PART I

ECONOMIC AND URBAN DEVELOPMENT CONTEXT

CHAPTER 1

CHALLENGES OF SUSTAINABLE SHELTER DEVELOPMENT IN MACROECONOMIC CONTEXT[1]

During recent years, there has been a growing recognition of the importance of urbanization in the economic and social futures of nations by the international community, member states of the United Nations and a wide range of civil society organizations. This recognition is based on country experiences, development policies, studies and projects since the first United Nations Conference on Human Settlements held in Vancouver, Canada, during 1976.

Urbanization – and its many dimensions – has been important in all countries. The first and most evident dimension is demographic, as most developing countries have urbanized considerably since the 1950s and are projected to continue this process through the middle of the 21st century (see Figure 1.1). This increasing share of total population living in cities is similar to the historic patterns of Europe and North America, with increasing urbanization accompanying rising levels of gross domestic product (GDP). The key differences lie in the faster pace of urban growth in developing countries during this period and the absolute levels of urban population as represented both in the concentration of people living in mega-cities (urban agglomerations of over 10 million residents) and the increasing numbers of medium-sized cities of up to 3 million.

These facts of contemporary life in the 21st century have themselves transformed the world, with higher levels of individual and household incomes resulting from unparalleled levels of economic productivity benefiting from economies of agglomeration and scale. The concentration of economic activity and power in cities has, in turn, attracted footloose capital from the global economy, transforming the world itself in what is now understood as a process of 'globalization'.

These processes, however, have also created many problems and contributed to growing patterns of difference within countries and people. Urbanization, for example, has been accompanied by continued out-migration from rural areas in many countries. The mechanization of agriculture and the globalization of agricultural production have reduced both the local control of the rural sector and the demand for rural labour. When placed into a national and international context, what might be called 'a geography of difference' can be easily seen.

Together, these processes set the stage for the fundamental issue that this Global Report addresses: how can housing and infrastructure services be financed for growing numbers of urban residents during the 21st century? The first part of this chapter presents the building blocks of a conceptual framework for answering this question, while the second part presents, as a background, the macroeconomic context of financing urban shelter development.

The fundamental issue is: how can housing and infrastructure services be financed for growing numbers of urban residents during the 21st century?

UNDERSTANDING URBAN SHELTER DEVELOPMENT CHALLENGES

As mentioned in the preceding section, this first part of the chapter presents the building blocks of a conceptual framework for understanding the global challenge of financing the development of urban shelter, as well as related infrastructure and services. Individually, these building blocks are not controversial. They reflect the current knowledge and the collective thinking of observers and participants in the world's urbanization experience. However, when linked together, they demonstrate that the world is facing an urgent and dramatic problem, with significant consequences for individual cities, countries, regions and the world itself.

Demographic framework

The starting point of this analysis is the process of demographic transformation. United Nations projections and recent assessments of expected demographic growth in developing countries (see Statistical Annex, Tables B.1 and B.2) indicate that the *developing countries will add approximately 2 billion new urban residents during the next*

	China	India
Urbanization level in 2000, estimate (%)	35.8	27.7
Urbanization level in 2030, projection (%)	60.5	41.4
Urban population in 2000, estimate (000)	456,247	281,255
Urban population in 2030, projection (000)	877,623	586,052
Increase in urban population, 2000–2030 (000)	421,376	304,797
Increase in number of total households, 2000–2030 (000)	284,040	129,358
Average quinquennial increment, 2000–2030 (000)	47,840	21,560
Average annual increment, 2000–2030 (000)	9.568	4,311

Source: UN Population Division, 2004. UN-Habitat, 2003a.

Table 1.1

Demographic highlights (China and India)

25 years.[2] This robust finding, added to the existing numbers of 1 billion people currently living in slums, frames the 'demand side' for the need for housing and infrastructure services in developing countries.

Looking more closely, approximately 90 per cent of this demand will occur in 48 countries, with most of the growth occurring in East and South Asia. The concentration of this demand reflects both the overall population sizes of China and India, but also other large Asian countries such as Bangladesh and Pakistan in South Asia, and Indonesia, the Philippines and Viet Nam in East Asia. During 1950, these countries were largely rural; today they continue to experience rapid urban growth, with many of their urban concentrations reaching over the 1 million population level. Much of this growth has been fuelled by economic growth itself, with higher urban incomes attracting rural migrants. The enormous growth of urban populations of China and India are shown in Table 1.1, demonstrating that these countries have both experienced large-scale shifts in their populations towards urban centres while continuing to grow at aggregate levels.

Developing countries will add approximately 2 billion new urban residents during the next 25 years

It is predicted that the scenario of a decreasing rural population and increasing urban population, with the only possible exception of the African continent, will be exacerbated by expected universal reductions in fertility levels. Indeed, the prediction is that by 2020, the rural population growth rate will turn negative for the first time.[3]

Africa will also continue to experience rapid urban demographic growth, reflecting continued rural-to-urban migration, with push factors from the lack of productivity of agriculture and the inability to feed and provide incomes for rural populations. The slow growth of rural productivity in African countries has many causes: environmental pressures in the Sahel and East Africa, with severe water shortages, loss of topsoil and lack of rural infrastructure; overpopulation in some parts of the Great Lakes Region of Central Africa; or armed conflicts destabilizing cultivation patterns. These internal problems have been exacerbated by the global trading system, with subsidies by developed countries – for example for cotton – which displace cotton produced in Burkina Faso or Mali from world markets.

Even though Africa's cities have not generated the jobs needed to sustain growing urban populations, they have, nonetheless, attracted large numbers of people fleeing rural poverty. While studies during the 1970s showed that these migrants were largely attracted by the prospects of higher wages from urban employment,[4] this motivation has been strengthened by the lack of food security in rural areas, as well as by the need for physical security from armed conflict and environmental risks. This 'urbanization of rural poverty' is reflected in the increasingly large urban slums in most African countries.

In contrast, the Latin American countries experienced urbanization at an earlier period in which economic growth generated the financial resources needed for the construction of housing and urban infrastructure. Cities such as Buenos Aires, São Paulo or Mexico City demonstrated spectacular growth during the mid 20th century. Even during these periods of economic boom, however, this growth did not keep up with the growing demand for housing and urban infrastructure, such as water supply, sanitation and electricity. Public-sector institutions were unable to provide these services at a rate faster than the proliferation of *favelas* in Rio de Janeiro, *barriadas* in Lima or *tugurios* in Quito.

Nevertheless, Latin American cities have become the loci of economic productivity and employment growth. At the same time, they are also the loci of growing urban poverty and inequality between the rich and poor. How to bridge this gap will be discussed in later chapters of this Global Report.

In contrast to the developing countries, transition economies and developed countries face different challenges in the financing of urban development. Previous public patterns of provision of housing and infrastructure in the transition countries have been disrupted by the political and economic changes following the collapse of the Soviet Union. These systems had provided a very minimum quality of housing and infrastructure in most countries, with long waiting periods for new households. Whether these cities will become productive engines for the growth of their new reformed economies remains to be seen.

Cities in developed countries have occupied an increasingly important place in their respective national economies. As economies shift towards financial services and the knowledge economy, these activities tend to be located in large cities. How well the cities perform with these functions depends upon the reliability of their infrastructure and the quality of urban life as factors in attracting new investment.

Each of these regions and individual countries have always had their own set of characteristics that determine their patterns of urban growth and specific development challenges to be faced by their governments and societies at large.[5]

Translating demographic growth into the demand for housing and infrastructure

Recent data and analyses indicate that the current global backlog of slum dwellers is about 925 million people.[6] As shown in Table 1.2, when this figure is combined with the projected 1.9 billion additional urban population, approximately *2.825 billion people will require housing and urban services by 2030*. This projection is the starting point for this Global Report.

In considering this number, precision is not really very important. What is critical, however, is the *order of* *magnitude*. Close to 3 billion people, or about *40 per cent of the world's population by 2030*, will need to have housing and basic infrastructure services. Table 1.3 demonstrates that in order to accommodate the increments in the number of households over the next 25 years, 35.1 million housing units per year will be required. This estimate, in turn, translates into completing 96,150 housing units per day or 4000 per hour. These figures do not include replacements of deteriorated and substandard housing stocks.

Socio-behavioural framework

The challenges raised are not, however, exclusively about the quantity of population, but also about its composition. A recent publication argued that the *processes of social differentiation in cities are also accelerating*[7] because they are interacting with the scale and rate of demographic change. There are not only more people in cities, but they eat, work, play, educate, dress and express themselves differently. The richness and, indeed, the tolerance of the culture and diversity of urban behaviour is a major factor in explaining why there is not more violence and conflict than exists in cities. One could easily make the argument that Mumbai and Bangkok are surprisingly peaceful, given their scale and complexity. These processes of urban social and cultural differentiation require much more documentation and research because they are an important factor in what would actually be 'sustained' in sustainable cities.

Processes of differentiation also have financial implications as diverse populations express their special needs, with more elderly populations requiring special services at the same time that there are school-age children require more schools and teachers. A wider diversity and range of social needs implies a wider and more diverse set of services, whether provided by government or non-governmental organizations (NGOs). Growing ethnically diverse cities can also create the need for ethnically sensitive policies and programmes, as well as the necessity to maintain peaceful relations between communities. For example, one can imagine that ethnically homogeneous neighbourhoods and communities may exclude other people not sharing their particular identity. These conflicts can have direct impacts upon the quality of life in neighbourhoods and on access to infrastructure services.[8]

Economic framework

The capacity of developing countries to *finance* their needs depends largely upon their level of future economic growth and development. If countries are productive and able to generate employment and incomes for growing populations at an accelerated rate, they will be able to generate and mobilize the savings and investment to finance basic needs, such as housing and infrastructure services. Then, with realistic policies supported by effective institutions, they can have a chance at meeting growing needs. If, however, they remain at current growth rates or, as in some cases, are unable to grow economically, there will be little likelihood that these resources will be available. In this sense, *macro-economic growth* is a necessary but not sufficient condition for addressing this problem.

Table 1.2

People requiring housing and urban services by 2030

Urban population (2003)	3,043,934,680
Estimated urban population (2030)	4,944,679,063
Additional urban population 2003–2030	1,900,744,383
Population living in slums (2001)	923,986,000
People requiring housing and urban services by 2030	2,824,730,383

Source: Statistical Annex of this report

This Global Report will examine that relationship and identify each of the possible sources of finance for urban development in order to determine which policies and programmes are likely to assist in this process. The following sections present the differences between the macro-economic conditions of countries, as well as the various sources of macroeconomic growth needed to provide the foundation for urban development, while also demonstrating that this is a two-way process: cities and towns are also important contributors to macroeconomic performance.

Urban development requires the support of urban-based economic activities, including manufacturing, services and construction, among others. It must also alleviate existing constraints to those economic activities, such as reducing infrastructure deficiencies by improving the reliability of water supply, electricity and telecommunications, as well as by addressing the negative health and environmental impacts of human and solid waste, as well as pollution from transportation.

The capacity of developing countries to finance their needs depends largely upon their level of future economic growth and development

Public authorities will also need to strengthen the institutional framework within which private economic activity occurs – for example, the regulatory framework determining how many steps are required to obtain a building permit or a licence to open a small business. Studies during the 1990s showed that some countries required extraordinary numbers of steps to obtain construction permits, such as 55 in Malaysia and 27 in South Africa.[9] These excessive regulatory steps sharply increased the cost of housing through the delays involved, even reaching 3 per cent of GDP in Malaysia, as well as the transaction costs for individual builders and construction enterprises. Local government institutions have a large role to play in reducing the costs of economic activity in cities. Similarly, local financial institutions that provide credit for construction or loans for small enterprises also play a pivotal role in stimulating the local urban economy.[10]

The economic paradox of this situation is that while cities are the loci of productivity, they are also the loci of increasing poverty. This poverty has many causes. Some of it is a result of the overall level of national income of countries: Burkina Faso is poorer than Brazil, which means that, on average, people in Burkina Faso consume less in absolute

Table 1.3

Housing requirements to accommodate increments in the number of households over the next 25 years

Increments in the number of households over a 25-year period	877,364,000
Average size of annual increments	35,094,000
Per day	96,150
Per hour	4,000

Source: Statistical Annex of this report amounts of goods and services than do their Brazilian counterparts, and also that there is a narrower range of goods and services than are available in Brazil. It can also mean that the social indicators of health and welfare are lower in terms of longevity, health status, literacy and infant mortality, as well as gender equality.

In urban areas, however, much of this poverty is a result of the lack of housing and infrastructure services that are necessary for people's and enterprises' basic needs, consumption and production. It is clear that the lack of these services has an impact upon the productivity of urban economic activities and, therefore, on the city and the nation as a whole. A study of infrastructure services in Lagos, Bangkok and Jakarta during the 1990s demonstrated that enterprises which had to provide their own water supply, electricity and other infrastructure services had lower profits and were therefore constrained in their growth. Infrastructure deficiencies had a direct impact upon how many jobs were being created. These companies in Lagos actually spent up to 35 per cent of their fixed investment in providing their own infrastructure; as a result, they had lower profits and were thus unable to grow.[11]

Varying types of deprivation, such as health, malnutrition and a lack of clean water supply, also have both short- and long-term impacts upon the health status and, thus, the productivity of men, women, and children.[12] Poverty, therefore, becomes intergenerational, as is observed in many large city slums in developing countries, such as the Dharavi slum in Mumbai, which now houses almost 2 million people, or the slum in Mathare Valley, Nairobi.[13]

Cities will have to increase their productivity in order to generate jobs, incomes and financial resources as well as to provide urban services

The key issue, however, is that increased urban population growth – increasing the denominator in the per capita calculation of gross domestic product – will necessarily mean that urban areas will become poorer if they are unable to augment jobs and incomes faster than their populations grow. Because rapid and large-scale urban population growth is expected between 2005 and 2030, cities will have to dramatically increase their productivity in order to, first, generate jobs and incomes and, second, generate the financial resources for housing and urban services. In this sense, the issue of urban employment generation cannot be easily separated from the options for financing future urban development in developing countries.

Employment and income generation will also have a major impact upon what kinds of housing and infrastructure will be affordable to growing urban populations. These issues are both quantitative and qualitative: quantitative because absolute levels of income will be needed to finance specific types of housing and infrastructure, and qualitative because the stability and growth of income over time will permit certain financing options – for example, mortgages – while lower levels of income will not qualify for financing.

The economic condition of cities – how fast job opportunities and incomes increase – is further complicated by the growing impact of *exogenous economic factors* upon cities. Processes of economic globalization and trade have changed patterns of production in cities, leading to deindustrialization in many cities. This means that footloose industries close in cities with higher relative costs and move to new locations with lower costs – for example, from the US to Mexico or, later, from Mexico to China. The pursuit of profit-maximizing locations by private enterprises has led to major economic and social disruption in many countries over the last two decades.

Today, this disruptive behaviour by firms is compounded by new factors in the global economy, including global interest rates, whereby change in one large economy affects the price of money in the global economy as a whole. The Asian financial crisis of 1997–1998, followed by crises in the Russian Federation, Brazil and, later, Argentina, all demonstrated the volatility of the global economy. Changes in the supply and demand for specific products led to changes in the demand for their inputs, as well. In some cases, the analyses of the distribution of risk for foreign investors at a global level increased the cost of borrowing by individual countries, precipitating new crises, as in the case of Argentina during late 2001. The oil price increases of late 2004 have added to the feeling, in many developing countries, that global market forces are beyond the control of individual countries. These processes have even intensified as competition has grown between countries in providing various factors of production. Overall, the impact of the volatility of global economic and financial forces upon cities is manifested in dramatic and socially harmful impacts upon employment and labour markets, more generally, with the frequent flight of investment and jobs to new locations.[14]

Within this new global economic context, the economic roles of cities have become increasingly important for individual countries. If São Paulo is not productive, the economy of Brazil will suffer; similarly, if India is unable to efficiently move its exports through the port of Mumbai, the costs of those exports will be higher and India's overall economic performance will be hurt. Long journeys to work through the traffic congestion of Bangkok reduce worker efficiency. During the mid 1990s, Mexicans working in the *maquiladora* factories in Ciudad Juarez had to spend 29 per cent of their incomes on transportation to work, thereby reducing the possibility of meeting other household needs.[15] In contrast, the modal integration of transportation in the Netherlands facilitates the access of workers to a wide range of employment opportunities.

The key point here is that housing and urban infrastructure is a critical part of the economic production function of cities. Without housing and public services, workers cannot be productive, and whole urban and national economies will feel the impact. Basic services such as water and sanitation have immediate impacts upon the health of the population.

In this context, meeting the financial needs of cities in developing countries, and particularly the financing of infrastructure and housing, should be high national priorities. Yet, too often, national budgets for investment in urban infrastructure are very low, if existent at all. It is interesting to note that official development assistance also contributes few resources for these investment needs.

Because the economic performance of cities is critical to national economic performance and, indeed, to the functioning of the global economy itself, these financial needs should be considered essential international priorities as well. Housing and infrastructure are essential for both production and human welfare. It will be impossible to reduce urban poverty if slum conditions are not improved in many cities throughout the developing world. In this regard, the Millennium Development Goal (MDG) of significantly improving the living conditions of at least 100 million slum dwellers by 2020 is important in bringing some international attention to this problem. It is equally important, however, to note that this MDG only represents about 4 per cent of the projected demand for slum improvement by 2030.

Environmental framework

An additional and important dimension of this problem is the management of natural resources required by the urban population, such as clean water and clean air. Growing demand for infrastructure services places immediate pressures on these natural resources. It is also apparent from most environmental studies that cities have important impacts upon the natural environments in which they are located. Studies during the 1990s demonstrate that the ecological footprint of cities is having enormous consequences for the sustainability of natural resources.[16] Consumption of natural resources by urban residents is frequently growing faster than the environment's ability to reproduce those resources. A clear example of this situation is the deforestation of areas near African cities. Urban residents collect firewood for use in cooking and heating, cutting down trees and scrub bushes, thereby contributing to the erosion of topsoil and the sustainability of local ground cover.

One of the most important environmental issues to be addressed is the increasing cost of potable water in almost every city in the world. High levels of water consumption, with little attention to conservation or conserving behaviour, has had the effect of increasing the distance that cities must go to find potable water. Beijing now collects its water from sources 1290 kilometres from the city. Indeed, there are over 30 Chinese cities that currently have severe water shortages. This problem affects cities in both rich and poor countries: Los Angeles also goes 1290 kilometres for its water and New York is dependent upon distant water resources in New York State. Yet, efforts to conserve and improve the efficiency of water use are minimal in most cities. Some cities have used higher water charges as incentives for conservation and in order to improve the efficiency of water use. Bogotá has worked on this problem by educating its population.[17]

Another critical area is the management of human and solid waste. This problem also becomes increasingly significant as urban populations grow. Water-borne sewerage systems are prohibitively expensive for most cities in developing countries. On-site methods of sanitation and waste treatment are, in some cities, necessary alternatives to so-called conventional solutions. These issues also apply to non-human solid waste, where the quantities of waste quickly outstrip landfill capacity in many cities. The need for collection and recycling programmes to avoid the complete waste of reusable materials is of high priority.

If these urban problems have important local and regional consequences, they also have global impacts. A recent study from China demonstrates how urbanization is contributing to global warming, with carbon dioxide emissions largely coming from cities.[18] Another study also notes that global warming is reducing rice yields in Asia, suggesting that food may prove to be one of the most serious constraints to urban population growth over time.[19] The systemic character of the impacts of urban settlements upon the environment and, in turn, the impact of global climate change and other forms of environmental change need to be better understood. However, it should be noted that cities can also provide positive impacts upon the environment – for example, in concentrating all of the waste in specific locations rather than dispersing it.

These environmental externalities, and particularly the likelihood of severe shortages of natural resources and increasing costs of infrastructure services, must be included in any financial and economic framework for cities in developing countries. The notion of 'sustainable development' needs to be made operational, rather than just a normative and rhetorical objective of governments and visionaries. As a result, this is an important component of the challenge posed by this Global Report. The task of mobilizing finance should not simply be intended to have more resources to extend current housing and infrastructure services, but rather to change the production and consumption of those services in the direction of methods, costs and impacts that can enhance the sustainability of cities and their surrounding regions.[20]

One of the most important environmental issues to be addressed is the increasing cost of potable water in almost every city in the world

Financial framework

The most fundamental financial issue in this Global Report is that cities will require very large investments in order to create infrastructure and services with long-life benefits – yet, they lack the systems to finance these services. For example, it is almost impossible in most developing country cities to obtain mortgages to finance the purchase of housing. And yet it is difficult to imagine that the great majority of cities and their residents can afford to use disposable cash to finance long-life investments.

The following chapters in this Global Report undertake an in-depth examination of potential sources of finance at the international, national and local levels. A preliminary review of these sources suggests, however, that it is unrealistic to expect major additional financing from international donors, the global financial sector, the national level (where most governments are facing serious fiscal deficits) or the municipal level (where local budgets are also severely constrained).

