

- About 70 per cent of land in Kampala is privately owned, making planning and provision of land for infrastructure development difficult.
- There is inadequate funding for infrastructure provision resulting in problems in solid waste management, poor road maintenance and insufficient

coverage of water and sanitation services. Unplanned developments magnify these problems.

- Local contractors widely lack planning and implementation capacity. In addition, there is limited expertise and transfer of knowledge by stakeholders involved in infrastructure development.

Given these challenges, KCC has been active in engaging the capacities of the private sector in local service provision.

PSP at sub-national level

There is an absence of an overarching legal and regulatory framework for PPPs, both at the national and at sub-national level.[28] However, the Local Governments Act 1997 permits local governments flexibility in choosing the most effective methods of service delivery. All urban councils may contract out services to the private sector, and local governments are encouraged to outsource service provision.[29] In line with this policy, KCC has been actively pursuing contracting out of non-core public services since 1995. KCC concentrates on the role of a facilitator and enabler in service delivery.

The most notable examples of PSP include outsourcing contracts in solid waste management, road maintenance, operation of the taxi park, street parking and local markets. PSP has largely materialised in contracting out of these services to the private sector, while KCC retains the overall supervisory and regulatory control. Contracts are generally awarded for one to three years on a competitive basis using standardised contract documents.[30]

There are no official estimations of efficiency savings through private sector contracting of services. Lack of competitiveness of the tendering process and poor capacity of the private sector operators remain problematic in many cases and the quality of services provided is found to be poor. Table 4.9 briefly describes the most significant examples of PSP in the city.

Table 4.9. Ongoing practices of PSP in Kampala

Municipal services	*Examples of private sector participation*
Solid waste management	KCC embarked on a policy reform to revise the solid waste management ordinances and resolve the poor state of environmental conditions in the city. In 2004, this led KCC to involve private sector operators in collection and transportation of wastes to the landfill. KCC remains responsible for waste disposal while collection and transportation is fully privatised.[31] However, there have been growing complaints about inadequate collection and contracts are to be re-tendered shortly.[32]
Road maintenance	The city's five divisions are in charge of road maintenance. Maintenance work is largely contacted out to private sector operators and payment is said to be performance related. The award of contracts attracts a lot of attention and is allegedly subject to strong political interests.[33]
Retail/ wholesale markets	Markets are in most cases managed, controlled and maintained by private firms. The operation is advertised competitively and contracted out. Revenues are collected from market fees and the operators are obliged to make fixed contractual payments to KCC.[34]
Taxi park	The operation of the city's taxi park is contracted out. The initial contracts attracted funding of USh60 million per month. However, the contract value was renegotiated and the current collection from the taxi park amounts to USh120 million per month.
Property development	There are currently plans to harness private sector activity in property development. Two KCC owned estates are dedicated for development by private operators. The development is expected to include housing units and business parks. KCC provides the land to private operators for free and, in turn, expects to collect a substantive amount of property rates once construction is complete. The infrastructure should be returned to KCC after about 15 years. Total investment is estimated at US$300–400 million.[35]

Alternative sources of municipal financing

As mentioned earlier, to date neither KCC nor other municipalities in Uganda have accessed any borrowing from the capital or credit markets for their capital investments. The idea of a municipal fund type institution, as well as the possibility of accessing capital markets has been explored in the past, but it has not materialised.[36] The cost of raising funds through commercial banks is very high to meet the credit needs of sub-national governments. Also, the creditworthiness of sub-national governments remains an issue, and local authorities have few securities or assets in the form of buildings and other property.[37]

In 2007/08, KCC intended to borrow USh1 billion from Stanbic Bank to finance development projects in the city.

The state of the Ugandan financial sector

The financial markets in Uganda have limited depth and breadth of products, but are gradually evolving. In the late 1990s, the Bank of Uganda and other commercial banks supported the introduction of long-term government bonds. The Kampala Stock Exchange was set up in 2000 and has issued long-term bonds of up to 10 years since 2004. The market capitalisation in 2007 was about US$2.9 billion with 22 bonds traded in the fixed income market. From the take-up of government bond issues, there appears to be sufficient liquidity in the capital market.[38] Nevertheless, there are limited investors that hold long-term liabilities and can invest in long-term assets. One such potential investor, the National Social Security Fund (NSSF), has USh600 billion of its current portfolio of USh800 billion invested in fixed-income securities.[39]

Some of the key challenges to further develop the country's financial markets include:

- The savings rate in Uganda remains low at about 10 per cent of GDP. This is not expected to change in the near future, without a concerted effort to expand financial sector outreach.[40]
- There is a need for competition in, and regulation of, the pension industry. The current social security reforms envisage the abolition of NSSF's exclusive status in mobilising compulsory savings to foster demand for capital investment. This is expected to lead to the emergence of several private providers offering competing savings vehicles, supervised by an independent regulator for the industry. The regulator is expected to close down bogus schemes and clearly stipulate how much of the funds collected should be invested in the country to benefit the wider economy.[41]
- The absence of sufficient long-term funds in financial institutions has made long-term lending and borrowing hard. This continues to constrain long-term investment sectors, such as the mortgage industry. In an attempt to jump-start the development of the mortgage market, the International Finance Corporation (IFC) has issued a partial local currency guarantee to the NSSF for lending to local commercial banks.[42]

Summary

Uganda's economic performance over the last decade has been outstanding by regional standards, and growth has particularly occurred in urban areas. The country's urban population is expected to increase fourfold to 15 million by 2030. Local

governments in Uganda have been assigned a large set of functions and their expenditures account for almost a quarter of national public expenditures.

Kampala, the capital with a daytime population of about 2.5 million, generates over 50 per cent of the country's GDP and hosts almost the entirety of the country's industrial and service sectors. The city represents the highest level of local government, has legislative power, financial and planning autonomy, and executes significant expenditures on its own. It can devolve certain municipal service responsibilities to its five urban divisions.

Kampala's fiscal capacity is strong in comparison with other local governments, which depend almost exclusively on government transfers (on average 90 per cent) and suffer from declining own-source revenues. The city is taking initiatives to strengthen its pool of own-source revenues, which currently constitutes 50 per cent of the city budget. Property tax and business-related taxes are the main revenue drivers. Enhanced revenue collection and improved financial management are expected to strengthen own-source revenue further. Nevertheless, revenue sources, in particular government transfers, are considered insufficient to close the infrastructure financing gap. The city is unable to ensure proper operation and expansion of infrastructure services, and 60 per cent of the population live in unplanned settlements.

The private sector capacity to provide and finance infrastructure services has only been harnessed to a limited degree. Borrowing is allowed by law, but confined to a maximum of 25 per cent of own-source revenues. Kampala has so far not accessed market finance. The financial sector is evolving and long-term government bonds have been taken up comfortably. However, market financing has not been pursued at the municipal level.

As for private sector participation (PSP), the city council has been contracting out services like solid waste management and operation of taxi parks. However, an overall legal and regulatory framework to strengthen PSP at the national and subnational level is still outstanding. The lack of local capacity to implement infrastructure projects has been named as a further constraint.[43]

Notes

1. The Republic of Uganda (2005); (IMF 2007a); (IMF 2007b).
2. World Bank (2006d); United Nations (2006).
3. In addition to the Local Government Act 1997, the fiscal decentralisation framework is supported by Local Government Financial and Accounting Regulations (LGFAR), initially enacted in 1998 and revised in 2005. It is in line with the 2003 Public Finance and Accountability Act and covers the framework for development planning, budgeting, revenue collection, expenditure management, accounting and audit.
4. The Republic of Uganda (2006); Ahmad et al. (2006).

5. Commonwealth Local Government Forum (2007b). Overall, the local government system comprises 69 districts, 88 town councils, 13 municipal councils, 900 subcounties, 5,225 parishes and 44,402 villages. In the rural areas, the districts are split into subcounties (LC3) and subsequently into parishes and villages.
6. The Republic of Uganda (2002). To address some outstanding problems in the decentralisation process, the Fiscal Decentralisation Strategy (FDS), adopted in 2002, aims to improve the grant allocation formulae and expenditure management by local governments.
7. Despite increased allocations of government transfers to the sector and universal primary education as a key government policy, the quality of primary schools and their infrastructure remains inadequate.
8. Ahmad et al. (2006).
9. Equalisation grants are given to local governments that are lagging behind the national average standard in service delivery. It is planned that the magnitude and distribution of these grants will be revised in the context of the Fiscal Decentralisation Strategy (Ahmad et al. 2006).
10. Section 81 of the Local Government Act 1997 provides local government powers to levy, charge and collect fees and taxes.
11. There is currently no recent financial data on own-source revenues across all local governments available from local government institutions.
12. For example, due to its lack of popularity, the graduated income tax was picked up as a frontline issue in the local and presidential campaigns of 2004/05.
13. Ahmad et al. (2006).
14. Ibid.
15. Ibid.
16. World Bank (2005b).
17. Lwasa (2004).
18. UN-Habitat (2007).
19. KCC (2007a,b,c).
20. Property tax collection is governed by the Local Government (Rating) Act 2005. The Act provides for the levy of rates on property by local governments within their areas of jurisdiction. However, the Local Government (Rating) (Amendment) Act 2006 has exempted all owner-occupied residential buildings in an urban area.
21. Kampala City Development Strategy (2003).
22. KCC (2007a).
23. World Bank (2005b). Earlier revenue enhancement strategies, which started in the 1990s, included contracting out of revenue management by promoting PPPs and divesting KCC of non-core activities.
24. KCC (2007b).
25. KCC (2007c).
26. The council currently employs 326 health staff, 639 regular council staff, 1,476 primary school staff, 1,043 secondary school staff and 94 tertiary institutions staff. There are also

several hundred pension staff. The teachers' bill is a delegated service that is handled separately.

27. Kampala CDS (2003); Interview with Kampala City Council.
28. Generally the national precedence for PSP is very limited. There were attempts to build toll roads in the 1990s, but the plans were discarded.
29. Interview with World Bank Kampala Office, and KCC.
30. Interview with KCC.
31. Households pay between USh10,000 and 15,000 per month for door-to-door emptying of their waste storage facilities.
32. Interview with KCC.
33. Interview with Kampala World Bank Office and KCC.
34. Ibid.
35. Interview with KCC.
36. Danida (2000).
37. Interview with Local Government Finance Inspectorate, and the Kampala Securities Exchange.
38. Interview with Kampala Securities Exchange.
39. Kitabire (2005).
40. *East African Business Week* (2007).
41. *People Daily* (2007). The NSSF, which is a mandatory contribution scheme, has an asset portfolio of USh800 billion in 2007. Apart from that, there are more than 50 private occupational savings schemes, with assets of about USh100 billion – these funds remain unregulated.
42. IFC (2007). The guarantee of US$10 million will enable the mobilisation of a total of US$40 million in local currency mortgage long-term funding for developing a sustainable mortgage market.
43. At the time of writing, the government is commissioning consulting services to strengthen the PPP environment and intends to set up a PPP unit.

5

Pakistan – The Case of Karachi

This chapter sets out the context of local government finances in Pakistan and reviews the state of municipal infrastructure financing in Karachi. It describes the country's economic and local government framework in an urban context, along with the framework for decentralisation and local government finances. The section goes on to focus on the state of infrastructure finance and private sector participation in municipal service delivery in Karachi.

Macroeconomic context

Pakistan is a federal state situated in the north west of the Indian subcontinent. It has a land area of 796,095 square kilometres and a population of 162 million. The country's economic growth averaged 3.7 per cent over the period of 1995 to 2005, and has picked up considerably in the recent years with a growth rate of 7.8 per cent in 2005. An average growth rate of 6.5 per cent is expected for the period of 2005 to 2009. Pakistan's GDP per capita was estimated at US$830 in 2006, while the inflation rate was 7.9 per cent in that same year. Deregulation and privatisation, particularly in banking, telecommunications, and the oil and gas sectors are believed to have had a positive effect on the economy.[1]

Most of the recent GDP growth has come from the industrial and service sectors. The share of the agricultural sector was 24 per cent of GDP in 2004. In parallel with the shift in the country's economic structure, the level of urbanisation in Pakistan is one of the highest in South Asia. About 35 per cent of Pakistan's population lived in urban areas in 2005 and the urban population is likely to equal 50 per cent by 2030. There is a huge variation in the size of local governments, with more than half of the total urban population living in eight urban agglomerations in 2005.[2] Between 2000 and 2005, these cities grew at the rate of around 3 per cent per annum, and this growth is expected to continue over the next decade. The growth of informal settlements in the two megacities, Karachi and Lahore, has been particularly significant.[3]

At the same time, given fiscal constraints, government expenditure on infrastructure has fallen from around 5.5 per cent of GDP in 1993 to 3 per cent in 2003. Recent private sector investment in infrastructure primarily focused on the power sector. The government's constrained development budget has limited the capacity to provide adequate infrastructure services to its growing population. At least one in every three city dwellers in Pakistan lives in slums.[4]

Decentralisation framework

This section outlines the fiscal and functional framework for decentralisation that governs local government in Pakistan.

Local government legislation and organisation structure

Pakistan is a federation of the four provinces of Balochistan, North West Frontier, Punjab and Sindh. In 2000, the federal government launched a programme to restructure the administrative, functional and fiscal relations between different levels of government. The main local government legislation is the Local Government Ordinance (LGO) re-enacted by each province in 2001. This transferred a larger set of responsibilities and more autonomy to lower levels of government.[5] The devolution process was based on a number of structural changes, including the abolition of the divisional tier under provincial administration and the creation of a new, tiered structure of local governments comprising:

- districts (city districts in the four provincial capitals),
- towns (*tehsils*), and
- union administrations.

At present, the number of local governments in the country is as under (NRB 2009):

- City districts: eight, including four provincial capitals
- Districts: 102
- Towns: 68 (in city districts only)
- *Tehsils*: 334
- Union councils: 6,125

The large cities have the status of a city district to deliver 'organised urbanisation'.

Functional and fiscal devolution of powers

Under the new government structures, provinces are transformed from direct providers of largely municipal services to financiers and regulators of lower levels of local government that are expected to deliver services.[6] Consequently, the district governments have been assigned certain local functions, which were previously performed by the provincial government. Figure 5.1 sets out the split of responsibilities across different levels of local government. Since the devolution of service delivery in 2001, the current functional devolution is organised as follows:

- The four *provinces* are, inter alia, exclusively responsible for highways (inter-district roads), irrigation, and industrial and labour regulation.

Provinces further have shared responsibilities with the districts for health and education.

- The focus at the *district* level is on education, health and infrastructure development. Provinces largely devolved budgeting, planning and development of these functions.
- At the *town (tehsil)* level, the town municipal administrations take responsibility for key municipal services such as water supply, sewerage, sanitation, drainage schemes and street lights. In urban areas, however, the city districts, not the towns, undertake these responsibilities.
- Community-based services are largely dealt with at the *union* level.

In addition to the higher responsibilities and authority, decentralisation foresees a shift of financial resources to the lower levels, which is expected to strengthen participation and accountability of local governments.

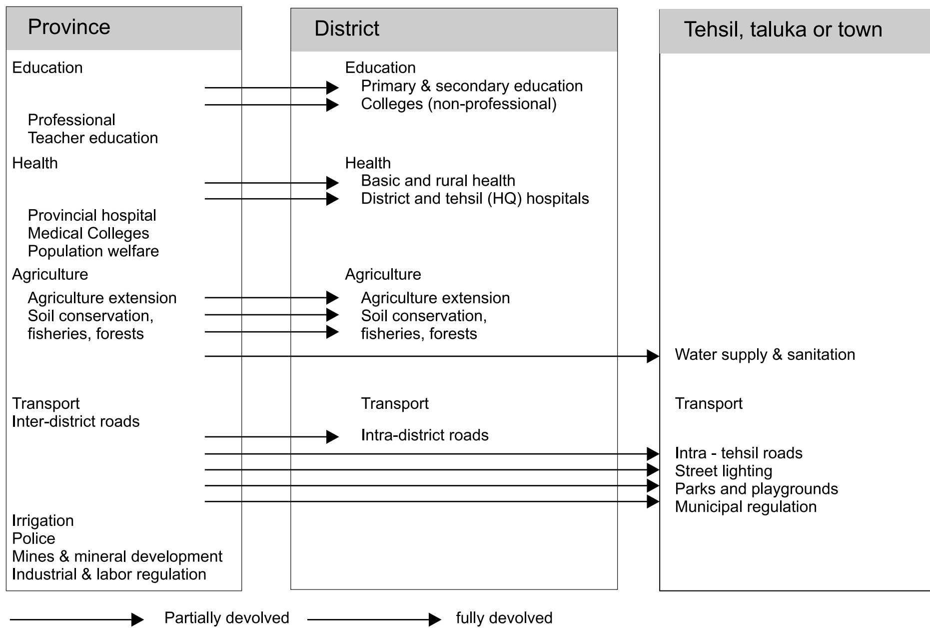

Figure 5.1. Post-devolution assignment of responsibilities to local governments
Sources: ADB/DFID/World Bank (2004); Local Government Ordinances 2001

Provision of municipal services and expenditure

Given the pressure on infrastructure facilities through rapid urbanisation and increased local government responsibilities, it remains a key challenge for local governments to deliver adequate infrastructure and public services. For example:

- Only 63 per cent of the overall population has access to potable water and as little as 42 per cent of the population has access to sanitation facilities. With the exception of a few big cities, sewerage facilities do not exist.[7]
- Only 40 per cent of solid waste is disposed of properly.
- A large proportion of provincial roads are in poor condition.[8]

Local government expenditures

Since there is no up-to-date financial data on countrywide provincial and district budgets available, we use the province of Sindh to illustrate the structure and size of sub-national budgets. Table 5.1 sets out the expenditure budget of the province of Sindh. The key points to note are:[9]

- Current expenditures amount to 120,825 million Pakistan rupees (PRs) or 69 per cent of the total budget in 2006/07. The volume of development spending, although only 31 per cent of total expenditures in 2006/07, has increased significantly over the years.
- With greater responsibilities devolved to local government at the district and town level, recurrent expenditures like salaries constitute a relatively low share of provincial budgets (16 per cent in the 2006/07 budget). In turn, a significant amount of local government transfers are allocated toward salaries at the district level. About a third of the total provincial budget is passed to lower levels of local government, in the form of transfers to city districts and towns.
- Funds for development expenditures include own provincial contributions, foreign/donor assistance and federal grants. Development expenditures include PRs8,000 million (in 2006/07), which is transferred to the district governments. Overall, as a magnitude of expenditure, transport, housing, water and education have been assigned the highest priorities in 2006/07.

