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URBAN FINANCE

RAPID EVIDENCE ASSESSMENT, JUNE 2015

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Funding

This document is an output from a project funded by UK Aid from the UK Department for International Development (DFID) for the benefit of developing countries. However, the views expressed and the information contained in it are not necessarily those of or endorsed by DFID, which can accept no responsibility for such views or information or for any reliance placed upon them.

Acknowledgements

The authors would like to thank experts from The Urban Institute, the Center on International Cooperation of New York University, and the City Creditworthiness Initiative for their willingness to provide input and comments.

Conflicts of interest

There were no conflicts of interests in the writing of this report.

Contributions

The opinions expressed in this publication are not necessarily those of the Department of International Development. Responsibility for the views expressed remains solely with the authors.

Citation

This report should be cited as: Nixon, H., Cambers, V., Hadley, S. and Hart, T. (2015) *Urban Finance: Rapid Evidence Assessment.* London: Overseas Development Institute.

LIST OF ABBREVIATIONS

DFID	Department for International Development
FINDETER	*Financiera del Desarrollo Territorial*
GAVI	Global Alliance for Vaccinations and Immunisation (commonly known as the Vaccine Alliance)
INCA	Infrastructure Finance Corporation
IFFIm	International Finance Facility for Immunisation
ISS	Innovations for Successful Societies
LIC	Low-income country
MDG	Millennium Development Goal
MIC	Middle-income country
MIIU	Municipal Infrastructure Investment Unit
ODA	Official Development Assistance
ODI	Overseas Development Institute
PPP	Public–Private Partnership
REA	Rapid Evidence Assessment
UNCDF	United Nations Capital Development Fund
WASH	Water and Sanitation

Abbreviations for in-text referencing[1]:

PEL, PEM, PEH:	Primary Experimental Low/Moderate/High
PCL, PCM, PCH:	Primary Comparative Low/Moderate/High
PSL, PSM, PSH:	Primary Single-Case Low/Moderate/High
SSL, SSM, SSH:	Secondary Systematic Low/Moderate/High
SOL, SOM, SOH:	Secondary Other Low/Medium/High

[1] References include an annotation indicating the type of study and assessment of evidence strength. It is important to emphasise that these indicate the strength and applicability of the evidence in relation to this evidence assessment, not a general assessment of quality (as detailed in Part 2).

EXECUTIVE SUMMARY

This REA assesses evidence on the following question: *What are the most effective interventions for city government in low-income countries to increase their access to financial resources both public and private?*

By 2050 the global population will have grown to over 9 billion. At least 70% of this population is likely to live in urban areas and virtually all of this growth will occur in low and middle income countries. Part of the fiscal challenge facing cities is to meet new and more acute needs created by the pressures of urbanisation. The presence of informal settlements and underserved slums in poor cities dramatically increases their infrastructure and service deficits. Without services and infrastructure, cities cannot attract the kinds of workers and economic activities needed to compete in an increasingly global economy and therefore produce the revenue required to support continued growth. The defining challenge for authorities in medium and large cities in developing countries is how to raise and deploy resources to fund the huge expenditure needs created by rapid growth, while contributing to continued economic growth and employment.

This REA takes a purposive and structured approach to gathering, including and assessing evidence. The REA began with a set of interviews with experts in urban finance to identify and validate the general approach to addressing the research question, how to organise the evidence, and to gather impressions on some key innovations or trends in the literature. Searches were conducted for academic and grey literature using a combination of phrase-based searches of general databases and purposive searches of specific communities of practice. Sources were generally limited to those produced in the last ten years in English. Resources were prioritised for analysis according to the following criteria:

1. Existing systematic reviews and synthetic literature.
2. Comparative studies and evaluations, both quantitative and qualitative.
3. Single-intervention evaluations and case studies.

As a result, 98 substantive and 2 methodological studies were reviewed in the preparation of this report. The evidence has been organised according to four broad categories of urban finance:

- Intergovernmental finance
- Own-source revenues
- Borrowing
- Foreign or external assistance

Studies were classified according to their type and design, and their strength was rated, informing the assessments of the strength of evidence in the report. The strength of the evidence base reviewed has been assessed for each revenue type, and the concluding section includes a discussion of the overall evidence base.

KEY FINDINGS

- The intergovernmental context in which cities are located can vary widely, and this context is the most important cross-cutting factor in cities' access to finance. Efforts to bolster poor cities' access to finance should therefore begin with an analysis of, and perhaps support to, the national context in which they operate.
- The intergovernmental framework should be as clear as possible, and the design of effective intergovernmental transfers depends on careful consideration of the objectives of the transfer. The role of intergovernmental transfers can be hampered by central government instability or excessive dependence and lack of autonomy on the part of local governments.
- There is no quick or easy reform to increase own-source revenues. Cities in developing countries can improve the collection of property tax, innovations (such as betterment levies) and more simple administrative approaches (such as area-based property valuations) may provide modest gains. Other financing sources, such as land sales, can also provide windfalls.
- For cities to play a wider role in public services, they need to obtain access to wider tax bases such as income or consumption taxes, through tax assignment or sharing.
- Cities need to be able to borrow to finance large capital investments, but their ability to borrow largely depends on their own creditworthiness and on the broader regulatory and economic environment. To improve their own creditworthiness, cities need to generate reliable income streams, improve their financial management, and be able to demonstrate this through publically available audited accounts
- To reduce the cost of financing for cities, two frequently used innovations are revenue-intercept mechanisms that reduce the risk of default to lenders, and the use of financial intermediaries to pool risk between municipalities.
- ODA for urban projects is hard to calculate, but falls short of the needs and has not increased much, despite accelerating urbanisation.
- ODA for infrastructure is undergoing changes with the entrance of new donors, particularly in Sub-Saharan Africa, but there is still relatively limited urban focus.
- Most aid to urban areas is sectoral, limiting its catalytic impact on cross-cutting management, public finance or sustainability, and that which does focus on these issues in LICs tends to be focused on small or rural sub-national governments.
- ODA for municipal development funds has shown results, and other innovations such as results-based financing may help improve local government performance.

The evidence points towards the importance of strengthening fundamentals – improving the intergovernmental environment, coherent decentralisation, improving the administration of core revenues such as property taxes. There are innovative financing and management practices, but in many cases these are consistent with this overall emphasis. However, there is no single best set of interventions or sequence of reforms. General trends such as weak revenue base and capacity, poorly defined and incentivised intergovernmental systems, and a lack of attention to infrastructure, do indicate some important directions. Furthermore, innovations in municipal and urban finance in developed and middle-income countries may be increasingly adopted by poorer cities. In general, then, the best approach to strengthening the resource base of cities in LICs is to address their particular sources of weakness, including ensuring that they are embedded in coherent and resourced intergovernmental.

CONTENTS

1.0 INTRODUCTION

By 2050 the global population will have grown from its 2012 level of 7 billion to over 9 billion. At least 70% of the world's population are likely to live in urban areas. Virtually all of this global population growth will occur in urban areas in low and middle income countries. By 2025, more than three-quarters of all cities over 5 million inhabitants will be in less developed countries; already 17 of the world's 22 'megacities' of over 10 million inhabitants are in developing countries (Bahl and Linn, 2014: 4 - SOH). The rate of urbanisation will also be highest in the areas currently with the lowest income – by 2050 the urban population will triple in Africa and double in Asia (Slack, 2009: 10 - SOH). In the face of these changes, cities in LICs will require improved access to finances both to confront dramatic environmental and service-provision issues, and to create opportunities to support growth and employment. This Rapid Evidence Assessment (REA) provides an overview of existing evidence and knowledge about how to overcome this fiscal challenge.

1.1 THE URBAN FISCAL CHALLENGE IN POORER COUNTRIES

Part of the fiscal challenge facing cities is to meet new and more acute needs created by the pressures of urbanisation. Rapid urban growth:

> *… has created and will continue to create serious challenges for municipal governments in both developed and less developed countries in terms of air and water pollution, transportation gridlock, shortage of affordable housing, inadequate waste collection, deteriorating infrastructure, mounting violence and crime, and income polarization. (Slack, 2009: 11 - SOH)*

In 2006 UN-Habitat estimated that half of the urban population of Africa and Asia had inadequate water provision, and 60% had inadequate sanitation, with only slightly better provision in Latin America and the Caribbean (Dirie, 2006: 257 - SOH). Beyond these services, the growth of urban areas is increasingly associated with violence that particularly affects the poor, which raises the issue of the provision and management of public security (Muggah, 2012 - SOM).

The presence of informal settlements and underserved slums in poor cities dramatically increases their infrastructure and service deficits. The one billion existing slum dwellers of the mid-2000s are expected to double by 2030, with the largest concentrations in Africa and South Asia. One estimate of the cost of meeting the demand for services implied by such growth is $900 billion over 15 years, or 'a sixfold increase over what is currently being spent' (Bahl, Linn and Wetzel, 2013: 23 - SOH).

Inadequate finance means more than inadequate service provision. Without services and infrastructure, cities cannot attract the kinds of workers and economic activities needed to compete in an increasingly global economy and therefore produce the revenue required to support continued growth. As drivers of growth and linkages to the global economy, cities can lead the development of poorer countries. At the same time, investment in and the growth of metropolitan areas creates further migration and demands for infrastructure and services, and leads to congestion and to environmental and social problems (Bahl and Linn, 2014: 2 - SOH). In this sense, inadequate urban finance contributes to a vicious cycle, undermining the future bases of growth.

Box 1: Factors that will drive increases in public expenditure in urban areas

- Population growth
- Growing per capita incomes
- Business demands to upgrade the infrastructure and the public amenities necessary to attract and retain a strong labour force
- The need ot address the negative externalities that come with urbanization, such as pollution (e.g. solid waste collection) and congestion (transport)
- The special needs of a heavy concentration of poor and badly housed families, often in sprawling slums, that call for major public investments by metropolitan governments

Source: Bahl and Linn, 2014: 8

To meet these challenges cities will need greater financial resources, and this problem is particularly acute for cities in poor countries. Poor cities both have weak revenue bases, and are typically found in more fiscally centralised contexts. Data from 40 countries for the 2000s showed that sub-national government expenditure and tax revenue in developing countries were much lower than in developed countries: both spending and local tax revenue were less than half as much as a proportion of GDP as those in richer countries (Bahl and Linn, 2014: 10 - SOH). Similarly, a study of Commonwealth countries found that an unweighted average of local government spending in selected developing countries belonging to the Commonwealth is just 2.1% of GDP, compared with 11.1% across 21 wealthy countries belonging to the Organisation for Economic Co-operation and Development (OECD) (Dirie, 2006: 259 - SOH). In both industrialised and developing countries, metropolitan areas account for more than 25% of GDP, meaning that cities in poorer countries are disproportionately under-resourced (Bahl and Linn, 2014: 4 - SOH).

In addition to weak revenue bases, cities in poorer countries have less revenue assigned to them, often lack incentives and/or the capacity to collect it effectively, and have little control over the tax rates they can apply. These cities may experience less stable and predictable transfers from central government – almost universally an essential component of local government finance – and have restricted ability to borrow either due to central government restrictions, lack of market access, or limited creditworthiness (Slack, 2009: 13 - SOH). Cities in general, but poor cities in particular, have governance structures that are fragmented both horizontally (across jurisdictions) and vertically (among levels of government), making it especially difficult to coordinate the provision of services and infrastructure (Bahl and Linn, 2014: 3 - SOH).

Poor cities also face particular challenges in relation to funding infrastructure. There is in general a tendency to fund recurrent costs, such as salaries, over capital expenditure in local government spending across poor countries. For example, the City of São Paulo has capital spending levels at 8-10% of its total recurrent expenditures, and Mumbai's metropolitan local governments could cover only 10% of infrastructure needs, even if borrowing was at full capacity (Bahl and Linn, 2014: 9 - SOH). In industrialised countries, local governments often manage 70% of resources for public infrastructure projects, whereas in developing countries they control nearer to 30% (Dirie, 2006: 264 - SOH).

In theory 'one would expect that metropolitan-area governments spend more than other local governments in a particular country and that they rely more on their own resources than do other jurisdictions' (Bahl and Linn, 2014: 17 - SOH). Best estimates based on the limited fiscal data that is widely available suggests, however, that reality – while extremely varied – broadly agrees with this assumption on spending, but not on revenues (Bahl and Linn, 2014: 17 - SOH). Large cities are rarely subject to specialised intergovernmental regimes, meaning they may also experience particular fiscal gaps: 'Rarely are large cities treated differently, however, in terms of their taxing authority or the intergovernmental transfers they receive' (Slack, 2009: 12 - SOH).

This resourcing gap is not just – or even primarily – a matter for the largest cities. Since the 1980s, secondary towns in sub-Saharan Africa (SSA) have grown at approximately twice the rate of main cities, doubling every ten years (Dirie, 2006: 256 - SOH). As small and medium-sized towns may typically enjoy less comprehensive devolution and lower resource bases, this tendency only heightens the resource challenge:

> *Generally, large cities and metropolitan areas have greater fiscal capacity than smaller municipalities and rural areas, both in terms of greater responsibility for local services and greater ability to levy their own taxes and collect their own revenues. (Slack, 2009: 12 - SOH)*

1.2 OBJECTIVES AND APPROACH OF THE RAPID EVIDENCE ASSESSMENT

The defining challenge for authorities in medium and large cities in developing countries is how to raise and deploy resources to fund the huge expenditure needs created by rapid growth, while contributing to continued economic growth and employment. The objective of this REA is to assess the evidence on the following question: *What are the most effective interventions for city government in low-income countries to increase their access to financial resources both public and private?*

In general, cities can raise revenue from internal or external sources, usually comprising taxes, fees and charges, intergovernmental transfers, borrowing or external development assistance. This largely holds across urban settings, and guides the approach of this REA (Table 1). While there can be a range of innovative ways to modify or combine these sources, or supplement investment through co-financing initiatives such as public–private partnerships (PPPs), these are discussed within this framework. The full range of co-financing options for infrastructure is a large field that lies beyond the scope of this review except insofar as it relates to one of the other categories of revenue.

Table 1: Summary of typical local government revenue sources

Internal Sources			External Sources		
Land Revenue	Non-Land Revenue	User Charges	Intergovernmental Transfers	Borrowing	Development Assistance
Property Tax	Taxes on households, vehicles etc.	Services (water, sewerage, parking)	Unconditional grants or shared taxes	Governmental	Domestic assistance (disaster relief etc.)
Land Fees	License fees for businesses etc.	Administrative fees (building permits, business registration, market fees)	Conditional grants	Private sector borrowing	International development assistance

Source: Adapted from Dirie (2006: 261 - SOH)

The single clearest message of this REA is that there is no single best set of interventions or sequence of reforms to address the fiscal challenge facing cities in poor countries. There are, however, general trends among cities in LICs – notably those outlined above, of weak revenue base and capacity, poorly defined and incentivised intergovernmental systems, and a lack of attention to infrastructure – that point the way towards approaches to strengthen their fiscal position. Furthermore, innovations in municipal and urban finance that have spread in developed and middle-income countries may be increasingly adopted by poorer cities. In general, then, the best approach to strengthening the resource base of cities in LICs is to address their particular sources of weakness, including ensuring that they are embedded in coherent and resourced intergovernmental systems.

Following this introductory section, the Rapid Evidence Assessment goes on to describe the methods used, and then reviews these trends and innovations, building on the range of revenue sources typically available to local governments.

2.0 METHODS

This REA takes a purposive and structured approach to gathering, including and assessing evidence. It does not seek to be comprehensive but focuses on 'effective interventions' and 'access to financial resources', and avoids a 'rigid and non-reflexive approach' (Hagen-Zanker and Mallet, 2013: 1 - NA).