The problem is both an issue of what is actually financed and whether sufficient levels of finance are being mobilized for this sector

International development aid

Current levels of foreign investment, international aid and government financing are clearly not meeting the current demand for housing, as Box 1.1 illustrates. Furthermore, official development assistance (ODA) to Africa and South Asia does not seem to have had any major impact upon the incidence of slums (see Figure 1.1). Individual projects in

Box 1.1 Demonstrating the foreign direct investment and official development assistance paradox: The case of Mali

Mali has one of the highest amounts of foreign direct investment (FDI) as a percentage of gross domestic product (GDP) and a significant amount of official development assistance (ODA); yet, 93.2 per cent of Mali's urban population live in slums. During 2002, FDI in Mali totalled US$102.2 million and ODA was over US$472 million.

However, if US$574.2 million from the combined FDI and ODA were devoted solely to housing the 3.4 million people in slums, it would not suffice. Estimating 7 persons per household and US$5000 to build each housing unit, it would cost US$2.4 billion to house the current population, not taking into account the projected population growth of over 11 million by 2030.

Source: World Bank, 2004d.

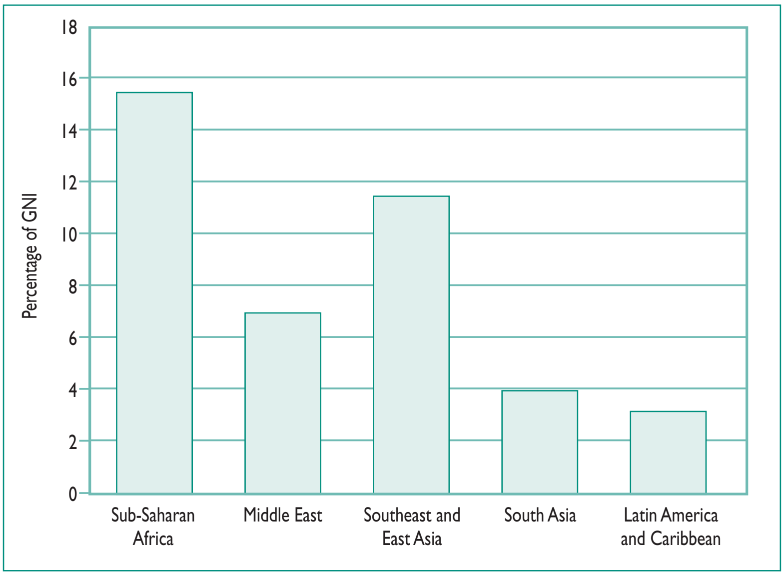


Figure 1.1

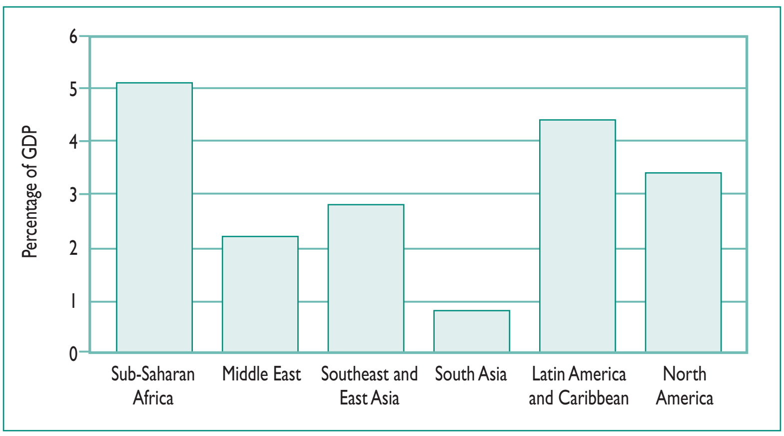
Official development assistance (percentage of GNI), 2002

Source: World Bank, 2004e.

Figure 1.2

Gross foreign direct investment (percentage of GDP), 2001

Source: World Bank 2004e.



specific cities may have been successful, such as Jakarta, Madras or Nairobi; but their national and even citywide impacts have been limited.

Foreign direct investment

As shown in Figure 1.2, sub-Saharan Africa has the highest levels of foreign direct investment (FDI) as a share of GDP; yet, in absolute terms, this level of FDI is only approximately US$191,329,892, compared to US$535,569,231, which South Asia receives. It is apparent from the data in Figure 1.2 that FDI, even if it were addressed to improving slums, cannot make (and has not made) any appreciable difference.

In any case, only infrequently do private foreign investors place their investment funds in slums, even though there would probably be a high rate of economic return, if not financial return. Exceptions include the Community-led Infrastructure Financing Facility (CLIFF) initiative in India (see Chapter 6, Box 6.9).

National public investment in shelter

A third source of finance for housing and urban infrastructure would be national public investment – that is, publicly allocated funds from national budgets or special funds. With the exception of China and India, very few developing countries have allocated large absolute amounts of financial resources to housing and urban development.

The problem, therefore, is both an issue of what is actually financed: whether public investment in housing and urban infrastructure has been directed towards the needs of the poor and whether sufficient levels of finance are being mobilized for this sector. Both issues are important and are addressed in subsequent chapters of this Global Report.

The question of *what is financed*, however, must be broadened to include a wider range of infrastructure and housing solutions than normally included in international discussions. For example, in lieu of extending the network of urban water supply, it may be necessary to drill boreholes in un-served areas on the urban periphery. This approach would tap aquifers whose water is then distributed by above-ground tubing or pipes. Such a solution is a fraction of the cost of extending the existing water supply network – although, admittedly, it may present other problems, such as the need for later aquifer recharge. This suggests that how housing and urban infrastructure are considered in terms of technology, standards and costs can have very important implications for their financing.

Valuing urban assets

Another related issue to estimating the finance needed for cities is the fact that existing cities have enormous *present asset value*. A rough exercise in the World Bank during the early 1990s attempted to determine the 'financial value of cities'.[21] It concluded that the infrastructure stock of cities in developing countries was worth about US$3 trillion. This compared to an annual investment flow of approximately US$150 billion each year, or 5 per cent of the stock. More than 95 per cent of this annual flow came from domestic resources in countries, both public and private. This is a substantial figure, but woefully inadequate when one observes the large numbers of households worldwide without adequate water supply or sanitation.

Nevertheless, it points to a critical policy problem: it is known that most urban infrastructure in developing countries does not last as long as that in developed countries. Maintenance is neglected, both for financial and technical reasons. If, however, cities were able to obtain, say conservatively, another 5 per cent of benefits from improved maintenance of the stock, this would amount to US$150 billion or roughly current annual investment. Better operations and maintenance could reduce the need for some, though certainly not all, of the new annual investment, thereby reducing environmental and social impacts and avoiding additional debt.[22] Improved initial design of infrastructure will also reduce maintenance costs in the long term.

A key policy conclusion, therefore, is that cities must obtain more benefits from their existing assets, in a financial and economic sense, and that increase can allow their networks to be sustained longer, at lower costs.[23]

This conclusion is of enormous strategic value in assessing the current balance of new investment versus improving the management of current stock. It suggests that a first step in a strategy for sustainable cities would be an intensive examination of *maintenance programmes* to improve infrastructure performance. This might include, for example, various ways of improving information systems about the condition of infrastructure (smart infrastructure), which would alert city managers about the need for maintenance.

When these issues are discussed together, it raises questions about what, indeed, is to be financed. For example, rather than assume that it will be possible to finance large-scale extensions of conventional urban infrastructure, with their heavy upfront investment costs and high maintenance requirements, perhaps an alternative strategy is needed to complement ongoing infrastructure finance. This might involve developing smaller decentralized clusters of infrastructure services that lead to the growth of multi-nucleated urban centres, thus avoiding high downtown densities and mass transit to central points of employment. This spatial alternative is also an engineering and financial alternative.[24]

Governance framework

Such a spatial approach also implies the need for a *decentralized approach* to urban governance. It connects well to the principle of 'subsidiarity', which the European Union (EU) has urged on its members, whereby problems are best resolved at the jurisdictional level at which they occur rather than being referred to high administrative and political levels.

It should also be noted that the participation and voice of urban populations in formulating policy and programmes by the public sector is a critical dimension of urban management. One aspect of participation is the need to shift from the top-down administrative formulation of strategy to including the full range of civil society interests and organizations in governmental processes.[25] This includes thinking about the future and adding broad-based citizen involvement to conventional urban plans. The recent 2050 initiatives in Buenos Aires, New York and, now, Barcelona demonstrate the importance of this issue.[26]

Using these elements of an analytic framework as points of departure, it is important to recognize the value of making virtue from necessity, or rather of using the lack of finance for conventional solutions as an opportunity to refocus the discussion of urban policy towards urban forms and processes that may be able to enhance sustainability. Finance is therefore a critical lever to orient policy and to recognize the growing role of community-based urban processes.

Mobilizing finance: removing constraints and reducing risks

As noted earlier, the conventional forms of finance – national public investment funds; ODA; FDI; national and local private-sector finance; and municipal finance – either do not seem to place high priority on investment in housing and urban infrastructure, or they simply do not have the requisite resources.

While these various forms of finance will be analysed in greater detail in Chapters 4 to 7 of this Global Report, there are three important issues that deserve to be highlighted at the beginning. These are:

1. What forms of housing and urban infrastructure investment are legitimate and deserving of public- or private-sector investment?
2. What are the constraints to mobilizing these types of resources for housing and urban development?
3. What are the risks to providers of finance for these purposes?

Addressing shelter and infrastructure standards

Public opinion has now recognized that the bulldozer and evictions are not effective answers in meeting the demand for shelter

One of the serious issues to be addressed in considering the financing of housing and urban infrastructure is the view that housing and settlements which do not conform to building codes and land-use regulations should necessarily be excluded from consideration. This view, commonly heard during the 1970s, has evolved over recent years; many governments now recognize that millions of people, mostly the poor, are unable to find reasonably priced land for settlement and construction. The drive to evict squatters from land legislated for other purposes, while continuing in some cities, has been reduced substantially as public officials and public opinion have now recognized that the bulldozer and evictions are not effective answers in meeting the demand for shelter. The result of evictions has simply been to move the poor to even more distant locations, increasing their transport costs to places of work. There is now greater willingness for public authorities to upgrade, *in situ*, the settlements of the poor, allowing them at least occupancy permits, if not full ownership of the land.

These upgrading projects have been very successful in many countries, ranging from large-scale efforts such as the Kampung Improvement Programme in Indonesia, begun during the late 1960s and expanded with World Bank support during the 1970s and 1980s, to the Bustee Improvement Programme in Calcutta, to smaller-scale upgrading programmes in African and Latin American cities. These programmes have several key features (see Box 1.2), discussed in more detail in subsequent chapters of this report.[27]

A second aspect of determining what is legitimate for financing is the role of building codes. In many countries, building codes require standards of construction that are prohibitively expensive for the majority of the population.

Box 1.2 Key features of slum upgrading projects

Among the more than 200 donor-assisted projects for slum upgrading, the following features are found in most of them:

- *in situ* introduction of infrastructure services, such as water supply, sanitation and electricity;
- minimal demolition of existing housing structures;
- provision of minimal guarantee of legal occupancy, if not tenure;
- provision of accompanying social services, such as education and public health;
- expectation of community participation in the design, construction and/or maintenance of new community services; and
- some degree of cost recovery through periodic household payments to the implementing public authority.

A sharply declining percentage of the population in many cities in developing countries is actually able to afford living in 'legal buildings' – that is, those buildings which conform to existing codes. This problem, originally a legacy of former colonial rule in many countries in Anglophone or Francophone Africa, or in South Asia, can no longer be simply attributed to the past. Codes which insist on high standards in the name of 'being modern' or ensuring public health standards are very much a product of post-independence governments as well.

Constraints to mobilizing resources

This Global Report will demonstrate that the constraints to mobilizing financial resources are both financial and non-financial. The second part of this chapter explains how macroeconomic circumstances affect national and sub-national systems of public finance and limit the availability of financial resources. However, there are also important non-financial constraints, such as building codes. These include national and local regulatory frameworks governing land use, land occupancy and landownership. In many cities, low-income people are caught in a cycle in which they lack formal permission to occupy land and therefore are not eligible to receive essential infrastructure services, such as water supply or public transport. As a result, they remain without services, which undermines their health and access to employment. This keeps them poor and unable to rent shelter in so-called 'legal' land subdivisions.

During 2004, the global GDP grew by 4 per cent

For example, pavement dwellers in India, who have been frequently subjected to evictions and the demolition of their self-constructed homes, become accustomed to rebuilding using temporary materials that must be replaced annually. It is estimated that over a 20-year period, these investments are equal to those of a household making annual instalments on a 40,000 rupee house.[28] The difference is that one household will have secure tenure and improved access to services and the other will still face periodic demolition and no infrastructure. While one household must use scarce funds to go further and will often pay more for water and cooking fuel, the household with legal tenure frequently has access to these resources more efficiently and cheaply and can use freed-up funds to invest in a better business or better education.

Risks to providers of finance for low-income households

The factors mentioned above also contribute to the risks perceived by lending institutions in providing finance to low-income households. If potential clients live on land without the legal recognition of municipal authorities, these clients are potentially subject to eviction from their homes, regardless of the level of financial investment which has been made. Providing finance for these households is therefore risky business from the lender's perspective. Similarly, if the major assets of these families, their house and the land they occupy are not recognized as collateral, it is unlikely that other smaller and less fixed assets will be more secure forms of collateral.

These issues form part of a vicious circle which millions of poor households have faced for generations. The circle has begun to break down in some countries where its obvious negative results do not benefit anyone – neither governments, nor lending institutions, nor infrastructure providers, nor households. However, this process is slow and filled with institutional impediments, reflecting different perspectives and interests.

What is needed is an acceptance of new categories of risk by the providers of finance, and an understanding that these clients form a majority and growing share of potential consumers for the future. The issues around this risk will be discussed in Parts II and III of this Global Report.

THE MACROECONOMIC CONTEXT OF URBAN SHELTER DEVELOPMENT

The second part of this chapter presents the macro-economic context that influences many of the issues discussed in this report. While much has been written about the global economy and the impacts of globalization, this picture needs to be disaggregated into data and analyses at the regional level in order to distinguish the specific challenges facing particular regions and countries. This section addresses the following factors: patterns of economic growth; sectoral performance and productivity; income distribution and inequality; poverty and employment; savings; external debt; patterns of investment (public, private and foreign); impacts of external factors upon macroeconomic performance; and the urbanization of national economies.

Patterns of economic growth

The publication of this Global Report coincides with a period of unprecedented economic growth at the global level. During 2004, the global GDP grew by 4 per cent. All developing regions grew at a pace faster than their growth rates during the 1980s and 1990s.[29] This is surprising, given the combination of the downturn following 11 September 2001 and the large increase in oil prices during 2004, reaching over US$50 a barrel. Global trade also expanded considerably, with China's demand for imported raw materials and food spurring exports from other developing countries, particularly in Latin America where Brazil exported steel and Argentina provided soy beans and meat to the growing Chinese market. The continued high demand for imports by the US economy supported the growth of global trade.

The most striking feature of economic growth has been the high rate of growth for developing countries, exceeding 6 per cent for the first time. This was heavily fuelled by China at 8.8 per cent. Table 1.4 presents the regional breakdown of economic growth, showing the sharp contrasts between regions.[30] While East Asia and the developing countries in Europe and Central Asia were above 7 per cent, sub-Saharan Africa was below half of that rate, at 3.2 per cent. Latin America and the Middle East grew at 4.7 per cent each, certainly a respectable rate for Latin America after the stagnation of 2002–2003.

From a distribution perspective, these patterns are worrying because they continue the trend towards greater disparity in income levels between the regions, as well as between developing and developed countries. Global inequality between rich and poor countries, therefore, continues to worsen, even when there have been extraordinarily high rates of economic growth.

The most questionable aspect of this growth in 2004, however, is whether it is likely to be sustained in the future. This depends upon many factors, including the changing position of the US dollar in global currencies and, hence, the power of the US economy; how China will cope with the danger of inflation; and whether global interest rates will affect debt payments by developing countries and their ability to finance needed investments for growth. These exogenous factors are clearly important influences on national macro-economic performance.

As Table 1.4 demonstrates, robust growth is expected in all regions, even though the high growth rate in China is expected to decline during 2005–2006, thereby reducing the demand for goods and services from East Asian and other developing economies. In contrast, South Asian countries are expected to sustain their growth through the liberalization of their economies, generating more trade. Latin America is expected to continue to benefit from higher commodity prices and strong trade performance. Africa is expected to improve its performance, but barely, so that its extreme poverty is unlikely to be improved by macro-economic growth in the coming decade.

Sectoral performance and productivity

One of the most startling aspects of the macroeconomic performance of the past few years – and most visible in 2004 – is the growing importance of world trade.[31] This means that ‘tradeables’, whether manufacturing products or commodities, have become increasingly central to the economic growth of all countries, whether developed or developing. The growth in commodity prices in 2004 suggests that demand has grown, particularly in China and the East Asian countries, for raw materials and specific items such as steel – for example, for automobile and machinery production. While this places great emphasis on agriculture and the production of raw materials, it also requires improvements in the efficiency of infrastructure in telecommunications, transport and key services such as electricity and water supply necessary for manufacturing and other industries.

Table 1.4

The global outlook in summary

Percentage GDP change from previous year, except interest rates and oil prices	2002	2003	Estimates 2004	Forecast 2005	2006
Developing countries	3.4	5.2	6.1	5.4	5.1
East Asia and Pacific	6.7	7.9	7.8	7.1	6.6
Europe and Central Asia	4.6	5.9	7.0	5.6	5.0
Latin America and the Caribbean	-0.6	1.6	4.7	3.7	3.7
Middle East and North Africa	3.2	5.7	4.7	4.7	4.5
South Asia	4.6	7.5	6.0	6.3	6.0
Sub-Saharan Africa	3.1	3.0	3.2	3.6	3.7

Source: World Bank, 2005.

Another sector demonstrating continued growth is the financial sector, which has benefited from the absence of major crises during 2003 and 2004. Even cases such as the economic collapse and debt default of Argentina in late 2001 proved to have had little impact, or ‘contagion’, on other than its closest neighbours, thereby reflecting the increased stability of financial markets since that time. While the decline of the US dollar and the growing strength of the Euro are likely to produce some adjustments in 2005 and 2006, there is little likelihood of major changes in the sectoral composition of growth in most countries. Information technology continues to contribute to notable increased efficiencies in industry and services in most countries. Indeed, high returns to industries, such as the financial sector, which rely upon information technologies have contributed to growing inequalities in earnings between sectors within countries.

Income distribution and inequality

One of the consequences of the pattern of economic growth described above is growing inequality. Figure 1.3 depicts the share of income earned by the poorest 10 per cent and richest 10 per cent across the regions. Latin America continues to have the highest rate of inequality, with South Asia the lowest. This extreme inequality in Latin America has been analysed in some depth and has its roots in many historical patterns of landownership, political and institutional development and, more recently, economic policy.[32]

Global inequality between rich and poor countries continues to worsen, even when there have been extraordinarily high rates of economic growth

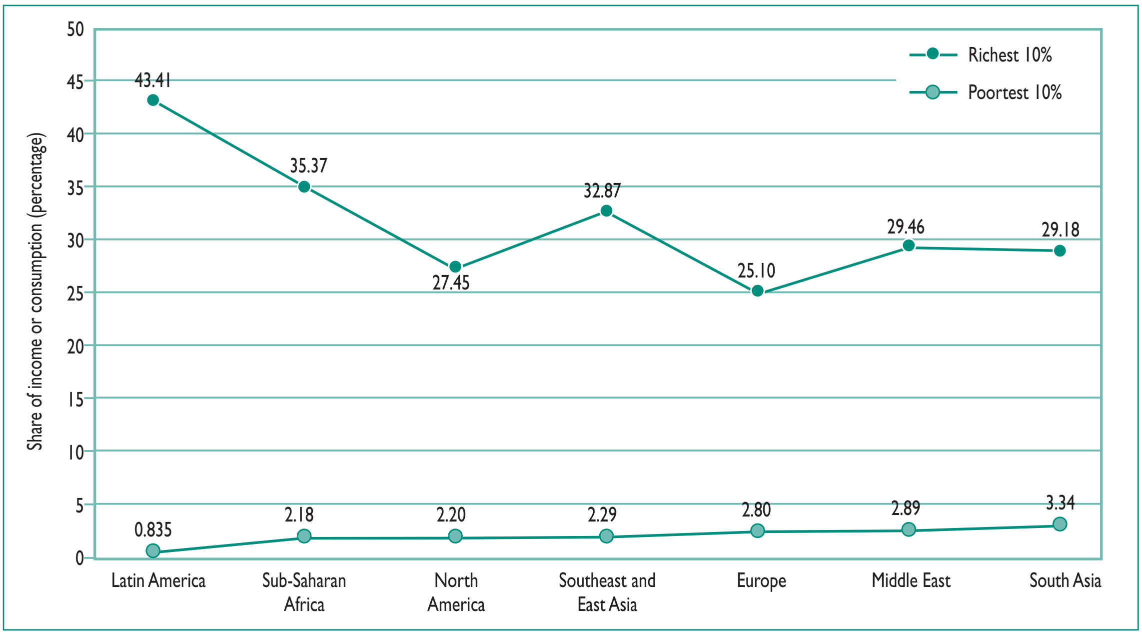
Inequality has become increasingly recognized not just as a problem to be addressed in its own right, but also because of its substantial impacts upon economic growth, poverty reduction and productive investment strategies for the development of human capital. Studies over the past decade have demonstrated the high correlation between inequality and poor performance in other aspects of development.[33]

While some forms of inequality have been attributed to differences in the level of education between people,[34] and yet others associated with higher returns to capital in

Figure 1.3

Regional income/consumption inequality patterns

Source: UNDP, 2004.