Table 5.1. Province of Sindh expenditures – PRs in million

Expenditures	*2003/04*	*%*	*2004/05*	*%*	*2005/06*	*%*	*2006/07**	*%*
Current expenditures, of which	**76,093**	**80**	**85,055**	**74**	**106,620**	**71**	**120,825**	**69**
Expenditures of province	33,491	37	42,254	36	60,121	40	66,327	37
Wages	12,307	13	20,370	18	25,434	17	27,723	16
Commodities and services	4,622	5	4,877	4	13,697	9	18,420	10
Interest payments	10,110	11	9,731	8	9,060	6	9,377	5
Pension	4,393	5	4,216	4	4,825	3	5,115	3
Repairs and maintenance	1,552	2	2,553	2	2,674	2	3,476	2
Subsidies	507	1	507	0	4,431	3	2,216	1
Local government transfers	42,602	45	42,802	37	46,498	31	54,499	31
Salary to district government	20,217	21	22,894	20	24,271	16	27,749	16
Transfers to district govts	8,165	9	10,676	9	13,784	9	17,462	10
Grants to LG and others	14,220	15	9,232	8	8,443	6	9,288	5
Development expenditures, of which	**19,095**	**20**	**29,453**	**26**	**42,756**	**29**	**55,197**	**31**
Provincial ADP	10,849	11	11,074	10	20,664	14	27,000	15
District ADP	–		6,885	6	6,593	4	8,000	5
Federal/donor funding	8,246	9	11,494	10	15,499	10	20,197	11
Total expenditures	**95,188**		**114,508**		**149,376**		**176,022**	

Source: Finance Department Government of Sindh (2007)
*Estimations

Provincial and local government revenues

This section sets out details of provincial and local government revenues. It first provides an overview of total sub-national finances across the provinces of Pakistan. It then reviews in more detail the finances of the province of Sindh as an illustrative example.

Table 5.2 summarises the main sources of provincial revenues in 2002/03.[10] The key points to note are:

- The recurrent revenues in the provinces are primarily comprised of federal transfers (80 per cent in 2002/03) and only a limited amount of provincial own-source revenues.[11] Across the four provinces, Punjab is endowed with the largest budget (more than double that of Sindh, which is the second largest).
- While reliance on federal receipts varies in magnitude between 68 and 95 per cent, the overall dependence of the provinces on government transfers is apparent.
- Except for the province of Punjab, the others rely more heavily on non-tax charges for their own-source revenues. Only Punjab raises higher revenues from provincial taxes compared to non-tax receipts.

Table 5.2. Provincial consolidated revenues – in PRs million, 2002/03

Current revenues	*Balochistan*	*NWFP**	*Punjab*	*Sindh*	*Total*
Federal transfers	22,960	27,357	107,275	57,299	214,891
Provincial taxes	594	1,775	12,568	7,851	22,788
Provincial non-tax receipts	733	7,907	9,494	19,096	37,230
	%	%	%	%	%
Federal receipts	94.5	73.9	82.9	68.0	78.2
Provincial taxes	2.4	4.8	9.7	9.3	8.3
Provincial non-tax receipts	3.0	21.3	7.3	22.7	13.5

Source: ADB/DFID/World Bank (2004)
*North West Frontier Province

The following subsections provide an outline of the different revenue sources – transfers, own-source revenues and borrowing of provincial governments. This is followed by a review of the provincial budget of Sindh illustrating each revenue source.

Federal transfers[12]

Parts of the provinces' budget resources are passed on through transfers to local governments, mostly to city districts and town municipal administrations.

Provinces receive a share of federally levied and collected taxes. Federal transfers consist of the Federal Divisible Pool (FDP)[13] and straight transfers. At least every five years, the National Finance Commission decides the list of taxes comprising the FDP, the ratio of the provincial to the federal share of the pool and the formula for distribution of resources between provinces. Revenue sources from the FDP are further broken down into:

- revenue assignment,
- grant-in-aid (subvention) and
- district support grant in lieu of the abolished octroi and zila tax (OZT).[14]

Each component is governed by a specific formula for vertical distribution (between federation and the provinces) and horizontal sharing (among provinces).

Own-source revenues

Provincial own-source revenues comprise tax and non-tax receipts. Provinces are empowered to collect stamp duties on financial and property related transactions, motor vehicle taxes, agriculture income tax and land revenue, registration fees, and other user charges. Overall, the tax base and tax instruments of local governments are narrow and considered below their full potential.[15]

Borrowing and capital receipts

Capital receipts of provinces include new loans from borrowing and recoveries of loans extended by the provincial governments to their subsidiaries/autonomous organisations and government employees.

Article 167 of the constitution authorises the provincial governments to borrow. However, provincial borrowing requires the approval of the federal government.[16] Provinces, in the past, have taken on substantial amounts of debt to finance their recurrent and capital expenditures. Large overall deficits of the provinces have caused an accumulation of debt. Substantial contingent liabilities exist in terms of guarantees for loans to public sector enterprises and autonomous corporations.[17]

Finances of the provincial government of Sindh

To further illustrate the revenue structure of provincial governments, table 5.3 presents the current local government revenues (recurrent and capital) of Sindh. These statistics are more recent and include the latest budget of 2006/07. The main points to note are:

- Federal transfers, on average over the years, constitute about 78 per cent of the total provincial budget. Own-source revenues, in contrast, constitute only 13–14 per cent of the current revenues.
- Of the federal transfers, revenue assignments account for the highest (about 40 per cent) portion of the provincial budget. Its absolute growth has outstripped overall budgetary growth over recent years.
- Straight transfers, received on account of various levies on natural resources, have grown to become the second most important federal transfer in the province of Sindh, and constitute 28 per cent of the current budget.
- District support grants and grants-in-aid, received as a budgetary support to create fiscal space, are the other federal transfers.
- Of the own-source revenues, provincial tax receipts are the dominant source of Sindh's revenues. The major provincial taxes include taxes on agriculture, professional tax, stamp duty, registration tax, motor vehicle tax, hotel tax, etc.
- Sindh's borrowing is accounted for by the provinces' capital budget. The total amount of capital receipts in 2006/07 is estimated at PRs15,570 million and mainly comprises public debt.
- The provincial government has been borrowing largely from foreign lenders and the level of debt has increased manifold over the last two decades.[18] Foreign loans have largely been borrowed from multilateral development agencies. The total foreign debt liability in 2005/06 was estimated at PRs71,425 million. In addition, the province has accumulated a substantial amount of domestic debt liability, amounting to PRs24,560 million.[19]

Table 5.3. Province of Sindh, current and capital revenues – PRs in million

Revenues sources	*2003/04*	*%*	*2004/05*	*%*	*2005/06*	*%*	*2006/07**	*%*
Current revenues	**85,639**	87	**105,125**	95	**129,255**	92	**157,190**	91
Federal transfers, of which	73,054	74	89,349	80	110,102	78	135,046	78
Revenue assignments	37,578	38	49,992	45	56,683	40	64,512	37
Straight transfers	26,263	27	29,554	27	39,733	28	47,802	28
District support grants	9,213	9	9,803	9	13,686	10	16,903	10
Grant-in-aid	0	0	0	0	0	0	5,828	3
Own-source revenues, of which	12,586	13	15,776	14	19,153	14	22,145	13
Tax receipts	9,679	10	11,776	11	13,642	10	15,208	9
Non tax receipts	2,907	3	4,000	4	5,511	4	6,937	4
Capital revenues	**12,430**	13	**5,918**	5	**11,469**	8	**15,570**	9
Recoveries of loans and advances	574	1	257	0	113	0	1,693	1
Public debt	5,777	6	4,860	4	5,718	4	6,377	4
Floating debt account**	6,079	6	801	1	5,638	4	7,500	4
Total current and capital receipts	**98,069**		**111,043**		**140,724**		**172,760**	

Source: Finance Department Government of Sindh (2007)
*The figures represent revised estimates, **this debt is maintained for transactions on account of state trading

Local government revenues

To ensure that local governments can perform their functions and deliver the municipal services assigned to them, the Provincial Finance Commission (PFC) allocates financial resources to them. The PFC determines the process of conditional intergovernmental transfers from provincial to local governments by setting the 'PFC awards'.

The PFC first sets aside the so called 'priority expenditures'[20] of the province from the Provincial Divisible Pool, which consists of federal transfers and provincial own-source revenues. The remaining amount is distributed among provincial and district governments with a current vertical sharing ratio between provincial and city districts of 45:55. In addition, the provincial government transfers the entire district support grant to the local governments – district governments, town municipal administrations and union administrations – without retaining any part of it.

A recent study on the implementation progress of the 2001 LGO demonstrated that city districts continue to depend heavily on the transfer of funds from provincial and federal governments. They have not established a sustainable local revenue base.[21] With regard to the own-source revenues of local governments, city districts

collect revenues from shop tax, fire tax, auction of park admission charges, sale of land and development charges, trade licence fees, car parking charges, animal tax, rent-lease money from shopping centres and market places etc. In this context, property tax was earlier collected by the provincial government and passed on to the town municipal administrations, which are now supposed to assess, levy and collect the tax.[22]

In contrast to the legislation on provincial governments (which are permitted to borrow), Section 120 of the LGO of 2001 prohibits local governments from incurring debt.

The case of Karachi

This section reviews the municipal finances and service delivery in Karachi city, the capital of Sindh province. It sets out the city context and summarises the administrative framework guiding the local government functions. The section goes on to discuss the sources of municipal revenues and expenditures respectively. It then examines the ongoing activities of private sector participation in the city's service provision and finally reviews the current state of financial markets and potential of market finance.

City context

Karachi, the major commercial centre of Pakistan situated in Sindh province, had a population of 13 million in 2007 with an annual growth rate of 4.8 per cent compared to a national growth of 3 per cent per annum. In 2009, its population is estimated to be approximately 20 million according to the City District Government of Karachi (CDGK). Sindh is the most urbanised province, with 49 per cent of the population living in urban areas. More than 60 per cent of the population of urban Sindh lives in Karachi and this concentration has increased over time. Karachi is the country's principal urban centre and is twice the size of the next largest city. Its unprecedented growth rate is mainly attributed to the large-scale migration from all rural areas of Pakistan to Karachi besides natural growth. It is estimated that approximately 200,000 people are added to the metropolis every year.

Karachi is the country's hub of trade and commerce. It accounts for 95 per cent of Pakistan's foreign trade, contributes 30 per cent to the country's industrial production and hosts about 90 per cent of head offices of financial institutions and multinational companies. The city generates about 15 per cent of the national GDP, 42 per cent of value-added in large-scale manufacturing and 25 per cent of the revenues of the federal government.[23]

City administration

The Sindh Local Government Ordinance 2001 provided for the establishment of a city district government to respond to the specific needs of Karachi and other megacities and larger urban units. Karachi has a three-tier local government system consisting of a city district council, 18 town councils and 178 union (neighbourhood) councils. In all 18 towns of the Karachi city district, there is a town municipal administration. Some of the main functions of the CDGK and the town councils are set out in Table 5.4.

Table 5.4. Responsibilities of CDGK and town councils

City District Government of Karachi	*18 town municipal administrations*
• Master plan	• Land use, zoning and control
• Land management	• Enforcement of municipal laws
• Education, including primary and secondary education	• Local roads
• Health, including food and nutrition, medical services etc.	• Fairs and cultural events
• Works and services, including roads and buildings, water,[24] energy, industry, transport	• Water supply and sewerage systems
• Public transport, expressways, roads, streets etc.	• Solid waste collection
• Agriculture	• Street lighting
• Community development, including labour and social welfare	• Fire fighting
	• Parks and recreation

Source: Local Government Ordinance 2001

Municipal revenues

This section describes the revenues of the CDGK. Table 5.5 shows the revenues of CDGK based on the actual figures for 2003–06, and the latest budget estimate for 2006/07.[25] The main observations in relation to CDGK's revenues are:

- Provincial/federal transfers constitute about 43 per cent of CDGK's budget. Own-source revenues have been about 14 per cent of the total budget. However, they are budgeted to increase significantly to about 41 per cent of local revenues in 2006/07. In that regard, please note that in the period 2003–06, the actual revenues were less than 50 per cent of the budgeted figures. Therefore, the budget estimates for the latest year are to be analysed in light of this.

- As regards transfers, PFC awards to CDGK include transfers for salary and non-salary expenses of devolved departments, which make up 23 per cent of the CDGK budget. Districts support grants in lieu of octroi charges account for 16 per cent of the CDGK budget in 2006/07. These are further

supplemented by annual development programme (ADP) grants, which are provincial transfers earmarked for capital expenditures. ADP grants have grown slower than the total budget and constitute 3.7 per cent of revenues.

- Own-source revenues are collected by the district, town and unions. They are generated from the town councils' shares of property tax, plot development charges, receipts from trade licensing fees, revenue from fire tax, rents etc.[26] The city's own-source revenues are budgeted to nearly triple in 2006/07 compared to actuals in the preceding years. The Sindh government is planning to sanction an increase in the property tax raised by towns by about 50 per cent of the current levels. Furthermore, overall user charges are also expected to increase significantly in 2006/07. In particular, the city aims to strengthen revenue collection from solid waste charges. It is yet to be seen how these plans materialise to actual revenue increases.
- The Karachi Water & Sewerage Board (KWSB) income includes special transfers and revenues accruing from water supply and conservancy charges, earmarked for KW&SB. These have typically accounted for about 20 per cent of the CDGK budget.[27] The city recognises the urgent need to reform tariff structures and improve collection of user charges, including water and sewerage.
- There has been no borrowing, since the CDGK is not empowered to access capital markets or raise loans.

Table 5.5. Karachi City District Government, revenues – PRs in million

Revenues	*2003/04*	*%*	*2004/05*	*%*	*2005/06**	*%*	*2006/07**	*%*
Transfers	**11,619**	**49.2**	**12,960**	**45.7**	**16,034**	**44.4**	**18,643**	**42.5**
Devolved dept.**	6,034	25.5	7,166	25.3	8,850	24.5	9,996	22.8
ADP	930	3.9	1,162	4.1	1,395	3.9	1,643	3.7
OZT releases	4,655	19.7	4,632	16.3	5,789	16.0	7,004	16.0
Own-source revenues	**3,508**	**14.8**	**3,728**	**13.1**	**5,084**	**14.1**	**17,777**	**40.5**
Taxation sources	2,213	9.4	2,452	8.6	2,907	8.1	6,768	15.4
User charges	1,294	5.5	1,277	4.5	2,177	6.0	11,009	25.1
Capital receipts	**3,491**	**14.8**	**5,008**	**17.7**	**7,596**	**21.1**	**2,171**	**4.9**
Water and sanitation department (KWSB)	**5,017**	**21.2**	**6,662**	**23.5**	**7,359**	**20.4**	**5,306**	**12.1**
Total revenues	**23,635**		**28,358**		**36,073**		**43,897**	

Source: City District Government Karachi (2007); Government of Sindh (2007); Karachi Megacity Development Project (2007)

*Estimated actuals in 2005/06 and budget in 2006/07 (actuals for 2003/04 and 2004/05), **transfers for devolved departments (salary/non-salary)

Municipal services and expenditures

With rapid urban growth and the corresponding pressures to deliver adequate urban infrastructure and services, Karachi faces a number of challenges:

- It is estimated that about 50 per cent of the city population lives in squatter settlements.[28]
- While 82 per cent of households have a water supply connection, water quality is poor and irregular, with high system losses.
- The sewerage network suffers from poor connectivity. Estimates reveal that only 40 per cent of all households are connected to piped sewerage lines.
- Only 60 per cent of solid waste is collected and no more than 25 per cent is transferred to landfill sites.
- The population relies almost entirely on the road network for urban transport, and there is currently no mass transit system.

Table 5.6 sets out the current expenditure budget of the CDGK. The main observations on the CDGK budgeted expenditures are:

- Development budgets increased significantly since 2003/04 to 2006/07. Estimated development expenditures outstrip the recurrent expenditures since the fiscal year 2004/05 and constitute about 50 per cent of the entire budget expenditures.
- The increase in the development budget is primarily on account of development expenditures of the city government and the Tameer-e-Karachi Programme.[29] It also includes the allocated annual development programme (ADP).
- Recurrent expenditures, at about 45 per cent of the total budget, cover expenses for responsibilities of devolved departments, mainly salaries/non-salaries for education and health. In addition, recurrent expenditures include establishment charges (allocations for salaries and allowances of officers and support staff), contingencies (consumption of utilities, expenditure on stationery, and other consumables etc.), and allocations for repair and maintenance of assets transferred to CDGK, such as roads, buildings and equipment.
- In addition, transfers to towns/unions constitute 6 per cent of budget expenditures.

Table 5.6. Karachi City District Government, expenditures – PRs in millions

Expenditures	*2003/04*		*2004/05*		*2005/06*		*2006/07*	
Recurrent expenditures, of which	**12,799**	**46**	**14,437**	**44**	**17,189**	**39**	**19,898**	**45**
Devolved departments	6,034	22	7,166	22	8,850	20	9,996	23
Establishment	2,645	10	2,802	9	3,302	8	3,990	9
Contingent	1,064	4	1,180	4	1,246	3	1,446	3
Repair and maintenance	161	1	174	1	193	0	280	1
Water and sanitation dept	2,895	10	3,115	10	3,598	8	4,186	9
Development budget, of which	**10,136**	**37**	**15,966**	**49**	**24,042**	**55**	**21,567**	**49**
Development expenditure	7,085	26	9,257	28	12,886	29	8,911	20
Tameer-e-Karachi progr.	–		2,000	6	6,000	14	9,893	22
Water and sanitation dept	2,121	8	3,547	11	3,761	9	1,120	3
ADP expenditures	930	3	1,162	4	1,395	3	1,643	4
Transfer to towns and union councils	**4,647**	**17**	**2,238**	**7**	**2,577**	**6**	**2,623**	**6**
Total expenditures	**27,582**		**32,642**		**43,807**		**44,087**	

Source: City District Government Karachi (2007)
All financial data based on budgets, not actuals.