2.1 EVIDENCE SELECTION AND RETRIEVAL

Experience suggests that triangulating the retrieval of evidence through structured enquiries ('snowballing') with thematic experts and specialist communities of practice will produce a higher quality evidence base for assessment than would a purely systematic review (Hagen-Zanker and Mallet, 2013: 9-12 - NA). In practice, this means that significant categories of financial resources available to cities were identified through expert input via interviews, and particular efforts were made to identify innovative and unusual approaches in relation to cities in low-income settings; the review purposively selected evidence from communities of practice that tend to document such innovations.

2.1.1 EXPERT INTERVIEWS

The REA began with a set of interviews with experts in urban finance to identify and validate the general approach to addressing the research question, how to organise the evidence, and to gather impressions on some key innovations or trends in the literature. A shortlist of eight experts and/or institutions was drawn up, and interviews were conducted with five of them.[2] These interviews validated the framework of using four key categories of finance to organise the evidence in line with the categorisation in the literature on fiscal decentralisation. In general these interviews also supported the conclusions drawn from the evidence – that there are few generalisable innovations that could work everywhere, and suggested that systemic improvements were better than 'magic bullet' type innovations.

2.1.2 SEARCHES AND INCLUSION CRITERIA

Searches were conducted for academic and grey literature using a combination of phrase-based searches of general databases and purposive searches of specific communities of practice for relevant documentation. (See Annex 2 for the list of search strings used; and Box 2 for the databases and communities of practice consulted.)

Sources were limited to those produced in the last ten years, which were available in English and which addressed specifically the question of increasing urban finance (not urban governance in general), though earlier and more general literature informed the framing of categories of financial resources to organise the evidence.

[2] Institutions represented in interviews included ODI Senior Research Associates, The Urban Institute, the 100 Resilient Cities Initiative, and the City Creditworthiness Initiative at the World Bank.

Box 2: Databases and communities of practice consulted

- Google scholar
- Governance and Social Development Resource Centre (GSRDC)
- SOAS/University of London
- International Centre for Tax and Development
- Applied Social Science Index and Abstracts (ASSIA)
- Google
- 100 Resilient Cities
- Urban Institute
- Hague Academy for Local Governance
- World Bank
- World Bank Institute

2.2 EVIDENCE ASSESSMENT AND ANALYSIS

Once identified, resources were entered into bibliographic software to enable easy classification, filing and access by the whole team.[3] This allowed documents to be prioritised for analysis, given the rapid nature of the REA, broadly according to the following criteria:

1. Existing systematic reviews and synthetic literature.
2. Comparative studies and evaluations, both quantitative and qualitative.
3. Single-intervention evaluations and case studies.

The purpose of this prioritisation was not primarily to include or exclude studies to be reviewed, but rather to create the most efficient approach to coding, review and analysis, given the constraints of the rapid assessment. This prioritisation does mean, however, that secondary studies were more likely to be reflected in the textual analysis than lower quality or single case studies without clear methodologies, even though the latter were included for review.

In total, 145 studies were retrieved, entered, and assessed for their robustness and applicability. Of these, 45 were excluded after retrieval due to being earlier than 2005, not focused sufficiently on developing countries, not sufficiently focused on urban financing, or of inadequate quality or applicability for inclusion. Of the remaining 100, two studies treated the methodology of evidence assessment and so were excluded from the quality assessments used throughout the remainder of this REA and in the annexes and references. These 98 substantive studies were reviewed, and through the prioritisation described above, 68 appear as direct citations in this REA report.

[3] The software used is the open-access product Zotero, which enables export of the database in a range of transferable formats that are available with this review.

2.2.1 STRENGTH OF EVIDENCE

Strength of evidence descriptions and classification broadly followed guidance in DFID's March 2014 *How to Note* on 'Assessing the Strength of Evidence', with some simplification and modification. Studies were classified according to their type and design (Table 2), and their strength was rated based on the criteria described in Table 3 and **Error! Reference source not found.**. With only a few exceptions, low-quality studies were excluded, unless there was ambiguity over their rating, as was the case for nine studies.

Table 2: Study Types and Designs

Type	Design
Primary	Experimental or Quasi/Natural Experiment [PE]
	Comparative [PC]
	Single Case Study [PS]
Secondary	Systematic [SS]
	Other review [SO]

Table 3: Assessing Primary Studies

Principle	Questions	Scoring
Conceptual Framing and Cogency	Does the study have a conceptual framework and clear research question? Does the study appear to draw conclusions based on its results rather than theory or policy?	0 Neither 1 One 2 Both
Methodology and Transparency	Does the study explain its research design and data-collection methods? Does the study present or link to data sources?	0 Neither 1 One 2 Both
Appropriateness and Validity	Does the study directly address the research topic: increasing access to financial resources in cities in LICs? Does the study appear transferable?	0 Neither 1 One 2 Both
Score (Sum)		0-1 Low 2-4 Moderate 5-6 High

Table 4: Assessing Secondary Studies

Questions	Scoring
Does the study describe where and how studies were selected for inclusion?	0-1 Low
Does the study assess the quality of the studies included?	2 Moderate
Does the study draw conclusions based on the reviews conducted?	3 High

The strength of the evidence base reviewed was briefly assessed for each revenue type, combining an estimate of the quality, size (relative to other types), coverage and consistency of evidence used. Since this REA entails prioritising evidence, the assessment was partial and the analysis therefore placed greater emphasis on high-priority sources such as large synthetic studies. The concluding section of this REA includes a discussion of the overall evidence base for the research question.

2.2.2 CODING OF EVIDENCE AND ANALYSIS

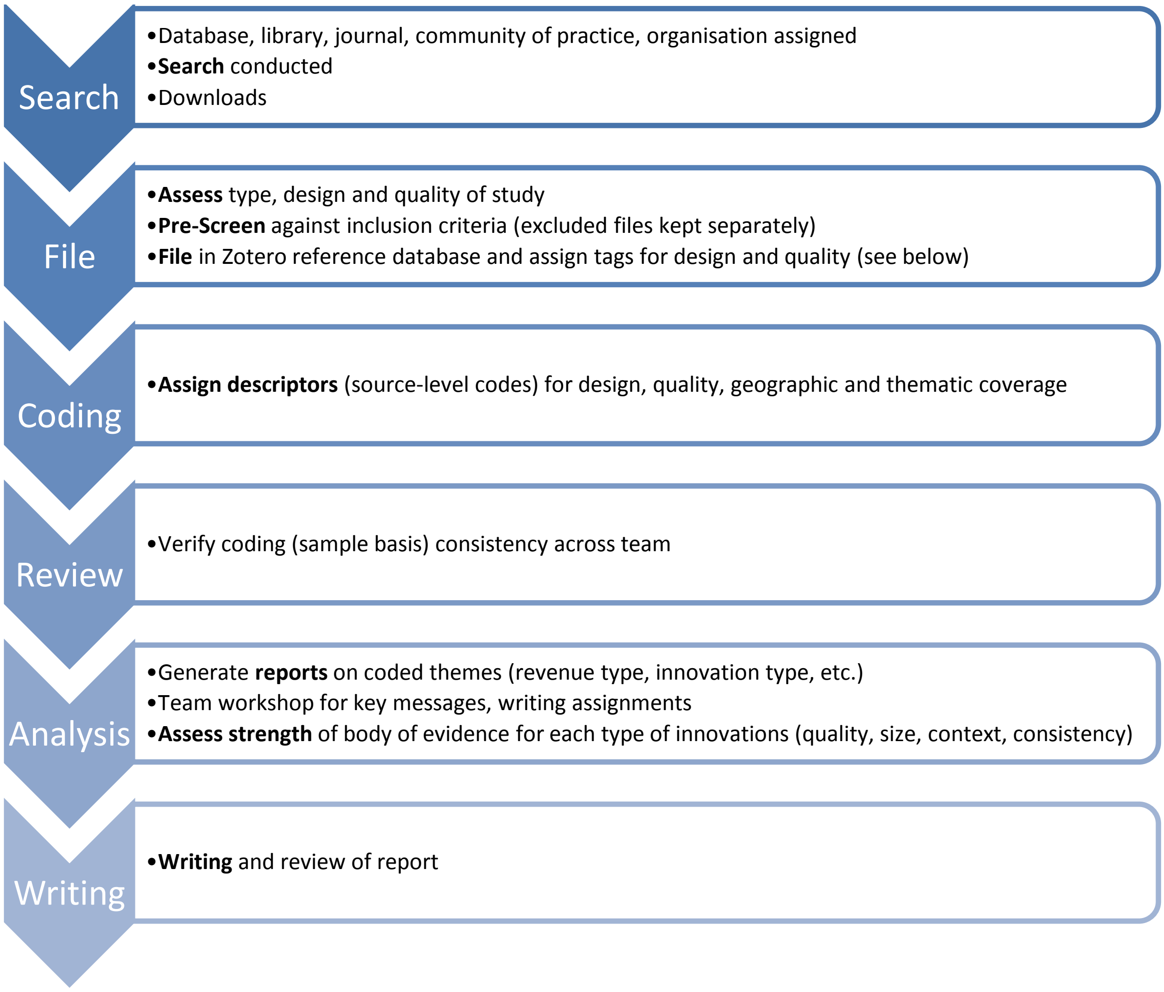
In addition to coding for quality, the resources were coded according to the review framework described above, using five main codes:

- Intergovernmental finance
- Own-source revenues
- Borrowing
- Foreign or external assistance
- Cross-cutting sources

These codes represent the main categories of sub-national finance around which the conceptual literature is structured, and reaffirmed through expert interviews. This coding ensured a balance across the relevant themes and enabled cross-team working. Coding was verified by coding each source twice – once by a single team member reviewing the entire set of sources, and a second time by the thematic author of the relevant section, who examined the studies in detail. The team leader subsequently resolved any discrepancies.

Analysis was led by team members on the basis of their qualifications and background according to each theme, further validated in a series of team meetings and discussions.

Figure 1: Summary of search, retrieval, classification and analysis process



3.0 IMPROVING THE INTERGOVERNMENTAL CONTEXT

The 'textbook' approach to local government finance and fiscal decentralisation that guides most conceptual discussions usually begins with discussing local expenditure responsibilities followed by own-source revenues before turning to the question of intergovernmental transfers – which are sometimes viewed as a kind of 'residual' source of finance after expenditure and revenue assignments are determined (Steffensen, 2010 - SOH). It is increasingly recognised, however, that a range of political drivers and sequences shapes decentralisation, and this more nuanced 'second-generation fiscal federalism' views political economy to be as important in determining the nature of fiscal decentralisation as theoretical underpinnings such as the principles of fiscal federalism (Weingast, 2014 - SOH; Eaton, Kaiser, and Smoke, 2011 - SOM). In this sense, the starting point for an analysis of resources for a given city may begin with its political and intergovernmental context, and this REA therefore departs slightly from convention in discussing the intergovernmental context – and hence transfers – first.

Box 3: Key findings on intergovernmental context

- The intergovernmental context in which cities are located can vary widely, and reforms must take into account the context of decentralisation and intergovernmental relations.
- This context is the most important cross-cutting factor in cities' access to finance because it determines not only their transfers, but other revenue rights, influences creditworthiness and access to aid, and shapes the coherence of local governance structures.
- Efforts to bolster poor cities' access to finance should therefore begin with an analysis of, and perhaps support to, the national context in which they operate.
- The intergovernmental framework should be as clear and unambiguous as possible with respect to the relationship between central and sub-national governments, while flexible enough to enable and encourage local autonomy and initiative.
- The design of effective intergovernmental transfers depends on careful consideration of the objectives of the transfer, which may include correcting for vertical financing gaps, providing horizontal equalisation, compensation for externalities, or promoting central policy objectives.
- The role of intergovernmental transfers can be hampered by central government instability or excessive dependence on transfers and lack of autonomy on the part of local governments.

3.1 STRENGTH OF THE EVIDENCE

Table 5: Studies reviewed

	Primary Type			Secondary Type	
Quality	Primary Experimental	Primary Comparative	Primary Single Case	Secondary Systematic	Secondary Other
High		1			6
Moderate	1		2		5
Low					1

Sixteen studies with specific emphasis on intergovernmental fiscal relations in general, and transfers in particular, were reviewed. The most valuable of these are listed in Annex 1. The bulk of these studies (11) were medium- and high-quality secondary studies, representing a well-developed conceptual, analytical and empirical knowledge base on the topic. These could be described as synthetic studies since they combine conceptual and empirical material, rather than systematic reviews. The literature on intergovernmental transfers, drawing as it does on wide experience in developed countries, is consistent in its broad direction over time. It tends to be based on conceptual underpinnings in the literature on fiscal federalism and decentralisation.

All of the more synthetic studies also draw on the experience of developing countries. There is a significant and growing body of experience in implementing and reforming transfer systems in developing countries, which means that this conceptual literature on issues such as performance-based systems is increasingly bolstered by case-study experience. Nevertheless, the availability of more rigorous experimental evidence is still limited, although there is considerable potential for more of this type of work. For this reason, this REA relies more on higher quality secondary studies that integrate findings across cases rather than a small number of low-quality primary cases that did not feature strong methodology, results, or transferability. One strong opportunity is an increasing focus on 'within case large n' analyses, which draw on evidence from multiple local settings within a single larger country, such as India, Kenya or Tanzania.

3.2 THE IMPORTANCE OF THE INTERGOVERNMENTAL SYSTEM

One of the clearest and most consistent messages from the evidence assessed is that the ability of cities to obtain access to more finance, through whatever means, remains highly contextual and dependent on the intergovernmental relations in which they are embedded. All the cross-cutting sources on municipal finance reviewed in some way agree with the sentiment summed up by Bahl and Linn (2014: 15 – SOH): 'the success of metropolitan-area public finances depends on how vertical intergovernmental relations are structured'. This is much more than a question of how revenues are shared, because a city's ability to use revenues of any kind depends on the 'multi-dimensional constitutional/legal/administrative framework' including both the 'legal status, powers, functions and autonomy of subnational governments' and the wider 'enabling environment' (Smoke, 2013: 3 - SOH).

Such a framework should be as clear and unambiguous as possible with respect to the relationship between central and sub-national governments, while flexible enough to enable and encourage local autonomy and initiative. **Error! Reference source not found.** presents a list of the typical features of such a framework, and all textbooks on municipal finance suggest similar requirements though they may not all include issues such as redistribution and democracy (Bahl, Linn and Wetzel, 2013 - SOM; Slack, 2009 - SOH; Farvacque-Vitkovic and Kopanyi, 2014 - SOH).

Box 4: Elements of an effective intergovernmental revenue framework

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

Source: Dirie (2006: 259 - SOH)

An appropriate framework does not only encompass those aspects that touch directly on local government or municipal activities: national legal and public financial management systems can have an important impact on cities. Legal frameworks can facilitate all the major elements of a sound municipal finance system, and there is a consensus across the studies reviewed that to do so they need to regulate municipal financial management, clarify responsibilities, provide a framework for borrowing, and entrench legal rights and transfer entitlements. **Error! Reference source not found.** outlines the South African Municipal Finance Management Act, which illustrates the requirements of such a legal framework.