The most direct and important factor contributing to urban poverty is the shortage of well-paid employment in cities

sectors favoured by the global economy, there are also many forms of inequality that can be attributed to the policies of national and local governments in urban areas. A study of public investment in infrastructure among the various neighbourhoods of Buenos Aires from 1991 to 1997 demonstrated that 11.5 per cent of the population received 68 per cent of total investment.[35] Inequality through skewed local public investment can therefore be a local product and cannot always be blamed upon external forces outside the country.

Poverty and employment

Despite the impressive economic growth of the past few years, the enduring problem of massive poverty in the developing countries remains the top priority problem facing the world today. Figure 1.4 depicts the share of the population in the six regions below their respective national poverty lines during the period of 1990–2001, below US$1 per day and below US$2 per day for the period of 1990–2002. These figures are daunting, with approximately 64 per cent of the populations in Africa and South Asia living below the US$2 a day threshold for the period of 1990–2002.

The incidence of poverty at the national level is highly correlated with low levels of education and poor health status, lack of access to basic infrastructure services (such as clean water supply), sanitation and electricity. This vicious circle of poverty is also intergenerational, with families caught in a poverty trap in which income-earning opportunities are frequently tied to educational attainment, location or access to credit.

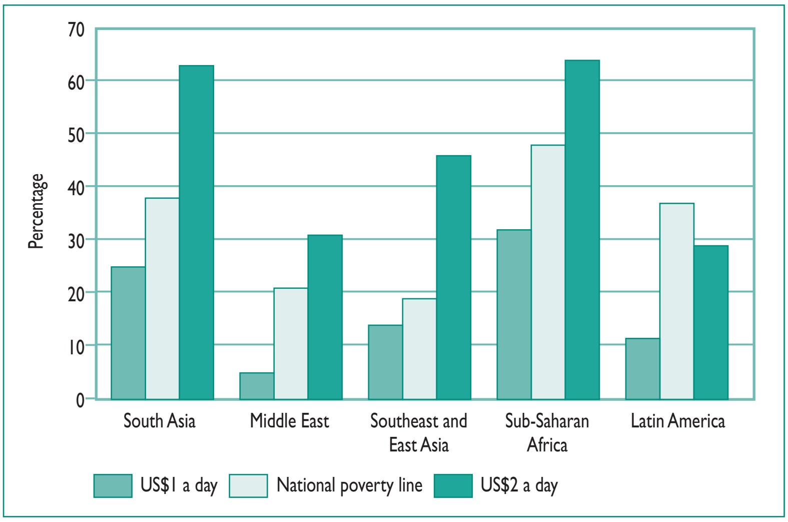
The poverty problem is also characterized by strong differences between urban and rural residents. If the urban poor lack services and education, they have at least found some ‘space’ or land to occupy, albeit in squatter settlements in the less desirable areas of the city. In contrast, the rural poor are often landless, working as contract labour and continuously facing the threat of food insecurity. As noted earlier, the rural poor face two major and contradictory threats. High agricultural productivity is most likely to come from increased mechanization of agriculture, thereby reducing the demand for labour. Alternatively, low productivity will keep incomes low for everyone and also push people off the land. Both threats will lead to the same result: rural-to-urban migration. These growing tensions are very much evident in both China and India, but less so in Latin America where the largest share of the population has already moved into urban centres.

The most direct and important factor contributing to urban poverty is the shortage of well-paid employment in cities. The challenge here is both the creation of jobs and the level of wages. The generation of employment depends generally upon savings and investment within the macro-economy and local economies, as well. As noted earlier, much of the growth of economies over the past decade has been in technology industries and financial services, neither of which requires large labour forces to be productive. While many argue that improving education in cities will be sufficient to help young people find jobs, this argument is not always true empirically, especially in the short to

Figure 1.4

Population below income poverty lines in five developing regions

Source: World Bank, 2004e.



medium term because there are growing levels of urban unemployment in cities despite increasing investments in education. Having secondary or even university education may be a necessary, but not a sufficient, condition to find work in environments with growing numbers of job seekers.

With growing global pressures towards profits in manufacturing and service industries, there has also been little incentive for medium- and large-scale enterprises to pay 'living wages' to those lucky people who do find jobs. If cheaper labour is available elsewhere, investors urge the managers of these enterprises to move to sites with lower labour costs. This pattern is found in both developing and developed countries where the so-called 'fast food jobs' pay notoriously low wages. Again, with increasing supplies of labour in local markets, it is not surprising that wage rates are very low.

Savings

A strong consequence of high levels of poverty is a lack of domestic savings within national economies. As shown in Table 1.5, national savings rates are closely correlated with levels of GDP, with rates in Africa (14 per cent) and South Asia (13 per cent) less than half of the rate in East Asia (35 per cent). Low levels of domestic savings – both public and private – contribute to low levels of capitalization of the financial institutions in poor countries, including housing finance institutions. They are also reflected in low levels of tax revenue collection and therefore place great limitations on public expenditures and public budgets. Households and families at low incomes are able to find ways to survive, albeit marginally in many cases, with minimal expenditures for food, water and shelter. But paying taxes to institutions that appear to offer little in return is a much lower priority.

The issue of savings is particularly important when considering how to finance urban infrastructure and housing, as is discussed in Part II of this report. As noted earlier, both infrastructure and housing are durables – they are expected to have a long life, at least 50 years in the case of infrastructure; but they require large upfront investments in the expectation that they will provide a long stream of benefits well into the future. Savings is the foundation of investment. Without some surplus, investment in these future benefits is impossible. Therefore, patterns of income generation are critical factors in determining whether households will be able to invest at all in their future.

External debt

Another factor that heavily conditions the macroeconomic environment of developing countries is the significance of external debt for specific countries. Built up over time and frequently connected to the volatility in the world economy during the oil shocks of the 1970s, many national governments borrowed heavily in order to finance increased energy costs during the 1970s, as well as to finance projects in all sectors. Even where these projects were well conceived and 'successful' in meeting their objectives, including contributing important support for economic development such as roads, schools, factories and irrigation canals, the legacy of external borrowing has left many countries with unsustainable levels of external debt service. In some countries, particularly in Africa, the debt service to GDP ratio has reached over 400 per cent.[36] Figure 1.5 depicts the total levels of debt service in various regions.

One of the consequences of these levels of debt is that it immediately reduces available domestic capital for investment. The net transfer out of developing countries to both public and private institutions in the developed countries, as well as to multilateral institutions, underlines the fact that the external community in some countries is not only a source of funds for domestic investment, but is a net drain on available surpluses which individual countries can generate. This negative net transfer has occurred in

Box 1.3 Poverty reduction strategy papers

While the dire shortage of affordable housing has been recognized internationally as a deep and pervasive problem, strategies to address this have not been thoroughly addressed in existing mechanisms, such as poverty reduction strategy papers (PRSPs). These are documents that the International Monetary Fund (IMF) and the World Bank require from national governments detailing their plans to reduce poverty in order to qualify for debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. Out of the 54 countries with PRSPs or interim PRSPs, many of them address housing, but with varying degrees of commitment or specificity with regard to resource requirements. Many of the PRSPs discuss housing as a problem and some have conducted surveys to identify housing needs more exactly. Some countries propose building a few hundred or few thousand units, while others propose public–private partnerships and land reform measures. However, it is disappointing that many do not include clear measurable goals or budget information.

Source: www.poverty.worldbank.org/prsp/.

Table 1.5

Gross domestic savings, 2003

	Percentage of GDP	Current US$
Sub-Saharan Africa	14	1,783,690,767
Middle East	24.5	27,261,325,959
Southeast and East Asia	35	321,936,208,750
South Asia	13	37,536,526,160
Latin America	16	38,121,260,000
North America	19	817,705,450,000
Europe	21	305,467,000,000

Source: World Bank, 2004e.

Figure 1.5

Debt service, 2002

Source: World Bank, 2004e.

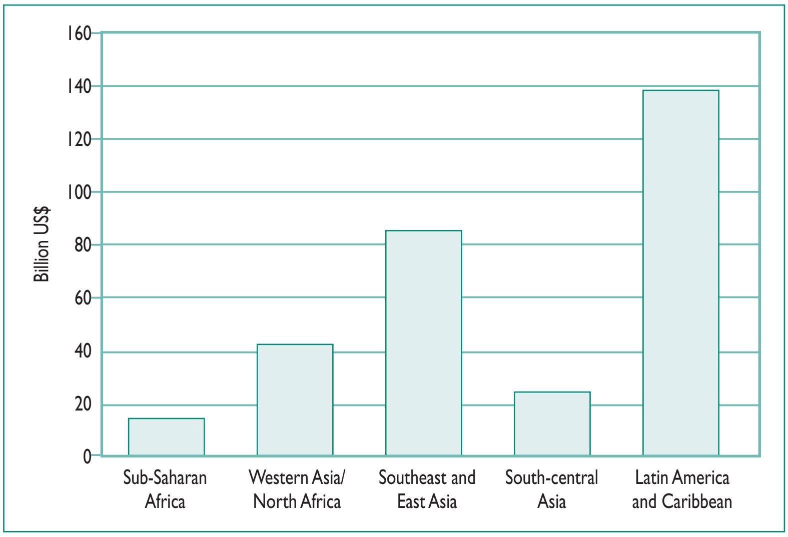


Table 1.6

Size of public budgets relative to GDP (%), selected countries

Argentina	2002	19.54	Lesotho	2003	41.36
Armenia	2003	21.59	Lithuania	2003	30.84
Australia	2003	26.56	Luxembourg	2003	43.37
Austria	2002	40.27	Madagascar	2002	14.26
Bahrain	2002	35.88	Malaysia	2003	28.21
Bangladesh	2003	11.33	Maldives	2003	41.79
Belarus	2002	27.12	Malta	2000	37.03
Belgium	2002	43.18	Mauritius	2003	24.08
Bolivia	2003	31.21	Mexico	2000	15.95
Bulgaria	2003	36.08	Mongolia	2003	42.85
Canada	2003	18.47	Nepal	2003	16.42
Chile	2003	21.85	Netherlands	2003	43.60
Congo, Democratic Republic of	2001	8.95	New Zealand	2003	33.74
Costa Rica	2003	24.34	Nicaragua	2003	26.51
Côte d'Ivoire	2001	16.49	Norway	2003	38.71
Croatia	2001	44.55	Pakistan	2003	22.39
Cyprus	1998	36.81	Panama	2001	24.85
Czech Republic	2003	40.65	Poland	2002	35.29
Denmark	2003	36.06	Portugal	2001	42.11
Dominican Republic	2002	17.64	Romania	2001	30.39
El Salvador	2003	18.00	Russia Federation	2003	25.21
Estonia	2001	28.02	Seychelles	2002	56.73
Finland	2003	36.62	Singapore	2002	18.82
Georgia	2002	12.60	Slovakia	2003	38.63
Germany	2003	32.81	Slovenia	2003	45.56
Hungary	2003	43.68	South Africa	2003	29.70
Iceland	2002	33.69	Spain	2002	32.79
India	2003	16.45	Sweden	2002	37.62
Indonesia	2001	24.77	Switzerland	2001	19.04
Iran	2003	28.50	Thailand	2003	17.49
Israel	2002	52.60	Tunisia	2003	32.10
Italy	2000	38.58	Ukraine	2002	31.24
Jamaica	2003	42.40	US	2003	21.01
Kazakhstan	2003	16.37	Uruguay	2001	31.34
Korea, Republic of	2001	20.16	Vanuatu	1999	23.24
Latvia	2003	28.41	Venezuela	2002	25.38

Source: IMF, 2004

Low levels of domestic savings – both public and private – contribute to low levels of capitalization of the financial institutions

many countries in Latin America, as well as in Africa. However, external debt swaps have begun to be used to finance poverty reduction programmes related to the HIPC initiative, including at the city level, as is shown by the example of Bolivia in Chapter 3.

Patterns of investment

Foreign investment

Given the above, the patterns of investment in developing countries have changed markedly over the past decade. Whereas, during the 1970s and 1980s, many countries relied upon the international institutions to provide needed capital, the transaction costs and conditions of those lenders have reduced their attractiveness for those countries able to enter global financial markets to raise investment capital. Countries such as the Republic of Korea and Thailand have sharply reduced their borrowing from the World Bank and the regional development banks because they are able to obtain necessary funds from private lenders. Other countries, such as Brazil and Mexico, have been able to raise funds from global markets, but by paying a premium to lenders. In contrast, most of the African countries have been unable to enter these markets, despite their offering tax holidays and other benefits, because their economic environments are unable to offer the short- and medium-term financial returns to private capital available elsewhere.

Not surprisingly, there has been an important segmentation in the global financial markets whereby some countries – particularly the East Asian countries and, notably, China – have been able to attract high levels of foreign direct investment.

The reason for this segmentation is, of course, that FDI is now private investment, with no particular public obligation to provide funds to countries where the conditions are not perceived to exist for maximum private financial returns. This logic can be perverse as well, with 'country risk' – the premium that countries must pay to lenders – determined by market perception of the risks of investing in specific countries. This leads to anomalies where risk is not associated with the income levels of countries, or with their levels of education and institutional development, or even with natural resources. Rather, it is determined by a narrow financial and political judgement about whether countries will be able and willing to honour their financial obligations in the short to medium term. This has led, for example, to the declaration that the country risk for Argentina was higher in 2002 than for Nigeria, even though the former has considerably higher social indicators than the latter. These financial market-driven realities have enormous consequences for individual countries, determining both their possible access to the markets themselves as well as the costs of borrowing.

The patterns of FDI also affect the allocation of finance across sectors. A study of FDI in Indonesia from the 1970s to the 1990s found that FDI 'encouraged the growth of a network of large cities but generally neglected rural areas and smaller cities'.[37] In general, there are few cases where FDI was actually devoted to housing projects in developing countries, unless this housing was for upper-class communities. FDI has supported large shopping malls in Latin American and Asian urban and suburban areas, but these investments have not contributed much to financing basic infrastructure for the poor in these communities.

Public investment

Given that there is a paucity of foreign investment in most countries, and that domestic savings rates are low, it should be no surprise that public investment as a share of GDP is low in most developing countries. Developing countries generally have relatively large deficits in their public budgets, straining to meet their recurrent expenditures, such as the salaries of civil servants or operational expenditures in school and health services. Maintaining infrastructure should be a priority in most countries; however, deferred maintenance is often not the exception but the rule. Table 1.6 shows the size of public budgets relative to GDP in selected countries.

The lack of resources for public investment in the poorest countries poses a serious dilemma. If these countries do not qualify for FDI, they are dependent upon official development assistance as the major source of financial support for economic development. Yet, ODA is also severely limited. Even with promises of additional aid from the developed countries at the International Conference on Financing for Development (Financing for Development Summit) held at Monterrey, Mexico, in 2003, the actual levels of official finance for development are constrained by lack of domestic political support in the developed countries, or by the restrictions of macroeconomic agreements with the international financial institutions (IFIs).[38]

It is important to note that the poorest countries have been heavily dependent upon ODA as a source of government revenue. Rwanda, for example, received ODA equivalent to more than 300 per cent of government revenue during the period of 1995–2000. Figure 1.6 shows that a large number of African countries, as well as Central Asian countries such as Tajikistan, Georgia and Kyrgyzstan, are all extremely dependent upon ODA.

It is important to acknowledge that urban development must compete with other priorities in the allocation of ODA for specific countries. The difficulties experienced in raising funds for the Global Fund for HIV-AIDS suggests that it would not be prudent to expect that the international community will be a major source of funds for urban development.

The issue of the composition of public investment also applies within countries. There are two issues here. The first is the sectoral allocation of aid (that is, for housing versus education or urban water supply). These allocations are clearly politically determined within individual governments. Second, there is an issue of the institutional level from which allocations are made. For example, many governments increasingly assign responsibility for housing and urban development to the provincial, state and local levels, rather than to national government. This means that patterns of intergovernmental financial relations and, specifically, financial transfers have a large impact upon what level and type of funds find their way to cities and towns (see Chapter 3).[39]

Public investment as a share of GDP is low in most developing countries

In many cases, the transfer of funds from national to sub-national units is used to cover recurrent priority expenditures. They are often not intended to cover new public investment projects. This process of decentralization has increasingly been both political – in terms of the authority for local issues being transferred to local institutions – and technical, with local officials authorized to make the important design and financial decisions regarding individual projects. What has been missing is authorizing local bodies to be able to enter local, national and global financial markets in pursuit of the funds needed to implement those projects. While there are notable cases of local governments entering financial markets – for example, the Ahmedbad Municipal Corporation during the mid 1990s – this trend has not made as much progress as originally hoped. Financial institutions have tended to be hesitant in buying the municipal bonds of local authorities without clear sources of revenue other than local taxes.

Private investment

The weaknesses of the public sector and its inability to mobilize substantial resources for urban development therefore point to the need to give greater attention to private sources of finance. Here, there is a major policy paradox: on the one hand, it is possible to readily identify the constraints facing private financiers – for example, why should they provide scarce capital to investments with medium- to long-term pay-offs, or why should they orient capital to the urban poor or even to municipalities, who, for different reasons, are equally risky even if they are deserving beneficiaries? Yet, while these questions are posed, it is true that private finance is the foundation for most investment in cities (the private sector finances precisely those infrastructure services and types of shelter for which there is such a large demand). This paradox is clearer when it is acknowledged that in no countries other than China and those of the former Soviet bloc have more than 15 per cent of the demand for housing been financed by the public sector.[40]

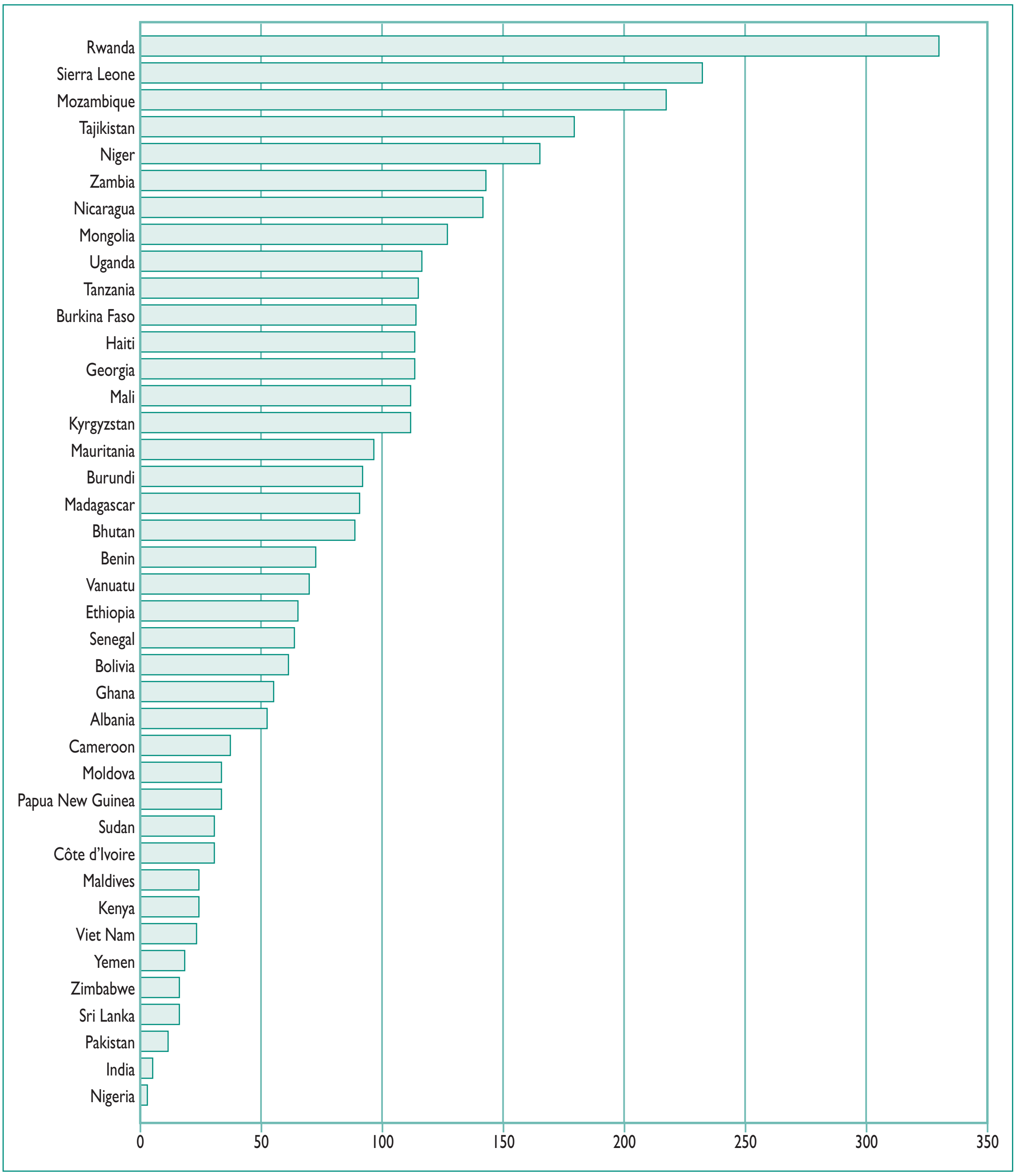
While there are notable cases of local governments entering financial markets, this trend has not made as much progress as originally hoped

The answer, therefore, is that the private sector is financing urban development: witness the shopping centre along the highway, the corner store near the market or the houses on the vacant plot across the street. The problem is that this is not keeping up with the pace and magnitude of demographic growth. There are important examples of this finance, as is illustrated in Box 1.4. The promise and limitations of this experience are presented in Chapters 4 and 5 of this Global Report.