Local PSP activities

To accelerate the pace of infrastructure development in the city, CDGK and the provincial government are making a concerted effort to promote private sector participation. The provincial government is open to receiving unsolicited bids for public–private partnerships (PPPs). At present, there is a strong private sector interest in infrastructure projects, but the procurement process remains problematic. Overall, current activities of PSP include:[30]

- *Karachi Megacity Development Project (KMDP):* The KMDP is an Asian Development Bank- (ADB-) funded infrastructure development project, which includes a technical assistance loan to enhance the government ownership of investment projects, capacity building, and institutional reforms. The technical assistance implementation started in February 2006 and is expected to last until December 2009. It is expected that the project will attract about US$800 million for Karachi, focusing on up to six sectors partly funded by PPPs at the city level. Projects will include the water and sanitation sector, the M9 motorway, traffic management/signalling etc.
- *Elevated expressway:* There are plans to build an elevated expressway with a total length of 25 kilometres, financed by Malaysian investors who approached the city government with an unsolicited proposal. The project is currently in the environmental assessment stage and the estimated cost amounts to US$350

million (PRs21 billion). If it were implemented, it is expected that the investor will recover investments by collection of tolls from all vehicles over a period of twenty years.

- *Mass transit system and public transport improvement:* A rail-based mass transit master plan has identified three corridors. It is expected that the project will be built on a 'build, operate and transfer' (BOT) basis. In addition, the induction of 8,000 environmentally friendly buses under PPP operation has been planned (2006–2010) and plans for a rapid bus transit system are under consideration.
- *Real estate developments:* A deal has been signed by a consortium of international companies for the construction of an IT Tower and call centre. The design work for the construction of the 46-story building has been completed. The tower will host a call centre with 10,000 seats, shopping, entertainment and parking facilities, as well as government offices. It will be constructed under a BOT contract with foreign investment of US$250 million.
- *Solid waste management:* CDGK has recently introduced some form of PSP for solid waste management at the town level. Many local companies are operating rubbish collection, but currently only 30 per cent of waste goes to landfills. Plans to introduce PPP for solid waste management has been under consideration for some time and negotiations with interested companies are going on, but so far no formal arrangement is in place in CDGK.
- *Markets and bazaars:* The city government has decided to lease out properties such as markets and bazaars to private operators to enhance efficiency and reduce costs.

Alternative sources of municipal financing

To improve the access to local credit markets, innovative financing schemes are being developed. As part of the Karachi Megacity Development Project (KMDP), a specialised finance vehicle is being developed with ADB assistance. It will serve as a channel for financing bankable infrastructure projects in CDGK. A registered public company will be established with the Government of Pakistan, Government of Sindh province, donor agencies and banking institutions on the governing board. The vehicle's resource base would be expanded through PPPs and pooling project credit risk through infrastructure banks and credit enhancements.[31]

This section summarises the state of the capital and credit markets in Pakistan, with respect to their potential for infrastructure financing.

State of the infrastructure finance markets

The Pakistan financial sector is growing rapidly, having reached a market capitalisation equivalent to US$40 billion in 2006. This is partially supported by growing FDI inflows and home remittances. Whilst debt markets are still underdeveloped by developed country standards, equity markets have grown steadily.[32] However, local credit is growing with an increase in banking net assets and domestic debt.

Local credit institutions

Pakistan's banking sector has experienced substantial growth and development, especially after the privatisation of a number of banks over the past few years. Islamic banking is also developing further with 2.7 per cent of the total local bank deposits, projected to increase to 10 per cent by 2010. While liquidity has increased, and thereby the provision of banking credit, there is a liquidity gap for infrastructure finance, with local credit markets being inadequate to meet project finance demands in terms of both volume and tenor. Presently, the average loan syndicate or transaction is US$250–300 million and the maximum capacity of local banks is about 4–5 projects per annum. Average loan tenor has risen from 7–8 years to 12–13 years (including grace period), but is still relatively lower than the project requirements. Islamic banks are relatively more risk averse than other local banks, as Sharia imposes certain additional risks and structuring complexities.

Local capital markets

A money market has developed following the launching of financial reforms in the early 1990s. Local capital markets have experienced some growth, more so in the equity markets than in the debt markets. However, the primary equity markets are not mature, with newly developing stock exchanges with relatively limited listings and limited trading. Despite recent growth, Pakistan's equity markets are still characterised by a low absolute level of market capitalisation.

The securities market, including the market for corporate bonds, has shown encouraging growth. An auction system to raise government debt based on two key debt instruments, treasury bills and Pakistan Investment Bonds, has been established, while a new debt instrument – the term finance certificate (TFC) – has been used by the corporate and commercial banking sectors.[33]

The local debt markets are characterised by the absence of a long-term yield curve to serve as a benchmark rate, thereby constraining debt pricing for infrastructure projects. The medium- to long-term sovereign bond market is not developed, with a yield curve being available only up to 5–10 years and with relatively low levels of liquidity. In addition, there is almost no secondary market for these securities and auctions of Pakistan Investment Bonds have been infrequent. The corporate bond market in

Pakistan is at an early stage of development (limited issue size and tenor), with total public corporate debt accounting for just over 1 per cent of GDP. Corporate bond market development is impeded by the lack of benchmark rates as well as administrative impediments stemming from their prohibitive issuing cost.

There is limited local development in derivative financial products, particularly interest rate and foreign exchange hedging instruments. Also, lack of well-developed swap and forward markets has impeded foreign exchange financing. Since 2000, some US$:PRs hedging instruments have become available through the foreign banks and financial institutions in Pakistan.

There is limited number of institutional investors in Pakistan. With pension assets at just 1.6 per cent of GDP and life insurance assets at 2.1 per cent of GDP in 2004, Pakistan has one of the smallest institutional investor bases of any of the emerging market countries. The institutional investors market in Pakistan is constrained by the predominance of the public sector, regulatory weaknesses and certain tax anomalies.

Summary

Pakistan's economy has grown strongly since 2002, and has profited from deregulation and privatisation. The rising urban population is concentrated in a few agglomerations. With decentralisation policies enacted in 2001, many responsibilities were transferred to local governments, despite the mismatch of fiscal autonomy. The provinces largely act as financiers and regulators of service provision, whilst local government, in particular (city) districts, are assigned the responsibility to deliver infrastructure and public services. Some municipal services are further devolved to the lower town level. In this context, Karachi with an estimated population of 20 million (CDGK, 2009), is the country's commercial hub and largest city.

Among sub-national governments, provinces are largely dependent on federal government transfers, with a very narrow base of own-source revenues. Almost half of the capital development budget is further transferred from the provinces to districts. City districts like Karachi are therefore equally dependent on transfers. Karachi's own-source revenues are currently limited to about 15 per cent, which underscores its limited fiscal autonomy. Also, the City District Government Karachi (CDGK) is not allowed to access any type of borrowing as of yet (although provincial governments can). On a positive note, there is a marked trend of rising budgets for development expenditures, which account for half of the city's budget. Nevertheless, with more than half of the population living in informal settlements and no existing urban mass transport system, the city faces a number of challenges in delivering adequate infrastructure.

The level of PSP at the city district level has so far been limited to private contracting of services such as solid waste and markets. A donor funded infrastructure

development project, the Karachi Megacity Development Project, is expected to provide technical assistance to strengthen the institutional environment for private sector participation and to also set up a special finance vehicle to harness private sector finance. Overall the project is expected to attract US$800 million in funding for various infrastructure sectors, some of which will be funded on a PPP basis. In parallel, the banking sector has experienced significant growth, but a liquidity gap for infrastructure finance remains. The government is undertaking several initiatives to attract private financing for infrastructure projects at the national and subnational levels.

Notes

1. World Bank (2006e); IMF (2007b).
2. The eight cities are Karachi, Lahore, Faisalabad, Rawalpindi, Multan, Hyderabad, Gujranwala and Peshawar.
3. UN Population Fund (UNFPA, 2007); CLGF (2007c).
4. World Bank (2006e); UNFPA (2007).
5. Kardar (2003).
6. Ibid.
7. Shah (2003). The cost of upgrading water infrastructure alone is estimated to range between US$60 and 70 billion. The water sector largely falls under provincial jurisdiction. Provincial infrastructure regulatory authorities have been established to regulate the water sector and other areas that fall under provincial jurisdiction, such as urban transport.
8. Asian Development Bank (ADB, 2006a).
9. Government of Sindh (2007).
10. Please note that the most recent provincial finance data available is for 2002/03.
11. Kardar (2003).
12. Ibid.; Qasim (2006).
13. The FDP is sourced with proceeds from income tax, sales tax, customs duties, central excise, general sales tax on services, capital value tax and wealth tax.
14. Octroi is a local levy on goods being brought into the respective local jurisdiction.
15. Government of Sindh (2007).
16. Ibid.
17. Kardar (2003).
18. While foreign loans were initially contracted by the Government of Pakistan and passed on to the provinces, provinces now borrow directly for their capital expenditures with the consent of the federal government.
19. In 2007, the total debt liability of the government of Sindh, including contingent liabilities, amounted to PRs126,178 million or 80 per cent of the total provincial budget.
20. Priority expenditures include mainly social services such as health and education, and debt servicing of the provinces.

21. Cheema et al (2007).
22. However, the power to levy taxes has been conferred subject to the rules and instructions and approval of rates by the provincial governments. In many cases, it has been found that districts and towns are in conflict over collection of certain taxes. In Quetta, the conflict over property tax collection was decided by the High Court in favour of the district government. The case is now being filed in the Supreme Court. Similar complaints/cases have been reported in Peshawar and Lahore. Disputes on ownership of various taxes existed visibly in Karachi too, but they seem to have resolved the differences through out of court settlements.
23. Karachi City Government (2007).
24. The former Karachi Water & Sewerage Board (KWSB), which was a provincial organisation, has become the Water and Sanitary Department of the CDGK.
25. There was no consolidated financial data for CDGK available at one source. Therefore, this table has been developed based on aggregating the data (actuals and budgets, as appropriate) from multiple official sources, as presented in the sources at the end of the table. While we have attempted to confirm these figures with officials in the Karachi city government, this data should be interpreted with some caution.
26. The CDGK cannot raise new taxes without the clearance of the principal authorities, and new tax proposals have been declined in the past.
27. It is worth noting, in this context, that KWSB continues to suffer from a low rate of billing and collection and was not financially viable at the time of writing. KWSB was unable to attain the 2007 target of PRs5 billion through its revenue collection.
28. Siddiqui (2004).
29. The provincial government has initiated a plan to rehabilitate and develop the infrastructure of Karachi. The plan, under the Tameer-e-Karachi Package, has a total outlay of PRs29,600 million.
30. Interview with Karachi Megacity Development Project Manager.
31. Interview with Karachi Megacity Development Project Officer; also Shah (2003).
32. This implies that the Pakistan economy is relatively underleveraged.
33. Kardar (2003).

6

Bangladesh – The Case of Dhaka

This chapter reviews the state of municipal finance in Bangladesh. The chapter focuses in particular on the practices of municipal infrastructure financing in Dhaka. It first sets out the country's macro-economic context, before outlining the framework for decentralisation and local government finances. The chapter ends by reviewing in detail the municipal finances and approach to infrastructure finance in Dhaka.

Macro-economic context

Bangladesh, located in Southern Asia, has a population of 144.3 million and covers a land area of 147,000 square kilometres. It is one of the most densely populated and rapidly urbanising countries in the world. As of 2007, about 30 million people or around 25 per cent of the population live in urban areas. The current rate of urban growth is 3.5 per cent, twice the rural growth rate. The growth of a high natural urban population, expansion of urban boundaries and the rising migration from rural to urban towns are dominant causes of the rapid urbanisation.

The four largest metropolitan areas – Dhaka, Chittagong, Khulna and Rajshani – together contain over 56 per cent of the total urban population of the country. The contribution of the urban economy to the GDP is increasing, and is currently at 50 per cent of GDP. At the same time, the contribution of the agricultural sector is less than 20 per cent of GDP.[1]

Decentralisation framework

Decentralisation has been on the government's agenda since the 1980s, when plans to give greater responsibility to local governments were developed.[2] However, as yet, implementation has lagged behind. The government has presented plans to create effective local governments and strengthen local government institutions. Nonetheless, local governments remain dependent on the central government and the overall administrative system of the country.[3]

Local government legislation and organisation structure

Bangladesh has six administrative divisions, each of which is divided into districts (*zilas*). In total, there are 64 districts, with an average population of 1.9 million.

Districts act as the focal points of the administrative system. Local governments have two streams: urban and rural. Urban local governments are composed of six city corporations, 271 *pourashavas* (municipalities) and about a dozen urban centres under military cantonment boards. Small urban centres are administered as non-municipal rural entities under the parishad system.[4]

Functional and fiscal devolution of powers

Table 6.1 shows the set of responsibilities assigned to the local government levels of cities and urban municipalities. In terms of the assigned responsibilities, city corporations and urban municipalities are very similar.

A large part of municipal infrastructure responsibilities, from solid waste to upgrading of informal settlements, have been assigned to local governments. Some of the functions of urban local governments have, over time, been taken over by parastatal bodies. In the case of Dhaka City Corporation (DCC) and Chittagong City Corporation, water supply and sewerage planning and development responsibilities are given to special authorities – Water and Sanitation Authorities (WASAs). These

Table 6.1. Bangladesh, assigned local government functions and expenditure responsibilities

Level of government	*Local government activity*	*Sources of financing*
City corporation	• Solid waste disposal • Road building and maintenance • Street lighting • Parks and greenery • Upgrading of informal settlements	• Property taxes • Conservancy • Fees • Rental income • Government grants • Donor funds
Urban municipality (*pourashava*)	• Sanitation • Solid waste disposal • Road building and maintenance • Street lighting • Parks, greenery • Upgrading of informal settlements • Poverty alleviation • Planning	• Property taxes • Conservancy • Fees • Rental income • Government grants • Donor funds
Water and Sanitation Authorities (WASAs) at Dhaka and Chittagong cities	• Drinking water supply and sewerage	• Water tariffs • Loans • Grants from government and donors
Specialised authorities: PWC, NHA, DPHE, LGED	• Civil works, housing, physical development	• Government budget • Donor funds
Development authorities: RAJUK, CDA, KDA, RDA	• Planning and development of physical infrastructure	• From sale of lands and government grants

Source: Chowdhury (2004)

responsibilities remain with urban municipalities. Co-ordination between city corporations and parastatal bodies in large metropolitan cities is a crucial problem.[5]

Overall, the decentralisation of political decision-making and administration is in an uncertain state in Bangladesh. Although urban local governments are elected through a democratic process, they do not enjoy significant political, administrative and financial autonomy. At the moment, fiscal decentralisation is limited. All local government financial decisions, including the annual budget, need central government approval.[6]

Overview of the provision of municipal services

This section provides an overview of local government services. The shortage of development expenditures has constrained the delivery of infrastructure services at the local government level. At present, most of the larger new municipal infrastructure development is financed by foreign aid and government grants. Few urban government units are capable of generating sufficient resources to meet their capital and recurrent costs. Overall municipal services are considered inadequate, as summarised in the indicative overview provided below:

- Between 30–50 per cent of the urban population live in marginal *informal settlements* and the environmental conditions in most of the urban areas are very poor.[7]
- *Water services*: in the cities, WASAs have been constituted to provide domestic water supply and sewerage. In other urban areas, water supply remains the responsibility of municipal authorities. Piped water supply is still low in Bangladesh, with only 26 per cent of households having access to tap water. The proportion of urban households possessing latrines is 70 per cent.[8] The revenues of the WASAs comprise water and sewerage charges. Whilst the revenue collection rate is fairly high, there are large system losses, leading to financial non-viability.
- *Sanitation services:* Dhaka is the only city with a waterborne sewerage system, but this only serves about 15 per cent of the population, while another 30 per cent are served with septic tanks.[9]
- *Solid waste*: the city corporations are able to collect over 52 per cent of waste, while urban municipalities collect only 39 per cent.
- *Roads* are additional expenditure allocations. Overall, unfunded mandates of delegated responsibilities towards road maintenance and construction remain an outstanding issue.[10]

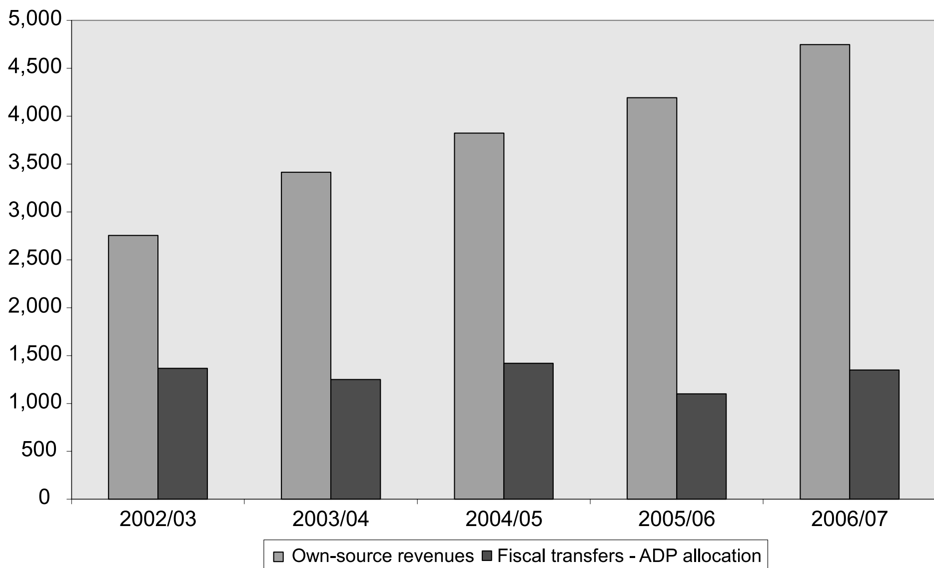

Figure 6.1. City corporations, local government revenues 2002–2007, in million taka (Tk)
Source: Government of Bangladesh, Local Government Division

Local government revenues

Figure 6.1 sets out the total revenue of the six city corporations in Bangladesh.[11] These include own-source revenues and transfers from the federal government in the form of ADP allocations. As shown in the figure, the own-source revenues of the six city corporations are, on average, three times the annual development grants (ADP allocations). Dhaka City Corporation accounts for the vast majority of these revenues, with Chittagong a distant second.

ADP allocations are formula-based block grants provided to urban and rural local governments based on the population, physical area and extent of backwardness of the local area. In addition, for the urban municipalities, the grant formula includes their level of annual own revenue collection for the past three consecutive years.[12] The ADP is mostly financed by the surplus of the federal revenue budget and domestic and external loans and aid. In recent years, the relative share of ADP grants is declining and grants are mostly financed from domestic sources. The Ministry of Finance decides the total ADP grant amounts across the local governments, and the Ministry of Local Government, Rural Development and Co-operatives (MLGRDC) is responsible for specific allocations to each urban and rural local body.[13]

In addition to the above revenue sources, the city corporations receive donor project aid channelled through the Government of Bangladesh to fund its development

Table 6.2. City corporations, local government revenues 2004–2007, in Tk million

Transfers	*2004/05*	*2005/06*	*2006/07*
Project aid from Government of Bangladesh	5,195	3,902	4,845
Grants-in-aid (including other revenue grants)	50	50	1,220
Other revenue sources	5,244	5,293	6,098
Total revenues	**10,489**	**9,245**	**12,163**

Source: Government of Bangladesh, Finance Division

expenditure, and grants-in-aid to fund revenue expenditure. These are set out in table 6.2, below, for the years 2004–2007. Grants-in-aid typically finance the city corporation's revenue/establishment expenditure. In special cases, they may be provided to fund maintenance costs or for payment of electricity.