Box 5: Outline of the Municipal Finance Management Act of South Africa 2000

- **Interpretation**, object, application and amendment of this Act.
- **National and provincial supervision** deals with the intergovernmental aspects of local government financial management. It defines the major relationships between the different spheres of government as they relate to municipal financial management.
- **Municipal revenue** sets out conditions for municipal revenue and investments.
- **Municipal budgets** defines a process of annual budgeting for municipalities (within a framework of multi-year budgeting), including provisions for regular reporting to their councils and the national and provincial governments.
- **Debt** deals with the borrowing of money by municipalities. It limits short-term borrowing to bridge operating cash shortfalls or capital requirements, on the basis of anticipated income streams, grants or long-term debt in waiting. It requires that short-term debt is paid off annually. Long-term borrowing is limited to funding of capital investment. It also sets requirements for the authorisation of municipal debt, without national or provincial approval, and spells out the conditions for providing security. It rules out guarantees of municipal debt by national and provincial governments, other than what is provided for in the Public Finance Management Act. Disclosure requirements for the borrowing of money by a municipality are also set out.
- **Responsibilities of municipal officials** define the responsibilities of officials involved in municipalities' financial management.
- **Municipal budget and treasury offices** require that the municipalities establish Treasury and Budget Offices, under control of a chief financial officer.
- **Municipal entities** allow municipalities to retain or establish a variety of corporate entities in terms of other relevant legislation, but also make it possible for statutory and regulatory limitations and requirements to be imposed on such entities.
- **Financial statements and auditing** outlines requirements and procedures for local governments' financial statements and auditing.
- **General treasury matters** assigns powers to the National Treasury to make regulations or issue instructions relevant to the Act or specific aspects of the municipal financial management in general and for borrowing by municipalities. Provisions are also set for the creation of audit committees.
- **Financial misconduct** is concerned with financial misconduct within municipalities and defines the concept of financial misconduct.

Source: Government of South Africa Ministry of Finance (cited in Dirie, 2006: 262 - SOH)

Equally, national-level public financial management is an important enabler of, or significant impediment to, municipal finances. Many aspects of the national legal and institutional environment are also key determinants of the potential for local borrowing and developing effective own-source revenues, as detailed in Sections 4 and 5.

In practice, very few countries enjoy a consistent mix of all these constitutional, legal, institutional and procedural elements. In developing countries, which tend to be more centralised, considerable reform and decentralisation may be necessary:

> *The defining feature of public finance and governance in most developing countries is centralization…there are only a handful of developing countries where local governments are specifically recognized in the constitution. Central governments raise most of the tax money, spend the largest share of the public budget, and make the rules about how subnational governments operate. The road to better metropolitan governance and fiscal outcomes in metropolitan areas begins with the national government (and with the state government in some large federal countries). Virtually all enabling legislation for metropolitan-area governance is the responsibility of central or state government. (Bahl and Linn, 2014: 15 - SOH)*

As noted in the introduction, this centralisation of developing countries is quite widespread and well-documented through comparative fiscal data. Furthermore, there is a growing consensus in the literature on decentralisation – for example in three of the most comprehensive syntheses of lessons learned reviewed here –that decentralisation in general, and municipal finance in particular, must rely on stronger systems at both central and local levels (Local Development International, 2013 - SOH; Charbit, 2011 - SOM; Farvacque-Vitkovic and Kopanyi, 2014 - SOH). In a sense, the most important first lesson from this REA is that efforts to bolster poor cities' access to finance must begin with an analysis of, and perhaps support to, the national context in which they operate. Moreover, once this context is taken into account, there is a need to pay further attention to the specific question of how resources are to be shared between the vertical tiers of government, and this inevitably involves the issue of intergovernmental transfers.

3.3 THE CRUCIAL ROLE OF INTERGOVERNMENTAL TRANSFERS

There is a vast literature on the design, functioning, and outcomes of intergovernmental transfers, which encompass a range of financing instruments from grants, subsidies and subventions to shared taxes (for a review, see Steffensen, 2010: 13 - SOH). At a broad level, intergovernmental transfers have three design dimensions: the determination of the transfer pool (the total resources to be transferred); the distribution criteria (how these are divided among sub-national units); and the type of conditionality used to determine eligibility, use of and any incentives for the transferred resources. For example, the pool of resources may be defined as a share of revenue or gross domestic product (GDP), or based on estimates of expenditure needs, among other means. Allocations may be distributed on an ad hoc, formula-based, or reimbursement basis. Transfers are broadly divided into conditional (earmarked for particular purposes) and unconditional, and increasingly involve some performance-based component.

The crucial lesson – repeated across the two main sources summarising international experience with transfers reviewed – is that there is no single best approach to intergovernmental transfers, in theory or in practice (Smoke, 2013: 3-4 - SOH; Steffensen, 2010 - SOH). What is important is that design and implementation are suited to the underlying objectives of the transfer. While some authors identify as many as seven objectives for intergovernmental transfers, the consensus in the literature rests on at least four that are most important in informing transfer design as they relate to the political objectives of and factors behind the transfer (Steffensen, 2010: 14-15 - SOH; Slack, 2009: 36 - SOH):[4]

- Correcting for vertical fiscal imbalance, or the difference between the expenditure responsibilities of local government and their resources from other means (fiscal gap);
- Correcting for horizontal fiscal imbalance, or unevenness in the fiscal capacity of different sub-national units and hence inequities;
- Compensating for externalities, or positive and negative spillovers of effects or benefits of activities carried out within a sub-national jurisdiction;
- Supporting political objectives such as ensuring compliance with national minimum standards in service provision or incentivising local revenue mobilisation.

The type of transfer that is most appropriate depends on the underlying rationale for the transfer. Another important issue is the aggregate impact of the transfer *system* as a whole. It is far beyond the scope of this Review to discuss in detail the principles that can underlie these three dimensions, but there are useful orientations in the resources referenced in Annex 1 and in Steffensen (2010 - SOH), Steffensen and Larsen (2005 - SOH) and Bird (2002 - SOH). It is, however, possible to identify from the evidence assessed several issues of particular importance for intergovernmental transfers in the context of poorer urban settings.

3.3.1 DEPENDENCY ON TRANSFERS AND AUTONOMY

The first is the degree of dependency on transfers. Decentralisation specialists agree that local governments in general are unlikely to fund their responsibilities wholly from own-source revenues. The extent to which metropolitan local governments depend on transfers varies greatly across cities. On the one end of the spectrum, cities such as Buenos Aires have been assigned significant taxing powers and finance nearly with 70% of their budget from own-source revenues. The same is true for the metropolitan areas in South Africa. But most large urban areas depend much more on intergovernmental transfers (Bahl, Linn and Wetzel, 2013: 17-18 - SOH). In Tanzania, the site of a comprehensive decentralisation reform, the total volume of local government revenues has increased substantially since 2002, but this growth is primarily driven by the increase in intergovernmental transfers, which now account for nearly 90% of local government revenues (Venkatachalam, 2009: 2 - PSM).

This financing gap has both vertical and horizontal dimensions. Vertically, without sufficient and well-designed transfers, there is the problem of unfunded mandates: local government services and responsibilities that are inadequately financed. In China, for example, leaving intergovernmental expenditure responsibilities undefined has given upper-tier governments more flexibility in offloading responsibilities to lower tiers without compensatory transfers of revenue or fiscal autonomy (Peterson and Annez, 2007: 77 - PCM). There is also variation

[4] Others include compensating local government for implementing delegated activities from higher tiers of government and providing central government with the flexibility to influence macroeconomic conditions by influencing levels of local government economic activity (Steffensen, 2010: 15).

in the mix of budget composition in transfers to municipalities, between operating and capital expenditure (Paulais, 2012: 12 - PCH). In some situations, the central government may designate a large share of central government or regional transfers for municipal capital expenditure (Venkatachalam, 2007: 3).

Horizontally, equalisation is a significant motivation for the use of intergovernmental transfers, as some municipalities are less able than others to provide an adequate level of service at reasonable tax rates. Tax bases differ from one municipality to another, the need for and costs of providing public services may be higher in one municipality than another (Slack, 2009: 37 - SOH).

A side effect of dependency on transfers is that, as noted above, local budgeting is hampered when local governments do not know in advance what fiscal transfers they will receive from the central government. A weak intergovernmental fiscal relationship weakens the ability of local governments to forecast revenues or forces them to make 'guesstimates' in their budget documents (Farvacque-Vitkovic and Kopanyi, 2014: 107 - SOH).

Two of the comparative sources reviewed argues that high dependence of cities on intergovernmental transfers reduces their autonomy and accountability, a position found more commonly in discussions of effective decentralisation to local governments in general. The economic argument runs that earning a greater share of financing from own sources drives up the tax price of public services and reduces upward pressure on sub-national government expenditures, and thereby promotes efficiency. Heavy reliance on intergovernmental transfers – the common situation in most developing countries – has precisely the opposite effect (Bahl and Bird, 2008: 5 - SOM). Quantitative evidence from Italy appears to support these hypotheses, finding that more fiscally autonomous municipalities (those that raise more of their own revenues) spend more efficiently (Boetti, Piacenza and Turati: 2010 - PSM).

Similarly, transfers (other people's money), borrowing (a problem for the next government), and taxes on business that can largely be exported are all, from the perspective of sub-national governments, politically preferable to confronting local citizens with the true costs of government decisions (Bahl and Bird, 2008: 12 - SOM). In general,

> *… experience tells us that large metropolitan areas can and should have greater fiscal autonomy than other urban or rural areas. Autonomy means both greater responsibility for delivering local services and greater ability to levy their own taxes. All local governments, however, need to be responsible, accountable, and efficient. To do so, they need to raise their own revenues as much possible, adhere to an open and visible municipal budgetary process, and engage in transparent and prudent financial management.* (Slack, 2009: 72 - SOH)

It follows, therefore, that paying attention to intergovernmental systems, as advocated by the evidence reviewed in this section, must be supplemented by efforts to increase municipal autonomy, covered in Section 4.

3.3.2 ASYMMETRY

Asymmetric decentralisation refers to a differential assignment of decentralised rights and responsibilities across different sub-national units, and a particular problem for urban areas is a tendency for intergovernmental systems to underestimate the case for asymmetry to cater for the differences between cities and rural local governments (Bird and Slack, cited in Bahl, Linn and Wetzel, 2013: 135-159 - SOH). There is a good case for an asymmetrical transfer system in terms of how metropolitan local governments are treated compared with other local governments, mentioned by two of the strongest synthetic studies. Their stronger economic base and hence higher capacity to mobilise local revenue suggest that they will require fewer transfers than other jurisdictions and will not participate in equalisation grants. On the other hand, higher spending responsibilities, and the costs of fragmented local government structures, may require more financing from transfers. In cases where metropolitan areas combine state/provincial and local government responsibility, as is often the case for capital cities, Bahl et al. (2013 - SOH) argue that they need to be entitled to a larger transfer share.

This asymmetry may be more important when it comes to capital expenditure, as a small central budget divided on a formula basis applied to a large number of jurisdictions may leave little for the more expensive, one-off projects that larger towns and cities will require. One approach to dealing with this issue is found in Ghana, where central government transfers from the Common Fund are dedicated to capital investments, and therefore have a major impact on spending on infrastructure at the local level (Dirie, 2006: 260 - SOH).

3.3.3 INFORMATION ISSUES

Any intergovernmental transfer carries with it significant institutional burdens and requirements. An overriding issue is the constraint on design imposed by the availability of data, particularly in low-income settings. The allocation of most transfers is based on detailed formulas, all of which require information that is often not available, which means that their design must be adapted (Boex and Martinez-Vazquez, 2007 - SOM; Alm, 2010: 10 - SOM). It is, therefore, important to consider ways to improve data collection. Intergovernmental transfers also require a strong central government ability to monitor how grants are used as well as their performance. Supporting these informational needs may be a good way to support a sound transfer system.

3.4 INNOVATIONS

Innovation in the intergovernmental system largely falls into contextual reform – legal and institutional changes at national level that enable sub-national revenues – and innovative use of intergovernmental transfers. In considering these innovations, it is important to recall the risks from the unstable nature of central transfers in some developing contexts and the problems arising from excessive dependence and lack of autonomy described in section 3.3.1.

3.4.1 LEGAL AND INSTITUTIONAL CONTEXT

Some of the important dimensions of systemic reform summarised by Bahl and Linn (2014: 15 - SOH) from contributions by many authors across a wide range of country contexts include improved application of asymmetry to match urban conditions, integration of service responsibilities across tiers of government, and measures to increase the effective autonomy of metropolitan local governments.

This can be a difficult balance to strike. Tanzania conducted a comprehensive reform of its local revenue system by abolishing unsatisfactory instruments (including the poll tax), and simplifying rate structures and collection procedures for other measures. The Tanzanian reform demonstrates that it is possible to make radical changes to the local revenue system, but the longer-term impact of this reform on local government revenues has been reduced fiscal autonomy and increased dependency on central government transfers (Fjeldstad, Braathen and Chaligha, 2006 - SOM).

As described earlier, legal frameworks also can play an important role. A solid local government budget law and regular external auditing can help support such autonomy, not least by separating local government budgets from central approval, as is as is the case in numerous developing countries. This can even be as simple as cash management: Is local government authorised to decide where to keep cash deposits? Is it allowed to earn interest on these deposits, or to invest them? (Dirie, 2006: 260 - SOH).

3.4.2 TRANSFER DESIGN, CONDITIONALITY AND PERFORMANCE BASED GRANTS

The revenue mobilisation hypothesis holds that sub-national governments have the potential – and, if the intergovernmental transfer system is well designed, the incentive – to reach the traditional income, consumption and wealth tax bases in ways that the central government cannot (Bahl and Bird, 2008: 3 - SOM). Urban areas, as home to relatively large potential fiscal bases, and also concentrations of expenditure needs, depend particularly on good transfer design, as this is important for encouraging own-source revenue mobilisation, enabling effective borrowing, and equity between municipalities.

An increasingly common innovation is the use of *Performance-based Grants* or transfers to encourage local government performance. A number of Asian and African countries have experimented with performance-based allocation incentives, especially addressing the generic elements of local government administration. The earliest and more studied of these are in Bangladesh, Kenya, Nepal, Tanzania and Uganda. The most systematic comparative review found that these experiences have generally been positive, providing incentives to improve on performance in planning, budgeting, financial management and project implementation, as well as aspects of good governance such as participation (Steffensen and Larsen, 2005: 9-10 - SOH). In Kenya and Uganda local development plans and budgets are elaborated with greater involvement of citizens, transparency and inclusiveness than before the systems were adopted. Final accounts are being produced, mostly on time, weaknesses in financial management are being addressed, internal audit functions established, accountability procedures strengthened, and councils and committees, tender boards and other statutory bodies have started functioning. Careful design of the performance component, credible monitoring of local government performance, and the provision of capacity-development opportunities alongside the reformed grant system are important determinants of local government performance with these systems (Steffensen and Larsen, 2005: 9-17 - SOH).

4.0 STRENGTHENING OWN-SOURCE REVENUES

Own-source revenues are funds that local governments raise directly and include those that accrue to the municipal treasury and budget, most notably taxes. Revenues can also be earmarked in a separate fund or retained by service providers, but nonetheless free up fiscal space for other activities by substituting for existing resource provisions. These include many user fees and service charges. Some reviews consider the revenue of state-owned enterprises in this category, but these are not covered here both because they are typically only relevant at national level, and because they are generally being phased out (Shukla et al., 2011 - PSM).

The literature on financing municipal governments focuses predominantly on the resources that accrue to the municipal treasury. It is also heavily influenced by both microeconomic and public economics theories, and by diverse country experiences of devolving taxation to lower tiers of government, particularly in OECD countries but also MICs. The largest body of work is on property taxes, which are used to finance local government rather than central government spending in most countries. There are also reviews of other forms of local government taxation, such as sales taxes and income taxes, especially in large federations. Finally, there are numerous discussions on user fees and charges.

Box 6: Key findings for raising own-source revenues

- The literature on local government taxes and other own-source revenues is grounded in decades of theory and empirical work, centred mostly on advanced economies such as the USA.
- Fiscal decentralisation theory has few unambiguous recommendations other than property tax and user fees for local governments to finance local-level services independently of fiscal transfers.
- Property tax is politically and administratively difficult to implement well and rarely exceeds 3% of GDP, even in OECD countries.
- There is no quick or easy reform to increase own-source revenues. At the margins, cities in developing countries can improve the collection of property tax, particularly in larger cities where property tax has greater potential. Innovations (such as betterment levies) and more simple administrative approaches (such as area-based property valuations) may provide modest gains. Other financing sources, such as land sales, can also provide windfall revenues.
- In order for cities to play a wider role in public services, they need to obtain access to wider tax bases such as income or consumption taxes, either through tax assignment or tax sharing.