Figure 1.6

Official development assistance, selected countries, average during 1995–2000 (percentage of total government revenue, excluding grants)

Source: IMF and IDA, 2004, p8.



One controversial aspect of private investment was also the trend, during the 1990s, to privatize public services on the grounds that private management was more efficient and cost conscious, and frequently could be counted upon to help mobilize needed capital for investment in the rehabilitation or expansion of infrastructure networks. While some of these privatization experiments resulted in such benefits, many were sharply criticized because private managers often increased the tariffs of previous public services, thereby excluding the poor from needed infrastructure, such as water supply. In addition, many privatized firms were unable to attract new capital for network expansions. This created political problems for public authorities who had justified their decisions to privatize, in part, on the expectation that unserved populations would receive services. While an overall assessment of the privatization experiment remains to be done, it is clear that effective privatization requires effective public regulation, and this factor was often missing (see Chapter 3).

Other dimensions of macroeconomic performance that have affected the availability of private finance for urban development have been the level of interest rates and inflation in the respective developing country economies. While, in general, global interest rates have been low and money has been available for investment in developed countries, this pattern has served to discourage greater exploration of so-called 'emerging markets', where risks are higher and the potential for inflation greater due to uncertainties in macroeconomic management and the impact of the global economy upon local markets and specific investments. The concentration of capital in European and North American markets has tended to attract new investment as well because there are more opportunities to diversify within these markets.

The impact of external factors on macroeconomic performance

As noted earlier, the macroeconomic performance of countries is highly conditioned by the global economic environment. Relative prices of goods and services are determined both by real-sector production costs (land, labour, technology and capital) and by currency values. They are also affected by interest rates, which fluctuate at the global level in relation to the large aggregates of finance – mostly in the US, Japan and Europe – and not very much in relation to regional factors. Countries which have begun to produce specific products for trade – for example, tea in Kenya – find themselves in serious competition with producers in other countries. Countries which followed import substitution strategies during the 1950s and 1960s found themselves at a serious disadvantage during the 1970s as trade expanded and energy prices increased.[41]

These patterns of competition and risk have dramatically increased with the globalization of the economy. Footloose industries which left the US for Mexico under the North American Free Trade Agreement (NAFTA) have, in some cases, moved on to new locations where labour costs are lower, such as China. The notion of 'outsourcing', where parts of industrial and commercial processes are assigned to enterprises in other countries with lower labour costs, has become more than a frequent subject of conversation – it has also become a real threat to the stability of employment in all countries.

While this issue has been largely understood in relation to labour costs, it can also be expected that footloose industries will move some of their production and service functions to locations with more efficient infrastructure services, particularly telecommunications and transport. The most notable example of this process was described in a 2001 book by a leading author on the subject of cities and globalization, which focused on the management functions in the financial sector and how they were located in New York, London and Tokyo.[42] This need for reliable infrastructure has spread well beyond the financial sector in many countries to the creation of industrial or office parks, where special services for particular economic functions are available.[43] Indeed, these spaces are linked within the global economy, creating integrated economic activities through space.[44] While these higher levels of integration have been heralded as offering new levels of productivity and efficiency, they can also lead to new levels of vulnerability to external shocks, where a shock to one economy or activity can affect others.[45]

The urbanization of national economies

A final characteristic of the macroeconomic context for urban development is the urbanization of national economies themselves. Abundant evidence exists to demonstrate the growing importance of cities in the overall productivity of countries. The increasing share of national GDP produced in cities has been well documented.

This is very much related to the 'agglomeration economies' found in urban areas, which results in very large cities having a substantial share of national productivity. For example, São Paulo has 8.6 per cent of Brazil's population, but produces 36.1 per cent of GDP, while Mexico City has 15 per cent of the national population and produces 34 per cent of GDP.[46] These patterns do not only apply to very large metropolitan areas. For example, the five largest cities in Mexico accounted for 53 per cent of national value added in industry, commerce and services, even though they contain only 28 per cent of the Mexican population.[47] A study of 13 industries in India shows that firm output is greater in larger cities.[48]

The phenomenon of increasing concentration of productivity within national economies in cities and towns reflects the absolute advantages of cities resulting from agglomeration economies and localization economies. However, it also reflects the relative advantages of cities vis-à-vis rural areas. This is evident through an examination of the wages earned by workers in cities, even when they are working within the informal sector. A study of labour markets in São Paulo from 1989 to 1999 shows a growth of informal-sector employment from 2.4 million to 3.7 million during this period. There is a noticeable 'casualization of work'.[49] Even if workers do not have the legislated benefits of formal employment, there is, nevertheless, a large increase in informal-sector employment in many cities in developing countries, thereby demonstrating the 'pull' of urban wages.

Patterns of competition and risk have dramatically increased with the globalization of the economy

Box 1.4 Housing Development and Finance Corporation (HDFC) in India

Based in India, the Housing Development and Finance Corporation (HDFC) was incorporated in 1977 to provide the long-term finance that was lacking for housing needs. With offices in over 130 cities in India and abroad, HDFC's loan approvals for 2004 were 152.16 billion rupees while disbursements amounted to 126.87 billion rupees.

While it is common for housing banks to lend to middle- and upper-income households, which are perceived to be less risky, HDFC has made a concerted effort to address the dire shortage of affordable housing for low-income people in India. During 2004, with funds from the German state-owned bank Kreditanstalt für Wideraufbau, HDFC disbursed 1250 million rupees in loans to over 140,000 poor families. It also approved 303 million rupees towards 49 low-income housing projects and 282 million rupees to cover 58 loans under its microfinance facility. HDFC has also released 366 million rupees in grants towards the construction of 10,058 houses for low-income people.

Source: www.hdfc.com, www.kfw.de

CONCLUDING REMARKS

This chapter has presented data suggesting that, despite historically rapid rates of economic growth, there is little likelihood that conventional sources of funds will be available for investment on the scale needed to meet the projected demand for urban infrastructure and housing. Many countries continue to face the combination of significant external debt burdens, deficits in public budgets and weak financial sectors. Local governments have begun to seek finance in national and global markets; but this is only in its initial phase. Countries and cities, therefore, will have to rely upon the savings of their citizens. How those savings are mobilized through diverse mechanisms will be the subject of subsequent chapters of this Global Report.

Key underlying questions that have been addressed in this chapter are summarized and answered as follows:

- *How have macroeconomic trends affected the living conditions of urban households during the last two decades?* With the exception of East Asian countries, most developing country regions have not experienced sustained positive growth over the past two decades. Africa has continued to suffer the most, with at best uneven growth in a few countries; but most sub-Saharan states have continued to deteriorate in providing needed urban employment and incomes. Latin America has also been quite disappointing as the promised neo-liberal reforms have failed to deliver the anticipated patterns of sustained growth. In general, the upper end of the income distribution has benefited from the new patterns of economic growth in the age of globalization. While in some countries there is evidence of a new middle class, particularly in China and India, the middle class has actually disappeared in other countries, joining the poor in the absence of 'living wages'.
- *Have macroeconomic trends and national development policies of the last two decades improved urban- and housing-sector operations?* The answer here is mostly negative. With exceptions in some countries, again in parts of India and China, and in richer developing countries such as the Republic of Korea, Thailand or Mexico, national economic authorities have generally been preoccupied with macrostability, debt and trade, and have tended to neglect implementation of the needed policy and institutional reforms in the urban sector.
- *Has international financial assistance to the municipal and housing sectors made a significant contribution to improving urban infrastructure services and housing within cities in developing countries and countries in transition?* It must be recognized that, despite considerable effort to encourage urban and infrastructure policy reform and capacity-building in the developing countries, there is little evidence of any sustained large-scale impact. One senior government official in a large developing country once replied to this question by suggesting that the question itself was presumptuous in that the level of financial resources and the applicability of the policy advice were both considerably short of what was required.

NOTES

1 This chapter is based on two background papers prepared by Michael Cohen, New School University, New York, US, with assistance from Deanna Fowler.
2 UN Population Division, 2004; National Research Council, 2003.
3 UN Millennium Project, 2003, p4.
4 Harris and Todaro, 1970.
5 George Beier, Anthony Churchill, Michael Cohen and Bertrand Renaud developed this typology of urban growth and the range of challenges facing individual countries. See Beier et al, 1976.
6 UN-Habitat, 2003a.
7 Montgomery et al, 2004. See also UN-Habitat, 2004.
8 Sharma, 2005.
9 Angel, 2002.
10 World Bank, 1991.
11 Lee et al, 1999.
12 National Research Council, 2003.
13 Sharma, 2005.
14 UN-Habitat, 2004.
15 Dillinger et al, 1994.
16 Rees, 1992.
17 Mockus, Antanas, 'Camino a la Igualdad', included in Memorias Encuentro Internacional de Competitividad, 2002.
18 National Academy of Science, 2004.
19 National Academy of Science, 2004.
20 Roberts and Cohen, 2002.
21 World Bank, 1992.
22 According to 1990 World Bank estimates.
23 Cohen, 1998.
24 See Graham and Marvin, 2001.
25 National Research Council, 2003.
26 Margarita Gutman, Presentation on the 2050 Initiatives at the World Urban Forum, Barcelona, September 2004.
27 UN-Habitat, 2003a.
28 Homeless International Dialogue, 'Risk and investment in urban communities around the world', September 2002.
29 World Bank, 2005, p1.
30 World Bank, 2005, p2.
31 UNCTAD, 2004.
32 IADB, 1998.
33 Birdsall, 2001.
34 UNHCS, 2001.
35 Cohen and Debowicz, 2004.
36 For detail see: IMF and IDA, 2004.
37 Douglass, 1997, cited in National Research Council, 2003, p345.
38 United Nations, 'Building on Monterrey' Financing for Development, 2002.
39 See, for example, Bird and Slack, 2003.
40 World Bank, 1993.
41 UNCTAD, 2003.
42 Sassen, 2001.
43 See for example, Graham and Marvin, 2001.
44 Sassen, 2002; UN-Habitat, 2004.
45 Pettis, 2001.
46 Freire and Polese, 2003, p6.
47 National Research Council, 2003, p303.
48 Cited in National Research Council, 2003, p309; see also Shukla, 1996.
49 Buechler, 2000.

CHAPTER 2

SHELTER POLICY AND FINANCE: RETROSPECTIVE OVERVIEW[1]

Housing finance is both the servant and the master of the housing process. The finance available fits into the general policy framework in that it enables the construction of housing within the wider supply context current at the time. It also drives the process: reductions in finance affect the scale of supply and allocation among groups supplying and demanding housing. In times when centralized control is politically dominant, finance is likely to be directed at governments and their agencies. Decentralization directs finance to smaller units, concentrating more on local authorities than on central governments. In times when non-governmental organizations (NGOs) are trusted above governments, shelter finance will be channelled through them. The same occurs when citizen groups gain power and respect.

There have been major shifts in housing policy at the international level during the last six decades or so, and these have tended to drive the agenda, especially when countries rely upon international institutions to support their endeavours. However, at the same time, some countries have been following old agendas, while others have been driving forward innovative ideas.

This chapter discusses the general trends in housing and urban development policy since the end of World War II and highlights the paradigm shifts that have occurred during the last 60 years, and particularly during the last 30 years. From a time when colonial governments, especially in France and the UK, drove policy to supply urgently needed urban improvements and 'homes for heroes', there have been major changes. The recognition that ordinary people could participate in the housing and urban development process gave rise, first, to self-help projects in which people with little income were expected to provide goods and services for themselves that those with high incomes were provided with, often free of charge. This has now developed into community-led urban programmes in which ordinary people drive the process.

The context in which housing is provided has progressed from welfare provision, through an understanding that better conditions result in healthier and more productive people, to housing as a basic human right. In parallel, financing has moved from subsidizing the cost of a few high-quality dwellings in well-serviced neighbourhoods, through enabling the finance markets to provide for most, to the beginnings of a recognition that some subsidized housing is required for households too poor to be catered for by the free market. Table 2.1 depicts the evolution of policies since 1945.

CONTEXT TO INTERNATIONAL THOUGHTS ON FINANCING FOR URBAN DEVELOPMENT

During the early post-World War II years, house building was regarded as a social overhead cost to economic development. This focused on several issues: economic development; the construction industry and construction quality; development of human capital; social development; and subsidies for workers.[2]

It was assumed that good housing assisted economic development; therefore, investments in housing were worth making. As such, it became a suitable case for treatment by international aid organizations and lenders. During the 1960s, the US Agency for International Development (USAID) began loaning substantial sums for housing development in Latin America as a direct contribution to economic development within the context of thrift institutions to finance housing.[3]

It was assumed that good housing assisted economic development; therefore, investments in housing were worth making

During the 1950s and 1960s, the modern movement in architecture generated a branch of interest in tropical architecture.[4] Its concern with climatic comfort and the use of local materials was set within the context of the view that good design and construction were key elements in creating affordable and appropriate towns. At the same time, building research establishments set up in the colonies – such as Central Building Research Institute (CBRI) in Roorkee, India, Housing Research Development Unit (HRDU, now known as Housing and Building Research Institute (HABRI)) in Nairobi and Building and Road Research Institute (BRRI) in Kumasi, Ghana – were at the centre of the housing effort, including experimentation and testing of materials, techniques and designs.

However, the nature of the construction industry, especially the part of it that constructs housing, is so diffuse,

Table 2.1

Milestones of housing policy development

Phase and approximate dates	Focus of attention	Major instruments used	Key documents
Modernization and urban growth: 1945 to early 1970s	Physical planning and production of shelter by public agencies	Blueprint planning: direct construction (apartment blocks, core houses); eradication of informal settlements	
Redistribution with growth/basic needs: mid 1970s to mid 1980s	State support to self-help ownership on a project-by-project basis	Recognition of informal sector; squatter upgrading and sites-and-services projects; subsidies to land and housing	Vancouver Declaration (UNCHS, 1976); *Shelter, Poverty and Basic Needs* (World Bank, 1980); World Bank evaluations of sites-and-services (1981–1983) (e.g. Bamberger et al, 1982; Keare and Parris, 1982; Mayo and Gross, 1987)
The enabling approach/urban management: late 1980s to early 1990s	Securing an enabling framework for action by people, the private sector and markets	Public–private partnership; community participation; land assembly and housing finance; capacity-building	*The Global Shelter Strategy for Shelter to the Year 2000* (UNCHS, 1990a); *Global Report on Human Settlements 1986* (UNCHS, 1987); *Urban Policy and Economic Development* (World Bank, 1991); *Cities, Poverty and People* (UNDP, 1991); *Agenda 21* (UNCED, 1992); *Housing: Enabling Markets to Work* (World Bank, 1993)
Sustainable urban development: mid 1990s onwards	Holistic planning to balance efficiency, equity and sustainability	As above, with more emphasis on environmental management and poverty alleviation	*Sustainable Human Settlements Development: Implementing Agenda 21* (UNCHS, 1994)
Habitat II: 1996	'Adequate shelter for all' and 'sustainable human settlements development'	Culmination and integration of all previous policy improvements	*The Habitat Agenda* (UNCHS, 1996a); *An Urbanising World: Global Report on Human Settlements 1996* (UNCHS, 1996b)
Istanbul+5 2001/the Millennium Declaration and the Millennium Development Goals (MDGs)	Review of the Habitat Agenda process	Renew Habitat Agenda commitments and seek/devise more effective strategies	*Declaration on Cities and other Human Settlements in the New Millennium* (UN, 2001b); *Cities in a Globalising World: Global Report on Human Settlements, 2001* (UNCHS, 2001);

uncontrolled, fluid and complex that many have despaired of its being part of development programmes. Indeed, some even denied that a building industry existed in most developing countries.[5] During the 1950s, there had been several attempts to industrialize building, with success levels varying from reasonable in parts of Europe and America to disastrous in Africa.[6] Their replacement of cheap and abundant labour inputs with expensive and scarce industrial and imported resources was illogical and ran counter to development. However, it is undeniable that there was a lack of trust between governments and local builders, even though they were mutually dependent; the former needed the contracts to be fulfilled, the latter needed the work from a volatile group of politicians and officials. This mistrust was not helped by sometimes poor standards of delivery on the part of the builders, and favouritism, non-transparent and corrupt tendering procedures, and poor payment records on the part of government agencies. Thus, international agencies often favoured large contractors based in the industrialized countries over their local counterparts when they offered contracts to implement aid projects.

However, by the early 1970s, the concept of intermediate technology had been developed and became popular, with the recognition that different technologies were appropriate in different contexts.[7] In the developing world, compromises and hybrid technologies were seen as, perhaps, more suitable than imported 'Western' industrial methods. This coincided with a new interest in the panoply of tiny businesses which were so obvious in developing cities but hardly considered in official documentation. Pioneering work during the early 1970s recognized the presence and contribution of the informal sector in all manner of industrial and commercial sectors, not least construction.[8]

The informality of the construction industry presented a challenge that could only be dealt with positively by the kind of paradigm shift exercised in the acceptance of non-Western technologies. In the same way, informality in land markets and housing credit pointed to the need for lateral thinking about appropriate approaches to assessing urban and shelter development which could embrace their positive aspects while protecting against the negative.

Human capital development has been a concern of economists from the pioneering ideas of Adam Smith, through to the development economists of the 1950s and 1960s, such as Arthur Lewis and Theodore Schultz. Schultz argued that, although housing may have little effect on productivity in affluent countries, better housing may be crucial where health conditions are poor. Thus, investments which improve human capital should be top priorities in development planning.[9]

During the late 1960s and early 1970s, John Turner's writings arising from his experiences in Peru, where squatter invasions were leading housing development, established the important place self-help housing could have in social development.[10] His theories extrapolated an ongoing process of founding and consolidation of neighbourhoods out of observing different settlements in various conditions of development. While this has been criticized, his argument that housing did something for its occupants' welfare and social and economic progress were highly influential and timely, coming as they did when city administrations were being swamped by a pace of development which they had little capacity to control.[11] The ideas that informal suburbs could be the solution rather than the problem, and that improving what was there was the way forward rather than bulldozing it away and starting again, became conventional wisdom in international circles, if not in country policies.[12]

In the formal sector, during the 1950s and 1960s, subsidies were an important part of housing policy. Both before and after the war, housing for urban workers tended to be rented out at less than economic rents, usually related to income. Occasionally, this would be a direct relationship by being a certain percentage of wages extracted at source by employers (typically large manufacturing and extractive industries) who provided housing for their workers. For others, rents were fixed at what was thought to be a realistic amount for the average household to afford. In parallel, during World War II, many countries had sought to control the effect of wartime inflation on urban rents by imposing controls. These were often continued into peacetime and became a feature of many cities' housing. They constitute a subsidy offered (reluctantly) by landlords to tenants.

There was, therefore, little link made between the need to finance housing and its supply. As an example, in the Gold Coast/Ghana, although it was acknowledged in successive development plans during the 1950s and 1960s that the private-sector landlords provided most housing, rents were consistently controlled to levels that affected the profitability of such supply, and rental income was taxed at higher levels than 'earned' income.[13] The costs of such practices, represented by the poor condition of the stock and the lack of new supply, are well known.[14]

TRENDS IN SHELTER AND MUNICIPAL FINANCE DEVELOPMENT: 1972–2004

Between 1972 and 1982: Habitat I

The World Bank began lending for urban development projects during the 1970s. It made an explicit effort to demonstrate that it was financially and economically feasible to provide services and shelter for the lowest income segments of society.[15] However, the focus of financing at that time, as outlined in the report of the first United Nations Conference on Human Settlements, was on low-interest loans, loan guarantees and subsidies as a means of making housing affordable to low-income people.[16] In addition, the active use of pricing policies was seen as the means to enhance equity in service and infrastructure delivery to all. The sources of funding and the implications of under-pricing the services were not discussed.[17]

The project approach

Interventions during this period concentrated on demonstration projects of limited size with respect to a city or region, and usually confined to a particular neighbourhood or group of neighbourhoods. The idea of the projects was to demonstrate the feasibility of providing low-cost housing and services in particular ways thought to be suited to low-income people and capable of replication at a large scale elsewhere in the city/country and in other countries. Replication demanded full-cost recovery as a basic premise. Only in this way could the project benefits be rolled out to the general population living in poor housing conditions through follow-up projects. Unless costs could be recovered, the financing would be used up and the self-perpetuating and limitless growth of subsidies would have to continue.[18] In practice, there was little success in collecting repayments. Project beneficiaries were not pursued when they defaulted and it was politically unacceptable to evict them. Thus, they received further subsidies in forgiven payments and tolerated arrears at the expense of others who could benefit from the replication of the projects. In the event, replication rates were very poor.