Grants in lieu of octroi were introduced in 1982, but these revenues are now minimal having declined progressively. Salary subventions (allowances for members and staff for elected officials) are provided for lower levels of local government, but are not provided for city corporations.

The Government of Bangladesh has set up a Local Government Commission to analyse, among other things, the finances of the local governments and to suggest measures for financial strengthening. One of the areas that requires revenue enhancement is property tax, as several properties are either unassessed or underassessed. There is an ongoing exercise to map all the wards in the DCC through a Geographic Information System database, in order to ensure the full enumeration of tax-liable units. Furthermore, there are proposals to levy conservancy taxes based on the use of property, i.e. for commercial, industrial and residential use. At the time of writing, all three were levied the same percentage of taxes.[14] It is pertinent to mention that the Local Government Commission that was established during caretaker set up was abolished in 2009.

Local government borrowing

The Bangladesh Municipal Development Fund (BMDF) started operations in 2002 as a government-owned company to provide financial support to urban local governments for infrastructure development projects. It commenced operations with a line of credit of US$78 million funded by the World Bank and the government.[15]

All types of urban infrastructure projects are eligible for BMDF financing, and co-financing by the local government for the project cost is expected. The lending rate is set at 9 per cent and no municipality is eligible to apply for funds unless it fulfils a set of conditions relating to municipal financial management, stakeholder involvement and revenue enforcement.[16] Table 6.3 presents details of the BMDF's lending policy and loan structure.

Table 6.3. Bangladesh Municipal Development Fund (BMDF), lending policy

Lending policy	*Eligibility criteria*
Eligible projects	Water supply and sanitation, roads, drainage, solid waste disposal, bus terminals, parks, community centres, street lighting, office buildings etc.
Loan/grant conditions	• For revenue-generating projects, at least 50 per cent of the financing is loan-based from the BMDF – the remainder grant. It is expected that at least 10 per cent of the project cost will be co-funded by the local government. • For non-income generating projects, about 85 per cent of financing will be a grant, with at least 10 per cent of the cost co-funded by the local government. • As for private sector participation, loan financing may be used to finance the municipal share of a joint venture investment. Such financing must not exceed 50 per cent of the joint venture. • The borrower's total annual debt servicing does not exceed 15 per cent of the borrower's total budget. • Municipalities are requested to open an escrow account.
Repayment period	Five years, with a grace period up to 20 years

Source: BMDF

By June 2006, 204 urban local bodies (ULBs) had applied for 13,420 million Bangladesh taka (Tk) in loans from the BMDF. Out of these, the BMDF has made agreements with 113 ULBs at a cost of Tk4,370 million. Table 6.4 below provides a selection of the projects where construction is underway with BMDF financing.[17] A majority of projects are for building roads and drainage, water supply and sanitation, street lights and markets.

Table 6.4. BMDF projects (commenced civil works)

Name of Component	*Quantity*	*Number of ULBs*
Road	803km	97
Drain	165km	68
Kitchen market	185	41
Public toilet	65	25
Water supply pipeline	141km	18
Production tube well and water treatment plant	19	13
Street light	9,318	8
Bus/truck terminal	7	7
Community centre	7	7
Slaughter house	6	6
Office complex	3	3

Source: BMDF

Municipalities, whose loan applications were approved, deposited the equivalent co-funding (10–12 per cent) of the total cost. As a result, it has been observed that most of the urban municipalities that applied for funds raised their collection capacity and efficiency, as well as improved their asset management system and accounting procedures.

At the time of writing, the BMDF was soliciting additional funding to meet the potential demand of the approved and potential ULBs. Furthermore, initiatives are being undertaken to make the BMDF a sustainable and self-sufficient organisation.

The case of Dhaka

This section studies the municipal finances and service delivery in Dhaka. It sets out the city context and describes the administrative framework guiding municipal finances in the city. It goes on to discuss the sources and uses of municipal finances, along with private sector participation in the city's service provision. The final section looks at the current state and potential of market finance.

City context

With a population in 2007 of 11–13 million, the Dhaka metropolitan area has become a megacity and continues to grow. The district of Dhaka is 90 per cent urban. The city comprises 38 per cent of the country's urban population, as shown in table 6.5. Its population has been growing at a rapid rate with 300,000 to 400,000 new migrants annually and is characterised by large informal settlements. The stable growth rate of the past decade is anticipated to continue, with Dhaka's population expected to grow to about 20 million people by the year 2020.

Table 6.5. Population of Dhaka in the national urban context

Year	*Population (millions)*	*Percentage of the national urban population*
1974	1.77	28.2
1981	3.45	26.0
1991	6.84	30.5
2001	10.71	37.4
2005	12.0	37.5

Source: Islam (2006)

Dhaka has a disproportionately large concentration of industrial and various public sector investments, despite the government's declared policy of decentralisation. While some commercial activity is located in the second city, Chittagong, Dhaka hosts the country's main economic activities in trade and finance.[18]

City administration

Dhaka City Corporation (DCC) is functioning on the basis of 'Dhaka Municipal Corporation Ordinance XL 1983'. The administrative structure that relates to service delivery is complex. Though the DCC is autonomous and commissioners are elected by direct votes, its power is controlled by the Ministry of Local Government, Rural Development and Co-operatives (MLGRDC). DCC is responsible for a wide range of services, as listed in table 6.6, below.[19]

DCC is headed by a chief executive officer (CEO), who is an appointee of the central government. The CEO is supported by a board, represented by all ward commissioners. The board has 16 standing committees for various sectors and services. However, the CEO and the board have limited decentralised authority and require the mayor's approval for all major investments or expenditure exceeding Tk50,000.[20]

For the purposes of administration, the city is divided into 10 zones, with 90 directly elected ward commissioners who are members of the DCC having both policy-making and input monitoring roles.[21]

Table 6.6. Functions of the Dhaka City Corporation

Public health	• Sanitation • Hospitals and dispensaries • Health, infectious diseases and maternity centres • Waste disposal
Water supply and drainage	• Water supply and drainage schemes
Urban planning	• Master plan and regulation of building control
Streets	• Roads • Street lighting • Public transport
Education	• Education
Development	• Development plans • Community and health development projects • Commercial schemes • Slum development
Other responsibilities	• Social welfare • Public and private markets • Parks and greenery • Culture • Public safety

Municipal revenue structure

Table 6.7 presents the DCC revenues for the period 2003–06 and the budget for 2006/07. The key points to note are:[22]

- Own-source revenues account for over 70 per cent of the DCC revenues. The remaining 30 per cent is funded by transfers from central government.
- Property tax is the main revenue income for the corporation, and comprises nearly 35 per cent of own-source revenues. Property tax is charged at 12 per cent on the annual value of the property.[23] This includes 7 per cent holding tax, 2 per cent conservancy tax (for cleaning, solid waste management, sewerage etc.) and 3 per cent lighting charges.
- Other income includes market fees, charges for trading licences, advertisement fees, road digging charges, property transfer fees etc. Market fees are levied on the construction of any new market or community centre. Charges for trading licences are levied annually.
- The intergovernmental transfers primarily consist of ADP lump-sum allocations and other special grants. As in the case of other municipalities, the compensation in lieu of octroi charges (abolished in 1982) is minimal.

Table 6.7. Dhaka City Corporation revenues, 2003–2006, in Tk (millions)

Revenues	*2003/04*	*%*	*2004/05*	*%*	*2005/06*	*%*	*2006/07*	*%*
Own-source revenues, of which	**2,323**	72.4	**2,523**	71.5	**2,950**	78.9	**4,664**	64.9
Property tax	1,150	35.9	1,170	33.1	1,309	35.0	2,300	32.0
Property transfer fee	237	7.4	265	7.5	372	9.9	400	5.6
Other fees	287	9.0	321	9.1	354	9.5	475	6.6
Rent and property income	226	7.0	306	8.7	310	8.3	446	6.2
Trade licence fee	221	6.9	222	6.3	255	6.8	320	4.5
Market fees	96	3.0	141	4.0	204	5.4	450	6.3
Other own-source revenues	96	3.0	78	2.2	147	3.9	224	3.1
Capital revenues	10	0.3	19	0.5		0.0	50	0.7
Intergovernmental transfers	**884**	27.6	**1,006**	28.5	**790**	21.1	**2,525**	35.1
Special grant from government	450	14.0	364	10.3	250	6.7	1,500	20.9
ADP allocation	409	12.8	617	17.5	515	13.8	1,000	13.9
Octroi compensation	25	0.8	25	0.7	25	0.7	25	0.3
Total revenues	**3,207**		**3,529**		**3,740**		**7,189**	
Project aid*	2,944		4,531		2,478		7,740	

Source: Dhaka City Corporation, Accounting Department

* Included in the official budgets. Project aid includes private investment and donor-funded projects.

In addition to intergovernmental transfers, the DCC receives project aid from the Government of Bangladesh to finance specific project capital expenditure. Project aid varies by year, depending on the nature of donor projects and level of disbursements. It amounted to about Tk2.5 million in 2005/06, and is estimated to be as high as Tk7.7 million in 2006/07.

Borrowing

DCC is legally allowed to borrow, with the approval of the MLGRDC. It did not have any loans on its books at the time of writing. However, it has borrowed from commercial banks in the past for projects such as the construction of new markets and of its office building. The key constraint in bank borrowing is the high rate of interest that is charged.

Dhaka had not borrowed or obtained grant financing at the time of writing from the BMDF. However, it has recently submitted a funding application to the BMDF.

Municipal expenditures

Table 6.8 below provides an overview of DCC's expenditure over the period 2003/04 to 2005/06. The key observations are:

- Recurrent and development expenditure account for approximately equal shares of the corporation's expenses.
- Salary, pension and allowances are the majority of the recurrent expenditure, followed by electricity and supplier costs.
- Roads and drains comprise over 50 per cent of development expenditure. Given the flooding that Bangladesh (and Dhaka city) is prone to, it has been suggested that a significant part of development expenses go towards maintenance and rehabilitation of roads and storm water drains. There has not been much investment in the construction of new infrastructure, although these are being planned, with donor project support.
- The other category of development expenditure is for the creation and maintenance of markets. The need for municipal markets was recognised when Dhaka became a provincial metropolis in 1905. By 2007 there were about 104 markets of varying sizes in the city, owned by the DCC. These markets may be wholesale or retail, and house shopping complexes.[24]

Table 6.8. DCC expenditures, 2003–2006, in Tk (millions)

Expenditures	*2003/04*	*%*	*2004/05*	*%*	*2005/06*	*%*
Recurrent expenditure, of which	**1,310**	**45.8**	**1,569**	**50.9**	**1,684**	**43.6**
Salary and allowances	679	23.8	667	21.6	810	21.0
Electricity, fuel and water	212	7.4	380	12.3	387	10.0
Supply goods	185	6.5	185	6.0	182	4.7
Mosquito control (Monitoring)	99	3.5	149	4.8	135	3.5
Repair and maintenance	35	1.2	79	2.6	64	1.6
Other recurrent expenses	49	1.7	62	2.0	53	1.4
Private waste management	44	1.5	35	1.1	42	1.1
Rent, rates and taxes	8	0.3	12	0.4	12	0.3
Development expenditure, of which	**1,390**	**48.7**	**1,331**	**43.2**	**1,952**	**50.5**
Roads and drainage	1,056	37.0	824	26.7	1,051	27.2
Market development and maintenance	78	2.7	119	3.8	208	5.4
Community centre	43	1.5	72	2.3	131	3.4
Special projects	90	3.1	85	2.8	128	3.3
Other capital expenditures	123	4.3	231	7.5	434	11.2
Loan repayments	**157**	**5.5**	**182**	**5.9**	**226**	**5.8**
Total expenditure	**2,857**		**3,083**		**3,862**	

Source: Dhaka City Corporation, Accounting Department

Financial management[25]

DCC maintains its accounts based on the double entry principle. However, it still partly follows cash accounting and partly accrual-based accounting. The DCC accounts are reviewed by the central government auditor periodically. The Revenue Department is responsible for collections of taxes and charges, and the Accounting Department is responsible for the budget, annual accounts and internal audit. While the accounts are computerised, there is no systematic database or management information system (MIS) to assist in financial decision-making.

Municipal service provision and local PSP activities

Overall, the private sector capacity in Bangladesh is quite weak, with limited willingness to invest in infrastructure projects. Given the uncertain political environment and the caretaker government, foreign investors are not coming forward to finance projects in Dhaka.

Most PSP activity has been in the power sector (thermal and renewable energy projects), land ports (connecting Bangladesh to India and Myanmar) and mobile telecoms. In addition, the government is considering PSP options for:

- An additional 2,238MW power generation capacity on a 'build, own and operate' (BOO) basis,

- Two inland container terminals (ICTs) on a BOO or build, operate and transfer (BOT) basis,
- Operation and maintenance concession contracts for the repair and maintenance of the extensive road network, and
- Water distribution projects in selected municipalities (these are at feasibility study stage at the time of writing).

The Infrastructure Investment Facilitation Centre (IIFC) was established in March 1999, to promote private sector participation and financing for infrastructure projects in Bangladesh. It assists the government in facilitating the above transactions and also develops PPP guidelines and policies to enable faster implementation of projects.

PSP at sub-national level[26]

The DCC has the authority to sign contracts with and outsource services to the private sector (on approval of the MLGRDC). There have been some limited experiments in attracting PSP in municipal services or projects, the details of which are provided below:

- *Solid waste management:* The DCC is divided into ten zones, of which two zones (Uttara and Gulshan zones) have outsourced waste collection and management to the private sector. Four companies have been awarded contracts to provide this service, and are compensated by the DCC. These two zones are expected to be 'pilot' areas, and the services are to be outsourced in other zones if considered successful.
- *Bus terminals and markets:* Some of the bus terminals and operation of markets have also been let on one-year private contracts. Three bus terminals have been let by the DCC to private operators on three-year contracts. The operators are expected to develop the infrastructure and facilities in the terminals and manage them. They charge the bus companies for their services and share the accruing revenue with the DCC, after deducting their share of fees to cover their costs. The contracts for these services were developed under a World Bank-funded project.
- *Primary healthcare:* The public–private partnership model is being implemented under the auspices of an ADB-sponsored project to improve the services of urban primary healthcare across the six city corporations and urban municipalities. The first phase of the ADB project covered the city corporations with the Project Management Unit, hosted by the Dhaka City Corporation. On its success, the second phase of the project commenced in 2005 and will run until 2011. As part of the project, 24 'partnership areas' have been created based on population size, of which 10 are within the DCC remit. Within each partnership area, a comprehensive reproductive healthcare centre is

being established by the government and is tendered out to the NGO and private sectors for operation and maintenance. It is expected that the healthcare centres will provide free services to 30 per cent of patients (i.e. those who are below the poverty line) and charge nominal fees (below market rates) for the others. The first phase of the project demonstrated a significantly higher quality of service in these centres, compared to central government health centres.

- *Street cleaning, conservancy and the dumping of waste:* These services have been outsourced to a private operator in nine wards of a zone in DCC. The private operator has had a three-year contract until 2007/08 and is paid by the DCC, based on the weight of waste dumped. There are clear performance requirements in the contract and a conservancy inspector from the DCC assigns performance grades to the operators. A minimum number of 'A' grades are required for extension of contract.

In addition to the above, two new projects are being planned by the DCC to attract private sector funding and participation. These are:

- *Jatrabari – Gulistan flyover:* This is being planned to reduce traffic congestion and improve the economic viability of Dhaka City. The flyover would be seven kilometres long and will cover a vast area.[27] Urbanisation opportunities and residential uses surrounding 50 kilometres of the city would be increased, which is expected to reduce the pressure on the city's utility services. The flyover will be constructed through a 'build, own, operate and transfer' (BOOT) system, with construction costs estimated at about Tk67 million. Construction will take three years to complete. The construction and maintenance cost is to be recovered through the toll collection from the users of the flyover.
- *Multi-storey car parking in the city centre:* Due to lack of car parking facilities in the buildings of the Central Business District of Bangladesh, (Motijheel-Dilkusha areas), steps have been taken to build multi-storey car parking at the centre of the area. If built, this will have a nine-storey car park, able to host 500 cars at a time and 1,500 cars daily. As a result, it is expected that traffic congestion will be reduced. A 'city centre' containing modern facilities such as restaurants, commercial offices, international-standard conference facilities etc. is being planned in the district. The proposed building is scheduled to be finalised in two-and-a-half years.

Alternative sources of municipal financing

One of the objectives of the World Bank's Municipal Services project was to improve resource mobilisation and fiscal discipline by creating the Bangladesh Municipal Development Fund to facilitate urban infrastructure investment. It was

envisaged that the BMDF would ultimately help municipalities make the transition to commercial financing. However, municipalities continue to rely on grants and have weak financial capacity.

DCC has not accessed any alternate source of financing to date (nor have any of the other ULBs). The local governments are generally discouraged from borrowing, given their weak financial position.

Financial markets[28]

The financial system of Bangladesh consists of the Bangladesh Bank (BB) as the central bank, four nationalised commercial banks (NCB), five government-owned specialised banks, 30 domestic private banks, 10 foreign banks and 28 non-bank financial institutions. The financial system also embraces insurance companies, stock exchanges and co-operative banks. As of the time of writing, there has not been any significant lending from the credit or capital market systems in Bangladesh for infrastructure projects. As in other developing countries, the deposit portfolio of banks and the financial regulations do not allow them to lend for long maturities for infrastructure projects. As described in the case study on Bangladesh and Dhaka, there is no or negligible market lending for sub-national infrastructure projects. Furthermore, the overall financial system is still nascent and requires substantial reform and instilling of market discipline in its operations.

While Bangladesh has embarked on reforming its financial system, most prominently by privatising its government-owned banks, a sustainable long-term expansion of the financial system requires a more substantial change in the role of government. The growth of the banking sector is impeded by the government directly competing for deposit mobilisation through its National Savings Schemes (NSSs).