The role that own-source revenues play in financing municipal governments is closely tied to the overall system of political, administrative and fiscal decentralisation. For this reason it varies greatly between countries, and the consensus view is that there is no ideal assignment of revenue sources for municipal government.[5] In general, when local governments are responsible for a significant proportion of total public expenditure, they are likely to depend on national transfers (e.g. Korea and Mexico), piggyback on national income taxes (e.g. Nordic countries) or have access to a range of taxes (e.g. Italy) including business (Bird, 2010 - SOM).

Cities generally have authority to levy non-tax revenues and some local taxes – often only property taxes and some less desirable taxes that fall between the cracks (Farvacque-Vitkovic and Kopanyi, 2014 -SOH). Bahl et al. (2013: 15 - SOH) note that 'where metropolitan local governments have provincial status, sales and payroll taxes have been easier to assign'. However, municipal governments in most developing countries usually have more limited mandates for delivering services and raising taxes. They are also constrained by weak administrative capacity and smaller formal economies (Fjeldstad and Heggstad, 2012 - PCM), challenges also faced by many central governments (Kleven, 2014 - SOM).

4.1 STRENGTH OF THE EVIDENCE

Table 6: Studies reviewed

	Primary Type			Secondary Type	
Quality	Primary Experimental	Primary Comparative	Primary Single Case	Secondary Systematic	Secondary Other
High	1	5	1		6
Moderate	1	4	12		13
Low			2		1

The literature on own-source revenues is large and readily available, and 46 studies were reviewed for this section. The reason for this large body of evidence is in part because several distinct areas of study are included in the theme, and the largest, property tax, is the dominant topic in over a dozen studies. As with transfers, there is a well-developed synthetic literature, more of which is of high quality, but there is also considerably more empirical and case-study literature of moderate or higher quality than in the other areas. While most of these (12) are of moderate quality – essentially single case studies with limitations on their methodology – the nature of local taxation lends itself to more comparative and experimental (or in these cases, quasi-experimental) approaches, and ten such studies are reviewed. Most were secondary sources and scored as at least 'medium quality', on our scale. Many studies did not achieve a higher score because the authors either failed to explain why case studies were selected or did not judge the quality of the study.

Overall, there are two sides to the evidence. First, there is considerable knowledge, debate and understanding of how local taxes can be designed and where they go wrong. On the other hand, evidence for reforms that might work in other countries is more limited and less definitive – relying on isolated examples or broad international comparisons that are

[5] Out of seven 'cross-cutting' textbooks reviewed on own-source revenues, three explicitly state that there is no ideal assignment of tax revenues to local government or cities, while the other three suggest this implicitly by acknowledging the importance of context, notably the degree of political, administrative and expenditure decentralisation.

clouded by differences in fiscal decentralisation contexts. This is especially true of administrative reforms such as those aimed at improving tax collection. Finally, case studies of reforms in the secondary literature often muddy the distinction between financing 'cities', as opposed to provincial or small urban local governments, or where they treat cities explicitly, may concern municipalities or local governments in MICs or transition economies.

4.2 PRINCIPLES OF FISCAL FEDERALISM – THE SECOND GENERATION

The normative principles that have typically governed recommendations over what taxes should be levied at a national or local level have shifted in recent academic literature. The standard model for assigning taxes in all public economics literature suggests that an ideal local government tax imposed on local residents should be closely related to the benefit provided and the beneficiaries – the 'benefit principle' – and should not induce competition with other jurisdictions. From a macroeconomic perspective, the national government should be able to maintain economic stability. The tax should be easy to administer and visible to ensure accountability. In reality, it is not easy to satisfy all these conditions with the result that powers over productive taxes are often retained by the central government with local governments 'left with little but property tax' (Bird, 2010: 5 - SOM).

Property tax is widely recognised as an 'ideal' tax for local government on economic grounds, but in practice it has not been implemented well in many countries. Though more disputed in theory, some countries have also allowed local governments to collect sales taxes, income taxes, business and motor vehicle licences and other fees, often levying a surcharge to piggyback on central government taxes. It has also been suggested that central government limits on local government powers to tax have encouraged a greater reliance on user fees and charges (Kitchen, 2013 - SOH).

The most recent literature reviewed on local taxation supplements these considerations with increased emphasis on autonomy, with some combination of suggestions that (a) tax powers should broadly follow expenditure responsibilities; (b) these tax powers should allow local governments to set tax rates at the margins to encourage autonomy; and (c) the system should provide the incentives for local governments to act in a fiscally responsible way (Bird, 2010 - SOM). As discussed in the previous section, the importance to local fiscal autonomy of being able to set tax rates has often been overlooked and is increasingly seen as important (Slack, 2009: 72 - SOH).

> *The development of responsible and responsive local government is thus dependent on local government having at least some degree of freedom with respect to local revenues, including the freedom to make mistakes and be held accountable for them. This means that local government must have control over the rates of some significant revenue source if they are to be fiscally responsible and able to innovate as to the way they finance basic services.* (Dirie, 2006: 260 - SOH)

This increased emphasis on fiscal autonomy and its impact on local governance has been called a 'second-generation' model for fiscal decentralisation in recent synthetic literature

(Bird, 2010 - SOM; Boex, 2009 - SOM). It is a more pragmatic approach to fiscal decentralisation, one that promotes greater local autonomy, based on consideration of local government incentives and empirical evidence from a range of OECD countries, such as Canada, that greater access to national tax bases (at the margin) will foster better services. Furthermore, a growing case literature on urban renewal from cities in developing countries, such as Lagos, suggests that leadership in forging a development social contract based on taxation can play a role in transformation (Kuris, 2014 - PSM). Comparative research by the International Centre for Tax and Development (ICTD) also finds that there may be governance benefits to taxing the informal sector, but only if this is accompanied by 'strengthening the potential benefits of formalisation, from increased security to new economic opportunities' (Joshi, Prichard and Heady, 2012: 3 - SOM).

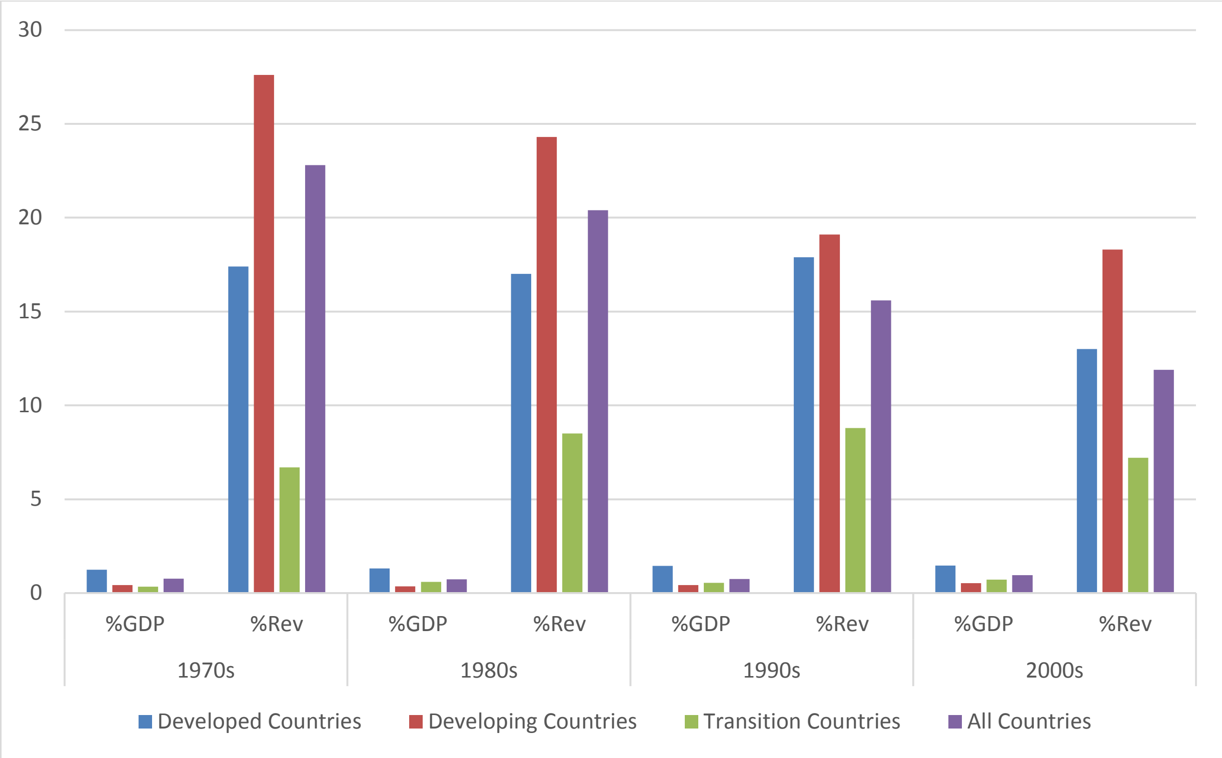
4.3 PROPERTY TAX

From a theoretical standpoint – under both standard and second-generation principles – there is near universal consensus that taxes on land and property are appropriate local government taxes. The tax base is immobile, yields are relatively stable and it is unlikely to be a basis for inter-jurisdiction competition (Kitchen, 2013 - SOH). Other than the Nordic countries, property taxes have been an important source of financing for municipalities in most industrialised countries, and are growing in importance in China, Russia and Eastern European states (Kitchen, 2013 - SOH).[6]

Both case study and comparative evidence show, however, that Property taxes are notoriously difficult to implement well. A UN-Habitat review of all countries for which relevant International Monetary Fund (IMF) data was available in 2008 showed that only OECD countries enjoyed a significant share of their overall revenue from property taxes, and that local tax-setting over property and income is rare in developing countries (Slack, 2009: 8 - SOH). Figure 2 below demonstrates that local governments in developing countries are, in general, more reliant than developed countries on property taxes (as a share of local revenues), but also less able to exploit them (as a share of GDP). The overall effect is the sharpened fiscal gap discussed in the introduction.

[6] Kitchen (2013: 3) writes: 'property taxes represent the highest percentage of local revenues in Organization for Economic Co-operation and Development (OECD) and Latin American countries, and the lowest percentage in Asian and central and eastern European countries. Countries in Africa tend to fall between these two extremes'. Overall it is rare for property tax to exceed 3% of GDP (Slack, 2013).

Figure 2: Local Property Tax as Share of GDP and Local Revenue



Source: Adapted from Bird and Slack (2006 - SOM)

Research found across more than half the sources on property tax reviewed has suggested a number of reasons for this failure to fully exploit the potential of property taxes in developing countries beginning with structural factors such as a high degree of informal settlement, and the absence of fully functioning property markets (Kitchen, 2013 - SOH). In Dar-es-Salaam, for example, it is estimated that 70% of the population lives in informal settlements (Venkatachalam, 2009 - PSM). Some barriers are administrative: maintaining property cadastres and valuing properties can be expensive and difficult (Smolka and De Cesare, 2010 - PCM). Enforcement mechanisms may also be less credible (Fjeldstad and Heggstad, 2012 - PCM). Other factors are more political: property taxes are highly visible and fall on landowners (Fjeldstad, 2006 - SOM), increasing their political import as well as the incentive to dodge them in loosely regulated environments. The combination of inequitable application (for administration) and high political visibility result in various interventions that reduce revenue yields, including limits on tax rates, freezes or caps in valuations, and exemptions (Kitchen, 2013 - SOH).

Conclusions about the future role of property tax are mostly consistent across the evidence assessed. First, that property tax is potentially (or in many cases already) an important financing mechanism for municipal governments, and particularly larger cities (Farvacque-Vitkovic and Kopanyi, 2014 - SOH). Second, that reforms to improve the design or administration of property taxes may yield increased revenues, but expectations should remain modest (Bird and Slack, 2006 - SOM), and should recognise the context-specific administrative and political barriers to improved collection. Finally, property taxes will only ever be enough to finance some basic services such as refuse collection, street lighting, road maintenance and street cleaning. If the municipality is to provide more extensive services, other tax bases or intergovernmental transfers will be needed (Bird, 2010 - SOM).

4.4 OTHER TAXES

In the evidence reviewed the discussion of other taxes available to local governments is less extensive than for property taxes, and generally combines a conceptual or synthetic approach over empirical examination – except in some individual case studies that make comparison difficult. It broadly points to two categories of additional own-source tax revenues: taxes that could be devolved to local governments (on businesses, vehicles, payroll) and taxes that can be manipulated at the margin or shared (personal income and value added taxes (VAT)) (Bird, 2010 - SOM).

Motor vehicle taxes are becoming more important in developing countries (Bahl and Linn, 2014 - SOH). From a conceptual approach, these could be fully devolved to city governments along with excise taxes on fuel, provided rates are reasonably similar between local government jurisdictions (Bird, 2010: 33-34 - SOM). Some have also presented a pragmatic case for improving the efficiency of business licences, which are popular with politicians in many local governments, despite concerns about their impact on business and employment (Bahl and Bird, 2008 - SOM). These are popular in European countries where local governments are not financed predominantly by transfers or surcharges on national income taxes (Bahl and Bird, 2008 - SOM). They may also be a good alternative to higher property tax rates levied on businesses in many countries (Kitchen, 2013 - SOH).

There is less evidence for these other taxes for developing countries. A local business tax was introduced in the late 1990s in Kenya, with some initial improvements in revenues, while in Tanzania, the local business licences were abolished in 2004 before being reintroduced in 2011 as a unified business tax (Fjeldstad and Heggstad, 2012 - PCM). There are other examples of less common taxes. For example, construction permits and building licences have been introduced in some countries and occasionally make up a substantial share of municipal revenues – two thirds in Teheran, as an extreme example (Farvacque-Vitkovic and Kopanyi, 2014 - SOH). It must be assumed, however, that these have limitations in proportion to the higher degree of informality in low-income urban economies.

The widespread introduction of VAT in developing countries has limited application to devolved taxes on goods and services, though some countries do have local sales taxes: Bahl et al. (2013 - SOH) point to São Paulo and Bogotá for useful examples of municipal sales taxes, though local sales taxes can distort markets across neighbouring jurisdictions. Brazil has also introduced a municipal sales tax levied on gross receipts, which has been criticised for its distortionary impact on production (Farvacque-Vitkovic and Kopanyi, 2014 - SOH). In general, there are no strong recommendations for extending this practice due to high administration costs and problems with inter-state trade. Although it may be possible to learn lessons from the Canadian systems established in Québec and three other provinces, these operate at provincial level and involve considerable inter-jurisdictional complications

(Bahl and Bird, 2008 - SOM; Bird, 2010 - SOM).[7] These are cited as the only functioning sub-national consumption taxes, and are closely harmonised with national administration.

Alternatively, the municipal government may be allowed to levy a surcharge on national taxes – effectively piggybacking on national or provincial tax systems. Indeed, this is how sub-national VATs are levied in Canada, outside Québec (Bahl and Bird, 2008 - SOM). These local consumption taxes account for half of local taxes in Spain, nearly a third in Austria, and a quarter in the USA. Municipalities in Denmark, Finland and Sweden rely on revenues from local income taxes that use the same tax base assessed for national income purposes. To prevent over- or under-taxation, it is possible to set tax ceilings or floors, as in Denmark, Norway and Sweden (Farvacque-Vitkovic and Kopanyi, 2014 - SOH).