During the 1950s and 1960s, subsidies were an important part of housing policy

Projects tended to be outside of municipal control, and to have different standards from elsewhere, different means of implementation (for example, materials procurement through project depots at subsidized prices and soft loans) and little effect 'outside the fence'.

Self-help

Projects during the first period of international financing for urban development focused upon self-help, providing a context in which the spare time and energy of low-income people could be devoted to house construction or infrastructure provision. They were broadly of two types: sites-and-services projects for new housing provision and settlement upgrading for bringing squatter and other informal settlements up to an acceptable standard of servicing and public space provision. Some of the classic projects during the early to mid 1970s, including the World Bank urban development projects in Botswana, El Salvador, Senegal and Tanzania, focused upon new development through sites and services – providing a minimal core house and infrastructure on 'greenfield' sites. This approach was much more cost effective than direct provision of housing. Other classic projects – notably, World Bank projects in Indonesia, Burkina Faso and Zambia – focused upon slum upgrading through improving conditions in un-serviced settlements and providing some serviced sites for overspill. This was more socially and politically acceptable than the alternative of wholesale clearance and relocation. They often ran together, as residents were displaced from the squatter settlements during the rationalization process required to retrofit roads and open up the most congested parts, would be given a serviced plot as recompense for their removal. Both types of development intended to provide occupants with 'acceptable' environments, though they often did not conform to the contemporary legal standards.

Residents of each would be involved in the project through their own physical work, either building the dwellings in sites-and-services schemes, or fitting infrastructure in upgrading. This concept of adding value through physical work, referred to as 'sweat equity', was strongly ingrained in the projects of the 1970s. For a household to engage artisanal help, by employing a builder to construct their home, was felt to be not playing the game by the rules. There was an assumption that, in a reflection of the Protestant ethic, hard work was morally good and, if it was expended building a home or improving the neighbourhood, the occupants would value the dwelling so much that they would look after it well and care for the neighbourhood and its services. In this, the project designers were supported by a then developing literature on the importance of making home as a process, not least by the highly influential work of John Turner.[19] Intuitively, it can be accepted that if someone has been part of constructing a dwelling or a sewer, they will be vigilant with respect to its maintenance and will also be capable of repairing it.

Participants in sites-and-services schemes were helped in their construction efforts by project staff who provided a range of services. They might provide plans of standard dwellings (in first phase and complete forms) including block-by-block guides to construction, help with setting out and laying foundation slabs, and constant encouragement to persevere until the construction was complete. Participants were meant to repay loans taken out to build the dwellings and also to repay the cost of infrastructure and the ongoing services provided. In slum upgrading projects, less repayment was expected; but users were expected to contribute in cash or labour in fitting infrastructure, as well as to pay for the water and other services as they used them. Recipients of upgrading benefits were expected to be among the poorest households in the city.[20]

One analysis of World Bank projects demonstrated that the projects generated greater than expected private investment in housing – in Senegal about eight times as much as the project cost – in addition to considerable benefits in the informal construction industry.[21]

Although land, infrastructure, services and administration were financed from loans, sweat equity became a major housing finance mode; the opportunity cost of leisure time or other economic activity replaced money to pay contractors, just as in pre-industrial societies. Self-help assumed that the opportunity cost of participants' time was near zero when, in fact, most low-income people are not really idle when they are not at their formal work (if they have any). Instead, they work hard as parents or make business to increase their household livelihood portfolio. It was, therefore, difficult for them to fit the sweat equity mould, and many employed artisans to carry out construction tasks.[22] Indeed, evaluations have shown how many participants used professional building workers[23] Only one fifth of households in a Philippines scheme had relied upon their own labour.[24] In Matero, Lusaka, 92 per cent of participants in the World Bank-financed sites-and-services scheme employed construction labour.[25] In the El Salvador World Bank projects, about 72 per cent of labour inputs (by value) were hired – a total of 6.5 work months hired labour per dwelling.[26] As might be expected, households with higher incomes and greater employment opportunities were more likely to contract out their 'sweat equity' contribution to artisans than those with lower incomes.[27]

In addition to finance by sweat equity, there were many subsidies. Some were declared in the project (on-budget) and others were hidden (off-budget). For example, project administrative costs were rarely passed on to the recipients, being absorbed, instead, as a hidden subsidy. Off-budget subsidies were usually many times larger than on-budget.[28]

The participants in sites-and-services schemes tended to have rather higher incomes than the rhetoric and intention implied. As they usually had to apply in writing, often in an international language or an urban *lingua franca*, most successful participants were literate in their second language and, therefore, able to earn more than the minimum wage. It was in the interests of project administrators to allocate plots and the consequent subsidized benefits to households who could well afford to keep up the repayments. Thus, the financial requirements, with respect to upfront payments and ongoing repayments, rendered the projects self-selecting to people who had a likelihood (and some evidence) of long-term stable income. Of course, this undermined the poverty alleviation goal of such projects. It is, therefore, not surprising that, in many projects, low-income households showed themselves able and willing to pay for housing and services in a way that undercut the basic premise of subsidies.[29] In others, poor repayment by occupants undermined any hope of replication. Only in a few countries (notably, Indonesia, Jordan and Tunisia) was substantial replication successful.

Dwelling owners in upgrading schemes, on the other hand, tended to be among the low-income groups and their tenants were probably in even lower income echelons (although their per capita income was probably similar or higher).[30]

Who took part in and benefited from the projects?

The successful project beneficiaries 'won the lottery' by having access to benefits unavailable to the mass population. They undoubtedly benefited with respect to long-term improvements in their housing conditions, the improved security of tenure which went with the schemes, and in terms of the consequent increase in the value of their property. However, they had to accept what was on offer and it may not have been what they had bargained for or what they required the most. Many found themselves unsuited to the project and bought their way out by selling to richer households, ignored some of the project requirements to better suit it to their needs, or defaulted on payments to make it affordable. Tenants tended not to benefit much as their rents would rise to cover any repayments required, often above their willingness to pay. Thus, they tended to move out to another non-upgraded settlement where rents were still affordable. In the process, however, their social and economic networks would probably be seriously dislocated.

Many owners took advantage of demand for the greatly improved housing and sold out to higher income households, who had not enjoyed such secure tenure, and then moved into another un-serviced area. Indeed, it was not uncommon for site-and-service owners to remain in the squatter settlement and rent out the newly built dwelling to another, better-off, household. Where those who sold or rented out achieved a good price for their dwelling, they might be said to have exercised a reasonable market choice to convert housing capital gains into more flexible forms in order to diversify the benefits into other parts of their household livelihoods portfolios.[31] However, anecdotal evidence suggests that few gained a full market price as even a relatively small capital sum represented more money than most had ever contemplated possessing, and they were easily wooed into selling themselves short and moving back into un-serviced squatter areas. This 'raiding', or 'poaching', by middle-income households has been a feature of many such interventions through the decades and is still an issue in South Africa's housing subsidy developments.[32]

Many participants benefited from learning new skills and gaining confidence in, and understanding of, construction and the installation of services, as well as in dealing with authority figures. Some went on to make a living with their new skills. However, it has been argued that the process of teaching lay-people to build their own dwellings is inefficient in that they only really master the process when they have almost finished.[33] The newly learned skills are then usually neglected and forgotten. This is counterproductive as it is more important to have a well-functioning cadre of small-scale contractors than to teach individuals skills that they will only use once.

There was an obvious problem about how far the recipients were being involved in planning and decision-making. Projects tended to include a bundle of services and components chosen by distant decision-makers and imposed upon the recipients, with their involvement sought only in a token participation exercise to gain their cooperation and acquiescence. Thus, in the World Bank's early Lusaka Project in Zambia, residents of squatter settlements went on collective walks to guide the detailed route of roads that had already been roughly marked out in thick felt pen on a diagram of the project.[34] They were not involved in the decisions about how much investment should be devoted to roads and what the general layout should be; their participation was restricted to details of routing and which buildings should be demolished to implement their construction.

The construction industry benefited in contrasting ways. Large formal (sometimes international) contractors had the opportunity to tender for the large contracts and the successful firms undoubtedly benefited. Their workers would also receive regular income and experience. However, much of the construction industry consists of independent artisans who tackle jobs alone or in informal gatherings of tradespeople and labourers. They were often disqualified from tendering because of the conditions about previous experience and the bonds to be deposited. Many, however, benefited from small contracts to provide skilled inputs into so-called self-help housing. However, they were unlikely to have garnered as much work as if the housing had been developed in a manner designed to value the role of local construction firms. The effect of the subsidy element in these self-help projects on small contractors was often conflicting. On the one hand, the reduction in land and other costs allowed clients to spend more on the structure, improving the opportunities for small contractors. On the other hand, the same contractors might also suffer a reduction in the value of their work as subsidized alternative housing goods became available.

The municipalities and utilities agencies took part and benefited in a limited way. The projects were often too complex for the municipal authority to implement. Municipalities provided the land for the projects at subsidized prices. The improvement in the housing stock and the upgrading of some of the worst housing undoubtedly took away some problems and generated potential for improved property tax and utility charges. However, they inherited servicing and maintenance burdens from the new infrastructure and often found that the clients had no intention of repaying the cost of fitting or the ongoing service charges. In addition, collection of taxes and charges is often very poor, so such benefits are minimized. Defaulting behaviour is likely to be particularly serious where some allocations have been made to return political or other favours, or where defaulting has been tolerated in the past or used as a political weapon – for example, apartheid South Africa. More importantly, perhaps, these early projects had almost no positive effect on the ability of the municipalities to manage urban programmes as their staff had been bypassed in the planning, financing and implementation, which were conducted by a specially recruited team only tangentially attached to the municipal councils. However, the negative effect on municipalities was often felt through the 'diversion of scarce talent to a small enclave of public programmes' that were not managed by the municipality in which they took place.[35]

The great majority of citizens – those outside the project 'fence' in the cities affected, those not finding work in the project, and those living elsewhere in the country (including the rural areas) – benefited hardly at all. Indeed, it is likely that they experienced poorer conditions than they could have done if the resources had been used differently, rather than being concentrated on the projects. Most people in the countries affected could, therefore, be excused for feeling it was all a waste of money that could have been better spent helping each qualifying household a little, instead of giving a windfall to a few. Furthermore, large amounts of subsidized dwellings in particular neighbourhoods may well have had a depressing effect on general housing values.[36] The inescapable reality is that most people living in poverty did not benefit from the project-based approach at all. Indeed, its poverty alleviation focus was probably subsumed, in implementation, by the impetus to complete the project on time within budget, and to demonstrate that the approaches worked and could be replicated, even though they did not reach those in the lowest income groups.

The 1980s saw 'step-by-step moves towards a more comprehensive whole-housing sector approach'

Towards financial sustainability: the 1980s

The 1980s were a period of change. The projects of the 1970s were subject to detailed analysis, both within international funding institutions[37] and from outside,[38] and lessons had been learned. For example, for all the efforts aimed at improving housing, the existence of un-serviced informal settlements appeared to be continuing; indeed, they appeared to be expanding rather than in decline. The limitations found in the project approach included the following: that they had a low impact on overall urban economic development; that they encouraged institutional reforms only in those organizations implementing the projects; and that the funder's funds were restricted to 'retail' rather than 'wholesale' roles.[39] The 1980s saw 'step-by-step moves towards a more comprehensive whole-housing sector approach' in which evaluating existing projects was as influential as general changes in policy towards housing and urban development.[40]

There was a perceived need to incorporate housing within the wider economic environment, rather than dealing with it as a special sector requiring attention out of welfare considerations. It was recognized that the individual sites-and-services and slum upgrading projects alone could not affect the growing housing need – a well-functioning finance system for housing for the majority was necessary.

This generated a paradigm shift from multi-sectoral, but quite localized, projects, affecting a fortunate few, to an emphasis on creating a sustainable capability for housing supply and urban development affecting most residents and congruent with the overall policy and economic environment. The locus of borrowing changed from almost exclusively public-sector institutions to financial intermediaries. In parallel, attention shifted from the physical asset financed to the institutional structure of the implementing agency and its ability to mobilize the development required.[41]

It was recognized that a well-functioning housing finance system for the majority was necessary

Quite early in this period, as a way of countering the obvious problem that the components planned were not necessarily the priorities for the recipients, the World Bank developed programmatic projects in which the local municipalities and other institutions could propose side projects within an agreed range. The prototype for these was Brazil's Parana Market Towns Improvement Project, implemented between 1983 and 1988, in which a large number of municipalities could compete for investments according to local priorities. This project demonstrated early success in proliferating urban projects and targeting them to the sectors in which there was local need.

Structural adjustment: towards macroeconomic orthodoxy

During the early 1980s, World Bank loan financing was made available to enable governments to recover from years of decline through structural adjustment programmes (SAPs). Indeed, for many countries, the SAP was imposed as a condition on other loan finance. It consisted of, among other things, a reduction in government and quasi-government agencies, a reduction in public spending, and the introduction of markets in the supply side of housing and urban development. The purpose of SAPs was to:

- introduce economic reforms and reduce balance of payments deficits;
- reduce public expenditure to more manageable levels; and
- carry out medium-term reforms to improve exports and growth.

SAPs were intended to integrate local economies within the international trade and finance systems and to establish balance between state and market roles.[42] The advocates of this approach saw the free market as the means of improving efficiency and injecting dynamism into the economy. The state's role was that of enablement: securing private property rights; reducing regulations in inhibited markets; achieving macroeconomic stability; developing finance capital markets; and providing sector policies and institutional frameworks for effective development.[43]

There was a perceived need to be involved in the promotion of sound financial institutions in the borrowing countries, in which housing finance was seen to be a part.[44] Public institutions were the target provider. At the same time, there was a change in attitudes towards subsidies. It was believed that they should be reduced, effectively targeted and changed from financial (money up front) to fiscal (tax breaks or credits). This occurred in parallel with structural adjustment in the wider economic and financial context.

Structural adjustment has often been seen as ultimately unhelpful to the countries upon which it was imposed. It frequently resulted in a reduction of formal-sector employment without enough alternative employment opportunities, and the social welfare protection introduced in mitigation programmes was often insufficient. It focused upon exports; but Organisation for Economic Co-operation and Development (OECD) countries did not lift tariff and quota restrictions to allow the exports to compete on equal terms in the world market.

Externally supported projects at the time channelled housing and urban loans into housing finance institutions and municipal development funds, where they would be disbursed more widely and quickly than could geographically delineated inputs.[45] A key objective of projects promoted by the World Bank was financial sustainability – creating housing finance systems that fitted into a generally sound and sustainable financial sector.

In the housing sector, the direct results of SAPs were often some or all of the following:

- development of housing finance capital markets, including intermediaries capable of offering mortgages to middle- and low-income households;
- deregulation of interest rates on loans;
- collapse of uncompetitive housing finance institutions;
- curbing of public expenditure, which often cut infrastructure programmes and maintenance;
- taking direct provision away from the state in favour of private developers and NGOs; and
- diversion of investment from construction into other, so-called 'more productive', export-orientated sectors.[46]

The shift from project-orientated lending to lending for housing finance brought about a major shift in the scale of loans. World Bank project averages rose from US$19 million during 1972–1975 to US$211 million during 1985–1990. At the same time, there was an increasing number of loans and a larger share of lending to housing and municipal financing. From 1986–1991, housing and related residential infrastructure (about 70 per cent of urban lending) ranged from 3 to 7 per cent of World Bank lending and averaged US$900 million annually.[47] However, at the same time, the countries assisted by the financial-sector loans tended to be better off than those assisted in the project-based phase.[48]

The birth of the enabling strategy: the mid 1980s

One significant review of housing policy transition argues that there was a fulcrum of policy change during 1985 to 1987, a mid point between the two major United Nations conferences.[49] It was a time when the in-depth reflection on the accumulated experience in the shelter sector was bringing improved understanding and there was discussion of the way forward in several influential documents. There was also advocacy arising out of the 1987 International Year of Shelter for the Homeless.[50] Self-help was then seen as provisional, evolving from sweat equity to contracting of construction professionals.[51] Furthermore, by the end of this short period, the enabling approach had been put together and launched on the international agenda. As mentioned earlier, the 1980s saw 'step-by-step moves towards a more comprehensive whole-housing sector approach' in which evaluating existing projects was as influential as general changes in policy towards housing and urban development.[52]

The Global Report on Human Settlements 1986 introduced the enabling approach as a development from the project-based approach towards settlement-wide, participatory action aimed at reducing the ring-fenced effects of the earlier projects and allowing all to enjoy better housing conditions.[53] It was clear that there was an inescapable need to scale up activities to meet the needs of the very large numbers of people living in poverty. It was also becoming obvious that whole housing sector development depended upon how well the economic, financial, legal and institutional environment supported it.[54]

The enabling approach treats housing and urban development as a multi-sectoral issue, affected just as much by efficiencies and inefficiencies in finance as in the construction industry or land-tenure systems, or the regulatory framework. The task of the state is to create the legal, institutional and economic framework for economic productivity and social effectiveness, in which efficient settlement development can then flourish.

The enabling approach calls for a housing policy environment that oversees and regulates the sector, with the government not supplying housing directly, but leaving actual production and delivery of housing to the housing market, in which all 'actors', ranging from large formal-sector developers through artisans and individual households, to voluntary community organizations, involve themselves at their most effective level in the production process. The enabling approach replaces the interventionist provision of public housing by the state, which presupposes that the government and its agencies are the best actors to supply the kind of housing that society should have.

In the World Bank's 1993 housing sector paper, which reflected many aspects of its urban policy document of 1991, the enabling approach was introduced in some detail in the context of overall financial markets.[55] Both sector papers emphasized enablement approaches, the sectors' contributions to general macroeconomic development, and the acceptance of pro-poor policies, including targeted subsidies.[56] There was also a recognition that most housing and infrastructure loan programmes required a mix of market, state, voluntary sector and household roles, especially in recognizing that each may be most effective at a particular level.

The enabling approach treats housing and urban development as a multi-sectoral issue

In order to enable housing provision, the six inputs (five markets and one intervention) in the housing supply system should be freed up to operate effectively. The six inputs are: land; finance; construction industry/labour; building materials; infrastructure; and the regulatory framework. The argument is that removing bottlenecks from each of these will enable housing supply at the requisite scale and variety for urban development to effectively accommodate the people. For example, if finance is easily available but construction materials are in short supply, extra financial inputs to end-users might only raise the price of materials. What may be needed more is investment in building materials supply.

It is vital for the enabling approach to shelter that a wide range of non-state actors are willing and able to produce and market housing, and to undertake essential support roles in the housing process, such as facilitating the flow of housing inputs, organizing communities and operating services. These non-state actors include the commercial private sector (such as developers/real estate agents and banking/finance institutions) and, more importantly for the urban poor, NGOs, community-based and other socio-civic organizations, as well as small-scale producers in the informal sector. Since each of these actors has distinct comparative advantages in housing, the goal of policy is to develop partnerships that complement their strengths and weaknesses. This will maximize their contributions and minimize costs to particular groups or to the city as a whole. Partnerships are thus fundamental to the enabling approach and to achieving adequate shelter for all.[57]

Sustainability and the brown agenda

The mid 1980s also saw the birth of sustainability as an overarching rubric for development activity. Following the founding of the World Commission for Environment and Development (WCED) in 1983, the Brundtland Report devised the now classic definition of sustainable development as meeting 'the needs of the present without compromising the ability of future generations to meet their own needs'.[58] From that time on, no agency could ignore the need to consider environmental impact alongside the social and economic benefits of its projects. Shortly after, the 1992 United Nations Conference on Environment and Development (UNCED, or the Earth Summit) in Rio de Janeiro agreed on Agenda 21. Its Chapter 7 dealt with human settlements, emphasizing the significance of urban environments and community-based environmental planning and management. Housing, infrastructure and urban governance were firmly rooted into the sustainability agenda. An essential component of sustainability in human settlements is equity in distribution, with particular emphasis on the low-income groups.

The most immediate and critical problems confronting developing country cities are the health hazards deriving from inadequate water, sanitation, drainage and solid waste services; poor urban and industrial waste management; air pollution; accidents linked to congestion and crowding; occupation and degradation of marginal and sensitive lands; and the interrelationships between these problems. This aggregation of problems, which collectively constitute the 'brown agenda', disproportionately affects the urban poor, who are most affected by ill health, lower productivity, reduced incomes and lowered quality of life.