Other segments of the financial system, such as the insurance sector and the stock markets, are substantially less developed than in comparable countries. The insurance sector is small and inefficient, and the penetration of both life and non-life insurance is very low. There are few private pension funds and mutual funds whose development is most likely prevented by competition from the NSS. The pension and mutual fund industry is dominated by public pension schemes by the Investment Company of Bangladesh (ICB). With respect to the stock markets, Bangladesh's stock market capitalisation and trading relative to economic activity is miniscule. The shares of financial institutions – mandated by law to list – dominate the Dhaka stock exchange. In November 2005, they constituted 56 per cent of market capitalisation and 62 per cent of trading. There were only two Initial Public Offerings (IPOs) of non-financial companies in 2005 and none in 2004.

Summary

Bangladesh is among the world's most densely populated countries and is rapidly urbanising. Dhaka, with a population of more than 11 million, is the commercial, political and administrative centre. A large part of municipal infrastructure responsibilities have been assigned to local governments, but decentralisation of political decision-making and administration remains uncertain. Dhaka City Corporation (DCC) enjoys little autonomy and is severely constrained in its planning and expenditure policy by the federal government.

To finance its budget, DCC relies largely on own-source revenues (70 per cent), of which property taxes constitute almost a third. However, most of these revenues go towards meeting recurrent expenditure such as salaries and establishment expenses. Reforms of property tax assessment and collection are expected in the coming years. The intergovernmental transfer base is rather narrow and largely conditional. For financing of capital expenditures, funding through donor projects is accounted for separately and is almost equal to the entire DCC budget. Overall, municipal infrastructure services remain inadequate due to a shortage of development expenditures.

The private sector capacity and willingness to engage in infrastructure projects, particularly at the sub-national level, remains weak. PSP activities in the city are largely limited to contracting out of services such as solid waste management. Future projects to attract the private sector are being planned, such as a BOT contract to build a city flyover.

As for alternate sources of financing, DCC is legally entitled to borrow for its capital investments, but has only done so largely for working capital purposes. In this context, the government-owned Bangladesh Municipal Development Fund (BMDF) was set up under a World Bank credit to provide financial support for municipal infrastructure projects. Funding provided by the BMDF includes a significant grant component. The local financial markets are nascent, which constrains accessing market finance for infrastructure projects. Moreover, the creditworthiness of the municipal borrowing entities is not considered strong enough to tap private debt and ensure its timely servicing.

Notes

1. Chowdhury (2004).
2. The main legislation on local government are the Local Government Ordinance 1983, the Upazila Parishad Act 1998, the Zila Parishad Act 2000, the Hill District Local Government Parishad Act 1989, the Pourashava Ordinance 1977 and the City Corporation Ordinances/Acts (issued for various city corporations at various times).
3. Commonwealth Local Government Forum (2007d).

4. Islam (2006); UNDP (2003). Rural local governments have four tiers: *zila parishad* (district council), *upazila parishad* (sub-district council), union *parishad* (union council) and *gram sarkar* (village government).
5. UNDP (2003).
6. Islam (2006).
7. Chowdhury (2004).
8. Bangladesh Census 2001.
9. World Bank (1997).
10. Ahmad et al. (2006).
11. These are Dhaka, Chittagong, Khulna, Rajshahi, Barisal and Sylhet.
12. UNDP (2003). For example, Tk6 million +: A Category *Pourashava*, Tk2.5–6 million: B Category, and Tk1–2.5 million: C Category.
13. Meeting with the Local Government Division, MLGRDC, Bangladesh.
14. Meetings with the DCC, Local Government Division, MLGRDC, Government of Bangladesh.
15. The BMDF was set up in 1998 with a seed fund of US$70 million from the World Bank. The Bangladesh government also promised to contribute US$8 million to this fund.
16. The specific criteria is as follows: (1) holding tax collection is more than 50 per cent of the estimated revenue; (2) accounting system is converted to double entry system; (3) prepare budget to a realistic stage; (4) prepare an asset register; (5) track tax defaulters; (6) computerise accounts and office management and train staff; and (7) stakeholders are allowed to participate in projects.
17. Chowdhury (2004); BMDF (2007).
18. Islam (2006).
19. Profile of Dhaka City Corporation.
20. Meeting with the CEO, DCC.
21. World Bank (2007b).
22. Based on meeting with the chief accounts officer, DCC.
23. Annual value is typically equivalent to 10 months rent.
24. Profile of Dhaka City Corporation.
25. Based on meeting with the chief accounts officer, DCC.
26. Meetings with the Local Government Division, Ministry of Local Government and Rural Development, Government of Bangladesh, and the Asian Development Bank, Bangladesh, and the chief town planner, DCC.
27. This is expected to include parts of Chittagogn-Narayangonj-Mawa highways, Demra, Gulistan, DIT Avenue, Sayedabad Bus terminal, Dayagonj, 2nd Buriganga Bridge and Motijheet-Tikatuly Road. The improved road communication system would be developed with the adjoining 30 districts of Dhaka City.
28. See http://www.bangladesh-bank.org/fnansys/fnansys.html; Beck and Rahman (2006).

7

Innovative Approaches to Municipal Infrastructure Financing

The four case studies presented in previous chapters underscore the growing financing requirements of sub-national governments. This section considers some of the market-based financing initiatives that have been undertaken by sub-national entities in emerging markets and developing countries to finance municipal infrastructure and public services. It first sets the context for market-based financing and discusses the salient issues relevant for a change in financing approaches. The chapter then goes on to discuss different financing mechanisms that have proven successful across developing countries.

Introduction to market-based financing of sub-national infrastructure

The rapid urbanisation and globalisation of cities, combined with functional decentralisation, have increased the pressure on local governments' conventional sources of revenues from taxes and transfers. In addition to a reformed fiscal decentralisation framework, which includes higher predictability and transparency in the allocation of intergovernmental transfers, several sub-national governments have initiated revenue enhancement projects aimed at increasing the taxable base, tax rates and improving tax administration and collection efficiency. Revenue mobilisation strategies, such as voluntary contributions from the local population and charging for some municipal services that have been historically provided free of charge, have succeeded to varying degrees in closing the revenue expenditure gap.

However, since local taxes and charges cannot be expanded infinitely, most local governments are now seeking alternate forms of financing their fiscal expenditure responsibilities. In particular, investments for the maintenance and construction of urban infrastructure require high volumes of long-term finance. Sub-national governments of North America and Western Europe hold a long-standing record of harnessing long-tenor market capital for urban infrastructure, although they adopt different models. For example, North America has historically relied on municipal bonds; Western Europe has developed its home-grown development banks; and the United Kingdom is well known for its private financing initiatives (PFIs), where the

government contracts with the private sector to deliver specific infrastructure investments and services.

Similarly, governments in several emerging market countries are gradually embracing the idea of sub-national entities accessing private finance for investments in public infrastructure and services. It is important that the policies to foster sustainable municipal finance markets are supported by a robust regulatory framework that ensures prudent borrowing, accountability and financial discipline. In many countries, the traditional thesis of 'local government borrowing being irresponsible' has now been turned on its head to permit 'responsible' local borrowing, within the enabling environment and fiscal decentralisation framework prescribed by the federal government.

Recent policies to enable municipalities to raise market-based finance have been justified on several grounds, including:

- Recognition that public and donor finances are insufficient to meet the needs to build new infrastructure, or to repair and refurbish existing infrastructure,
- 'Intergenerational equity' – where the 'lumpy' costs of infrastructure investments should be spread over the useful life of the asset, and serviced through a regular stream of municipal income and project revenues resulting from the investment and
- Exposing a city's development financing, where viable, to the rigours of 'market discipline', and thereby mobilising domestic savings for long-term growth-oriented infrastructure needs.

However, establishing sustainable markets to enable municipal borrowing have numerous challenges. Most often, the credit and capital markets in developing countries are neither efficient nor deep enough in intermediating savings from institutional and individual savers to fund projects. Therefore, sub-national governments in emerging market countries are frequently attempting to access market finance through hybrid models, some of which include elements of credit enhancement or grant-based technical assistance.

Some of the principal approaches that have been adopted to access alternate private financing for infrastructure investments at the sub-national level include:

- Borrowing from development banks and financial institutions,
- Direct borrowing from capital markets, e.g. by issuing local authority bonds,
- Establishing specialised municipal intermediaries or funds to 'crowd-in' private capital for municipal infrastructure and
- Soliciting private sector investment through various forms of public–private partnerships (PPP).

Each of these financing models is discussed in turn below, along with some relevant case studies on their successful implementation. These illustrations are by no means exhaustive, and simply seek to demonstrate some of the viable alternatives to access market finance for sub-national infrastructure investments. Furthermore, there is a degree of overlap amongst these options. For example, a development bank or municipal intermediary may access funds through the capital markets, or a PPP project may be financed by the private operator through borrowing from local financial institutions.

Borrowing from development banks and financial institutions

Western Europe heralded the practice of establishing municipal banks and financial institutions to mobilise long-term savings and government contributions for municipal infrastructure needs. In the context of developing countries, some municipalities may have borrowed from banks to meet their working capital requirements. However, borrowing larger sums for long-gestation capital investment projects is more difficult. This is because banking regulations limit the banks' ability to lend for long tenors, since their deposit liabilities are short-term and volatile. Furthermore, most banks lack the expertise to evaluate the risks of a municipal finance investment. Therefore, they either refuse to lend, or charge exorbitant interest rates while demanding significant amounts of collateral to provide credit for municipal investments. Moreover, other potential sources of long-term credit, such as mutual funds, insurance and pension funds, are still nascent in several developing countries.

Despite these constraints, some developing countries have established development banks or non-banking financial institutions to provide long-term credit for infrastructure projects, both at the national and sub-national levels. Some of these institutions also provide guarantees and other credit enhancements to infrastructure project lenders. Two examples of development financial institutions are described below:

- Infrastructure Development Finance Company (IDFC), India: a non-banking financial company that primarily offers senior debt for promoting infrastructure projects in India.
- The Development Bank of Southern Africa (DBSA): offers loans, grants and technical assistance to public and private entities with the aim to promote infrastructure development and overall socio-economic growth of South Africa and the Southern Africa Development Community (SADC) region.

Infrastructure Development Finance Company (IDFC), India

IDFC is a non-banking financial institution established in 1997 to offer private financing for infrastructure projects in India, in addition to providing specialist

advisory services. The institution was originally sponsored by the Government of India and its financial institutions such as the Industrial Development Bank of India (IDBI). However, currently, a majority of IDFC's equity is held by other shareholders, including foreign institutional investors, banks and insurance companies, mutual funds and corporates. As of March 2007, IDFC's paid-in capital was 11.3 billion Indian rupees (Rs).

IDFC primarily offers senior debt for infrastructure projects (85.6 per cent of its outstanding disbursements in 2006), although in certain cases it also provides subordinated debt and equity capital. IDFC has also provided some contingent finance products such as financial and performance guarantees, and risk participation guarantees that are fully secured by security interests in the project's assets. Furthermore, IDFC offers take-out financing by 'taking over' the outstanding project loans from commercial banks and other financial intermediaries after a certain period (typically five years). This helps to extend the maturity of the loans to infrastructure projects.

As of March 2006, IDFC had approved financial assistance to 162 projects aggregating over Rs175 billion. Table 7.1 below presents the approved financing in 2005 and 2006 across the main sectors.

Table 7.1. Size of IDFC's portfolio for its key focus sectors in 2005 and 2006 in Indian rupees (Rs, millions)

Sector	*2005*	*2006*
Energy	Rs20,790 (15 projects)	Rs33,390 (34 projects)
Transport	Rs18,882 (15 projects)	Rs35,060 (24 projects)
Information and Communications Technology (ICT)	Rs13,305 (8 projects)	Rs16,700 (8 projects)

Source: IDFC

The Development Bank of Southern Africa (DBSA)

The Development Bank of Southern Africa (DBSA) is a leading development finance institution, whose purpose is to accelerate sustainable socio-economic development by funding physical, social and economic infrastructure in South Africa and the SADC region. In addition to being a financier for infrastructure projects, it also provides advisory support to develop the overall institutional, financial, technical and knowledge capacity for development. In recognition of the capacity constraints of the municipalities, the DBSA established a Development Fund in 2001 as a Section 21 Company. The mission of the fund is to provide grants and technical assistance to municipalities for infrastructure project implementation.

The DBSA is a self-funding institution and raises funds from domestic and international capital markets, institutional investors and bilateral and multilateral development finance institutions. The bank's capital as at 31 March 2006 stood at 13.2 billion South African Rand (R), comprising predominantly accumulated retained earnings of R8.5 billion. In addition, the South African government has a shareholding of R4.8 billion callable capital. Total assets as at 31 March 2006 stood at R26.5 billion.[1]

The DBSA has provided loans and grants (technical assistance) for infrastructure projects (to both public and private clients), spanning across municipal infrastructure, water and sanitation, transport, healthcare, education, agriculture etc. To qualify for a loan, the project needs to meet DBSA's investment policy criteria. Table 7.2, below, sets out a selection of its lending and technical assistance operations in South Africa in 2005/06.

Table 7.2. Selection of DBSA projects, 2005/06 in R[2]

Client	*Project description*	*Amount (R)*
Nelson Mandela Metropolitan Municipality	Technical and financial assistance for the Vision 2020 priority projects and the implementation of the municipal infrastructure development programme	800 million (loan) 85,000 (Grant)
Chris Hani District Municipality	Upgrading of sanitation in the whole of the municipal area	10 million (loan)
Ukhahlamba District Municipality	Restoration of water supply and sanitation services	1.5 million (loan)
Bethelsdorp Investment Holdings (Pty) Ltd	Procurement of equipment and material for a hand weaving enterprise	3.5 million (loan)
Alfred Nzo District Municipality	Upgrading of bulk sewerage and reticulation and road works	25 million (loan)
Ndlambe Municipality	Implementation of phase 3 of the municipal infrastructure programme	10 million (loan)
Mafube Municipality	Provision of infrastructure for the extension of municipal services delivery	8.6 million (loan)
Board of Bloemfontein Water	Implementation of the Bloemfontein Water capital programme	14.4 million (loan)
Blue Hills College (Pty) Ltd	Upgrading of infrastructure and provision of additional facilities and equipment for Further Education and Training	4.6 million (loan)
Lesedi Municipality	Building of a new switching station and upgrading of existing switching stations	5 million (loan)

Further to its loan portfolio, DBSA also underwrites guarantees and provides credit enhancements for projects and clients to attract better financing terms and conditions. Finally, it partners with international development and finance institutions to enhance integrated economic development and growth in South Africa and the SADC region.

Direct borrowing from capital markets – municipal bonds

The municipal bond market in the United States is the world's most sophisticated, in terms of the depth and nature of its long-term financing and in terms of the cash-flow functions it provides for municipalities across sectors of urban development. A major feature of US municipal bonds is the tax-free status of their interest payments, which helped attract wealthy individual savers in addition to institutional investors.

At its core, a municipal bond is a debt obligation issued by a sub-national borrower, with the undertaking to repay the bond principal with interest at a specified payment schedule. There may be several variants of municipal bonds developed using ingenious financial engineering. However, the two most common categories of bonds are revenue and general obligation (GO) bonds. As the names suggest, revenue bonds are serviced by the revenues of the particular investment, for example, toll roads. Typically, these are 'limited obligations' and do not have recourse to the municipality's revenues or assets. On the other hand, GO bonds are serviced from the general revenues – taxes and other income – of the municipality. Because of their nature, revenue bonds typically finance 'bankable' projects that have some charging mechanisms for cost recovery, while GO bonds may be used for investments that are not revenue generating.

The sections below provide case studies on the issue of GO and revenue bonds. They go on to present two cases on pooled financing mechanisms – a more ingenious bond issue used successfully by small and medium-sized municipalities in South India to raise market-finance for infrastructure projects like water and sanitation.

General obligation bonds

In the case of a GO bond, the debt is secured through the unconditional credit of the borrower, in this case the sub-national government. The local government uses its full set of revenue sources – own-source revenues and transfers – to service the outstanding debt and interest. Often, a portion of the general revenues of the municipality is 'ring fenced' in a dedicated account to ensure the timely servicing of the bonds, for example, through an escrow mechanism.

Long-term bond issue of the City of Johannesburg

Johannesburg, South Africa's largest city with a population of 3.2 million, is the country's main business centre. The city provides the full range of municipal services, ranging from power transmission to waste management. It operates a balanced budget with revenues primarily from power, water and sewerage tariffs, and property and business taxes. Johannesburg was seeking to access capital markets through issuing a GO bond with the objectives to:

- extend the maturity of its existing debt to better match its long-term assets,
- finance long-term infrastructure projects,
- refinance existing high-cost bank debt and
- diversify its funding sources away from exclusive bank lending.

The city sought long-term funding beyond 10 years, but faced a constraint that it could not issue bonds beyond six or seven years at an acceptable price without credit enhancement. The IFC assisted in structuring the transaction and provided the necessary credit enhancement in form of a partial credit guarantee equally shared with the Development Bank of South Africa. As a result, Johannesburg managed to issue a R1 billion (US$53 million), 11.90 per cent bond in June 2004, which matures in 2016 and amortises over the last three years in six semi-annual payments. The guarantee, sized at 40 per cent of the principal outstanding, can be used to repay up to the full amount of principal and interest, subject to guarantee limits, on any given payment date if there are insufficient funds for a particular period. Through the credit enhancement mechanisms, the bonds were rated AA- by Fitch Ratings, three levels above the city's stand alone rating of A-. The bond issue was oversubscribed 2.3 times.[3]

Revenue bonds

With a revenue bond, the pledge for debt repayment is limited to a specific source of project revenues, for example, fees from water utilities or a toll road. The borrower can either be the local government, a special fund or entity, or a utility company providing municipal services.

Revenue bond issue by Madurai Municipal Corporation, India

Madurai Corporation, with the assistance of the Tamil Nadu Urban Development Fund (TNUDF),[4] issued the first revenue bond in India based on ring-fenced project revenue streams. Funds were raised to refinance the construction cost of the 27 kilometre Madurai Inner Ring Road, inaugurated in 2000, which aimed at decongesting the city of heavy commercial vehicular traffic. The project cost of 440 million Indian rupees (Rs) was initially funded jointly by a loan of Rs305 from TNUDF and a grant of Rs130 million from Government of Tamil Nadu. After construction

was completed and following a year of operation, Madurai Corporation chose to refinance the TNUDF borrowing by sourcing market funds at cheaper cost.