Such taxes are rare in developing countries, although some transition economies have earmarked substantial shares of personal income tax to local government, which does not have significant freedom to change the rate (Bahl and Bird, 2008 - SOM). Russia is a prominent example, where central government sets the rate of tax but distributes all collections to sub-national government. On balance, personal income taxes receive stronger support than company payroll-based taxes, which are effectively levied on the same base (Bird, 2010 - SOM). However, there may be more potential for these types of levies, particularly in view of the growing recognition that the level of administration receiving the revenue need not be responsible for administering the tax, thus maximising access while streamlining administration (Mikesell, 2007 - SOH).

4.5 USER FEES AND CHARGES

One key study notes that user charges may be playing a growing role in financing local government services in the face of political pressure to restrain property taxes (Kitchen, 2013 - SOH). These have been common for water and sanitation, electricity, waste disposal, urban transport and mass transit services. The dominant theoretical underpinning for user fees is sometimes called the 'benefit model', because they have the potential to closely gauge the cost, demand, and beneficiaries of a given service (Bird and Slack, 2006: 71 - SOM). Usually, therefore, these are introduced as cost-recovery mechanisms, but there is also widespread use of surcharges above the cost of provision. These are usually allocated to finance new infrastructure or make the service more efficient in the future, although the significance can go much further: surcharges on water and electricity have become the largest source of local revenues for municipalities in the West Bank – accounting for over half of all local revenues (Farvacque-Vitkovic and Kopanyi, 2014 - SOH).

Municipal finance handbooks reviewing global experience suggests that problems with user charges include setting them too high (reducing access) or too low (encouraging overuse, damaging the service or increasing reliance on subsidies). This may vary for the services provided: while there is growing evidence that user fees reduce access to health care, the

[7] Since Québec is a province rather than a municipality, the lessons may not be fully transferable. Property tax is the sole tax levied by Canadian municipalities, as in Australia and the UK (municipal finances).

emerging consensus on the provision of water is that 'relatively simple pricing systems, such as a low initial charge for the first block of service use, can deal with most inequity concerns' (Farvacque-Vitkovic and Kopanyi, 2014: 177 - SOH). In practice, many user-fee regimes have been poorly implemented, and in some cases this has led to resistance to paying from segments of the urban population (Fjeldstad and Heggstad, 2012 - PCM). Case-study evidence from low-income settings such as Zambia also suggests that rationalising fees in contexts where there is low investment can reduce access without other sources of upfront investment in infrastructure (Dagdeviren, 2008 - PSM).

Some research suggests that there is scope to increase the use of user charges, or proposes the use of ancillary service charges – for example by leasing concessions for petrol stations or restaurants along new roads – as long as cross-subsidies are regularly reviewed (Farvacque-Vitkovic and Kopanyi, 2014 - SOH). It is, however, hard to avoid the overall conclusion that user charges are rarely enough to cover expenditures of large urban governments (Bahl, Linn and Wetzel, 2013 - SOH).

4.6 INNOVATIONS

The situation in developing countries is two-fold. On the one hand local taxes, user charges and fees are a significant source of revenue for local government, whereas shared taxes are uncommon and borrowing is an insignificant source of finance (Dirie, 2006: 261 - SOH). On the other hand, 'user charges and property taxes are dramatically underused as revenue-mobilization instruments in almost all metropolitan areas in developing countries due to pervasive political obstacles' (Bahl and Linn, 2014: 3 - SOH).

Identifying specific innovations for own-source revenue policy and administration is not straightforward. Countries have established a wide range of taxes and administrative systems. As Smoke (2013: 5 - SOH) explains, even problematic revenues have become productive in a particular context and difficult to modify or eliminate as a result. All the same, it is worth drawing attention to a few reforms that may be applicable to a range of developing countries. Of course, the more 'innovative' or unusual these are, the more limited (or contested) is the evidence base to support them, and the thrust of the evidence is that own-source revenues should be built on a solid foundation of conventional sources rather bringing in too many unusual channels. Furthermore, most of the innovations described in the literature are in MICs, raising questions about their applicability to LICs. A case study of China's urban finance situation illustrates both of these points, finding that

> *… unless Chinese cities are given sufficient 'good' fiscal instruments to finance their expansion, they are likely to continue, as in the past, to cope with the problems facing them by recourse to 'bad ones such as extra-budgetary funds, arbitrary and illogical fees, and distorted "public-private" schemes.* (Bird, 2005: 110 - PSH)

4.6.1 IMPROVING PROPERTY TAX

The debate regarding the problematic design and administration of property tax in many developing countries has led to a number of suggestions for how these could be improved

(Fjeldstad and Heggstad, 2012 - PCM; Fjeldstad, 2006 - SOM).[8] There is a useful debate about the respective benefits of property taxes assessed on area or value (Bahl, Linn and Wetzel, 2013 - SOH; Bird and Slack, 2006 - SOM; Fjeldstad and Heggstad, 2012 - PCM; Kitchen, 2013 - SOH). Area-based systems are easier to administer, but may be less buoyant, less equitable and have lower yields. These are becoming increasingly popular around the world, in place of value-based systems which are more complex and expensive to administer (Bird, 2010 - SOM). This is an interesting case of potential adaptation to low-income settings despite running counter to the standard proposed direction of property tax reform in developed countries with high administrative capacity (Bird and Slack, 2006 - SOM).

Colombia – where many of the reforms go against standard theoretical recommendations – is regularly held up as an example of how value-based property taxes could be better managed (Bahl, Linn and Wetzel, 2013 - SOH; Bird, 2010 - SOM; Bird and Slack, 2006 - SOM Farvacque-Vitkovic and Kopanyi, 2014 - SOH). One reform is the use of self-assessment systems, which has had some success in Bogotá, and was also recently introduced in Delhi (Bird, 2010 - SOM). Another is the use of indexing (where property values are uprated by the value of inflation). This makes the property tax less fair – because some properties increase in value more quickly than others – but may be appropriate where a proper value-based system cannot be established (Bird and Slack, 2006 - SOM). A third reform that may have wider applicability is the introduction of a computer-assisted, mass-valuation system, which is used to maintain property records and to calculate an approximate value of each property. Such systems have also been introduced in Kosovo and Cape Town, but collection systems are not always able to keep up with the new assessments, leading to substantial arrears (Farvacque-Vitkovic and Kopanyi, 2014 - SOH).

Freire and Garzón (in Farvacque-Vitkovic and Kopanyi, 2014 - SOH) report large improvements in revenue collections in a number of cities in West Africa where modern street-addressing systems were introduced and provided tax authorities with more reliable information on the location of taxpayers – personal and corporate. Similar reforms are becoming increasingly widespread (Swope, 2014 - PSL). The modern systems were coupled with a simplified residence tax, inspired by the urban tax in Morocco and the former Tunisian rent tax (Farvacque-Vitkovic and Kopanyi, 2014: 191 - SOH). This example did not appear in other studies reviewed in the course of our research.

4.6.2 LAND-VALUE CAPTURE AND PLANNING GAINS

Aside from standard property taxes, one prominent new recommendation emerging from the literature and discussed in detail in a strong comparative study reviewed as well as synthetic literature, is for cities to consider other ways to raise revenue on property through forms of land-value capture, as evidenced by one review of experiences across Latin America:

[8] For studies on the impact of property tax reforms in specific countries, Fjeldstad and Heggstad (2012) list SSA countries that have made changes since 1997: Lesotho (1997); Zambia (1997); Malawi (1998); Zambia (1999); Liberia (2000); Nigeria, Lagos (2001); Rwanda (2002); Mauritius (2003); South Africa (2004); Sierra Leone (2004); Uganda (2005); Mauritius (2009).

> *The notion of value capture is to mobilize for the benefit of the community at large some or all of the land value increments (unearned income or plusvalías) generated by actions other than the landowner's, such as public investments in infrastructure or administrative changes in land use norms and regulations.* (Smolka, 2013 - PCH)

There is a growing evidence base on various forms of land-value capture, particularly from Latin America. Three broad forms are betterment contributions linked to property taxation; exactions for building or development rights; and large-scale public land development. A related concept in capturing value from public intervention in land markets is 'planning gain': 'arrangements whereby local authorities, in granting planning permission, achieve planning and other community gains at the expense of developers' (Dirie, 2006: 257 - SOH).

Box 7: Typical approaches and benefits to planning gain

- Removal of obstacles to the implementation of planned development
- Paying for infrastructure and other public services
- Mitigation or compensation for development impacts
- Recovery of 'betterment' (i.e. any increase in the value of land as a result of the development).

Source: Dirie (*2006*: *257 - SOH*)

Bird and Slack (2006 - SOM) advocate for betterment levies, or payments made by owners of property that has increased in value as a result of improved infrastructure. The potential of these schemes is commonly referenced in relation to Colombia, where a *contribución de valorización* was established in 1921 and has risen from 16% of Bogotá's total income in the 1960s to 24% in 1993 (Bahl and Linn, 2014 - SOH). There are, however, likely to be high administration costs in most developing countries (Bird and Slack, 2006 - SOM), and although some form of land-value capture legislation has spread to most of Latin America, there is widely varying impact even among comparable jurisdictions (Bahl and Linn, 2014 - SOH). In many cases, political and ideological opposition has hindered their wider application, leaving supporters advocating for continued research, learning, and experience sharing (Smolka, 2013: 4 - PCH).

4.6.3 OTHER INNOVATIONS

Based on their consistent appearance in the literature, two approaches to increasing other sources of finance appear to be particularly worth highlighting.

The first is selling or leasing municipal land. Strictly speaking, such sales do not raise revenues but represent the disposal of an asset. Many large cities have, however, been able to attract significant resources this way, usually used to finance infrastructure development (Bahl, Linn and Wetzel, 2013 - SOH). In general, the revenue raised from these sales is large relative to the investments being financed, but cities in a number of countries (including China and the Balkans) have reportedly become over-reliant on these revenues (Farvacque-

Vitkovic and Kopanyi, 2014 - SOH); and there is always a risk that the money will not be used efficiently (Bahl, Linn and Wetzel, 2013 - SOH). Furthermore, case studies of Chinese urbanisation emphasise that inappropriate use of land-requisition rights by the state can heavily distort land use in the context of rapid urbanisation (Cao, Feng and Tao: 2008 - PSM).

Box 8: Land auctions proceeds

Although there is no systematic database of revenue raised from land sales, Farvacque-Vitkovic and Kopanyi (2014) illustrate the potential, based on relatively recent sales in three cities:

- $3.1 billion in Cairo in 2007 for 3,100 hectares of land for a new town
- $1.2 billion in Mumbai in 2006/07 for 13 hectares of land in the new financial centre
- $1.5 billion in Istanbul in 2007 for an old bus station and government building

Another popular recommendation is to outsource revenue collections to the private sector or (in rare cases) a semi-autonomous agency. The evidence that outsourcing actually increases revenues is inconclusive or limited, however. Only Peru was identified as having semi-autonomous revenue agencies at the local level. Von Haldenwang (2010 - PSH) makes an empirical assessment of the impact of these agencies on revenue collection, suggesting that there may be a positive impact on revenue growth, especially in the first two years. However, the sample is small and it would not be possible to generalise to other countries.

Turning to outsourcing to the private sector, Tanzania has outsourced collection of a number of local government revenues since 2000, including property taxes for some urban councils. However, an assessment in Dar-es-Salaam suggests that the public officials were more effective revenue collectors than their private agency peers (Fjeldstad and Heggstad, 2012 - PCM). At the very least, caution is needed in pursuing such reforms elsewhere.

5.0 BACKING LOCAL BORROWING

Borrowing is necessary for city governments to supplement current revenues, which are unlikely to be sufficient to finance large capital investments. Moreover, these should not be financed solely from current revenues if inter-generational equity concerns are to be met (World Bank, 2013 - SOH).[9] Whether city governments are able to take advantage of borrowing to increase their financial resources will depend not only on their own actions, but also on the broader domestic regulatory and economic environment.

Box 9: Key findings on debt and borrowing

- Cities need to be able to borrow to finance large capital investments.
- Their ability to borrow largely depends on their own creditworthiness and on the broader domestic regulatory and economic environment.
- To improve their own creditworthiness, cities need to generate reliable income streams from taxes and user fees, improve their financial management, and be able to demonstrate this through publically available audited accounts.
- To reduce the cost of financing for cities, two frequently used innovations are revenue-intercept mechanisms that reduce the risk of default to lenders, and the use of financial intermediaries to pool risk between municipalities.
- National regulations are also needed to guide, and manage the risks of, local government borrowing. If not managed correctly, insolvency can lead to macroeconomic imbalances, and threaten local service provision.
- The requisite national-level reforms will depend on the particular country context – the economic and regulatory environment and existing institutions, and could involve improving the regulatory framework for local credit or developing institutions that can reduce the cost of credit to cities.
- While innovations and national reforms can reduce the cost of borrowing to cities, ultimately cities need to maintain and invest in their creditworthiness by improving revenues and financial management.

Key factors that will affect the ability to raise finance from borrowing include (World Bank, 2011 – PSH):

- the intergovernmental fiscal framework
- municipal creditworthiness
- the regulatory framework that governs municipal borrowing
- the nature of the domestic debt market in general

The only area a city government can control is its own creditworthiness, which is just a small part of the action needed for cities to increase their access to debt finance. As discussed in Section 3, many of the key determinants of city creditworthiness relate to policy and regulation at the national level. As discussed throughout this section, this needs to create an

[9] The costs should be spread across the taxpayers who will benefit from the investment: the maturity of the debt should match the lifespan of the assets financed by the debt.

appropriate enabling environment for sub-national borrowing, and national action may be especially appropriate to create institutions that can reduce credit costs for city governments and pool risk to allow smaller urban governments to obtain access to loans that they could not do otherwise. The dependence of local governments on transfers rather than revenues can weaken their creditworthiness, particularly where intergovernmental transfers may be uneven or unreliable, as in many poorer countries.

Paulais (2012 - PCH) makes rough estimates of the borrowing capacities of local governments in Africa.[10] Eighty-six per cent of this borrowing capacity is concentrated in the middle-income sub-regions of northern[11] and southern Africa[12] with only 14% in the rest of Africa. In line with this, a review of World Bank lending for urban infrastructure funds between 1971 and 2006 found that it was essential to project success to tailor the financial model to the specific context, between the extremes of direct private market access and pure grants (Annez, Gwenaelle, and Peterson 2008 - SOH). In this sense, this section echoes two of the main findings of this REA as a whole, that the appropriate approaches and tools vary widely according to context, and that the broader intergovernmental environment is as important as any local factor in improving the scope for poor cities' access to finances.

5.1 STRENGTH OF EVIDENCE

Table 7: Studies reviewed

	Primary Type (Cited/Reviewed)			Secondary Type (Cited/Reviewed)	
Quality	Primary Experimental	Primary Comparative	Primary Single Case	Secondary Systematic	Secondary Other
High		1	1		8
Moderate		2	2		
Low					

This theme yielded relatively fewer sources than the others, which is not entirely surprising given that municipal borrowing is still rare in developing countries, and rarer still among cities in the poorest countries. There is a strong body of comparative literature on local government borrowing, but this is not generally peer-reviewed, and focuses on high-income countries. Much of the literature reviewed here is therefore contained within secondary studies, drawing on a number of cross-country experiences, and one very good review of financing in African cities (Paulais, 2012 - PCH). The advantage is that the literature is directed at practitioners rather than at an academic audience. The disadvantage is that the cases are likely to be selected because of their interest to policy-makers rather than for the robustness of conclusions that can be drawn from the comparison – as a result these are scored as medium rather than high-quality studies.

[10] Based on the assumption that local governments can use 5–10% of their revenues for loan repayments and would gain access to ten-year loans at 5% interest.
[11] Northern Africa defined as Algeria, Egypt, Libya, Morocco and Tunisia.
[12] Southern Africa defined as Botswana, Lesotho, Namibia, South Africa and Swaziland.