Chapter 7 reiterates the overall objective of improving the social, economic and environmental quality of human settlements and the living and working environments of all people, particularly the poor. Such improvement should be based on technical cooperation activities, partnerships among the public, private and community sectors, and participatory decision-making by community and special interest groups.

At the same time, there was a realignment of emphasis from the 'ability to pay' to 'willingness to pay' as a result of economic analysis which found that the latter produced much more accurate estimates in cost-recovery calculations.[59] Ability to pay depends particularly upon the economic conditions of the potential users and tends to be expressed as a percentage of household income (for example, 20 per cent for housing and 3–5 per cent for water), although this can vary considerably depending upon the nature of the local economy. Willingness to pay, on the other hand, represents perceived utility and benefit of a service. Factors that are likely to affect willingness to pay include household income; the potential of additional income or savings owing to the improved service; the level and value of time saved; and the perceived convenience, reliability and quality of the improved service compared to the old service.

Box 2.1 Seven-point conceptualization of whole-sector development

Sustainable development requires approaches that are integrated, reaching across sectors and touching physical, economic and social activities and institutions. Such integrated approaches have been promoted by major international organizations such as the United Nations system and the European Union (EU).

In its 1993 housing sector paper, *Housing: Enabling Markets to Work*, the World Bank conceptualized whole-sector housing development as comprising seven components, three on the demand side, three on the supply side and one appertaining to managing the sector:

Demand side

1 the development of property rights – for example, in regularizing tenure in squatter settlements and in removing rent controls;
2 the development of housing finance systems, especially mortgage finance;
3 the targeting of subsidies;

Supply side

4 infrastructure provision for residential land development;
5 the regulation of land and housing development, including introducing regulatory audits to remove barriers to development;
6 improved organization and competition in the building industry;

Managing the sector

7 appropriate institutionally loaded reform.

Source: World Bank, 1993; Pugh, 2001.

Whole-sector development: 1987 onwards

The 1990s saw a consolidation of the sector-wide approach that had emerged in the early 1980s in which major donors started giving support in an agreed sector to be coordinated by governments at local or national level (see Box 2.1) This shifted donor interventions from direct programmes, which suited the donor's priorities, to supporting governments to implement their own priorities.

Approaches range from a set of coordinated projects, to simply supporting a sector budget. This often occurred within a context in which governments agreed on core poverty reduction strategy (PRS) principles within which to disburse funding. Assistance was then given to achieve:

- greater government ownership of reform and development programmes;
- increased government accountability;
- development of sustainable capacity;
- transparency and predictability of resource flows; and
- maximum value for money and minimum transaction costs.[60]

The focus moved from physical targets to broad institutional development, including financially sustainable operation of upgrading programmes. In parallel, the lending agencies moved away from a 'retailing role', involved in every detail of the project, to that of a 'wholesaler', with local municipalities or other institutions planning and implementing the details within broad programme parameters and demonstration of administrative capability.[61] As in the Parana Market Towns Improvement Project, finance was awarded to an institution or consortium which then disbursed its components to others. This represented a 'wholesaler' to 'retailer' relationship that promised greater efficiency. Loan conditions required 'sustainable finance', represented in cost recovery, and in the skilled management of receipts and expenditures within a context of operational effectiveness. Members of the consortium (in the Parana case, local governments and their communities) selected their type of sub-projects, costed them, and rationalized community participation in the selection of priorities.[62]

The Global Strategy for Shelter

By 1990, the United Nations Centre for Human Settlements (UNCHS, now UN-Habitat) had formulated its comprehensive ideas of housing reform and released the Global Strategy for Shelter to the year 2000.[63] This had a laudable, but what is now recognized as an over-optimistic, objective of 'decent housing' for all by 2000.[64] Later in the decade, this term was replaced by 'adequate housing'; but this was also defined in some detail in the Habitat Agenda to include the physical conditions of the dwelling, its services, tenure security, location and many other characteristics.[65] The need for adequate housing has also been included in many United Nations summit recommendations and closing declarations, including UNCED in Rio de Janeiro,[66] the Social Development Summit in Copenhagen,[67] the Fourth World Conference on Women in Beijing,[68] the United Nations Conference on Human Settlements in Istanbul,[69] as well as the *Durban Declaration on Racism, Racial Discrimination, Xenophobia and Related Intolerance*.[70]

The 1992 UNCED Earth Summit in Rio de Janeiro influenced both UNCHS (Habitat) and the World Bank. As mentioned earlier, it included housing and urban policies within Chapter 7 of Agenda 21, its strategy for the 21st century. Sustainability is seen as a three-pronged approach, joining environmental, social and economic development in housing and urban programmes. Agenda 21 called upon local governments to mobilize their communities for policy formulation and action plans for environmental improvement in Local Agenda 21s.

The Global Strategy for Shelter to the Year 2000 (GSS) recognized that governments have an obligation to ensure that an appropriate environment is created for the mobilization of finance for housing. The objectives of such an effort are to promote and mobilize savings, reduce costs, improve the efficiency of financial intermediation, and assist the free movement of capital through the national economy. Housing finance reform, which is a key component of a shelter strategy, should be seen as part of a broad effort to reform and develop the financial sector.[71]

The GSS encouraged providers to reduce the cost of housing finance to the lowest possible level, but urged that the days of housing subsidies, artificially low interest rates and political interventions to forgive defaults be left behind. Instead, government interventions should be consistent with sound financial and economic principles through prudent interventions in the deposit rate, servicing costs, cost of risk, risks of default, fluctuations in interest rates, liquidity and repayment. Personal savings should still be the cornerstone of housing finance for lower income groups and these had to be mobilized as fully as possible.[72]

The GSS accepted that subsidies were necessary for some groups, but called for ensuring that they provided the greatest benefit to those most in need and treated equally those in equal need. They should be targeted to deliver the greatest possible benefit to their intended beneficiaries at the lowest possible administration cost. In addition, they should not impose unacceptable costs on others, including institutions.[73] Whatever else subsidies are, they should fit into an overall approach to social welfare for people living in poverty.[74]

Focus on building institutional capacity to develop housing and urban services

The new paradigm encouraged institutional reform and development. In contrast to the 1970s approach of bypassing local institutions, sending signals that they were untrustworthy and less than competent, the new approach was to uplift local institutions, affirming their trustworthiness and challenging them to be effective. This coincided with the spread of decentralization of power from the centre to regions and municipalities, and the growth of a local sense of responsibility for urban conditions. It also gave local authorities a financial resource to draw upon in a context where bond and financial securities markets were often undeveloped.[77]

Efforts to improve municipal government led to the setting up of the Urban Management Programme (UMP) as a partnership between UNCHS (Habitat), now UN-Habitat (the executing agency), the World Bank (the associate agency), and the United Nations Development Programme (UNDP) (providing core funding, with various bilateral donors, and monitoring) in 1986 (see Box 2.2)

The focus of the UMP echoes the more holistic, inter-agency approach which grew through the 1980s and the recognition that the future success of development might rest in the cities of the world. The emphasis on assisting municipalities to carry out their functions effectively illustrates the shift from early project-based assistance to addressing the core capabilities of public authorities and their citizens to improve service delivery and sustainability.

GSS recognized that governments have an obligation to ensure that an appropriate environment is created for the mobilization of finance for housing

In 1999, the Cities Alliance was established as a global alliance of cities and their development partners committed to improving the conditions of the urban poor through city development strategies and slum upgrading. Like the Urban Management Programme, it is a partnership between the World Bank and UN-Habitat, with several countries and other agencies involved in funding. It works in partnership with local authorities and national governments to, among other things, scale up solutions promoted by local authorities to address the shelter needs of the urban poor, who are treated as partners, not problems. With respect to finance, it engages potential investment partners to expand the resources available to local authorities and the urban poor, enabling them to build their assets and income.[78]

A holistic approach to settlement upgrading, sometimes called 'the Orangi model' after a successfully upgraded area in Karachi, Pakistan, has been replicated in several countries.[79] The process adopted involves making

Box 2.2 Urban Management Programme

The Urban Management Programme (UMP) was set up to strengthen the contribution that towns and cities make towards economic growth, social development, reduction of poverty and the improvement of environmental quality. In its first few years, it was mainly notable for the development of policy frameworks and discussion papers, especially on land and urban environmental management. From 1992 onwards, it focused upon technical cooperation on a demand-driven basis from developing countries, managed through regional offices.[75] It has emphasized participatory urban governance, urban poverty alleviation, urban environmental management and, more recently, the shelter effects of HIV/AIDS, with gender as a cross-cutting issue. Participatory decision-making processes have been institutionalized in participating cities through 120 city consultations. The UMP's way of working directly with cities, both in the city consultations and in its seven city development strategies,[76] is in line with the climate of directly funding existing local institutions.

know-how available to an organized community which has its own leadership for negotiating policy and for mobilizing local people to take part in self-help activities. Choices are made about the selection of affordable technology and resource allocation in water and sanitation services to bring health and economic benefits, including generating investment in housing improvement. Sometimes a community will manage the infrastructure system or contract with private or public sectors.[80] Of course, the model is implemented differently, and has different outcomes, depending upon political, cultural and professional factors in each place. In some projects, for example, the communities expressed their rights and needs in a unified way, and this facilitated better results per unit invested than in cases where political disputes arose among residents when deciding priorities for environmental improvements. Clearly, the 'political' realm can influence the effectiveness of upgrading investments.

It is clear that this is fundamentally different from the 1970s model used in Lusaka and elsewhere, where the only choices offered to the residents were the detailed routes of the already planned service lines, even though they were expected to expend time and energy in fitting the services.

The development of mortgage finance became a major focus for the World Bank's interventions and influenced other international lenders. It was recognized that less than 10 to 20 per cent of annual housing investment in developing countries was covered by mortgage finance. Over several decades, national banks and building societies had to cope not only with the age-old problem of mortgage financing (lending over the long term while borrowing over the short term – through deposit and current account balances), but many also had to endure political interference in their business dealings. They were, typically, coerced into lending at fixed rates (often at negative real interest rates) and forgiving loans; as a result, they could not maintain liquidity. Thus, numbers of mortgages were very small and institutions were extremely risk averse, lending only to the most financially secure or politically favoured clients.

Economic development depends on efficacy of financial systems

Reflecting the globalization beginning during the early 1990s, the World Bank pointed out the need for housing finance institutions to be able to compete for deposits and investments on equal terms with other financial institutions. Thus, lending must be at positive, real interest rates and deposits should be of sufficient term to support long-term lending. Characteristics of lending should include:

- mortgage lending at variable rates and appropriate indexation;
- secure land tenure and property rights; and
- enforceable foreclosure procedures.[81]

All of these are necessary to protect the lenders and to enable them to lend with some confidence.[82]

Finance capital in development

The *World Development Report* of 1989 was devoted to the role of finance capital in development.[83] Its key message was that effective growth and economic development depended upon having financial systems that were effective in linking markets and government agencies with the range of financial institutions and instruments. Gone were the days when it was efficient to have low interest rates in some sectors. It had become clear from research that the formal-sector financial institutions were fragmented, had liquidity problems, could not effectively manage credit and interest rate risks and could not make their capital profitable.[84] Moreover, and probably most importantly, they were involved in only 20 per cent of housing. There was urgent need for reform to generate confidence in finance institutions both among potential customers and among the donor agencies who would channel money through them.

During the 1990s, some developing countries developed proactive and well-integrated housing finance policies and institutions. In this, they responded to the unprecedented rate of urban growth and changes in global finance markets. In addition, there was a recognition that purely government-managed finance institutions had failed in their laudable aims and had become bureaucratic, inefficient and prey to exploitation by insiders.

A 1999 study suggested that there were six broad categories of housing finance systems in place, many of which needed a range of reforms in order to make them more effective (see Box 2.3).[85]

Countries with well-developed housing finance sectors, primarily among middle-income developing countries and some Asian countries, benefited from the international concentration on housing finance. Between 1982 and 1992, the World Bank invested US$715 million in housing finance institutions in Mexico, the Republic of Korea and India. This included a US$250 million loan to the private-sector Housing Development and Finance Corporation (HDFC) of India, with which it was able to take housing credit lower down the distribution of household income. The new policy was an effort to improve the performance of financial institutions by providing guarantees to international investors similar to those of the Housing Loan Guaranty Scheme used by USAID, the US government's bilateral aid agency.[86] Sri Lanka also received significant funds, which were then on-lent to local co-operative societies to boost its 2.5 million small loans programme.

However, some housing finance systems moved from boom to bust, with serious local consequences. One example was the Mexican housing finance system. Despite no lack of interest by private builders, speculative house building was severely limited in scope in Mexico until the end of the 1980s. However, liberalization of mortgage funds from commercial banks and privatization of some investments related to payroll funds boosted the housing development industry so that private developers became active all across the country. During the early 1990s, an influx of investment capital fuelled the mortgage market and increased the impetus of the building boom, especially in condominiums, driving up land prices. This all crashed in December 1994, leaving mortgagees with un-payable debts and negative equity in their homes. A special programme was launched in 1996 to bail out the banks, which continue to loan to middle-income homeowners while the low-income group is left to make its way in the informal sector.[87]

Box 2.3 Housing finance institutions during the 1990s

Housing finance institutions during the 1990s were based on the following systems:

- *Undeveloped housing finance systems*: common in sub-Saharan Africa, with weak financial systems and commercial banks. Priority should be given to improving urban laws, policies and practices affecting housing, beginning with clarifying traditional property rights. Public efforts should concentrate on infrastructure development, the supply of serviced land and titling, all within realistic affordability parameters.
- *Missing housing finance systems in formerly centrally planned economies*: one of the many problems in the former Soviet bloc, China and Viet Nam. Coordinated improvements are needed to establish primary mortgage lenders and secondary market facilities.
- *Fragmented and unstable housing finance systems*: fairly common in Latin America, where housing finance systems are very small with respect to the economy because of macroeconomic mismanagement and/or external shocks, and inflation has been high. In highly unequal societies, most cannot afford mortgage finance, so subsidy distortions are built in, which can help the general economy to implode. It is essential to separate subsidy from finance and to target subsidies at social housing.
- *Segregated but stable housing finance systems*: in the Middle East and East Asia, where a seemingly (but actually not) very stable group of institutions provide housing finance within restrictions and special advantages. They provide poorly targeted subsidies and finance at preferential rates in a context in which numbers of units are important determinants of success. The informal sector has a major role in finance for those missing out, leading to a high implicit cost of capital for housing.
- *Sound and integrated housing finance systems*: some countries in Southeast Asia have developed sound and well-supervised housing finance systems with secondary mortgage markets that manage to reach well down in the income scales. Because the bankers can choose what to fund, building contractors produce better-quality work. In addition, investors seek out innovative technologies from around the world to improve their investments.
- *Advanced housing finance systems*: found in Organisation for Economic Co-operation and Development (OECD) countries, these have grown out of the UK building society tradition and the savings and loans societies in the US. The continental European market tends to use bond market funding; but all of these special mortgage institutions are shrinking as globalized banking provides specialized financing services to take over the mortgaging business.

Source: Renaud, 1999.

GLOBALIZATION OF FINANCE

Globalization of finance has the following theoretical implications with respect to housing finance:

- It appears to force financial institutions to develop to the point where they are integrated within the financial and capital markets of the world. As a result, their capacities to interact locally with communities are eroded.
- It integrates the financial markets of the world so that the homebuyer in the poorest country is competing for finance in the same pool as the richest countries and corporations.[88]

In this way, globalization makes it much more difficult to have special housing loans in which a lending institution lends at below real market rates.[89] Such loans are usually supported by cross-subsidies from other lending activities; but it is very difficult in the globalized financial context as the high-value business simply transfers to any bank in the world to find cheaper rates.[90] Thus, lower income groups miss out on the opportunities to borrow more cheaply and, in turn, become more difficult to reach.[91] The effect of this is lost on most low-income households, however, as very few have access to such loans. Reasons of financial inadequacy are often cited for sluggish housing markets; but in the context of the housing market within South African townships, blame has been placed firmly at the door of legal, institutional and procedural constraints.[92] Householders cannot gain loans from the formal sector because their tenure is inadequate, transactions costs are very high, there is little market information, and loans are not available for the amount they want to borrow over periods that they regard as manageable. Nevertheless, many governments still have privileged circuits for housing finance through direct funding. This is common in Southeast Asia where governments have traditionally funded housing from direct budgets. In addition, regulatory and tax systems vary so much that households are quite removed from the effects of globalization on the funding at the core of their housing finance.

It is worth asking the question: 'Why should a financial institution lend money to low-income people?' This question encapsulates the following problems facing lenders:

- The essential nature of such housing loans, vis-à-vis other commercial lending, is their small size. Loans suitable for households with incomes of US$10 per day (and there are hundreds of millions such households) would be in the region of US$5000–$10,000. They require a similar amount of administration to set up and run as loans of 100 times as much or more, but the fees (charged as a percentage of the loan amount) are miniscule.
- Liquidity can be a problem for the lender. If the lender wishes to sell on the mortgages to another financial institution in order to boost its liquidity, its portfolio of low-income borrowers with doubtful

collateral and poor security is unattractive in financial markets.

It is partly because of these problems that shelter microfinance and community funding solutions have emerged, especially in developing countries (see Chapters 6 and 7).

THE NEW MILLENNIUM: POLICIES AND ORGANIZATIONS IN SHELTER AND URBAN DEVELOPMENT

The new millennium started with a very different climate of shelter and urban finance from that which appertained 20 years ago. During the early 1980s, large formal financial institutions were the main partners for international funders and lending was banker led; secondary mortgage markets were also seen to be the way forward and were thought to be able to reach as far down the income scale as bankers could countenance. Lending to low-income households was too risky a proposition for most banks.

The low-income worker's role in housing finance was often only to contribute to a compulsory savings scheme. However, all but a lucky few of the poor were untouched by the efforts of international and bilateral finance for housing and urban development. Municipalities were beginning to be trusted; but there was little effort to involve elected representatives who actually voted on resource allocation.

In the new millennium, formal bank financing is only one of several players in the field. Mortgage finance is available in most countries, but its limitations are obviously militating against its being the solution for most low-income households. Microfinancing has progressed from being only enterprise focused to being an important feature of the housing finance system. The savings and loans system, which contains within it the tradition of regular meetings of savers, establishing social links, is an important community builder as well as financial resource. Community grassroots activities are now centre stage in at least some countries in setting the agenda and disbursing the funding. They are reaching people at such low-income levels and in such large numbers that other systems can only dream of.

Mortgage finance is available in most countries, but its limitations are obviously militating against its being the solution for low-income households

The Habitat Agenda

Just before the turn of the millennium, the Global Strategy for Shelter to the Year 2000 and Agenda 21, Chapter 7, were consolidated into the Habitat Agenda at the Istanbul Summit in 1996. It reflects the essence of both previous documents and provides a basis for international and national housing and urban development policy for the 21st century (see Box 2.4).

Reaching the lowest income groups: community-based finance

There is no hiding from the unpalatable truth that formal housing finance institutions cannot address the needs of hundreds of millions of households whose incomes are low. Their assets are just too small and too insecurely held for the formal sector to bother with them or to feel secure in handing out funds to them. Even when formal housing financing is deepening and widening, a majority of households still do not meet the assets and collateral conditions of formal-sector lenders. Formally constituted microfinance organizations have been successful in funding many low-income households, especially through group loans; but even they are by no means universally distributed.

Only the most flexible housing finance organizations will directly help some of the poorest people in society, and even they will not reach the many millions of households who find any expense above actual survival difficult. The rise of community-based organizations (CBOs) involved in providing loans to people living in poverty has been an important feature of the last decade. Perhaps equally important has been the setting up of national and international umbrella organizations to enable and assist their operations, such as Shack/Slum Dwellers International (SDI) and the Society for the Promotion of Area Resource Centres (SPARC) in India. These can negotiate directly with the World Bank and bilateral agencies to borrow large amounts of money at favourable rates for onward lending to their member organizations, who can then use it in partnership with their clients, the households living in poorly serviced and ill-constructed housing and places with little security. They can also have access at the highest level to policy-makers in the United Nations system and national governments.[93] Because of the scale of their groups, and the links with major funders and policy-makers, international grassroots networks have become major forces at the international level on behalf of people living in poverty and are changing the way in which funding is offered and how it is disbursed.

This grassroots movement has introduced a new dimension to the financing of housing and urban development. Probably for the first time, the people who are the ultimate beneficiaries of major international loans are in the driving seat, determining how the money should be spent and organizing others to do the same. These more recent shelter financing approaches are discussed in detail in Part II of this Global Report, alongside reviews of the current status of mortgage finance and social housing approaches.