The annual interest rate for the TNUDF loan was at 15.5 per cent, while the rate for long-term government bonds had fallen to 10.3 per cent. Consequently, with TNUDF assistance, Madurai Corporation refined its loan through a Structured Credit Obligation on private placement worth Rs304 million (US$23 million) and priced at 12.25 per cent for a 10-year tenure. The debt was to be serviced solely from toll collections, ring fenced from other revenues of the corporation by a no-lien escrow account. Lenders would have recourse to project revenues only. The bond issue was backed by a credit enhancement and structured payment mechanisms that required the maintenance of a bond service fund equivalent to one year's principal and interest payments as collateral throughout the life of the bonds. This support helped Madurai Corporation to achieve a rating of AA+ for the bond issue. Investors included mainly commercial banks (70.5 per cent), the sponsors of TNUDF and insurance companies.[5]

The fact that the refinancing was structured after the road was operational with toll revenues accruing reduced potential construction risks. If the bond had been issued against the faith of Madurai Corporation's finances, the rating would have been downgraded, as its revenues did not permit sufficient borrowing capacity. TNUDF, having absorbed the initial development risk of potential cost and time overruns, enhanced the attractiveness of the Madurai bond. As at the time of writing, toll collections have afforded a moderate surplus in the escrow account after interest payment.[6]

Pooled financing bonds

Large municipalities with a strong economic base and predictable revenue streams and/or with 'bankable' project opportunities can raise finance from capital markets through municipal bond issues as described above. However, this may not be the case for small and medium-sized municipalities that are financially constrained and cannot develop projects that are commercially tenable (for example, water and sanitation projects in small towns). Transaction expenses like bond issuance fees, underwriting and credit rating charges involved in capital market access would constitute a high proportion of project costs for these smaller municipalities. Therefore, lack of credit worthiness and limited affordability of smaller municipalities constrains their access to capital markets.

In this context, an innovative approach to tap market finance is that of 'pooled financing'. Pooled financing entails a number of municipalities and projects being combined together for financing, so as to improve cost effectiveness and to share the risks involved. This improves their credit worthiness (which was otherwise proving to be a limiting factor on a standalone basis), and thereby ensures the

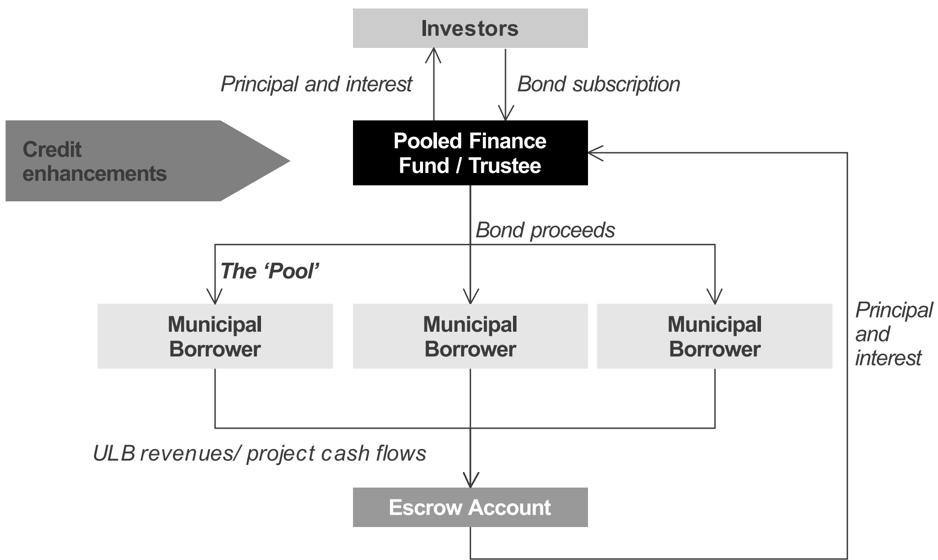

Figure 7.1. Pooled financing

inclusion of weaker municipalities and relatively small but essential projects. See figure 7.1 for an illustrative pooled finance structure.

There have been many cases of pooled financing in the US, where the federal government established state revolving funds and bond banks. These are municipal intermediaries that pool the borrowing needs of multiple smaller local entities that are unable to individually access capital markets.[7]

The first case of successful pooled financing in the developing world is the case of the Water and Sanitation Pooled Fund (WSPF) in the state of Tamil Nadu in India in 2002. Another recent example in 2006 has been the case of financing water projects in the Bangalore municipalities (in the state of Karnataka, India). We present a brief case study on each of these below.

Water and Sanitation Pooled Fund in Tamil Nadu, India[8]

The Water and Sanitation Pooled Fund (WSPF) is a special purpose vehicle instituted by the Government of Tamil Nadu in August 2002. It was incorporated as a trust with a small contribution of 10,000 Indian rupees (Rs) from the Tamil Nadu government. The fund was entrusted to the management of the Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL), a majority privately held asset-management company with the Government of Tamil Nadu holding an equity stake as well. It proposed to aggregate common infrastructure needs of a judicious mix of financially strong and weak urban local bodies (ULBs) in Tamil Nadu, and to

achieve economies of scale for small city projects that cannot individually access capital markets.

The shortlisted portfolio included water supply augmentation schemes for 13 municipalities and town *panchayats* (small to medium-sized ULBs), and an underground drainage project for Madurai Corporation (a larger ULB). The new connections were projected to increase daily per capita water supply for beneficiaries by 30–40 per cent over current baseline availability, although still below the state norm of 90 litres. The promoters of the WSPF cherry picked projects that were nearly commissioned, so that the funds could be deployed immediately (most of these projects were fully or nearly completed and initially financed by the TNUDF).

Pooling the water and sanitation requirements of 13 municipalities and town *panchayats*, WSPF mobilised capital market finances through an unsecured structured debt obligation for Rs304.1 million in December 2002. Privately placed at a competitive rate of 9.2 per cent, it was subscribed for by commercial banks and provident funds. The full subscription is important to note given that the WSPF bond income was taxable (as compared to comparable issues in the US, which were tax free). The bond proceeds were lent back to the 13 ULBs in the pool at 9.2 per cent per annum, resulting in substantial savings compared to their individual borrowing rate of 12 per cent.

Some notable features of the bond issue are as follows:

- This was truly a long-tenor municipal infrastructure bond, being issued for 15 years.
- The structured financing was enriched with put and call options for 10 years. The options provided a safety net to investors who may wish to divest their holding before maturity, thereby increasing bond liquidity.

In order to bolster market confidence, the debt had multiple layers of credit enhancements:

- The first level was a no-lien escrow account, established by the 13 ULBs on their revenues, including property and other tax collections, non-tax receipts and state devolutions. In order to avoid maturity mismatches in revenue and repayment profiles, each ULB had to transfer one-tenth of its annual debt service to a separate fixed deposit account, which had precedence over other commitments. The cumulative deposits were then transferred to the WSPF account to service bond holders. Any shortfall in monthly deposits was to be covered by future accrued state devolutions to the ULBs.
- A bond service fund of Rs69 million was created and invested in low-risk liquid securities.
- The USAID Development Credit Authority (DCA) provided a guarantee for 50 per cent of the principal amount, which would diminish annually as

instalments got repaid. The Tamil Nadu government agreed to bear the remaining 50 per cent of the principal, 100 per cent of the interest and a one-time utilisation fee for the USAID guarantee.

As a result, the enhanced pooled debt instrument secured a dual 'high safety' credit rating from Fitch Ratings and the Indian Credit Rating Agency.

Karnataka Water and Sanitation Pooled Fund in Bangalore, India[9]

The city of Bangalore in India is the rapidly growing IT hub of the country. Growth in the sector has led to a considerable rise on the city's population, resulting in many people moving to the suburbs. However, this growth in population has not been matched with an increased supply of crucial municipal services such as water and sanitation. As a result, the Government of Karnataka embarked on a programme to provide for the increasing demand for drinking water in the suburbs of Bangalore.

Across eight municipalities, Rs6.6 billion worth of aggregated projects were identified for financing, including water and sewerage components at Rs3.4 billion and Rs3.2 billion respectively. Of this, it was proposed that Rs1 billion be raised without Government of Karnataka guarantee under a pooled finance framework with credit enhancements.

The Karnataka Urban Infrastructure Development and Finance Corporation (KUIDFC), a state-level financial intermediary,[10] developed the physical and financial standards for the pool of projects to be included in the bond transaction. A debt fund called the Karnataka Water and Sanitation Pooled Fund (KWSPF) was established (managed by KUIDFC, an asset management company) to access the capital market by bond issue on behalf of the participating ULBs. The KWSPF borrowed from the market and on-lent the proceeds to the ULBs to construct the facilities.

The main security for the debt is a charge on receivables of the participating ULBs, to be escrowed in a water project account (WPA), with structured payment mechanisms to be monitored by a trustee. More specifically, a dedicated WPA will be maintained by each participating local body. An amount equivalent to one-and-a-half times annual debt service payments of market borrowing will be transferred to this account from the ULBs' general revenues (such as property tax revenues, other own sources and state devolutions, if necessary) and annual operating grants from the state government for the debt servicing. From the WPA, the necessary amount will be transferred to KWSPF for debt servicing prior to the due date of payment. It is important to note that the debt servicing towards market borrowings has seniority over repayments towards any other current and future debt mobilised by ULBs.

Similar to the Tamil Nadu WSPF and in addition to the WPA, the Karnataka pooled financed bond transaction is backed by a number of credit enhancements:

- The first layer of credit enhancement is the creation of a bond service fund (BSF). The BSF is set up at the state level for the pool of participating ULBs with Rs25.5 million. The BSF will be administered by the KUIDFC.[11]
- The second layer is the unrestricted ability of the trustee to intercept cash transfers from higher levels of government to the municipality.

A partial credit guarantee (50 per cent) by the USAID DCA provides the third level of credit enhancement, i.e. the DCA guarantee is not called upon unless the first two layers fail.[12]

Specialised municipal intermediaries

In recent years, several sub-national governments have set up specialised financial intermediaries or funds to develop Greenfield infrastructure projects. These funds have often been instituted (and in some cases, part financed) under the auspices of projects funded by the World Bank and other donors. Broadly, there are two types of such intermediaries:

- Municipal funds and facilities that provide funded products – debt and/ or equity.
- Facilities that offer contingent products – guarantees or insurance.

Each of these is illustrated below, with successful case studies from developing countries.

Intermediaries offering funded products

This section presents case studies on specialised financial institutions and vehicles that have been set up to provide long-term debt and/or equity to promote infrastructure development and crowd in private investment at the municipal level. Examples include:

- Local Development Investment Funds (LDIFs) in Vietnam: fully owned by the provincial governments of Vietnam, to help mobilise private sector financing and attract private sector participation in urban infrastructure.
- Paraná State Urban Development Fund (FDU) in Brazil: publicly owned fund to lend to municipalities and municipal utilities to finance urban development.
- Infrastructure Finance Corporation Limited (INCA) in South Africa: a privately owned and operated infrastructure debt fund, which provides long-term fixed interest loans to South African municipalities.

Local Development Investment Funds (LDIFs), Vietnam

Given the growing demand for infrastructure development and the consequent need to mobilise sufficient resources, the Government of Vietnam has decentralised responsibilities to improve and develop municipal infrastructure to the provincial governments. In this context, the Local Development Investment Funds (LDIFs) were established as an operational and legal structure for the provincial governments to invest in infrastructure, and to mobilise capital and enter into contracts with the private sector. The key objectives of the LDIFs are to:

- support a conducive legal and operational framework at the provincial level to develop municipal infrastructure and services,
- attract private sources of financing, equity and debt capital, for developmental infrastructure and
- enter into contracts and various forms of public–private partnerships to increase private sector participation in infrastructure development.

The LDIFs are established by the charters of the respective Provincial People's Committees (PPCs) that provide each fund's equity capital and wholly own them. The total provincial government investment channelled through LDIFs increased by approximately 65 per cent from 2002 to 2004. In 2004, the total operating capital of LDIFs in Vietnam was approximately US$300 million. In parallel, LDIF lending increased by approximately 20 times between 1997 and 2004, and the LDIF activities have expanded from simple loans to the establishment of joint stock companies engaged in infrastructure development.

The Ho Chi Minh City Infrastructure Fund for Urban Development (HIFU) was the first LDIF established in June 1996. It has the most diversified operations among existing LDIFs and has the largest portfolio of infrastructure investments. Its equity investments include, among others:

- 25 per cent equity contribution to the Tan Phu Trung Industrial Park in Ho Chi Minh City,
- 16 per cent equity contribution to the first domestically funded water BOO project in Vietnam – the Thu Duc Water BOO Corporation and
- 25 per cent equity contribution to the Saigon Medical Investment Joint Stock Company.

In addition, HIFU founded the Ho Chi Minh City Infrastructure Investment Joint Stock Company in December 2001, to act as an operating concessionaire of transport projects in Ho Chi Minh City and develop other revenue-backed municipal infrastructure PPP projects. HIFU has also provided debt financing to various projects across the transport, water, industrial parks, health and education sectors.

Since 1996, and given HIFU's track record, 13 other provincial governments have established LDIFs with the approval and support of the Government of Vietnam. The four most active LDIFs were all incorporated in the last decade and are entrusted with broadly similar mandates as presented above. In addition to the chartered capital contributed by the PPC, LDIFs mobilise loan capital from domestic banks and state-owned enterprises. The most active LDIFs are making progress in bringing different PPP models, including more sophisticated contracting mechanisms (BOO, BOT etc.) to Vietnam.

Paraná State Urban Development Fund (FDU) and PARANACIDADE, Brazil[13]

Paraná State Urban Development Fund (FDU) was created as a revolving fund within the Government of Paraná in December 1998. It is financed by the public budget from the federal and state governments, a loan from the Inter American Development Bank (IADB) and retained earnings from its operations. The size of the fund in 2001 was US$311 million. It is expected that the total assets of the fund will be US$1 billion by 2015.

FDU's objective is to lend to the municipalities of Paraná as well as to special utility companies (water, sewerage and electricity) by financing urban development plans, programmes and projects. FDU is not allowed to lend to private entities. The interest rates applicable to municipalities and utility companies vary depending on the programme. However, FDU's interest rates have been highly subsidised.

PARANACIDADE was created in June 1996 as a non-profit autonomous social service agency, which by law operates as a private sector entity. One of its roles is to manage the FDU. PARANACIDADE keeps separate accounting on an accrual basis for FDU and PARANACIDADE, including producing the consolidated accounts of both.

FDU has stringent criteria to qualify and in relation to debt servicing for its borrowers. Municipalities are required to commit their receipt of transfer from the state government to the debt services to FDU. FDU does not require any other guarantee from the state government. In the loan agreement, municipalities accept that the state government intercepts the debt service payment from their transfer of the state value-added tax share. In case of lending to utility companies, their revenue streams are hedged for the debt services. FDU has been able to maintain a 100 per cent loan recovery rate and has no provision for doubtful debt.

In addition to financing the construction of physical infrastructure, FDU has also contributed significantly to the improvement of financial and fiscal management of the municipalities and utility companies.

Infrastructure Finance Corporation Limited (INCA), South Africa

Infrastructure Finance Corporation Limited, trading as INCA, is an infrastructure debt fund established in 1996 in South Africa. INCA was established in response to the South African government's call for increased private sector involvement in infrastructure funding and is the only debt fund in the country that is a 100 per cent privately owned and operated.

It provides long-term infrastructure loan funding, with a focus on municipal infrastructure. Typical borrowers include municipalities, water boards and other statutory institutions in the public sector. Six metropolitan municipalities in South Africa account for 50 per cent of INCA's total advances.

INCA provides fixed and/or floating rate finance for terms from one to 20 years. Its main funding is, however, of long-term fixed-interest loans. In addition, it also provides financing of movable assets, as well as institutional capacity building and re-engineering advice.

The main funding sources it draws on are local and international market funds, raised through a series of INCA bond issues and long-term loans extended to the corporation by international financial institutions.

Intermediaries offering contingent providers

Intermediaries that offer funded products primarily help to address the liquidity gap in terms of either the quantum or tenor of finance available for infrastructure projects. In contrast, contingent financier vehicles offer second-tier financial support or risk mitigation products that either help to extend the tenor of existing debt for infrastructure or to provide guarantees that can mitigate the risk of default. Therefore, these vehicles typically enhance the credit worthiness of the investment and increase the market confidence in lending to infrastructure projects. They generally cover those risks that private financiers perceive to be excessive or cannot or will not take.

This section presents case studies of specialised financial institutions and vehicles that have been set up to provide contingent products, i.e. guarantees, insurance or re-financing arrangements, to promote infrastructure development and crowd in private investment at the municipal level. Examples include:

- The Local Government Unit Guarantee Corporation (LGUGC) in the Philippines: a privately owned corporation (national private and donor funding), which provides credit guarantees to financial institutions that lend to local government units in the Philippines.
- FINDETER in Columbia: Financed by the central and regional governments in the country, it provides second-tier financing by re-discounting or re-financing bank loans to local governments.

In addition, several multilateral and bilateral development banks and agencies also offer specific risk mitigation products for sub-national infrastructure financing. For instance, the European Bank for Reconstruction and Development (EBRD) and the World Bank/International Finance Corporation have created municipal finance units and provide partial credit guarantee support to selected sub-sovereign governments or entities based on their own credit.[14]

Local Government Unit Guarantee Corporation (LGUGC), Philippines

The Local Government Unit Guarantee Corporation (LGUGC) was set up in March 1998 and is a private financial credit guarantee institution. It is owned by the Bankers Association of the Philippines (38 per cent), the Development Bank of the Philippines (37 per cent) and the Asian Development Bank (25 per cent). LGUGC has a co-guarantee agreement with USAID, which effectively expands the corporation's capacity to cover infrastructure projects for local government units (LGUs) and other entities in the Philippines.

The primary goal of LGUGC is to make private financial resources available to creditworthy LGUs in the Philippines through its insurance/credit guarantee. Borrowers include first- and second-class cities and provinces, first-class municipalities and other developing LGUs. This remit has been extended to water districts, electric co-operatives, renewable energy technology providers, and state universities and colleges.

LGUGC's credit enhancement facilitates the entry of LGUs with infrastructure development projects into the capital market. In addition to the key municipal infrastructure sectors, the LGUGC also extends guarantees to agribusiness and food production, public utilities, and the tourism, housing, education and health sectors.

LGUGC guarantees loans (i.e. provides credit guarantees) obtained by local government units from partner financial institutions[15] as well as bonds underwritten by PFIs and floated in the capital market.[16] Loans may be guaranteed up to 85 per cent of principal and interest subject to interest rate cap and bonds are guaranteed 100 per cent of principal and interest subject to interest rate cap. The guarantee fee is a function of the underlying borrower and project risks, and as such the fees may range from 1–2 per cent p.a.

Figure 7.2 below describes the structure of the guarantee system operational by LGUGC (taking the specific case of loans only).