This also constrains the ability to draw generalisations on reform recommendations from this literature, which is noted in the literature itself: city government borrowing is a complex process, governed by the national economic and regulatory environment as much as by any actions a city government can take by itself. This makes it difficult to conclude that the success of any intervention could be replicated in a different context. There is, however, some strong comparative evidence from the case studies reviewed on the promotion of risk pooling for smaller cities through government and private institutions, as discussed in 5.4.2 below.

5.2 DEVELOPING AND DEMONSTRATING CREDITWORTHINESS

City governments need to establish their creditworthiness by establishing reliable cash flows from user fees and taxes, or reliable intergovernmental transfers (World Bank, 2013: 67 - SOH). City governments must also be able to demonstrate this creditworthiness to prospective lenders. This requires improving the quality of accounting and financial management systems, the human resources to run these, and making reliable financial data available through audited accounts, as evidenced by significant experience in developing creditworthiness in India (World Bank, 2011: 12-13 - PSH) or assessing municipal infrastructure financing frameworks in Vietnam (Lee and Tokiwa, 2013 - PSM). Where urban districts do not currently engage in borrowing, as in Ghana for example, an essential first step towards being able to borrow is to improve accounting systems and to make their financial situation transparent (Farvacque-Vitkovic et al., 2008 - PSM). The experience of Ahmedabad Municipal Corporation in India is emblematic of the importance of basic financial management systems, as well as the potential for official development assistance (ODA) to catalyse improved creditworthiness (**Error! Reference source not found.**).

Box 10: Ahmedabad Municipal Corporation Bond Issue, India

In 1994, the Ahmedabad Municipal Corporation (AMC) launched reforms to its tax collection and human resource management. USAID provided technical assistance in municipal accounting and financial management, project management and non-tax revenue generation. AMC worked to prioritise and analyse its investment proposals and analyse proposed investments: 'In 1996, Ahmedabad became the first urban authority in India to request and receive a rating for a municipal bond issue for water and sewerage expansion… As a result of this project, Ahmedabad's local government has learned to use bonds as a financial tool to raise investments for capital investment priorities.'

Source: Dirie (2006)

Cities can generally tap two sources of borrowing: loans or bonds. While bonds typically provide cheaper credit, they are also more complex and expensive to prepare (Freire and Petersen, 2004: 77-86 - SOH). If a city seeks bond financing, it has two main choices: general obligation bonds, which are paid from general city revenues, and revenue bonds, which are paid from specific revenue stream from a city asset, such as ports, toll roads or water utilities. The latter are especially useful where bond markets are not well developed, and lenders seek more assurance (World Bank, 2013 – SOH). Developing countries where cities have raised funds from municipal bonds include Colombia, India, Malaysia, Romania, Russia, Slovakia, Slovenia, South Africa and Venezuela (World Bank, 2013 - SOH; Freire and Petersen, 2004 - SOH). Often, however, there are no local government credit markets in developing countries, and the experience that local credit can play a key role in long-term financing of city investments comes from mostly developed countries (World Bank, 2013 – SOH).

If issuing bonds, cities will need a formal credit rating. However, even for loans, cities may seek transparent external ratings of their creditworthiness. This may be done through seeking a conventional public credit rating, which can be on an international, or national scale or through country-specific mechanisms (Painter and Gallo, 2012 - SOM).[13] Lima and Dakar have both received donor-funded technical assistance to apply for credit ratings from international rating agencies (World Bank, 2013 - SOH). International rating agencies generally use the national government (sovereign) rating as a ceiling for the rating of sub-national governments, another example of the importance of the national economic environment for sub-national government borrowing (Liu and Waibel, 2010 - SOH).

Table 8: Comparison of bonds and bank lending

	Bonds	Loans
Cost	High transaction costs with expensive preparation	Simple and fast transaction without costs, except for syndicated loans
Maturity	Relatively longer term	Short term
Interest	Fixed rates	Floating rates
Repayment	Redemption at maturity	In instalments
Merits and demerits	Fund raising from extensive investors; high credit rating is required for the issuance.	The credit rating is not required; banks may offer 'relationship lending' based on the trust built on previous interactions with the bank rather than on specific clear risk indicators (but pros and cons remain)

Source: Freire (2014 - SOH)

Colombia's 'traffic light' rating is an example of a country-specific mechanism highlighted in two sources reviewed that is used to facilitate and regulate municipal borrowing. The government publishes ratings of municipalities' debt performance based on interest payments and debt stock: a red light is given to municipalities with a ratio of interest to operational expenses exceeding 60% and a ratio of debt stock to current revenues exceeding 80%. The rating is also used to regulate borrowing. Green-light municipalities can borrow, yellow-light municipalities can borrow only after obtaining central government approval, and red-light municipalities cannot borrow (World Bank, 2013 - SOH: 69; Cities Alliance, 2005 - SOH).

[13] International scale ratings compares the risk of default of the city to the best credit risks in the world, AAA sovereign governments. National scale ratings compare the risk of default to the best credit risk in the city's country: the national government, which is rated AAA on the national scale, thereby allowing investors to compare the risks of lending to the city to the risk of national government bonds.

Table 9: Colombia's traffic light system for sub-national borrowing

Indicator	Borrowing Restrictions
Interest as percentage of operational savings less than 40% and debt stock as percentage of current revenues less than 80%	No restrictions
Interest as percentage of operational savings 40–60% and debt stock as percentage of current revenues less than 80%	Loans with Ministry of Finance approval
Interest as percengage of operational expenses greater than 60% or debt stock as percentage of current revenues greater than 80%	No lending without adjustment plan

Source: Adapted from Cities Alliance (*2005*: *6 - SOH*)

5.3 NATIONAL REGULATION

The manuals on municipal finance reviewed note that national regulations are necessary to guide, and manage the risks of, local government borrowing (World Bank, 2013 - SOH), and are a feature of municipal borrowing in developed countries. National regulation is needed both to reduce the risk of defaults, and to provide rules for debt restructuring in the case of sub-national debt distress or default. National regulations need to set out the conditions sub-national governments must fulfil when borrowing, including the purpose and type of borrowing, the amount of debt that can be taken on, and the institutional mechanism for approving this, e.g. whether or how this must be approved by national government (World Bank, 2013 – SOH). Insolvency also puts the provision of local services at risk. This leads to a common recommendation that strict limits should be imposed on the ability of sub-national jurisdictions to borrow (Fjeldstad, 2006 – SOM). The real risk that sub-national borrowing brings with it is shown by the sub-national debt crisis that affected many countries in the 1990s: Argentina, Brazil, Colombia, Hungary, Mexico, the Russian Federation, South Africa, and others (Liu and Waibel, 2010 - SOH). One study reviewed suggested that a more flexible regulatory framework can manage these risks, but at the same time help to expand sub-national borrowing and strengthen sub-national fiscal discipline, and approach that would seem to have more potential in developing countries in the early stages of creditworthiness (Liu and Waibel, 2010 - SOH).

Mechanisms to deal with default are essential, even if rarely invoked, as they remove expectations of a bail-out and encourage stakeholders to resolve financial distress. They can also help other (non-financially distressed) local governments to maintain access to borrowing (Bahl and Linn, 2014: 3 - SOH; Liu and Waibel, 2010 - SOH). Expectations that a sub-national government will be bailed out can lead to excessive borrowing, which may spill over into macroeconomic imbalances (Fjeldstad, 2006 - SOM).

5.4 INNOVATIONS

Local government borrowing is not innovative itself. It has a long history in Europe and North America (Paulais, 2012 - PCH). The key innovations typically seek to overcome two problems that raise the cost of borrowing to city government. The first is a lack of clear procedures in the case of default by adopting practices to reduce such risk, and the second is to pool risk between smaller municipalities.

5.4.1 REASSURING LENDERS: REVENUE INTERCEPT MECHANISMS

A common strategy for reducing the cost of credit is to use a mechanism that provides a lender with a senior claim on intergovernmental grants. This involves intergovernmental grants being paid into an account from which any unpaid debt repayments can be subtracted from before the grant reaches the local government.

Examples include intergovernmental grants in Mexico being paid into administrative trusts which make debt service payments to bondholders before any of the grant funds flow to local officials. This allows financing issued under these trusts to be nearly five rating grades higher than those the sub-national government usually achieved (Leigland and Mandri-Perrott 2008 - PCM). In Colombia, the government financial intermediary established to promote infrastructure lending to local governments FINDETER (*Financiera del Desarrollo Territorial*) operates in a similar way (World Bank, 2013: 79 - SOH).

A review of local credit-enhancement facilities and techniques in eight countries found that grant-intercept mechanisms play an important role in credit enhancement, and are likely to continue to do so for two reasons (Kehew, Matsukawa and Petersen, 2005 - PCM). First, improving legal arrangements for bankruptcy procedures takes considerable time. Second, even in developed countries, intercept mechanisms are widely used for local governments that are highly dependent on intergovernmental grants. The review warns, however, that 'excessive reliance on this device unfortunately may deflect attention away from consideration of the underlying creditworthiness of the borrower or the project'. Furthermore, where cities are highly dependent on intergovernmental grants, overuse of a mechanism could divert funds away from the provision of basic services. The solution to this is regulation to limit the proportion of such grants that can be used to secure borrowing (Kehew, Matsukawa and Petersen, 2005: 10-11 - PCM).

5.4.2 OPTIONS FOR SMALLER CITIES

Smaller towns and cities are more likely to be dependent on intergovernmental grants than larger ones (Slack, 2007). As a result they are less likely than larger cities to find private-sector credit affordable. To reduce these costs, governments of smaller cities are more likely to need to obtain credit through institutions that can pool this credit. Diverse forms of financial intermediaries can play this role, such as bond banks, loan pools, and guarantees to reduce lenders' risks (World Bank, 2013 – SOH).

A successful example from Colombia is FINDETER, a government company created to finance urban infrastructure projects. It provides resources to commercial lenders at discounted rates to finance municipal governments. Loans from commercial banks to municipal governments are jointly appraised by FINDETER and the commercial bank, and if approved, the municipal government sets up a special account into which intergovernmental grants flow, and the commercial bank has a senior right to intercept this revenue if loan payments are due. This system has resulted in cheaper finance for municipalities as a result of the greater security on the payments, and the high credit ratings FINDETER receives (World Bank, 2013: 79 - SOH). In South Africa, the Infrastructure Finance Corporation (INCA) is a fully private example of a similar initiative.

Box 11: The Infrastructure Finance Corporation Limited (INCA), South Africa

INCA is an infrastructure debt fund in South Africa that is 100% privately owned and operated. It was established following a call by the South African government for increased private-sector involvement in infrastructure funding. It draws on local and international market funds, raised through a series of INCA bond issues and long-term loans. Shareholder capital is another source of funding.

INCA's borrowers include municipalities, water boards and other institutions to establish social and economic infrastructure. Funding has mainly been through long-term fixed interest rate loans. INCA's loans vary between five to 13 years, depending on the repayment profile of the funds that INCA has itself raised. INCA is actively involved in work to build capacity in local government and also assists local authorities with long-term financial planning, and has a forecasting model to assist municipalities to calculate maximum levels of affordable borrowing.

Source: Dirie (*2006*: *265 - SOH*)

There are also cases of funds that failed to provide a sustainable source of debt financing for urban governments. Paulais (2012 - PCH) provides a case study of Senegal's Agence de Développement Municipal (Municipal Development Agency), founded in 1997, which by 2009 did not appear to be 'fully successful' in its original objective of increasing municipalities' borrowing capacity, and instead functioned more as a straightforward project-implementing agency. The reasons for this failure are not assessed, but contextual factors are likely to be important. A different measure adopted in Zambia has been to use pension funds as credit facilities for local government, but in general this approach has been limited in coverage due to the generally unfavourable comparison between sovereign and sub-national risk levels, or used as a crisis measure such as in New York City in the mid-1970s (Dirie, 2006: 264 - SOH; Freire and Petersen, 2004: 157 - SOH).

Kehew et al. (2005 - PCM) provide a comparison of credit-enhancement entities from eight countries, which provides some guidance on conditions likely to promote their success:[14]

- a corporate structure where the private sector has part ownership;
- credit-enhancement entities that can successfully play multiple roles;
- these roles may evolve, so inflexible design should be avoided;
- some design features are more suited to different market conditions and programme objectives;

[14] FINDETER, the Tamil Nadu Urban Development Fund in India, the Philippines' LGU Guarantee Corporation, the Infrastructure Finance Corporation of South Africa, partial credit guarantee programmes funded by the Global Environment Facility for local bank loans for energy-efficient investments in China, Croatia and Hungary, and bond banks and state revolving funds in the USA.

- acceptance that credit-enhancement programmes take time to achieve a sufficient volume of transactions to recover costs and become profitable.

For example, the study concludes that smaller, poorer municipalities are best served by a bond bank or credit-pooling facility, a broader objective of developing the municipality finance market can be achieved by a second-tier credit facility, and if the objective is to develop bond financing, this might best be done by a municipal bond-guarantee company that can provide access to institutional investors. These are among the most comprehensive findings on promoting urban borrowing, though a limitation of the study is that it is not clear how the case studies were selected.

The two types of mechanism – revenue intercepts and risk pooling through financial intermediaries – are not mutually exclusive. They are often combined so that repayment to a financial intermediary is done through a revenue intercept (Kehew, Matsukawa, and Peterson, 2005 - PCM). Finally, it is important to note that while financial intermediaries, resource pooling and guarantees can reduce the credit risk of lending to smaller cities, and thus make the cost of borrowing cheaper, this is not a substitute for cities taking actions to improve their overall creditworthiness.

6.0 LEVERAGING EXTERNAL ASSISTANCE

External assistance is funding from sources such as private grants and philanthropic aid, international aid and official development assistance (ODA). The literature reviewed on external assistance to municipal governments focuses on the use of ODA to help tap other sources of revenue such as borrowing; ODA or external financing for infrastructure; and other sources of external assistance such as migrants' remittances. In general ODA focuses on sector funding or seeking to act as means to attract urban financing through supporting processes such as decentralisation, own-source revenue mobilisation, intergovernmental transfers, and private finance. As such, it is cross-cutting with other sources of revenue.

Box 12: Key findings on external assistance

- ODA for urban projects is hard to calculate, but falls short of the needs and has not increased much, despite accelerating urbanisation.
- ODA for infrastructure is undergoing changes with the entrance of new donors, particularly in Sub-Saharan Africa, but there is still relatively limited urban focus in this assistance.
- Most aid to urban areas is sectoral, and thus limits its catalytic impact on cross-cutting management, public finance or sustainability, and that which does focus on these issues in LICs tends to be focused on small or rural sub-national governments.
- ODA for municipal development funds has shown results in a few settings, and other innovations such as results-based financing may help to improve local government performance.

6.1 STRENGTH OF THE EVIDENCE

Table 10: Studies reviewed

	Primary Type			Secondary Type	
Quality	Primary Experimental	Primary Comparative	Primary Single Case	Secondary Systematic	Secondary Other
High		2			4
Moderate		1	2		6
Low			1		

The literature on external assistance to promote poor cities' access to finance is relatively limited compared to the other themes of the REA, with 16 studies reviewed, including sections of cross-cutting sources. In part this is because much of the literature was cross-cutting and focused on potential roles of external assistance in supporting an increase in other sources of revenue. Most of the studies reviewed were secondary sources and scored as 'medium quality', and as with other areas, case studies were not selected systematically and authors of synthetic secondary studies and reviews generally failed to assess the quality of underlying primary sources.

The existence of large synthetic reviews of international assistance provides some overview of experience in urban projects, but these evaluations tend to focus on older interventions, and not on urban finance projects but rather reflect the focus on sectors that the assistance has had, and do not have quantitative bases (Kharas and Linn, 2013: 401 - SOM). The coverage of catalytic forms of aid such as Local Development Funds (LDFs), very rarely touches on the particular challenges of urban local governments, and falls into the 'local development' literature more generally.