The right to housing

During the 1990s, the need to ensure adequate housing became the right to adequate housing. This had already been on the agenda since it was included in Article 25 of the 1948 Universal Declaration of Human Rights.[94] During the late 1980s, it appeared again in the United Nations General Assembly, which reiterated:

> *… the need to take (at national and international levels) measures to promote the right of all persons to an adequate standard of living for themselves and their families (including adequate housing) (Resolution 42/146).*[95]

It was also reaffirmed in the *Vienna Declaration on Human Rights*, which emphasizes:[96]

> *… the rights of everyone to a standard of living adequate for their health and well-being, including food and medical care, housing and the necessary social services.*

The Istanbul Human Settlements Summit further reinforced the:

> *… commitment to the full and progressive realization of the right to adequate housing as provided for in international instruments. To that end, we shall seek the active participation of our public, private and non-governmental partners at all levels to ensure legal security of tenure, protection from discrimination and equal access to affordable, adequate housing for all persons and their families.*[97]

The 'progressive legal obligation' stance is enshrined in the cornerstone of the International Covenant on Economic, Social and Cultural Rights, which urges all states to make every effort towards 'achieving progressively the full realization' of the rights in the covenant.[98] However, this does not mean that states can wait until economic or financial conditions make fulfilment of housing rights more straightforward. Indeed, all states are expected to provide for at least a minimum essential level of each right such that a state in which 'any significant number of individuals is deprived of basic shelter is *prima facie* failing to perform its obligations under the covenant'.[99]

Any retrogressive measures, such as forced evictions, are violations of the right to housing. Indeed, states have a duty to respect, protect and fulfill housing rights. Respecting obligates the state not to do anything that violates rights; protecting obligates the state to prevent any other agency from violating people's right to housing; and fulfilling incorporates obligations both to facilitate (or enable) through national housing policies and to provide for those for whom housing is impossible within their own resources.[100] The latter is important to the financing of urban shelter development.

None of this embodies a state obligation to provide everyone with free housing, but rather to set up the legal, social and economic environment in which households have an adequate chance to fulfil their needs. An example of the outworking of this can be found in South Africa, where the new state constitution was being drafted at this time.[101] In it, the state must take 'reasonable legislative and other measures, within the available resources, to achieve the progressive realization of the rights'.[102] This has been tested through the legal campaign of displaced people in the celebrated Grootboom versus Oostenberg Municipality case (see Box 2.5).[103]

Box 2.4 Commitments on shelter finance, Habitat Agenda, 1996

On finance, paragraph 47 of the Habitat Agenda commits member states to:

> *… strengthening existing financial mechanisms and, where appropriate, developing innovative approaches for financing the implementation of the Habitat Agenda, which will mobilize additional resources from various sources of finance – public, private, multilateral and bilateral – at the international, regional, national and local levels, and which will promote the efficient, effective and accountable allocation and management of resources, recognizing that local institutions involved in microcredit may hold the most potential for housing the poor.*

Paragraph 48 also commits member states to:

> *(a) [Stimulating] national and local economies through promoting economic development, social development and environmental protection that will attract domestic and international financial resources and private investment, generate employment and increase revenues, providing a stronger financial base to support adequate shelter and sustainable human settlements development.*
>
> *(b) [Strengthening] fiscal and financial management capacity at all levels, so as to fully develop the sources of revenue.*
>
> *(c) [Enhancing] public revenue through the use, as appropriate, of fiscal instruments that are conducive to environmentally sound practices in order to promote direct support for sustainable human settlements development.*
>
> *(d) [Strengthening] regulatory and legal frameworks to enable markets to work, overcome market failure and facilitate independent initiative and creativity, as well as to promote socially and environmentally responsible corporate investment and reinvestment in, and in partnership with, local communities and to encourage a wide range of other partnerships to finance shelter and human settlements development.*
>
> *(e) [Promoting] equal access to credit for all people.*
>
> *(f) [Adopting], where appropriate, transparent, timely, predictable and performance-based mechanisms for the allocation of resources among different levels of government and various actors.*
>
> *(g) [Fostering] the accessibility of the market for those who are less organized and informed or otherwise excluded from participation by providing subsidies, where appropriate, and promoting appropriate credit mechanisms and other instruments to address their needs.*

Source: United Nations, 1996b.

CONCLUDING REMARKS

Despite many changes in emphasis, international and national efforts in housing finance have failed to reach the majority of households. Housing finance from international institutions began by encouraging projects aimed at improving housing in selected areas and for particular groups, primarily to discourage the growth of poor conditions in low-income neighbourhoods. Such finance was narrowly focused but had a catalytic purpose: to spread to other areas and groups until all were assisted. However,

Box 2.5 Housing rights in South Africa

In the final hearing of the Grootboom versus Oostenberg Municipality case, the South African Constitutional Court ruled that it was not for the judiciary to enquire whether better measures could have been adopted to provide adequate housing, but rather to determine whether or not the state had violated the right of access to housing of the people concerned. In determining the 'reasonableness' of the measures taken by the state, it is right to take into account the resources it has at its disposal. The constitution does not expect more than the state can afford and felt that its housing programme was, so far, a major achievement and represented a systematic response to a pressing social need. The overall programme was, indeed, aimed at realizing access to housing for all in the long and medium term. However, the court found that the state had neglected the short-term aspect. It was clear that no real policy existed which could be applied to people in need of housing in crisis situations. Apart from the normal channel of applying for low-cost housing, which normally takes years, there was no relief for Mrs Grootboom, her children and her neighbours. There was no provision in any policy, whether national, provincial or local, that applied to her desperate situation. Thus, they ordered that 'second-best' facilities, falling short of acceptable housing standards, but nevertheless a basic form of shelter, should be provided for the displaced people. However, this was not to be seen as a licence for people to jump the housing queue by squatting and then litigating for their rights.

Source: UN-Habitat, 2002

replicability turned out to be a chimera; projects did not generally provide a way forward for everyone, nor did they change the way in which housing was provided. Indeed, the pace of informal urbanization quickened and was patently untouched by international financing.

Multi-sectoral approaches followed, out of recognition that housing is only one of a group of interlinked sectors affecting the lives of city dwellers. In addition, the importance of the market as a context and a driver of urban development and housing dominated international and many national interventions through the final decade of the 20th century. However, only a few million households have benefited; the majority still have to provide their own housing without assistance from market lenders.

The growth of monitoring tools is probably one of the most important developments in housing finance since it has changed the way in which proposals are viewed. Once, to assist 250 households was sufficient cause for action, no matter what effect it might have on the ability of others to be assisted. With initiatives such as poverty reduction strategy papers (PRSPs) and the Millennium Development Goals (MDGs), targets are visible and can be monitored. Interventions can, therefore, be judged against the larger context, diluting the impressiveness of tightly drawn projects and promoting programmes that are available to a wide spectra of the population.

Similarly, there has been a long-term switch from top-down, imposed projects, in which participation was minimal, to community-led programmes in which people decide how housing finance institutions can help them and lobby for that assistance. This change has been facilitated by the growth of NGOs, through whom large quantities of finance were channelled during the last few years of the 20th century. However, there has also been a recent revival of channelling finance through governments, including local authorities, as an encouragement of, and response to, improvements in transparency and democracy. Chapter 3 turns to a review of recent financing developments at the urban local authority level.

NOTES

1 This chapter is based on a draft prepared by Graham Tipple, University of Newcastle upon Tyne, UK.
2 Harris and Arku, 2004.
3 Harris and Arku, 2004.
4 Fry and Drew, 1964; Koenigsberger, 1973.
5 Abrams, 1964, p60.
6 The Schokbeton scheme in 1950s Gold Coast stands as a farcical waste of resources abandoned following United Nations advice (Abrams, 1964), although the dwellings built still stand.
7 Schumacher, 1973.
8 Hart, 1973; ILO, 1972.
9 Harris and Arku, 2004.
10 Turner, 1968, 1972, 1976.
11 Burgess, 1982; Ward, 1982; Burgess, 1985.
12 For a discussion of the way in which central and local government in Zambia moved from being in the forefront of positive attitudes towards squatter settlements and their upgrading to having a negative view of the informal-sector built environment only a decade later, see Kasongo and Tipple, 1990.
13 Tipple, 1988.
14 Malpezzi et al, 1990; Malpezzi and Ball, 1991.
15 Kessides, 1997.
16 UN, 1976.
17 Kim, 1997.
18 Pugh, 1995.
19 Turner, 1967, 1972.
20 Kessides, 1997.
21 Kessides, 1997.
22 As observed by Martin (1983), one of the main reasons for employing skilled workers was to improve the quality of construction and, therefore, the status of its owner.
23 Keare, 1983.
24 Keare, 1983.
25 Laquian, 1983b.
26 Laquian, 1983b.
27 Jiminez, 1982.
28 Buckley and Mayo, 1989.
29 Kessides, 1997.
30 This is a reasonably consistent finding in work in Ghana over 20 years, and in work on user-initiated extension activities in several countries. See Tipple et al, 1999; Tipple, 2000.
31 Rakodi and Lloyd-Jones, 2002.
32 Gilbert, 2000; Napier et al, 2003.
33 Tipple, 1994.
34 Martin, 1983.
35 Renaud, 1999, p759.
36 This, however, might have much less effect in developing countries where few homeowners consider selling (Gilbert, 1999) than it would have in an industrialized country with a lively market in housing.
37 For example, Keare and Parris (1982), World Bank (1983) and numerous papers and reports emanating from the research team in the Infrastructure and Urban Department – for example, see Malpezzi and Ball, 1991.
38 For example, Laquian, 1983a; Skinner and Roddell, 1983; Rodwin and Sanyal, 1987.
39 Pugh, 2001, p409.
40 Pugh, 2001, p410.
41 Buckley, 1999.
42 Pugh, 1995.
43 Pugh, 1995.
44 World Bank, 1993.
45 Pugh, 2001.
46 The argument that housing construction is economically productive has been well made in earlier United Nations documents, especially UNCHS and the International Labour Organization (ILO) (UNCHS/ILO, 1995), and in other literature (for example, Tipple, 1995).
47 World Bank, 1993.
48 World Bank, 1993.
49 Pugh, 1997.
50 Including the first *Global Report on Human Settlements 1986* (UNCHS, 1987).
51 Pugh, 1997.
52 Pugh, 2001, p410.
53 UNCHS, 1987.
54 Pugh, 2001.
55 World Bank, 1993, 1991.
56 Pugh, 2001.
57 UNCHS, 1993, 1997, 1998; Porio, 1998
58 WCED, 1987.
59 For example, by Whittington et al, 1990.
60 DFID, 2004a.
61 Pugh, 2001.
62 Pugh, 2001.
63 UNCHS, 1990a.
64 Pugh, 2001.

65 UNCHS, 1996a.
66 UN, 1992.
67 UN, 1995b.
68 UN, 1995a.
69 UN, 1996b.
70 UN, 2001a.
71 UNCHS, 1990b, pp18–19.
72 UNCHS, 1990b.
73 Too many institutions who have given subsidies have been fatally damaged by this largesse, often imposed upon them by government.
74 UNCHS, 1990b.
75 McAuslan, 1997.
76 In Bamako, Mali; Cuenca, Ecuador; Colombo, Sri Lanka; Johannesburg, South Africa; Santo Andre, Brazil; Shenyang, China; and Tunis, Tunisia.
77 Pugh, 2001.
78 Cities Alliance, 2000.
79 Pugh, 2001.
80 These may require group guarantees where foreclosure procedures are weak.
81 World Bank, 1993.
82 World Bank, 1989.
83 World Bank, 1993, 1991.
84 Renaud, 1984.
85 Renaud, 1999.
86 Pugh, 2001.
87 Connolly, cited in UNCHS, 2001.
88 Tucker and Tomlinson, 2000.
89 Kim, 1997.
90 Especially those specializing in high-value niche markets.
91 Tucker and Tomlinson, 2000.
92 Nell et al, 2004.
93 Indeed, SDI was one of the most influential voices in organizing and hosting the Meeting of the World Urban Forum in Nairobi in 2002 and in Barcelona in 2004.
94 UN, 1948.
95 UN, 1987.
96 UN, 1993, para 31.
97 UN, 1996b, para 8.
98 UN, 1966, Article 2 (1).
99 UN-Habitat, 2002, p21.
100 UN-Habitat, 2002.
101 Kabir, 2002.
102 Republic of South Africa, 1996, Article 26.
103 Grootboom versus Oostenberg Municipality, which became Government of South Africa versus Grootboom 2000 (11) BCLR 1169 (CC).

CHAPTER 3

FINANCING URBAN DEVELOPMENT[1]

This chapter addresses the wide range of problems that face municipal authorities in financing urban development as they respond to the challenges of major shifts in their economic base, resulting from falling trade barriers and a globalizing economy. Concurrently, the devolution of administrative and financial responsibility from central governments has forced them to finance a growing proportion of their recurrent and capital expenditures at a time when, in most countries, the urban population is expanding rapidly. This chapter particularly highlights new and innovative approaches to financing urban development, as well as the contextual relevance of urban development finance to finance for shelter development. At the core of this linkage is the fact that municipal finance plays a central role in providing citywide infrastructure services, including within the slums that accommodate the majority of the urban population in developing countries.[2] Indeed, without such services, it would be very difficult and expensive to implement citywide slum upgrading programmes and, more generally, to improve access to adequate shelter for the vast majority of the urban poor.

Municipal finance plays a central role in providing citywide infrastructure services

Municipalities are only one actor in the financing of urban development; but in many ways they are the pivotal one because of their statutory powers and their ability to act on all sectors in a defined geographic space. Households and private enterprises are the developers and builders of urban communities and the owners and operators of economic activities. But unless the municipality can deliver to them the support infrastructure and services that they need, orderly development will be impaired. In developing countries, the rapid pace of urbanization and large migratory flows have increased the pressure on local government spending for urban development. In most of these countries, decentralization laws were enacted during the decades of the 1980s and 1990s amid fiscal deficits, financial crises and political unrest, eroding local revenue and disrupting access to funds for capital investment.

The chapter places emphasis on developing countries, where the challenges are the greatest and the resource constraints the most acute. They are the countries targeted by the Millennium Development Goals (MDGs) and associated 2015 targets adopted in 2001.[3] Multilateral and bilateral development organizations, as well as the individual states, are placing a priority on poverty reduction, reaffirming the world commitment to addressing the growing disparities in income and wealth among countries and within countries. The success of these efforts hinges upon democratic local governance, partnerships involving communities and stakeholders in urban development initiatives, and strengthening of the capabilities and resources of local governments as the pivotal partners in the development process.

Although differences clearly exist between developing, transitional and advanced economies, there are equally striking differences within each region. A series of cases presented in this chapter illustrates the range of issues faced by municipalities, how they have responded to them, their capacity to identify and work with strategic partners, the difficulties encountered and the results achieved. The fact that countries in different parts of the world have developed comparable approaches illustrates the emergence of several important new trends: the broadening of locally generated revenue sources; the strengthening of local financial management; partnerships to finance capital investments; and enhancement of access to long-term credit for municipalities. The cases illustrate innovative approaches to address these challenges. Some have received international recognition as 'best practices'.[4]

MUNICIPAL FINANCE AND URBAN DEVELOPMENT: THE MAIN ISSUES

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

In transitional economies, the evolution of municipal finance for urban development reflects the path followed by each country as it integrates within the global economy. The sequencing of the reforms affecting legal and institutional frameworks and economic sectors is of paramount importance. Political, administrative and fiscal decentralization, changes in public and private roles and responsibilities, devolution of functional responsibilities, adjustments in central transfers, and privatization of land and property ownership all affect the capacity of municipalities to deliver services and manage urban development, work with local communities and enter into partnerships with the private sector. In general, municipalities have initiated jointly funded programmes with residents and developers to improve infrastructure and housing. Leading cities seek to compete in the regional and global economy. They strive to manage their finances responsibly in order to attract private investors, obtain investment-grade credit ratings and access the capital markets. Where local authorities are not empowered to borrow, as in China, they have found off-budget methods and instruments to obtain the financing needed to drive and implement urban development strategies and key projects.

In developing countries, municipal finance suffers from the fiscally destabilizing effects of asymmetrical decentralization. Where devolution is proceeding according to a planned legal, institutional and regulatory framework, local authorities benefit from more predictable finances and, in many ways, greater discretion. Successive *ad hoc* adjustments to correct fiscal imbalances tend to disrupt municipal financial management. In all cases, local authorities in developing countries lack the supportive framework enjoyed by local governments in advanced economies. They have to be creative and experiment with innovative approaches to meet their economic and social objectives, particularly in generating employment, expanding service delivery, upgrading the urban environment and improving shelter conditions in poorer communities.

In some developing countries, government-sponsored municipal development funds have provided municipalities with resources for specific categories of projects, including revenue-producing services and infrastructure. Social programmes continue to rely upon central funding and upon support from bilateral and multilateral organizations. Lack of access to long-term financing hampers their ability to fund urban development and to finance the infrastructure services that are so critical to shelter delivery. They are learning to seek partners and alliances, and the best managed municipalities have managed to launch and sustain initiatives with higher levels of government, private businesses, NGOs and community-based organizations (CBOs), as well as bilateral and multilateral organizations.

In the poorer developing countries, local authorities depend heavily upon central transfers to cover deficits in their operating expenditures and upon grants from donors to address their most pressing environmental and social problems. External funds are the main source of financing projects to upgrade and expand infrastructure and urban services. Decentralization policies have devolved functional responsibilities to them without providing them with the fiscal resources needed to discharge this mandate.[5] The general poverty of the population erodes local revenue, which relies upon a multiplicity of low-yield taxes and fees, cumbersome to manage and difficult to collect. Municipal performance is further depressed by chaotic urbanization and the proliferation of informal activities.[6] The MDGs have opened up new opportunities for poor countries to access funding through the Heavily Indebted Poor Countries (HIPC) initiatives for social and environmental programmes. While municipalities can benefit directly and indirectly from these financial resources, the lack of technical and managerial capacity hampers their ability to use efficiently the funding they receive, let alone to leverage the funds.

Around the world, globalization has aggravated uneven spatial distribution of economic activity and increased disparities in income and wealth among regions and countries, and within countries. These inequalities affect urban centres, with some benefiting from locational advantages while others, sometimes even close by, are bypassed by development. These imbalances are aggravated by the social dimension of globalization that has increased and concentrated poverty, led to massive population movements, and reduced local revenues because of the greater mobility of tax bases.[7] Within the shelter sector, the unregulated acquisition of property rights by outsiders has tended to constrict access to shelter by local populations.

The MDGs have opened up new opportunities for poor countries to access funding through the Heavily Indebted Poor Country (HIPC) initiatives for social and environmental programmes

Municipalities are hard pressed to find the resources needed to finance urban development policies fostering shelter delivery, poverty reduction and social inclusion. This challenge is further compounded by the growing concentration of wealth in the private sector brought about by globalization, the concomitant retrenchment of governmental expenditures, and the disengagement of the international community from urban issues in developing countries. Municipalities have to learn to tap private resources and access capital markets, both domestic and global, in order to fund the delivery of urban services and finance urban development programmes.

NATIONAL MUNICIPAL FINANCE SYSTEMS

Two key emerging issues are affecting municipal finance systems in both developed and developing economies. The first is the progressive decentralization of the responsibility for infrastructure investment and the delivery of services to local governments, a trend that has increased their fiscal burden. In some countries, such as Brazil and Indonesia, municipalities have taken advantage of this new autonomy to develop innovative approaches – participatory budgeting in Porto Alegre and other Brazilian municipalities, and the matching grants provided by the central government to Indonesian municipalities that show good fiscal capacities, as well as meet specified need criteria. In other parts of the world, overcoming a tradition of centralized administration is proving difficult, particularly in many African and Asian countries.

The second issue is the rapidly evolving local and regional fiscal relations. While there is a relatively smooth transition to complementary roles between regional and local authorities in the European Union (EU), the situation is far less clear in developing countries, with the exception of India where the state and provincial governments exercise a high degree of control over municipal finance.

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

While each country is charting its own economic and social development path, shaped, to some extent, by history and tradition but determined mostly by contemporary political and economic considerations, decentralization has become a worldwide trend underlying the different approaches. Where progressive planned devolution has taken place, as in Europe, the reallocation of functions among levels of government has been guided by the concept of subsidiarity. Where political pressure has been the driving force, devolution has proceeded in a sporadic manner, resulting in serious imbalances between responsibilities and budgeting powers.

In developing countries, municipalities lack the sophisticated supportive framework from which their counterparts in the advanced economies derive technical and financial assistance. Furthermore, their fiscal autonomy is often constrained by the mismatch between devolution of control over expenditures and devolution of control over revenue, curbs on borrowing, caps on particular categories of expenditures, and limits on their discretion to reallocate funds among budget categories. Central recording of transactions relating to wealth-producing assets, including land registration and control of high-yield tax bases, has generally not been devolved, nor is it likely to be devolved in the near future since central governments are striving to strengthen their own finances.[8]

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

- large numbers of smaller, financially weak municipalities;
- asymmetrical decentralization;
- retrenchment of central transfers;
- weakness of local revenue sources;
- lack of strong domestic capital markets;
- impediments to the development of municipal credit institutions;
- inadequate capacity and rules for sound financial management at the local level;
- lack of mechanisms to finance urban investments; and
- lack of funds for maintaining existing assets.

Despite these constraints, democratic local governance has enabled local governments to address problems of poverty and exclusion, institute participatory processes, implement multi-sectoral programmes, and enter into partnership agreements with private enterprise, NGOs and CBOs to promote job creation and foster social inclusion. Most recently, concepts of 'rights to the city' and 'access to urban services' have expanded and reinforced the interaction between local governments and civil society.