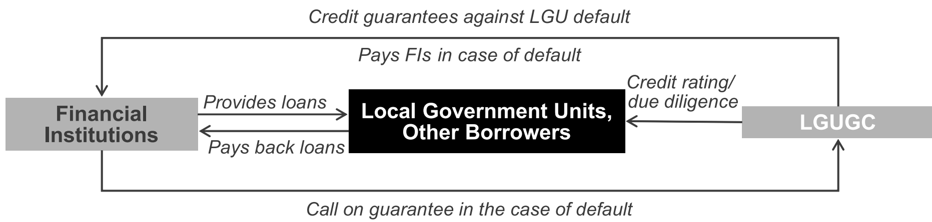

Figure 7.2. LGUGC guarantee system

The LGUGC follows several procedures to ensure financial prudence:

- The provision of a guarantee is backed by collateral of the assignment of project revenues and assets and the internal revenue allotment. For other borrowers, there is an assignment of a reserve fund created from the monthly gross revenues of the borrower. Assets offered as collateral must be insured with an LGUGC accredited insurance company.
- Guarantees are extended based on a minimum acceptable credit rating to be determined by LGUGC. LGUGC implements an internal LGU credit screening and rating system (LCSRS), which adopts internationally accepted standards fit for due diligence requirements of private financial institutions as well as individual investors.

The management of LGUGC allows a buffer in its leverage ratio. In the absence of a default track record, LGUGC currently applies a 'guide' gearing or leverage ratio of 10 times its guarantee fund or a prudential limit of 10:1. This translates to a maximum outstanding guarantee of 4 billion Philippine peso (P), given LGUGC's current guarantee fund of P420 million.

Financiera de Desarrollo Territorial (FINDETER), Columbia

FINDETER is one of the successful second-tier financial institutions lending to sub-national entities without a sovereign guarantee. It was established as a financial institution in 1989, supervised by Columbia's banking regulators. Eighty-six per cent of its shareholding is held by the Ministry of Finance and 14 per cent by regional governments. The fund size is US$1 billion, including its lending portfolio since 1990. The objectives of the fund are to support:

- long-term infrastructure loan funding,
- financing of movable assets,
- institutional capacity building, and
- financial re-engineering and advice.

Being a second-tier lender, FINDETER does not lend directly to municipal borrowers, but rediscounts bank loans to local borrowers. Specifically, qualified banks that provide long-term loans to sub-national agencies can borrow from FINDETER up to 85 per cent of the loan value with the same maturity (up to 12 years, with up to three years of grace). Commercial banks participating in the FINDETER programme must make loans at a maximum margin of 2.5 per cent over Colombia's standardised index of the competitive cost of capital.

From 2000 to 2002, Colombia's macro-economic and municipal finance crisis disrupted demand for infrastructure loans and the performance of FINDETER. However, FINDETER retained its financial strength (triple A local rating by Duff and Phelps) largely because of its structure as a second-tier finance institution, which avoided the losses of the banks that had lent directly to municipalities and urban service providers. Since 2002, the gradual recovery of overall economy and municipal finances have led to a sharp expansion in FINDETER lending – 33 per cent in real terms in 2003. By June 2003, about 71 per cent of FINDETER's loans had a tenor of at least eight years. By 2003, it had also acquired a fairly diversified portfolio of projects across sectors, as shown in table 7.3.[17] The end borrowers, in addition to municipalities, include water and sewerage companies, public and private education entities, housing entities, energy service companies and communications companies, amongst others.

Table 7.3. FINDETER loan portfolio by sector (2003)

Sector	*Percentage lending*
Transport	30.2%
Water and sanitation	24.8%
Schools	12.4%
Debt management	11.4%
Telecom	6.5%
Health	5.3%
Shopping centres	4.2%
Others	5.2%

7.5 Public–private partnerships

There are many differing views on defining the characteristics of public–private partnerships (PPPs) – based on the extent of private sector involvement and financing of public services. Broadly, PPPs are defined as risk-sharing relationships between the public and private sectors based on a shared aspiration to bring about a particular public policy outcome. PPPs can be understood along a spectrum ranging from simple service contracts awarded to the private operator, right up to joint ventures and full privatisations.

Typically, the public sector is the purchaser of services, let on a short-, medium- or long-term contract. Depending on the nature and specifications of the contract, the private sector is generally the provider of services and shares risk in terms of delivery (costs and benefits). In some cases, the private sector is also responsible for financing – for example, in the case of private financing initiatives (PFI) in the UK, or joint ventures between the public and private sectors.

It is much more challenging to execute PPPs for municipal services, given the affordability and non-bankability issues of these projects. Therefore, most successful sub-national PPPs have been of the former category – where the private operator is contracted for only the provision of defined municipal services (often subject to specified performance criteria), and the public sector is responsible for financing investments and owns the assets.

Three successful examples of ongoing PPPs at city level are presented in the sections below. These include the:

- Bogotá TransMilenio bus system concession contract,
- Lahore composting plant BOT and
- Senegal urban water sector concession.

Bogotá TransMilenio bus system concession contract[18]

Bogotá, the capital of Colombia, has a population of about seven million. In December 2000, the city, with the participation of private operators, inaugurated a new urban bus transport system. The objective was to reduce traffic congestion and to make public transport more equitable, reliable and secure. The first two phases have been implemented successfully and TransMilenio carries 1.3 million passengers on average each weekday.

Cost and features of the bus system

The TransMilenio is operated like a rail-based system, but is much more cost effective. The system's infrastructure provides for exclusive bus lanes based on the Curitaba model designed for trunk line services, roads for feeder buses, stations and complementary facilities. Stations on the trunk lines are closed facilities at an average distance of 500 metres from each other. While some buses stop at all stations, others operate express routes. When it is fully developed in 2016, TransMilenio will serve five million passengers per day along 388 kilometres of main lines on 22 corridors.

The bus system's cost is US$5 million per kilometre, which includes dramatic improvement of the public pedestrian space around the system, including sidewalks, plazas and the like, while the cost for metro systems reaches US$100 million per kilometre.

PPP structure and funding

Design, planning and investment in infrastructure were carried out by public institutions.[19] The infrastructure was jointly funded by the national government, a loan from the World Bank, the City of Bogotá, as well as stakeholders from the transport sector. Bogotá committed revenues from a 20 per cent gasoline sales surcharge for the construction cost.

The bus system is fully operated by private providers, which are consortia of local transport companies associated with national and international investors that own the buses and hire drivers and maintenance personnel.[20] The operation further includes fare collection concessionaires and control centre providers. Concessions for bus operation are awarded through open bidding processes and payment is related to the number of route kilometres served by each operator. The compensation scheme was redesigned so that private operators' primary incentive was to offer a high-quality service and not to deliver the highest number of passengers.

The operation of the system itself is funded entirely by fare collection and no subsidies are provided. Money collected through smart cards is deposited in a trust fund, from which the operators are paid according to the rules set forth in the concession contracts. Strict conditions are provided for all private operators in the concession contracts, and they are required to cover risks and losses. For oversight of operations and work issues, the system established a new public company, TransMilenio SA, funded through ticket sales.

Results and critical success factors

The evaluations of the project have been positive. The project resulted in a 32 per cent saving in travel time, pollution levels dropped sharply and accident fatalities were reduced by 93 per cent. Overall, the success of TransMilenio is attributed to a various factors, including:

- *Municipal leadership*: An important factor has been the city government's strong leadership with careful design, planning and implementation. A long-term vision and strategy, supported by awareness campaigns, helped to foster behavioural change among citizens.
- *The establishment of a good management company*: A new public company, known as TransMilenio SA, was created to be responsible for operations and issues of expansion and maintenance.
- *Implementation of the right incentive mechanisms*: Adequate incentives were considered for all stakeholders and built into every phase of the project. This includes issues of competition in the market, fare design and collection, safety features, drivers' working conditions, effective oversight institutions, penalties and bonuses built into the contracts etc.

- *Policy, technical and administrative expertise at the local government level:* The municipal team for the project was able to skilfully develop contracts and legal arrangements, and could also adopt state-of-the-art technologies to run the system. The connection of the bus system with the existing road transport system (feeder buses) is considered a key success factor.
- *Effective financial design and equitable pricing*: Financial sustainability was a key principle from the project's start. An efficient single-fare pricing system was designed to cover full operational costs. The ticket price was approximately US$0.55 in 2007. The fixed fare is based on cross-subsidising by passengers travelling long/short distances. This was deemed to be socially equitable, because the poor normally have to travel longer distances from their residences to the city centre.

With the overall success of the system, the local government is committed to its further expansion in the coming years, and aims to eventually make the TransMilenio accessible within 500 metres for 80 per cent of the population.

Lahore composting plant BOT[21]

In Pakistan, local government laws have in-built provisions enabling local governments to enter into PPPs.

Pakistan's first composting plant has been set up in Lahore in the province of Punjab, with financial assistance from a Belgian multinational company on a BOT basis for 25 years. The operation of the plant has been awarded to the SAIF Group, which is a diversified group of companies active in telecommunications, energy, textiles, cement, food processing, software and consultancy. The Punjab Bank is the main financier of the plant.

The plant is expected to transform around 20 per cent of the city's waste – i.e. around 1,000 tonnes of garbage – into 250 tonnes of organic fertiliser every day. There are plans to expand the capacity of the plant in the future. The 37.5 acre plant was built on land owned by the Solid Waste Management Department (SWMD) and cost 250 million Pakistan rupees (PRs). The private operator will operate the plant for 25 years, during which time it will give 10 per cent of its gross profits to the SWMD on an annual basis. The City District Government of Lahore (CDGL) plans to contribute 10 per cent of the revenue generated by the SWMD to its social welfare scheme.

The project is expected to be transferred to CDGL after the BOT period. This is the first PPP municipal project in Pakistan to take place on such a large scale in the area of municipal solid waste recycling. CDGL has granted an exclusive right to Lahore Compost Limited to receive 500–1,000 tonnes of municipal solid waste per day from different towns. The collection and transportation of the solid waste to the plant is the responsibility of CDGL.

Overall, CDGL considers the project a success and is planning to replicate the model for further waste disposal plants.

Senegal – Urban Water Sector Concession[22]

In 1995, more than half of Senegal's population lived in urban areas. Water shortages in Dakar were chronic and sanitation facilities barely existed. Only 54 per cent of the urban population had access to safe water. The Senegalese government embarked on a reform project to extend water and wastewater services. The objective of the project was to attract a private operator to improve service delivery and provide efficient water and wastewater services. Donors provided US$230 million in funding (inducing a US$100 million International Development Association credit) to the government of Senegal for implementation of its reform plans.[23]

The core of the initial reform was to establish three main sector institutions linked through a web of contracts. The three main actors were the Ministere de l'Hydraulique, a newly created state asset-holding company and a private operator. The government's main interest was to keep control over the assets and establish long-term financial viability of the system. The government decided to operate the sector under an affermage contract,[24] and the contractual framework was as follows:

- The asset-holding company was awarded a 30-year concession to manage the sector, with a contract outlining investment obligations.
- A 10-year affermage contract between all three actors, governing the operation of the system, was put in place. In addition, as an annex to the affermage contract, a performance contract outlined the specific responsibilities of the private operator.

The private operator signed the contracts in 1996. The PSP arrangement has been governed by the following key terms:

- The private operator is responsible for running the existing network, including maintenance of the infrastructure at its own cost. There are no ongoing operating subsidies.[25] Capital investments for the expansion of the system remain the responsibility of the state asset-holding company.
- The operator's remuneration is based on the amount of water produced and sold, creating an incentive to serve as many customers as possible while reducing water losses.
- The performance contract covers issues of reasonable price increases, expansion of services, the efficiency and effectiveness of technical management (reduced leakage), as well as financial management (collection and billing efficiency).

- An increasing block tariff structure was implemented, with social tariffs (a subsidised first block tariff for consumption under 10 cubic metres per month) for affordability reasons.

Results and success factors

As of 2007, the company produces and distributes drinking water for 54 towns in Senegal, serving 3.7 million people. Three million live in Dakar. Overall, the access to water services rose from 74–81 per cent in 1996 to about 98 per cent of the urban population in 2006. Water losses from leakages dropped and sanitation improved in urban areas. Tariff collection reached 98 per cent and tariff increases for consumers were kept to an annual average of 3 per cent – equal to inflation.

The affermage contract has been found an effective instrument to allow public resources and donor finance to leverage substantial private financing, while avoiding the major investment obligations and risks inherent in a concession contract.[26]

Overall, some critical success factors of the PSP arrangement were:

- The government took ownership of the reform process, and established a climate of trust and co-operation among the key stakeholders. A key part of confidence building was to keep the state asset-holding company institutionally autonomous.
- Sector investments were planned in parallel to operational reforms and investments were implemented in a timely manner.
- Long-term financial viability was achieved through increased efficiency and effectiveness. Revenues became sufficient to fully finance all operations, including debt service. This was achieved through gradual annual tariff increases that matched improvements in the quality of service. Tariff increases were accompanied by public awareness campaigns.
- To avoid conflicting interests of the asset-holding and operating companies, a high degree of clarity on asset holding and O&M responsibility was needed. It was recommended that fixed assets would be owned by the state asset-holding company and the operating equipment, comprising all moveable assets, be owned by the privately run operating company.
- The design of the affermage contract recognised the need to allocate sufficient, specific resources to finance increased access to piped water supply for the poor. As a result, a national fund was created to allow the private operator to subsidise social connections. Social connections were provided free,[27] while a connection fee was charged for ordinary connections of wealthier households. To facilitate collection and payments, the private operator set up a decentralised and computerised system of payment booths.

Notes

1. *International Investor* (2007).
2. Projects 2005/06, http://www.dbsa.org/Projects/Documents/DBSA%20projects%20report.pdf [accessed 25 March 2009].
3. IFC (2004).
4. Venkatachalam (2005); Freire et al (2004).
5. Ibid.
6. Venkatachalam (2005).
7. El-Daher (1997).
8. Venkatachalam (2005).
9. USAID FIRE Project (2003).
10. KUIDFC is a government entity. Its assets are majority-owned by the government and its management is majority controlled by the government.
11. The Government of Karnataka authorises KUIDFC to provide the up-front contribution required for the BSF from its own sources or government identified sources. KUIDFC, on behalf of the KWSPF and the Government of Karnataka, shall apply to the Government of India Pooled Finance Development Fund (PFDF) for part reimbursement of the BSF.
12. For the balance 50 per cent of principal and the interest component, availability of a backup guarantee from Indian financial institution(s) will be explored.
13. Suzuki (2001). Please note that we have been unable to source recent information in English on the activities of the FDU.
14. Public Private Infrastructure Advisory Facility (2006).
15. Accredited Bankers Association of Philippines (BAP) member bank and/or its subsidiary(ies).
16. The 1991 Local Government Code provides that LGUs can only issue bonds for revenue-generating and self-liquidating projects. However, LGUGC will entertain guarantee applications for non-revenue generating projects for direct loan transactions on a credit risk-sharing basis with the PFIs.
17. 'FINDETER, a model Municipal Development Fund', Presentation at the World Bank, April 2004.
18. www.TransMilenio.gov.co [accessed 26 March 2009]; Institute for Global Environmental Studies (2003); Fernholz (2005).
19. These include institutions such as the Bogotá Mayor's Office, the Secretary of Transit and Transportation and the Institute of Urban Development.
20. Main lines are operated by four companies and feeder buses are operated by three companies.
21. Meetings with the *Nazim* (Mayor) of Lahore and the Punjab provincial government.
22. United Nations (2005); IRIN Africa (2007).
23. World Bank (2006f).

24. Under an affermage contract, the private operator is paid a fee that is a part of the tariffs collected and this covers the costs of running the system. The remaining tariffs are remitted to the government to pay for any investments. The affermage contract differs from a concession in this respect; in the latter the operator retains 100 per cent of consumer tariffs and is accountable for covering costs and making investments.
25. The private operator is obliged to renew a minimum of 14,000 metres and 6,000 connections per year and has to meet the World Health Organization (WHO) standards for water quality. The total obligations mean that the operator, over the 10-year contract, had to invest approximately US$20 million.
26. World Bank (2004b).
27. In 2003, the private operator calculated that free water installations for poor users accounted for 85 per cent of new water connections.

8
Conclusion

As mentioned in the introductory chapter, this book seeks to identify some of the key challenges in municipal infrastructure financing and to provide broad suggestions for financial and institutional strengthening of sub-national governments so that they can mobilise alternate, including private, sources of financing for infrastructure investments. The sections to this chapter describe some of the key challenges of and the suggested financial strengthening measures to mobilise private sector financing for sub-national infrastructure projects.

Challenges of municipal infrastructure financing

The detailed case studies presented on four Commonwealth developing countries – Uganda, Tanzania, Bangladesh and Pakistan – underscore the gaps in fiscal decentralisation and the constraints faced by municipalities in promoting new growth-oriented infrastructure and public services. Given the rapid urbanisation across major cities and the growing demands for infrastructure investments, several local governments such as the Kampala City Council are undertaking initiatives to strengthen their traditional sources of tax revenues and user charges. However, there still exists a significant infrastructure financing gap at the sub-national level.

Based on the lessons derived from the four case analyses, the following are some of the key demand- and supply-side challenges faced by municipal authorities in the provision of local infrastructure and services:

- *Limited fiscal devolution of powers:* Whilst in theory, 'finance follows function', the reality in most developing countries is that local governments are not equipped with adequate revenue generating powers commensurate with the demands of local development. The financial decentralisation in Pakistan to provincial and local governments is a case in point. Federal receipts comprise nearly 80 per cent of provincial revenues, and further transfers and devolution account for a majority of local revenues. The ownership and levy of property tax, one of the major sources of local revenues, is still a disputed matter between the different levels of sub-national government. In the absence of sustainable sources of local revenues, local governments have limited flexibility or institutional strength to tap alternate market-based sources of revenues.