6.2 OFFICIAL DEVELOPMENT ASSISTANCE (ODA) TO URBAN AREAS

There is a strong international consensus on the need for external support to fill the domestic resource gap for urban investment in metropolitan areas in developing countries, as evidenced by major international consultations: the 2001 Zedillo Report on Finance for Development, and more recently the Asian Development Bank estimate that between \$3 billion and \$4 billion per year would be needed to meet slum-upgrading needs, far short of the needs for overall urban infrastructure (Kharas and Linn, 2013: 394-5 - SOM).

It is difficult, however, to measure the volumes of ODA to support urban development – there is ambiguity in what counts as 'urban aid'. Calculations based on a review of project documentation from the OECD indicate that ODA from bilateral and multilateral sources for explicit (1.2%) and implicit (6%) urban projects account in total for 7% of ODA, a small volume in view of the dramatic urbanisation trends discussed in the introduction. Furthermore, the share of ODA focused on urban development appears not to have changed much in recent years, and multilateral agencies are more oriented towards urban development than bilateral agencies (the top eight urban donors are multilaterals apart from Japan) (Kharas and Linn, 2013: 397-8 - SOM). Some go further, arguing that a combination of a programme resistance to decentralisation and an 'institutional bias' towards central delivery of ODA may militate against effective support to decentralisation (Boex, 2009: 15 - SOM). Only one recent review of multilateral support focuses directly on assistance for decentralisation, finding that World Bank support from 1990 to 2007 tended to focus on national-level policy reforms and not urban areas in particular (World Bank, 2008 - SOH).

Sub-Saharan Africa receives systematically less aid to the urban sector than other regions, although new donors, and particularly China, have been increasingly involved in infrastructure development in SSA. Between 2001 and 2010 the number of SSA countries receiving Chinese aid rose from five to 40, with Chinese companies leading construction and operations projects. Chinese aid has helped build and repair urban roads in Nairobi and N'Djamena, bridges in Bamako and Niamey, and some stadiums and other major facilities. Nonetheless, investment in urban areas remains small and is concentrated on transport infrastructure. Financing frequently relies on a barter mechanism known as ANGOLA MODE, which uses loans backed by supplies of natural resources – in this case funds do not pass through the government (Paulais, 2012 - PCH).

Other new bilateral donors such as Brazil, the Gulf States and India are also investing in infrastructure in Africa. India uses its public enterprises and the Export-Import Bank of India and focuses primarily on the electricity sector followed by transport, particularly railways. The Gulf States finance infrastructure through specialised funds and development agencies with a focus on transport and electricity.[15] Brazil invests in urban areas and housing in Mozambique and Togo (Paulais, 2012 - PCH).

ODA tends not to address cross-cutting capacity, public finance or sustainability issues in ways that are suited to urban areas. Aid in urban areas has often been confined to single sectors, such as roads or sanitation, without addressing broader, cross-cutting issues of management or intergovernmental institutions that might strengthen the sustainability of existing interventions (Boex, 2009 - SOM). There is a limited focus on either supporting more rational and reliable intergovernmental transfers or strengthening borrowing capacity, thus threatening both sustainability and the emergence of fiscal autonomy. A particular problem related to vertical and horizontal fragmentation of governance in metropolitan areas is that ODA may not correspond to their special financing needs and capacities – which are often not formal levels of government compared to other urban areas.

6.3 PRIVATE EXTERNAL RESOURCES

Donations from private external sources, such as foundations, have increased sharply since the 1990s, but urban and housing sectors are a marginal part of such activities and local governments rarely benefit from direct grants (Paulais, 2012 - PCH). Foundations typically fund NGOs and work in partnership with multilateral and international agencies such as the Cities Alliance to undertake urban-based sectoral work: for example, urban Water and Sanitation (WASH) projects or slum upgrading. They often assume the role of investor and may take risks to open the way for private sector.

Foundations have pioneered innovative initiatives such as public–private partnerships (PPPs), which raise funds in capital markets by issuing bonds, such as the Gates Foundation through the Global Alliance for Vaccinations and Immunisation, commonly known as the Vaccine Alliance (GAVI) and its entity the International Finance Facility for Immunisation (IFFIm). This model could be useful for local government and urban development initiatives (Paulais and Pigey, 2009 - SOM).

6.4 INNOVATIONS

The limited discussion of municipal assistance and the evidence of weak engagement by international donors suggest that ODA should include a more systematic focus on the financing and institutional capacity needs of urban governments. Rather than piecemeal sectoral support, international assistance should be aiming at cross-cutting capacity, finance and sustainability issues. This does not mean that support to national budget processes and intergovernmental frameworks are not also important and effective ways to financially empower cities as well as urban-focused investments. Equally, central government may

[15] Organization of the Petroleum Exporting Countries (OPEC), the Abu Dhabi Fund for Development, the Arab Bank for Economic Development in Africa, and the Kuwait Fund for Arab Economic Development.

assist in directing ODA to municipal ends: for example, it is increasingly common in Africa that the central government takes a sovereign loan from a donor and reassigns the funds to a local government in the form of a subvention. In such cases, the majority of funds are aimed at a specific investment or investment programme. A final area where expanding channels of external assistance – financial or technical – are available is in urban-based mitigation and adaptation to climate change (Huhtala, 2010 - SOM).

6.4.1 SUPPORTING CROSS-CUTTING URBAN CAPACITIES

Where assistance does focus on building local government capacity, as in increasingly popular Local Development Funds (LDFs) promoted by UNCDF and others, it tends to remain focused on small or rural units of government, thus bypassing many urban situations (Shotton and Winter, 2006 - PCH). An exception to this is found in municipal development funds (national-level agencies that provide funding and technical support to urban governments to meet their investment needs). In particular, municipal development funds have been successfully deployed in the Indian state of Tamil Nadu, in Senegal, and elsewhere in South Asia and SSA (Annez, Gwenaelle and Peterson, 2008 - SOH).

Another area of recent interest in promoting local governance performance is results-based aid. As with the increasing debate on the suitability of this approach in sectoral projects, the use of results-based aid in decentralisation reforms – while less common – is also inconclusive thus far. One review of two initiatives, in Ghana and Tanzania, finds cautious support for the approach, but also notes important caveats, including that it should be part of a much broader portfolio of decentralisation support using other modes, that it tends to be donor-driven and have high monitoring and administrative burdens, and requires the right kind of country ownership and care to strengthen country systems (Janus, 2014 - PCM).

6.4.2 ACTING AS A CATALYST FOR INVESTMENT

Finally, in keeping with the catalytic approach to urban assistance, assistance may be important to 'crowd in' PPPs where these would be rare or hard to arrange. PPPs are important in overcoming challenges to raising finance, and potentially improving effectiveness, although their form remains contested:

> *An enhanced role for the private sector has been most evident in areas such as transportation, water supply, and solid waste management. A principal advantage of public-private partnerships is that they relieve municipalities of the financial responsibility for up-front capital costs and allow them to build facilities without incurring municipal debt. The operation of facilities and programs by private operators reduces municipal operating expenditures and may enable additional revenue to be collected. Moreover, such operations permit the public sector to draw on private sector expertise.* (Slack, 2009: 17 - SOH)

Important innovations therefore may centre on overcoming hurdles to effective PPPs, particularly in smaller or medium-sized municipalities. One example is the Municipal Infrastructure Investment Unit (MIIU), another important decentralisation initiative in South

Africa. Beyond PPPs, as discussed in Section 5, ODA can play a key role in assisting municipalities to move towards greater creditworthiness, and initiatives such as the World Bank's City Creditworthiness Initiative are trying to build partnerships to build on this approach (City Creditworthiness Initiative, 2014 - N/A).

Box 13: Municipal Infrastructure Investment Unit (MIIU)

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

The MIIU manages a grant fund capitalised by the South African national government and a small contribution from the US Agency for International Development. Local government budgets typically cannot cover the necessary but often costly investigations on the viability of PPP projects. Without such investigations local officials cannot structure bankable projects or negotiate effectively with potential private partners. MIIU's fund provides resources for local governments to carry out feasibility studies, develop project specifications and contract negotiations. The projects are selected from a nationwide list of projects proposed, on a demand-driven basis, by any of South Africa's towns and cities.

Source: The Municipal Infrastructure Investment Unit: Dirie (2006: 265 - SOH)

7.0 CONCLUSION

7.1 NATURE AND STRENGTH OF EVIDENCE

Table 11: Studies reviewed

	Primary Type			Secondary Type		Total
Quality	Primary Experimental	Primary Comparative	Primary Single Case	Secondary Systematic	Secondary Other	
High	1	6	3		17	27
Moderate	2	10	20		30	62
Low*		1	5		3	9
Total	**3**	**17**	**28**	**0**	**50**	**98****

** Several low quality studies were reviewed due to ambiguous rating, but none cited in the analysis in this assessment.*

***Two of 100 sources reviewed were rated N/A since they were methodological guidance.*

One hundred studies were reviewed in the course of preparing this REA. In addition, 45 studies that had been identified during initial retrieval were subsequently excluded, generally due to having been published more than ten years previously, having no focus on developing country issues, or clearly being of poor quality. It should be noted that a small number of studies, fewer than five, were included in the review despite having been published before 2005 because of their clear relevance or high quality.

As the summary in Table 11 shows, secondary studies predominated. In addition, none of these were systematic or meta-reviews of evidence, which demonstrates the usefulness of this type of exercise. While there is a well-established academic literature on cities in industrialised countries, the literature on municipal finance in developing countries is limited by relative lack of comparative quantitative data. Most work is of two types: case-study-based 'grey literature' reporting on the experience of individual cities and programmes, or conceptually based synthetic studies and handbooks compiled by expert authors.

The latter format forms the strongest set of sources found for this assessment, with about half of all sources being secondary studies of moderate or high quality. This body of work – manuals and textbooks on municipal finance – is a major resource for the issues addressed in this REA. These resources are generally consistent in their key messages, and frequently draw upon a number of similar examples. They are also somewhat focused on a small group of expert authors, or departments at major donor agencies.

The case-study literature on reforms is limited by the difficulties of isolating their impact. One such weakness is that gains that have followed reforms are often compared in nominal terms (e.g. doubling in cash value) or are not compared to a base year (e.g. revenues from X increased to 90% of total revenues). This makes it difficult to judge the relative impacts of reforms, even if the underlying study was relatively rigorous and the reforms successful. There are also instances where the achievement of institutional change alone is used as a marker of success, even if the impact on revenues, economic activity or behaviour is largely unchanged or unverified. In general, primary studies were moderate in quality, and where high-quality primary work is found, it begins to resemble secondary studies by, for example, integrating evidence from across a range of cities into a thematic discussion. There seems to be, given the nature of the topic, considerable untapped potential for more systematic or even experimental designs in the study of reforms in low-income urban finance.

Although it is difficult to find global statistics on local government revenues and expenditures, some information from the IMF *Government Finance Statistics* gives an indication of the wide variation around the world (Slack, 2009: 2 - SOH). The most important sources of comparative fiscal information from the IMF and OECD do not, however, systematically report data for individual local governments, and where available, these are often not aggregated to a standard for metropolitan areas, which often span more than one jurisdiction. As one of the key cross-cutting studies notes:

> *… assessments are based on collections of case studies because there is a lack of comprehensive and representative data. It is, therefore, not possible to compare the practice in all metropolitan areas in developing countries, or even in a majority of them.* (Bahl and Linn, 2014: 3 - SOH)

While there are important attempts to widen the availability of accurate and comparable sub-national finance data (Local Public Sector Initiative, 2012 - SOM), these remain at relatively early stages of development. These constraints shape the type of studies that are prevalent in the field, reducing the availability of quantitative and comparative academic work that responds to the quality criteria set out for this type of evidence assessment.

7.2 CROSS-CUTTING FINDINGS

7.2.1 STRENGTHEN FUNDAMENTALS, BUT IN CONTEXTUALISED WAYS

The evidence points consistently towards the importance of strengthening fundamentals – improving the intergovernmental environment, encouraging coherent decentralisation, improving the administration of core revenue sources such as property taxes. There are also various innovative financing and management practices, but in many cases these are consistent with this overall emphasis since they support strengthened systems. The best way to do this may not align with simple theoretical prescriptions, particularly arising from earlier conceptions of fiscal federalism.

7.2.2 ABSENCE OF CLEAR REFORM TRAJECTORIES OR SEQUENCE

Both the relative lack of comparative data and studies, and the wide variation between practice and the theoretical underpinnings of the principles of local government finance suggest the need for caution in drawing conclusions across countries and cities in developing countries. Given the dependence on broader international, national and intergovernmental context that runs through the evidence on city-level efforts, there is little prospect of a single best sequence or reform trajectory. Rather, policy choices should be seen as set of trade-offs that imply important costs and benefits.

7.2.3 IMPORTANCE OF THE INTERGOVERNMENTAL CONTEXT FOR ALL EFFORTS

The intergovernmental context has a profound impact on the possibilities for all other means of raising finance, from the framework for local taxes, to the transfer system and the environment for local borrowing. This context includes governance and fiscal conditions, but also history, institutions and political economy. Among the most important factors, particularly in the relatively more centralised context of developing countries, is the progress and framework for decentralisation. Developing countries tend to be more centralised, their cities more fragmented and less able to self-finance and more reliant on grants, borrow less, and need more aid.

Three particular principles for the intergovernmental context appear particularly relevant for urban areas. The first is to emphasise metropolitan areas as a whole, not just individual sub-national jurisdictions. The second is to encourage autonomy through particular discretion over budgets, services, and financing. And third, in a related way, to consider the need for asymmetric arrangements for large and even medium-sized cities.

Box 14: Typical weaknesses in the decentralisation framework

- Weak local government revenue base relative to central government and the tasks assigned to local government.
- Lack of own revenue sources – the composition of revenues is inappropriate, especially the balance between grants and own revenue sources and the way these interact.
- Autonomy for revenues – strong central control is imposed on local government revenues; the control is irregular and not transparent; and there is a general lack of flexibility to adjust local revenues to meet expenditure needs.
- Central government transfers are not stable or transparent, criteria for their distribution are not objectively defined, and there is a lack of a legislative basis to guide and ensure their equitable distribution.
- Less than full use of the existing local revenue potential and lack of incentives to generate own revenues.

Source: Dirie (*2006*: *261 - SOH*)

7.2.4 IMPROVING ACCESS TO FINANCE IS A POLITICAL ECONOMY QUESTION

Political economy concerns are important constraints on efforts to improve access to finance for urban localities. At the local level vested interests and corruption may restrict the potential to introduce institutional change. The same factors may contribute to central government reluctance to decentralise coherently. National governments may also not wish to empower potential sites of political opposition. The greater the degree of vertical and horizontal fragmentation of governance structures – and in very few metropolitan areas are these reasonably aligned with territorial and economic geographies – the more likely competition and lack of coordination will hamper reform.

7.2.5 IMPROVE REVENUES FROM PROPERTY AND INNOVATE IN LAND-VALUE CAPTURE

Revenue from land will always be of central importance to urban finance, and there are substantial possibilities in both the administration of property taxes, and more innovative ways to capture land value or leverage municipal assets.

7.2.6 ENABLE LOCAL BORROWING, POOL FINANCE CAPACITY, AND ENGAGE INNOVATIVE PARTNERSHIPS

To strengthen borrowing, the main conceptual recommendation – backed by the experience of some innovative debt issuances – is for local governments to generate reliable income streams from taxes and user fees, and to improve their financial management, and be able to demonstrate this through publically available audited accounts. Beyond this, the necessary reforms will depend on the national economic and regulatory context, and may be better carried out by national government. This could involve improving the regulatory framework for local credit, developing institutions that can reduce the cost of credit to cities, or in the absence of borrowing, help to crowd in private finance.

ANNEX 1: KEY LITERATURE

Table 12: Study Type and Quality Ratings

Primary	Secondary
PE: Primary Experimental or Quasi-Experimental PC: Primary Comparative PS: Primary Single Case 0-2 Low 3-4 Medium 5-6 High	SS: Secondary Systematic SO: Secondary Other 0-1 Low 2 Medium 3 High

CROSS-CUTTING

Bahl, Roy W., Johannes F. Linn and Deborah L. Wetzel. 2013. 'Financing Metropolitan Areas in the Developing World.' In *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy. pp. 1-30. **[Secondary Other - High]**

The edited volume Financing Metropolitan Governments in Developing Countries *covers the full range of municipal financing mechanisms. In the opening chapter the authors review the key findings and innovations from the book.*

Farvacque-Vitkovic, Catherine D. and Mihaly Kopanyi, eds. 2014. *Municipal Finances: A Handbook for Local Governments*. Washington, DC: World Bank. http://elibrary.worldbank.org/doi/book/10.1596/978-0-8213-9830-2. **[Secondary Other - High]**

A systematic treatment of key concepts and experiences in municipal finance with contributions from noted experts in various subfields.

Slack, N. E. 2009. *Guide to Municipal Finance*. Nairobi: UN-Habitat. **[Secondary Other - High]**

An older UN-Habitat study focusing on innovative financing instruments and providing a good introduction to innovations across developed and developing countries.

World Bank. 2013. *Planning, Connecting and Financing Cities - Now: Priorities for City Leaders*. Washington, DC: World Bank. **[Secondary Other - High]**

Findings from recent urbanisation reviews in 12 countries and drawing on the wider literature to distill lessons for urban financing.

Dirie, Ilias. 2006. *Municipal Finance: Innovative Resourcing for Municipal Infrastructure and Service Provision*. London: Commonwealth Local Government Forum. **[Secondary Other - High]**

Contains a summary of key elements of a sound financing system for municipalities starting from national level. Also covers a range of innovative financing instruments for infrastructure.

INTERGOVERNMENTAL SYSTEM AND TRANSFERS

Tidemand, Per and Jesper Steffensen. 2010. 'Source Material on Decentralization and Service Delivery for the Poor.' Copenhagen: DANIDA. **[Secondary Other - High]**

Accessible resource guide summarising conceptual literature on decentralisation and basic features of sound intergovernmental systems

Steffensen, Jesper. 2010. *Fiscal Decentralization and Sector Funding Principles and Practices*. Copenhagen: DANIDA. **[Secondary Other - High]**

Steffensen, Jesper and Henrik Larsen. 2005. 'Conceptual Basis for Performance Based Grant Systems and Selected International Experiences.' In *Background Paper, National Stakeholder Workshop, May*. Vol. 31. **[Secondary Other - High]**

Two resource guides summarising conceptual literature and country experience in transfer design, with the second focusing on the introduction of performance-based grant components.

Boex, Jameson and Jorge Martinez-Vazquez. 2007. 'Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices, and Lessons.' In *Fiscal Equalization*. New York: Springer, pp. 291-343.http://link.springer.com/chapter/10.1007/978-0-387-48988-9_12. **[Secondary Other - Moderate]**

Introduces practical implementation issues in transfer design in low income or limited information environments.

OWN-SOURCE REVENUE

Freire, Mila E. and Hernando Garzón (2014) 'Managing local revenues' in Farvacque-Vitkovic, Catherine D., and Mihaly Kopanyi, eds. 2014. *Municipal Finances: A Handbook for Local Governments*. Washington, DC: World Bank. **[Secondary Other - High]**.

This chapter reviews the main own-source revenues including tax and non-tax sources, backed up by numerous country examples.

Fjeldstad, Odd-Helge. 2006. *Local Revenue Mobilization in Urban Settings in Africa*. 15. CMI Working Paper. Bergen: Chr. Michelsen Institute. **[Secondary Other - Moderate]**

Reviews challenges facing own-source revenue mobilisation in Africa, considering property taxes, business licences and user fees. The paper considers both economic issues and political constraints, and concludes that own-source revenues will not be enough for most urban local governments to provide the services expected from a growing urban population.

Bird, Richard and Enid Slack. 2006. 'Taxing Land and Property in Emerging Markets: Raising Revenue... and More?' ITP Paper 065. ITP Paper. Toronto: University of Toronto. **[Secondary Other - Moderate]**

In-depth review of the role of property taxes in developing countries. Describes the gap between theory and practice in the application of property taxes, suggest common areas of improvement, and concludes that reforms are possible, but the real potential for change is modest.

Smoke, Paul. 2013. 'Why Theory and Practice Are Different: The Gap Between Principles and Reality in Subnational Revenue Systems.' International Center for Public Policy - Working Paper 13-13. Atlanta, GA: International Center for Public Policy. **[Secondary Other - High]**

Explains the main principles of fiscal federalism that govern recommendations concerning revenue assignments between central and local government, and offers reasons why these have not always achieved the expected results or are followed in reality.

Smolka, Martim O. 2013. *Implementing Land Value Capture in Latin America*. Policy Focus. Cambridge, MA: Lincoln Institute of Land Policy. **[Secondary Other - High]**

Review of experience in the longest standing cases of land-value capture, or valorisation, policies.

KEY SOURCES ON OWN DEBT AND BORROWING

Freire, Mila Emilia. 2014. 'Managing External Resources.' In *Municipal Finances: A Handbook for Local Governments*. Washington, DC: World Bank, pp. 325-78. **[Secondary Other - High]**

Provides a comprehensive guide for local governments on managing borrowing.

Kehew, Robert, Tomoko Matsukawa and John Petersen. 2005. 'Local Financing For Sub-Sovereign Infrastructure In Developing Countries.' Discussion Paper. PLACE: PUBLISHER **[Primary Comparative - Moderate]**

A comparative study of seven ways to reduce the cost of credit for local governments.

Liu, L. and M. Waibel. 2010. *Managing Subnational Credit and Default Risks*. World Bank Policy Research Working Paper Series. Washington, DC: World Bank. **[Secondary Other - High]**

Sets out how national regulations should be structured to manage risks from sub-national borrowing.

DEVELOPMENT ASSISTANCE

Kharas, Homi and Johannes F. Linn. 2013. 'External Assistance for Urban Finance Development: Needs, Strategies, and Implementation.' In Roy W. Bahl, Johannes F. Linn and Deborah L. Wetzel (eds.) *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy. **[Secondary Other - Moderate]**

Reviews trends in ODA to municipalities and urban projects

Boex, Jameson. 2009. 'Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy.' IDG Working Paper 2009-06. Washington, DC: Center on International Development and Governance, The Urban Institute. **[Secondary Other - Moderate]**

Sets out an argument for increasing development assistance focus on decentralisation reforms and decentralised local governments.

ANNEX 2: SEARCH STRING COMBINATIONS USED

Small databases/Communities of Practice (Princeton, World Bank Institute, etc.)

Urban financing

Urban revenues

Municipal financing

Municipal revenues

City financing

City revenues

Borrowing urban

Borrowing municipal

Municipal bonds

Large databases (Ingentaconnect, Google Scholar, Google Books etc.)

Increasing financing urban

Increasing revenues urban

Increasing financing municipal

Increasing revenues municipal

Increasing revenues municipal low income countries

Public administration reform revenue urban

Innovative financing urban government

Development assistance urban revenues

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Alm, James. 2010. *Municipal Finance of Urban Infrastructure: Knowns and Unknowns*. Wolfensohn Center for Development at Brookings. Washington, DC: The Brookings Institute. http://econ.tulane.edu/RePEc/pdf/tul1103.pdf. **[Secondary Other - Moderate]**

Annez, Patricia Clarke, Huet Gwenaelle and George E. Peterson. 2008. *Lessons for the Urban Century: Decentralized Urban Infrastructure Finance in the World Bank*. Washington, DC: World Bank. http://elibrary.worldbank.org/doi/book/10.1596/978-0-8213-7524-2. **[Secondary Other - High]**

Bahl, Roy and Richard Bird. 2008. 'Subnational Taxes in Developing Countries: The Way Forward', *Public Budgeting & Finance* 28 (4): 1-25. **[Secondary Other - Moderate]**

Bahl, Roy W. and Johannes F. Linn. 2014. *Governing and Financing Cities in the Developing World*. Policy Focus Report. Cambridge, MA: Lincoln Institute of Land Policy. **[Secondary Other - High]**

Bahl, Roy W., Johannes F. Linn, and Deborah L. Wetzel. 2013. 'Financing Metropolitan Areas in the Developing World.' In *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy, pp. 1-30. **[Secondary Other - High]**

Bird, Richard M. 2002. 'Intergovernmental Fiscal Transfers: International Lessons for Developing Countries', *World Development* 30 (6): 899-912. **[Secondary Other - High]**

———. 2005. 'Getting It Right: Financing Urban Development in China.' Prepared for the Eleventh Five-Year Plan of China. Washington, DC: World Bank, April. http://unpan1.un.org/intradoc/groups/public/documents/unpan/unpan019990.pdf. **[Primary Single Case - High]**

———. 2010. 'Subnational Taxation in Developing Countries.' Washington, DC: World Bank. http://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-5450. **[Secondary Other - Moderate]**

Bird, Richard, and Enid Slack. 2006. *Taxing Land and Property in Emerging Markets: Raising Revenue... and More? ITP Paper 065*. 0605. ITP Paper. Toronto: University of Toronto. **[Secondary Other - Moderate]**

Boetti, Lorenzo, Massimiliano Piacenza and Gilberto Turati. 2010. *Decentralization and Local Governments' Performance: How Does Fiscal Autonomy Affect Spending Efficiency?*. Working Paper 11. Turin: University of Turin. **[Primary Single Case - Moderate]**

Boex, Jameson. 2009. 'Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy.' IDG Working Paper 2009-06. Washington, DC: Center on International Development and Governance, The Urban Institute. http://www.urban.org/url.cfm?renderforprint=1&ID=411919. **[Secondary Other - Moderate]**

Boex, Jameson and Jorge Martinez-Vazquez. 2007. 'Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices, and Lessons.' In *Fiscal Equalization*. New York: Springer, pp. 291-343.http://link.springer.com/chapter/10.1007/978-0-387-48988-9_12. **[Secondary Other - Moderate]**

Cao, Guangzhong, Changchun Feng and Ran Tao. 2008. 'Local "land Finance" in China's Urban Expansion: Challenges and Solutions.' *China & World Economy* 16 (2): 19-30. **[Primary Single Case - Moderate]**

Charbit, Claire. 2011. *Governance of Public Policies in Decentralised Contexts: The Multilevel Approach*. OECD Regional Development Working Papers 2011/04. Paris: OECD: http://www.oecd-ilibrary.org/governance/governance-of-public-policies-in-decentralised-contexts_5kg883pkxkhc-en. **[Secondary Other - Moderate]**

Cities Alliance. 2005. *Cities Without Slums: 2005 Cities Alliance Annual Report*. Washington, DC: Cities Alliance. **[Secondary Other - High]**

City Creditworthiness Initiative. 2014. 'City Creditworthiness Initiative: Concept Note.' Washington, DC: World Bank. **[N/A]**

Dagdeviren, Hulya. 2008. 'Waiting for Miracles: The Commercialization of Urban Water Services in Zambia.' *Development and Change* 39 (1): 101-21. **[Primary Single Case - Moderate]**

Dirie, Ilias. 2006. *Municipal Finance: Innovative Resourcing for Municipal Infrastructure and Service Provision*. London: Commonwealth Local Government Forum. **[Secondary Other - High]**

Eaton, Kent, Kai Kaiser and Paul J. Smoke. 2011. *The Political Economy of Decentralization Reforms*. Washington, DC: World Bank. **[Secondary Other - Moderate]**

Farvacque-Vitkovic, Catherine D. and Mihaly Kopanyi, eds. 2014. *Municipal Finances: A Handbook for Local Governments*. Washington, DC: World Bank. http://elibrary.worldbank.org/doi/book/10.1596/978-0-8213-9830-2. **[Secondary Other - High]**

Farvacque-Vitkovic, Catherine, Madhu Raghunath, Christian Eghoff and Charles Boakye. 2008. 'Development of the Cities of Ghana: Challenges, Priorities and Tools.' Working Paper 110. Africa Region Working Paper Series. Washington, DC: World Bank. **[Primary Single Case - Moderate]**

Fjeldstad, Odd-Helge. 2006. 'Local Revenue Mobilization in Urban Settings in Africa.' 15. CMI Working Paper. Bergen: Chr. Michelsen Institute. **[Secondary Other - Moderate]**

Fjeldstad, Odd-Helge, and Kari Heggstad. 2012. 'Local Government Revenue Mobilisation in Anglophone Africa.' Working Paper 7. International Centre for Tax and Development. Brighton: University of Sussex. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408608. **[Primary Comparative - Moderate]**

Fjeldstad, Odd-Helge, Einar Braathen and Amon Chaligha. 2006. *Local Government Reform in Tanzania 2002-2005: Summary of Research Findings on Governance, Finance and Service Delivery*. Brief 6. Dar-es-Salaam: REPOA. **[Secondary Other - Moderate]**

Freire, Mila Emilia. 2014. 'Managing External Resources.' In *Municipal Finances: A Handbook for Local Governments*. Washington, DC: World Bank, pp. 325-78. **[Secondary Other - High]**

Freire, Mila and John Petersen, eds. 2004. *Subnational Capital Markets*. New York: World Bank/Oxford University Press. **[Secondary Other - High]**

Hagen-Zanker, Jessica and Richard Mallet. 2013. *How to Do a Rigorous, Evidence-Focused Literature Review in International Development: A Guidance Note*. ODI Working Paper. London: Overseas Development Institute. **[N/A]**

Huhtala, Ari. 2010. 'Climate Finance in the Urban Context.' Issues Brief 4. Washington, DC: World Bank. **[Secondary Other - Moderate]**

Janus, Heiner. 2014. 'Real Innovation or Second-Best Solution? First Experiences from Results-Based Aid for Fiscal Decentralisation in Ghana and Tanzania.' Discussion Paper. Berlin: Deutsches Institut für Entwicklungspolitik. **[Primary Comparative - Moderate]**

Joshi, Anuradha, Wilson Prichard and Christopher Heady. 2012. 'Taxing the Informal Economy: Challenges, Possibilities and Remaining Questions.' http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408587. **[Secondary Other - Moderate]**

Kehew, Robert, Tomoko Matsukawa and John Petersen. 2005. 'Local Financing For Sub-Sovereign Infrastructure In Developing Countries.' Discussion Paper. http://globalclearinghouse.org/InfraDev/assets%5C10/documents/WB%20(Matsukawa,%20Peterson)%20-%20Local%20Financing%20for%20Sub-Sovereign%20Infrastructure%20(2005).pdf. **[Primary Comparative - Moderate]**

Kharas, Homi and Johannes F. Linn. 2013. 'External Assistance for Urban Finance Development: Needs, Strategies, and Implementation.' In Roy W. Bahl, Johannes F. Linn and Deborah L. Wetzel (eds.) *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy. **[Secondary Other - Moderate]**

Kitchen, Harry. 2013. 'Property Tax: A Situation Analysis and Overview.' *A Primer on Property Tax Administration and Policy*. http://media.johnwiley.com.au/product_data/excerpt/93/14051264/1405126493-74.pdf. **[Secondary Other - High]**

Kleven, Henrik Jacobsen. 2014. 'How Can Scandinavians Tax so Much?' *The Journal of Economic Perspectives* 77-98. **[Secondary Other - Moderate]**

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ISSN: 2052-7209

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