- *Inability of local governments to fully realise the potential of own-source revenues:* Across all the cities studied, the pool of own-source revenues is insufficient (and inelastic) to meet rising expenditure needs. Most economically buoyant sources of revenues are retained at the national level. In the Asian context, octroi charge – which is a levy on the inflow of goods and services into a city – has been abolished on account of its regressive nature. Property taxes, licence fees from markets, shops and establishments, and user charges are some of the main sources of local revenues. However, local governments often lack the autonomy and incentive to establish their own tax base, rate structure and enforcement procedures. Furthermore, income from property tax is often well below its potential. This is on account of multiple factors, including the spread of informal settlements and slums that are not enumerated for taxation, outdated property records, valuations that do not reflect the current fair market value, poor collection efficiency and political issues.[1] To counter these factors, for example, as part of the Financial Recovery Action Plan, Kampala City Council is undertaking a slew of reform measures to increase its property tax revenues from an estimated USh9.5 billion in 2007/08 to USh12 billion by 2010.
- *Inadequate government transfers:* As a general trend, local governments continue to depend heavily on government transfers, whether from the public budget or donor aid on-lent by the central government. Most governments adopt a defined formula-based distribution of transfers, based on criteria such as population, land area, stage of development, poverty levels etc. These criteria are often considered inequitable and regressive by the larger urban local bodies, which contribute a significant percentage of the country's local government revenues. Also, in several countries, the extent and basis of central government transfers are neither stable nor transparent. More recently, some governments have introduced discretionary performance-based grants to reward progressive municipalities that have strong own-source revenues. For example, discretionary local government grants in Tanzania have been linked to municipal performance in key areas of financial management, participatory planning, and issues of transparency and accountability. On account of limited own-source revenues, local governments are forced to rely on the strength and predictability of fiscal transfers, particularly to plan any capital expenditure.
- *Limited resources for capital expenditure:* As evident from the case studies, recurrent expenditure, including personnel costs and establishment expenses, account for the majority of the municipal expenditure. For example, such costs amount to over 80 per cent of total municipal expenditure for Dar es Salaam and Kampala, leaving minimal resources available for growth-oriented development expenditure. For historical reasons, the bloated staff strength of municipalities and administrative inefficiencies have resulted in increasing

establishment expenses.[2] In light of this and revenue constraints, municipalities are often unable to ensure even the proper operation and maintenance of local infrastructure. Market interviews highlighted the gaps in the repair and rehabilitation of municipal infrastructure across the transport, water supply, health and education sectors. Therefore, there are typically limited resources available to invest in greenfield infrastructure projects, unless financed externally through donors or development finance institutions (DFIs).

- *Poor financial management:* Poor financial management further contributes to weaknesses in municipal finances. Many local governments do not have the capacity and technical expertise to establish a sound planning and budgeting process nor an up-to-date and transparent management reporting system. At the same time, few accounts are computerised and may require manual collation of financial data across the sub-national units responsible for collection. Therefore, data is often unreliable and outdated. In addition, few municipalities follow accrual-based double-entry accounting. Yet accurate reporting of revenues and expenditures of the municipality is a fundamental requirement to reliably reflect its financial position in order for it to access any market financing.
- *Nature of municipal infrastructure projects:* Affordability constraints and/or public health and social policy considerations may mean that users are not charged for the full cost of delivering certain municipal services. Typically, the potential for cost recovery through user charges is more difficult for municipal services. In many cases, municipal infrastructure projects either require an element of public subsidy (e.g. projects that involve delivery of sanitation services etc.) or are particularly 'public good' in nature (e.g. upgrading of urban roads or provision of street lights etc.). An essential condition for accessing and servicing market borrowing is that the project should be bankable or at the least have some revenue streams (e.g. high-demand toll roads and bridges and piped water supply to residential and commercial users). The particular challenge of developing such projects at the sub-national level presents an additional constraint.
- *Nascent development of financial markets:* Infrastructure requires a large quantum of long-tenor finance – either debt or equity. However, in most developing countries, even where the rate of savings is quite high (as in the case of most Asian countries), the financial intermediation of savings into productive investments is relatively nascent. The banking sector, which is typically more developed than the capital markets, is constrained by prudential regulations and asset-liability mismatches to finance long-term infrastructure. Moreover, potential long-term institutional segments such as pension funds, mutual funds and insurance companies, are only gradually

developing. Therefore, there are often supply-side constraints to overcome in tapping market financing.

As an illustration, local government per capita spending in developing countries vis-à-vis OECD countries highlight some of their financial constraints. The share of local government expenditure as a percentage of GDP for selected Commonwealth developing countries averages just 2.1 per cent, compared with the unweighted average of 21 OECD countries of 11.1 per cent. For example, while the average per person expenditure of local government in the UK was US$2,798 in 2003, it was US$107 in Uganda and only US$18 in Tanzania.[3]

Measures to access alternate private financing for municipal infrastructure

With the limited financial resources available for long-term capital investments at the sub-national level, governments are becoming increasingly aware that private finance can form a considerable source of funding for infrastructure investments. In a number of emerging market countries, local government reforms like the restructuring of local government revenue sources, a greater autonomy to revise taxes, a transparent, predictable and formula-driven transfer system, as well as the deregulation of service provision have paved the way for local governments to mobilise domestic capital and harness the expertise of the private sector for infrastructure developments and service provision. Several cities, particularly in Asia, have tried to harness domestic private savings through intermediation in the credit and capital markets.

While there clearly needs to be caution in proposing local governments to take on debt and advocating private sector participation in service provision, it can provide local governments with strong incentives for improving project design, cost-recovery practices, budget transparency and financial management. However, empowering local governments to borrow requires effective regulation and financial controls to ensure overall fiscal discipline and stability. If managed effectively, it can have a beneficial ripple effect on the domestic financial markets and generate long-term financing for cities and their infrastructure agencies.

Chapter 7 illustrates some of the successful experiences in mobilising private financing and participation in the delivery of municipal services. Whilst there is no 'holy grail' to handle local government debt, there are some lessons to be derived from these successful examples with respect to the pre-requisites of developing local credit markets.

We classify these financial and institutional strengthening measures into 'fundamental' and 'credit enhancing' factors to enable alternate financing of municipal infrastructure. These factors are not exhaustive and focus on the 'demand-side'

issues that central and local governments need to put in place to mobilise private financing. To develop sustainable sources of private financing, these measures would need to be accompanied by the development of local financial markets.

'Fundamental' strengthening measures

As the name suggests, these measures are fundamental to improving the financial and institutional strength of local governments to mobilise private financing, and more importantly, to instil a sense of confidence in the market regarding the creditworthiness of local borrowing. A majority of these measures are required at the municipal level. Nonetheless, it is vital that the central government creates a suitable enabling environment to foster the growth of local credit markets and to encourage private sector participation. Some of the key fundamental strengthening measures are as follows:

- *Enabling policy environment:* Suitable central government policies and legislation often underpin the ability of municipal governments to borrow or contract with the private sector. For instance, the Vietnam government issued a decree to establish the Local Development Investment Funds as provincial legal mechanisms to develop growth-oriented infrastructure with private sector participation. Similarly, following the example of the US, the Indian government issued tax-free status to certain municipal bond issues to mobilise domestic saving for urban infrastructure financing.
- *Appropriate legal and regulatory regime:* Critical aspects of the enabling environment for local government borrowing/PSP include:
    - financial prudence norms and bankruptcy laws to protect the interests of lenders,
    - basic PPP or other laws, which inter alia define the roles of the contracting parties and those bodies required to approve any PSP investment,
    - streamlined government arrangements which enable the speedy establishment of a financial intermediary or fund, or an infrastructure project special purpose vehicle or company, or the sanction of capital market issues, as required, and
    - a truly impartial regulator, making decisions free from political pressure, or else a government commitment to back-stop any regulatory commitments so that any breach of contract would be protected against.

  In the absence of a strong regulatory framework, private operators have to rely on the robustness of the contracts and their possible enforcement. This factor is usually the least developed link in developing countries, constraining participation of the private sector.

- *'Balanced' books at the municipal level:* A key deterrent to municipal borrowing is their inability to repay the debt on account of poor financial strength. As a minimum, municipalities should strive to 'balance' their books through a combination of revenue enhancement and cost containment measures. Particularly, municipal agencies seeking to issue general obligation bonds need to ensure that they can service the debts with their own revenues and/ or allocated portions of the intergovernmental transfers. In order to derive comfort regarding the timely servicing of debt, lenders would typically assess the key financial ratios of the municipality such as its liquidity ratio, debt service coverage ratios, the overall surplus or deficit and collection efficiency of key own-source revenues.

  Similarly, the assets and liabilities of the municipality should be systematically accounted for, including regular valuations to reflect fair market value. Often, physical assets such as land and buildings could act as security against borrowing.

- *Financial management and accounting reform:* Most municipalities that have accessed capital markets have transitioned to accrual-based double-entry accounting. This is important to understand the magnitude of the municipality's future liabilities and receivables. For example, the issue of municipal bonds by the Ahmedabad Municipal Corporation in the state of Gujarat in India was preceded by several financial management reforms to improve budgeting, accounting and overall financial reporting. This is also one of the considerations that credit rating agencies evaluate in rating a municipality or bond issue.

  Another aspect of financial reform is to accurately account for the costs of the services that the municipalities deliver. Several local governments have outsourced the provision of selected municipal services such as the operation of local markets or bus terminals or street cleaning. However, in the absence of recording the actual costs of in-house delivery, these governments are unable to identify the financing savings as a result of outsourcing (these are of course in addition to any efficiency gains). Moreover, in the absence of proper accounting, local governments struggle to identify the appropriate price and performance terms at which they should award the outsourcing contract to the private operator and whether the tender represents value for money.

- *Structuring bankable projects:* Whilst the above enabling factors deal with reform at the municipality level, this factor focuses on developing commercially viable projects for private financing. One of the biggest challenges of accessing private finance for municipal infrastructure is that the projects are seldom revenue generating. Affordability and public/social goals impede charging for most municipal services on a cost-recovery basis. Given the

debt servicing demands of market borrowing (subject to the grace period), there is a high opportunity cost of not promptly deploying borrowed funds into projects that are ready for financing. Delays as a result of political pressures, or for example, land clearance issues, can be costly. As described in the case of the Tamil Nadu pooled financing, the bond was issued to finance water supply and sanitation projects that were already at construction stage or close to operation in order to ensure the speedy deployment of raised funds.

Even if the projects require subsidies, the subsidy element should be identified explicitly and structured as a separate stream of support to avoid distorting the financing structure. Typically, most municipal infrastructure projects require some element of concessional debt and/or grants or technical assistance to enhance their viability. For example, it has been found that 42 per cent of high-income countries are estimated to subsidise operations and maintenance costs of water provision for residential users (despite cross-subsidies between commercial and residential users).[4]

'Credit-enhancing' measures

Credit-enhancing measures may be adopted in addition to the 'fundamental' financial and institutional strengthening measures by governments, to enhance the creditworthiness (and to lower the risk) of the municipal agency. These measures are usually undertaken to increase market confidence amongst potential lenders to finance municipal units or projects and to improve the terms and conditions of financing. The fundamental premise of such risk-mitigation measures is to transfer certain defined risks from project financiers (debt or equity investors) to a creditworthy third party (guarantors, insurers) that has a better capacity to take on such defined risks. While these measures facilitate the mobilisation of private financing for infrastructure projects, it is important that the underlying borrower or project is adequately 'bankable' – otherwise, the providers of credit enhancements would be unable to properly assess the risks and offer (and indeed price) their risk cover.

The two typical credit-enhancing measures that have been adopted for attracting private capital at municipal level are obtaining credit ratings of borrowers/financing instruments, and purchasing risk mitigation/credit enhancement products.

- *Credit rating:* In cases where the issuing sub-national entity is strong or viable, it may choose to obtain a credit rating from a recognised international or local credit rating agency. Alternatively, particularly in the case of revenue bond issues – where the project is commercially self-sustaining – the bond instrument may be credit rated.[5] Several urban local bodies have obtained a credit rating primarily to lower the cost of borrowing. Few investors have the specialist expertise or skills to evaluate the risks of a local government entity

or infrastructure project. For example, the purchasers of municipal bonds are likely to be pension, provident and mutual funds, and insurance companies, who are typically looking for long-term assets to match their long-term liabilities. Their main requirement, however, is that such assets are investment grade – both from a prudence perspective, but also because the institutions involved do not understand the underlying risks of the infrastructure investment. Therefore, it is particularly beneficial if the municipality and bonds in question are credit rated as investment grade by a reliable credit agency.

It is important to note that the costs associated with credit rating are often quite high and may not be affordable for the municipality. Those costs therefore need to be weighed against the opportunity cost of financing and the benefits of lower borrowing cost. In this regard, the technique of pooled financing could help to spread the costs of bond issuance across the urban local bodies in the pool, arguably making it more affordable.

- *Risk mitigation instruments such as guarantees or insurance*: In cases where the credit strength of the issuing agency needs to be enhanced or when it is a pioneering bond issue in a relatively undeveloped financial market, the bond issue may need to be backed by risk mitigation instruments in some way to attract subscription. There are several types of credit enhancements that are available, but the broad categories are based on:[6]
    - Beneficiary of the guarantee or insurance contract: these may be debt providers facing credit risk, or equity investors facing investment risk and possible investment losses.
    - Types or causes of risk: some risk-mitigation instruments such as partial risk guarantees differentiate between and cover only specific types of risk, such as political or commercial risk.
    - Extent of loss coverage: this refers to the magnitude or percentage of debt service default or investment loss that is covered – i.e. whether full or 100 per cent coverage or lower.

In several cases, credit enhancement measures go hand in hand with and are, in fact, instrumental in obtaining a sound credit rating. For example, most of the bond issues (general obligation bonds, revenue bonds and pooled financing bonds) illustrated in chapter 7 had several layers of credit enhancement, including support from some risk-mitigation vehicles, which were key to their being assigned sound credit ratings.

Multilateral agencies like the World Bank/International Finance Corporation, Inter American Development Bank (IADB) and the Multilateral Investment Guarantee Agency (MIGA) offer guarantee or insurance products to specifically

cover sub-sovereign risk at state, provincial and municipal levels, subject to their credit assessments. Furthermore, private mono-line insurers also provide guarantees for municipal bonds in investment-grade developing countries. Again, the relative fee costs of a credit enhancement product need to be assessed vis-à-vis the benefits, such as potential crowding in of long-tenor lenders or extending the maturities of existing loans available.

Special purpose contingent finance vehicles such as LGUGC and FINDETER also aim to address the potential default risk associated with borrowing municipal agencies or projects. Their backing aims to increase the willingness of banks and other financial institutions to provide long-term finance for infrastructure projects.

Summary

Given the challenges of urban infrastructure financing, experience shows that market-based financing of municipal infrastructure in developing countries has so far been a small (although growing) proportion of the total investments.[7] A key challenge is to lower the overall risk profile of the borrower or project. Many of the factors that can enhance the creditworthiness of the municipality are often beyond its control – these include the quantum and predictability of intergovernmental transfers, the national policies and regulatory environment, and the depth and breadth of local financial markets, amongst others.

Nonetheless, given the trends of fiscal decentralisation and the growing infrastructure financing gap, a more pragmatic and selective approach to shortlist avenues for private sector financing seems plausible. As a first step, this underscores the need for local governments to focus on the range of 'fundamental' strengthening measures proposed to make private financing a viable proposition. Furthermore, it is important to recognise that the remit of private financing extends primarily to commercial and financially sustainable investments and therefore cannot be considered the panacea of all urban infrastructure financing constraints. While private financing can never be a substitute for government funds, it can contribute, to a limited and defined degree, to the growth of the economy and to long-term investments in infrastructure and public services.

Notes

1. Where municipalities derive revenues from property tax and service charges, meaningful tariff increases are sometimes refused or delayed by central government for fear of eroding political support among the local population.
2. For example, some municipalities have on their payroll all the staff responsible for street cleaning and municipal waste collection. Other local governments have now outsourced some of these activities to specialised private sector/NGO operators, leading to cost-savings and improved management efficiency.

3. In US$ at PPP.
4. Annez (2006).
5. The rating of the bond may be in addition to the issuing agency's credit rating. Clearly, the cost-benefit trade-off of obtaining each credit rating needs to be evaluated. Moreover, in instances, municipal bond issues (for example, in India) have obtained two independent ratings from different rating agencies to further enhance market confidence in the credit-worthiness of the issue.
6. PPIAF (2006).
7. Ibid.

9

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- International Finance Corporation Johannesburg: specialist, sub-national finance
- Kinondoni Municipal Council: mayor, director, municipal economist, municipal finance officer
- Local Government Loans Board: secretary
- National Social Security Fund: planning and investment manager,
- President's Office, Public Service Management: assistant director, human resource officer
- President's Office, Public Service Management: assistant director, technical co-operation
- Prime Minister's Office, Regional Administration and Local Government: assistant director, local government finance
- World Bank, Tanzania Country Office: urban specialist, lead transport specialist

Uganda

- Kampala Institutional and Infrastructure Development Project (KIIDP): programme co-ordinator, programme engineer, city engineer, programme accountant
- Local Government Finance Commission: commission secretary
- Ministry of Finance, Planning and Economic Development: principal economist, Transport Section Infrastructure
- Ministry of Local Government: commissioner, Local Authorities Inspection
- Ministry of Local Government, Local Authorities Inspection: technical adviser to the inspectorate, programme accountant, co-ordinator 2nd Local Government Development Project
- Ministry of Local Government: permanent secretary
- Uganda Local Government Association: secretary-general
- Uganda Securities Exchange: chief executive
- World Bank, Kampala: operations officer and urban specialist

Pakistan

- Asian Development Bank: investment officer
- Citi Bank: vice president, corporate finance and investment banking
- Habib Bank Limited: executive vice president, investment banking
- International Finance Corporation: country head
- Karachi Megacity Development Project: deputy project director
- National Bank of Pakistan: senior executive vice president
- Standard Chartered Bank: head of project and export finance
- State Bank of Pakistan: executive director, development finance
- United Bank Limited: executive vice president and group head
- World Bank: country director

Bangladesh

- Asian Development Bank: head of social sector, project implementation officer
- Bangladesh Municipal Development Fund: monitoring officer, programme officer
- Dhaka City Corporation: chief revenue officer, chief town planner, chief accounts officer
- Government of People's Republic of Bangladesh: joint secretary
- Government of People's Republic of Bangladesh, Ministry of Finance: joint secretary
- Infrastructure Investment Facilitation Centre: executive director
- Local Government Division, MLGRDC: joint secretary, senior assistant secretary
- The World Bank: senior urban specialist
- WSP Inc: country director

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Innovative Practices from Developing Countries

Municipal Infrastructure Financing provides an overview of the municipal finances and the extent of private sector involvement in the delivery of municipal services in selected Commonwealth developing countries. Four cities are examined in detail: Dar es Salaam in Tanzania, Kampala in Uganda, Dhaka in Bangladesh, and Karachi in Pakistan.

The book presents some innovative options for alternative sources of municipal infrastructure financing, including attracting private sector participation, based on the successful experience of other developing countries.

It also identifies the key challenges in municipal financing, and any broad institutional and financial strengthening measures that are required to tap alternative sources of financing for growth-oriented municipal investments.

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