The difficulty in charting an appropriate course for decentralization that does not disrupt the delivery of basic services and other functions devolved to the local level is a challenging task. The difficulties encountered often require a process of successive adjustments to correct serious imbalances that affect the economic and social life of citizens. Indonesia's experience with fiscal decentralization demonstrates that it is possible to undertake a phased reform programme of national policies that reflect national disparities and modulate the central government's role to address inequalities and national priorities (see Box 3.1).

Box 3.1 Development and equalization strategies under adverse economic conditions: Indonesia's fiscal decentralization process

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

In a major drive to decentralize the country during 1999 to 2001, the share of public expenditures channelled through local governments rose from around 17 per cent to over 30 per cent. Decentralization laws in 1999 devolved wide responsibilities to local governments, including health, education, public works, communications and the management of land and other environmental resources. Further regulations enacted in 2000 mandated the provinces to undertake functions that localities were unable to perform. The devolution of responsibilities was matched by the devolution of control over expenditures; but the decentralization of revenue did not follow.

In 2001, the routine transfers of the past that were largely used to pay the salaries of local civil servants, along with general development transfers, were replaced by general purpose grants (DAUs), currently set at 25.5 per cent of net central government domestic revenues, and divided between local governments and the provinces on a 90:10 basis. The allocation formula is based on fiscal needs and capacities. The DAU, which accounted for 71 per cent of total local governments' revenues in 2001, is the most important equalization mechanism.

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

Source: World Bank, 2003a; Menon et al, 2003; Lewis and Chakeri , 2004.

SOURCES OF MUNICIPAL FINANCE

Municipalities obtain their finance from a wide variety of sources, but the main categories consist of financial transfers from the central government and locally generated revenue, including debt finance. Central government transfers account for the bulk of local resources in most countries, particularly for capital investments, and are usually based on a redistribution of certain centrally collected revenues: a partial redistribution of the value added tax (VAT), entitlement grants for recurrent expenditures, and grants for specific projects. These transfers bridge the gap between the revenue-raising capacity of municipalities and mandatory local expenditures.

Locally generated revenues fall into three broad categories: taxes on property and on economic activities; user fees for the delivery of services and the improvement of infrastructure; and loans borrowed to finance long-term investments, generally infrastructure. While well-managed municipalities maintain a proper balance among these sources, the rapid urbanization that is taking place in most of the world, institutional constraints and weak local management have slowed the efforts of local governments to increase their financial autonomy as part of the devolution of responsibility from the central to the local level. Increasing the yield of locally generated taxes is therefore the key challenge faced by all developing economies. The inability to do so is manifest in the fact that almost all municipalities operate at a deficit that is bridged by transfers from the central government.

Taxes on real property and, to a lesser extent, business activities are the major potential source of local revenue. A combination of factors, ranging from technical issues such as the lack of computerized databases to complex legal issues of property rights under traditional and modern tenure patterns have suppressed the yield from property taxes.[9] Although they reflect the range of economic activities found in a locality, these local revenues are often set at the national or regional level (as is the case in India), and may be collected by a central administration on behalf of the municipality. In several West African countries, a portion of the tax collected is retained by the central government. A variety of low-yield local taxes are also to be found, often the hold-overs from the colonial era.

The price structure of user fees reflects social considerations and, for the most part, does not cover the recurrent costs of delivering the service, much less the amortization of its capital cost. As a result, most developed economies have moved towards more sophisticated means to recover a varying portion of the public costs induced by private development. They range from betterment taxes, assessed on either or both existing and new development, to exactions to fund social programmes. Since the mid 1980s, the proceeds of the linkage programme that mandates payments by developers of larger commercial development has financed both the construction of affordable housing and job training for residents of lower income neighbourhoods in San Francisco and Boston, US (see Box 3.2).

Box 3.2 Linkage fees in Boston, US

In Boston, developers sign a Development Impact Project agreement with the Boston Redevelopment Authority for substantial real estate projects that require a zoning amendment. A linkage fee is levied on each additional square foot of floor space in excess of a 100,000 square feet ceiling. In 2004, linkage fees equalled US$8.62 per square foot, out of which US$7.18 subsidize affordable housing and US$1.44 job training. This rate can be adjusted every three years to follow inflation. The schedule of payments is spread out over 7 years for downtown projects and 12 years for projects in other areas, and the fees are deposited in a special fund for affordable housing and training. Alternatively, developers may choose to build affordable housing projects or create a job training programme. Between 1987 and 2004, US$79.6 million were generated for housing through linkage, adding 7604 units to the city's housing stock, 6116 of which were affordable. The programme generated US$15.2 million for job training and awarded US$12.9 million to 190 different job programmes, such as school-to-work initiatives, family literacy or workplace-based education, creating over 1000 jobs.

Source: Boston Housing Authority, 2000, 2002, 2004; Avault et al, 2000, Boston Municipal Research Bureau, 1998.

The financing of capital investments by issuing long-term bonds is a well-established practice in the developed economies and the trend is spreading to other parts of the world, except in situations of high inflation, structural adjustment or economic recession. However, access to financial markets, both domestic and international, requires efficient municipal financial management and skills. In instances where municipalities are not allowed to borrow, ingenious alternative mechanisms have frequently been used by separating revenue-producing activities from the general budget and allowing them to borrow against future revenue, as is the case with China's special purpose vehicles (see Box 3.3).

Transfers

The rising share of total public expenditures channelled through local authorities testifies to the expanding scope of their responsibilities. In Indonesia, local government expenditures jumped from 17 per cent in 2000 to 28 per cent of public expenditures in 2001 following the enactment of decentralization laws. However, wide variations in levels of decentralization and fiscal capacities among regions and within regions prevail: from under 5 per cent to over 15 per

Box 3.3 The role of special purpose vehicles in China

In China, municipalities have no borrowing power and rely upon off-budget entities to obtain the capital they need for investment, primarily in infrastructure. These special purpose vehicles (SPVs) are wholly owned companies operating on a quasi-commercial basis. SPVs raise funds by borrowing from state-owned banks and undertake investments on behalf of provincial and municipal authorities. The Shanghai Urban Development Investment Corporation (UDIC), owned by the city, has directly issued bonds to finance infrastructure projects on the financial strength of the city authority. The implicit guarantee is that the city will not allow UDIC to fail. The bonds issued by a municipality are viewed as a contingent liability of the municipal authority and are usually backed by municipal assets transferred to the SPV or by the revenue stream of a self-sustaining project.

Local authorities are prohibited from guaranteeing loans to SPVs, and the extent of their indebtedness is a major concern as China restructures its domestic financial markets and plays an increasingly bigger role in the international capital markets.

Source: Serageldin et al, 2004.

cent in Latin America; from less than 10 per cent to more than 50 per cent in Asia; and from around 10 per cent in North Africa to under 10 per cent in sub-Saharan Africa, exclusive of South Africa, where provincial and local governments account for 29 per cent and 21 per cent of public expenditures, respectively.[10] Incomplete fiscal data and uneven geographic coverage within sub-regions precludes attempts at meaningful aggregation.[11] Given the wide variations encountered in any one region, averages would be unrepresentative of most situations and have limited comparative value across regions.

In India, transfers and shared taxes bridge the gap between the revenue-raising capacity of municipalities and their expenditure needs. These transfers influence their spending patterns and help reduce geographic inequalities. State transfers are a key component of municipal revenue, contributing an average of 31.7 per cent during 2001 and 2002. They have increased by a factor of 1.7 from 1997/1998 to 2001/2002. India does not have statutory provisions defining the modalities of state transfers to municipalities. This accounts for the wide variations observed among the states and the lack of stability in state/municipality fiscal relations. State financial resources are not strained by their transfers to municipalities since this accounts for only 2.43 per cent of their budget. The allocation criteria include indicators of size, equity, need and efficiency (see Table 3.1).

In most developing economies, the taxing powers of local authorities are inadequate to meet their expenditures

In East Africa, as in most developing economies, the taxing powers of local authorities are inadequate to meet their expenditures.[12] The high-yield taxes – namely, the VAT and taxes on income, sales and business – are controlled by central governments while municipal authorities derive their revenue from property taxes and charges on services. Transfers from higher levels of government lack stability, transparency and predictability, and are subject to sudden reductions. In Botswana, municipalities receive 40 to 60 per cent of their operating budget as a formula-based block grant and the totality of their capital investment budget from the central government.[13] In Kenya, there are formula-based block transfers; in Malawi, there are general purpose block grants and specific purpose transfers; in Uganda, the constitution stipulates that localities can receive block grants, specific purpose grants and equalization grants.

Table 3.1

India: role of transfers in municipal finances 2001/2002

State	Transfers (in lakh)	Percentage of total municipal revenue	Per capita transfers (in rupees)
Maharashtra	94,177	13.8	239.6
Uttar Pradesh	77,488	74.5	232.1
Karnataka	60,859	51.9	347.7
Rajasthan	51,703	83.3	403.5
Tamil Nadu	46,770	33.7	180.7
Gujarat	31,395	17.8	175.5
Kerala	17,949	44.5	296.9
Punjab	8489	10.1	105.1
Orissa	8047	44.2	153.8
Haryana	7892	39.5	135.5
Bihar	5559	62.0	64.4
Assam	1624	29.7	65.1
Goa	941	33.6	258.6

Source: Mathur et al, 2004.

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

In the countries of the West African Economic and Monetary Union (UEMOA), despite their lack of adequate technical, managerial and fiscal resources, local governments have become the prime providers of services and investments in basic infrastructure. Even though transfers from the central government are still dominant, the contribution of local taxes has been growing steadily. By 2003, the contribution of locally collected revenue to municipal budgets in the region ranged from a low of 45 per cent in Côte d'Ivoire to a high of 80 per cent in Niger, a marked improvement over previous years (see Table 3.2).

Taxes on property and businesses

Administration of the property tax demands a good real-estate valuation capability to perform periodic revaluations of all taxable property over a period of not more than about five years. Setting up a computerized system capable of maintaining property and valuation records greatly facilitates this task. Where these capabilities exist, it is possible to ensure that the assessed valuation of all properties is realistic relative to market conditions.

In many developing countries, property records are kept manually and valuation experts have a hard time keeping up with rapid urbanization. Tax valuations do not fully keep pace with actual values, and an increasing proportion of the urbanized area is not covered. In cities experiencing fast growth, cadastral records are obsolete and only cover a limited zone, and are unable to keep up with formal change in the use of land. Except for some regularized settlements, informal areas and squatter settlements are not covered; properties are not titled or registered and therefore are not taxed. There are exceptions to these general patterns. In Egypt, a long tradition of quasi-autonomous management of tax administration allows the taxation of real estate, whether or not it is regularized or registered. In Indonesia, an occupancy tax is levied and ensures some revenue in situations where property ownership is unclear or complex. In West Africa, a simple *adressage* system, locating and numbering properties by street address, is used as an expeditious alternative to cadastres. This method allows speedy and efficient regularization of informal settlements and registration of property, providing the basis for taxation.

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

Table 3.2

Structure of municipal operating revenue and expenditures in selected West African countries (percentage)

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

Source: PDM, 1998, 1999a,b, 2000, 2001a,b

- Tenure systems are complex, with layers of primary and secondary rights derived from customary rules and successive adjustments of past colonial legal and institutional frameworks. Inheritance laws and fragmentation of property in historic centres and older neighbourhoods compound the problems of updating records, identifying taxpayers and billing and collecting taxes.
- Central governments control high-yield tax bases and the recording of wealth-producing assets, including land registries. High fees and cumbersome administrative procedures discourage regularization and the issuance of titles in informal settlements and increase the cost of updating valuations and tax rolls still managed by branch offices of central authorities. Additions, renovations and conversions are unreported and untaxed. Monitoring is sporadic due to a lack of cadastral information and updated records. Despite regulations that mandate collaboration and coordination among levels of government, central government officials are reluctant to work with municipal departments.
- Taxation systems based on real or imputed rental value, rather than capital value, understate the value of the assets, while rent and tenant protection regulations further depress property assessments based on rental valuation, thereby adding to the erosion of the municipal tax base.
- Tax rebates and exemptions granted to encourage specific segments of the housing market (such as multi-family rental units and co-operatives) or new urban development. In North and West African countries, exemptions from one or more taxes are granted for periods ranging from 3 to 15 years (see Box 3.4).
- In most countries, informal settlements on the urban fringe are not taxed until they are regularized. In a few countries, including Egypt, they are assessed by the tax administration, a central agency, independently of their status since regularization is a local function. Property owners readily pay these taxes, which are not onerous and can be used to document occupancy and possession of urban land and buildings.

Because of their buoyancy and their importance to local revenues, taxes on commercial activities also tend to heavily burden formal private enterprise (see Box 3.4). There are taxes on licences to operate the business, on the exercise of a profession or occupation, on the rental value of the premises, and on the income derived from the businesses. Market stall holders usually pay a flat rate and, except in some West African countries, hawkers and other informal activities escape local taxation.

At local government levels, taxes on income are not nearly as common as taxes on property, although in some instances provincial governments have the authority to tax income. But local governments may be allowed a surcharge on the income tax levied by provincial and national governments. Alternatively, a fixed proportion of the national income tax may be transferred to the local level.

User fees

User fees form a significant part of municipal revenues, particularly in developed economies. Although widely used, their yield in developing countries has usually been less than the operating and amortization costs of infrastructure systems as many governments have set rates below their economic level in order to alleviate hardships on the poor. Even wealthy countries have found it necessary to subsidize the cost of public transportation for environmental as well as social reasons.

Pricing of user fees is a matter of public policy, since it plays a central role in determining the financial sustainability of urban services. In many cases, charges will be levied at less than their economically efficient prices. Balancing financial and social considerations, governments at all levels have instituted measures to alleviate the hardships suffered by the poor. The most commonly used are:

Pricing of user fees is a matter of public policy, since it plays a central role in determining the financial sustainability of urban services

- allowing a minimum consumption level per capita or household free of charge, as in South Africa;
- subsidizing charges for lower income populations; and
- establishing a pricing structure that is not discriminatory for small users.

Social, economic and environmental arguments have been advanced for pricing public transportation at less than full-

Box 3.4 Côte d'Ivoire: challenges constraining the taxation of property and businesses

Côte d'Ivoire exemplifies the challenges encountered by developing countries in taxing property and businesses.

In Abidjan, the principal commercial centre, the real estate sector is overburdened. There are no less than nine direct taxes on urban property, exclusive of the taxation of rental income. Four basic taxes are levied and collected by the Ministry of Finance's Direction Générale des Impots (DGI), which transfers to the communes a portion of the receipts according to a separate formula for each tax. The tax on built property is the mainstay of the taxation system. Other real estate taxes include the tax on un-built property, a tax on underdeveloped urban property to deter speculative land holding, and a tax on property belonging to real estate development corporations and building societies. Municipal councils can levy supplemental charges not exceeding 20 per cent of the tax. Two special purpose taxes earmarked for infrastructure maintenance are also levied on all built property and no temporary or permanent exemptions are granted: the sanitation tax is collected by the state and the tax for roads and refuse removal is collected by the municipality. Communes can levy additional taxes on real estate, which are collected on their behalf by the DGI, including a tax on net income from built property; a tax on the capital value of un-built property; and a tax on the rental value of premises subject to the commercial licence fees paid to the state.

The expansion of the urbanized area during the 1970s and 1980s has not been matched by a commensurate expansion of the tax base. Three factors contribute to the erosion of the tax base:

1. temporary exemptions granted to new construction for overly long periods ranging from 5 to 20 years;
2. central control of the tax roll and rates; and
3. the proliferation of informal development on the urban fringe through the unauthorized subdivision of tribal land.

Buildings in informal settlements were not legally recognized or taxed. When a regularization policy was adopted in 1977, the process was too cumbersome and lengthy and failed to keep up with the pace of urbanization. DGI estimates the performance of real estate taxes to range between 20 per cent and 30 per cent.

Commercial taxes are the mainstay of municipal finance in West African cities. In Abidjan, they account for over 50 per cent of local revenue. There are two main taxes: the *patente* levied by the DGI on larger businesses with annual sales volume above a specified threshold, and the *Taxe Forfaitaire*, a flat-rate tax levied on small retailers and craftsmen and collected directly by the communes. Small shops and workshops pay on a monthly basis, while street vendors pay a daily fee for a ticket which allows them to trade on the sidewalks or in the designated market areas. Central authorities tend to view local commercial taxes as too numerous, difficult to manage and enforce, and low yield in comparison to other forms of taxation. Yet, their contribution to local fiscal revenue cannot be overlooked.

Source: Serageldin, 1990.

cost recovery. For water supply, social considerations and, in many cases, the reassertion of pre-colonial traditions and/or religious beliefs have thwarted attempts to raise prices to financially sustainable levels since the 1980s. Under structural adjustment programmes, price increases have led to contentious debates and civil disturbances.

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

Betterment taxes and development exactions

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

Many countries with rapidly developing economies have instituted betterment fees and require developers to contribute to the costs of providing new services. They could benefit from the linkage concept as a mechanism employed in the US to redistribute the benefit of growth during periods of rapid economic development.

Borrowing

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

In situations of high inflation, economic recession, structural adjustment and other constraining factors, long-term borrowing is typically not available, although various methods have been devised to counter these constraints. The standard solution is to add the expected inflation rate to the real cost of money, adopt variable rates or index either the principal or the annuity payments to the inflation rate. Alternatively, domestic loans are linked to a stable foreign currency, as has happened in many Latin American countries.

Short-term borrowing

In the absence of long-term financing, local governments have tended to use short-term commercial debt where the option is available to them. Short-term borrowing by municipal governments is normally limited to covering capital investments. In many countries, attempts have sometimes been made to continuously roll over short-term debt used to finance capital expenditure. Debt has sometimes been used to cover recurrent budgetary deficits or for short-term cash-flow management. Accumulated debt has to be brought under control and refinanced, otherwise it can lead to financial crisis. Box 3.5 highlights some of the borrowing challenges faced by city authorities.

Credit enhancement, access to financial institutions and capital markets

Local governments need sophisticated debt management capability to draw on the range of financial options and instruments to finance their capital investment needs. These capabilities are not currently prevalent among many local administrations in the developing world. In order to strengthen local finances and enhance municipal access to medium- and longer-term credit, shared revenues are regarded as part of the local resources available to service debt and can be pledged as collateral. Thus, shared revenues serve as loan guarantees and central governments can withhold them from municipal governments and authorize lenders to intercept the transfers in order to settle arrears of debt service obligations. This arrangement enhances the credit rating of municipalities.

International capital markets and multilateral financial institutions have focused upon East Asia's credit market in light of the strength of the regional economy, anchored by Japan and China, and the Asian countries' own performance rebounding from the 1997 financial crisis. However, these countries offer sharply contrasting financial environments. The Philippines was one of the first Asian countries to devolve functions and resources to local government units. A 1991 code allowed localities to create new own sources of revenue and gave them borrowing powers. Municipalities and provinces are authorized to issue bonds to finance self-liquidating, income-generating projects, enhancing the quality of life in the city. Two government-owned banks and two municipal development funds provide local governments with credit. A steady flow of generous central transfers and the power of state-owned financial institutions to intercept these transfers to settle arrears have allowed the municipal credit market to function and a limited domestic bond market to operate.[14]

By contrast, Viet Nam is barely starting on the transition path and local authorities have little fiscal autonomy. Borrowing is restricted to capital expenditures and the state bank can extend loans to localities for up to 30 per cent of project cost.[15]

In India, the Ahmedabad Municipal Corporation became the first municipality to issue bonds on the capital market; but other municipalities have also used this method with the back-up of credit rating agencies. The nine municipalities that have accessed the capital market have thus far been able to issue bonds without requiring a guarantee from the state government or a bank, as traditionally required by lenders to municipal entities. They

Box 3.5 The challenges of borrowing

Russia

During the mid 1990s, a series of Russian laws established rather liberal borrowing rules for sub-national entities and authorized municipalities to issue bonds and lottery tickets, to extend and take out loans, and to open municipal accounts with banks and other financial and credit institutions. Municipalities borrowed from regions to cover deficits, issued municipal bonds and contracted short-term loans from banks. Municipal financial mismanagement and indebtedness led to the revocation of these laws. Following the 1998 financial crisis, the Law on Specificity in Issuance and Circulation of State and Municipal Securities and the Budget Code prohibit municipalities from contracting external debt or debt obligations exceeding ten years. The issuance of debt obligations is limited to the financing of capital expenditures. These restrictions, while justified to curb runaway municipal finances, constitute a constraint on the financing of local public infrastructure projects.

Indonesia

In Indonesia, during the aftermath of the 1997 financial crisis, widespread defaults on outstanding loans from the Indonesian National Development Fund need to be resolved and the stability of the banking system fully restored before borrowing can be meaningfully addressed. In the meantime, regional governments depend upon donor and sovereign loan funds (primarily from the World Bank and the Asian Development Bank) for regional infrastructure projects. Despite favourable loan terms, arrears reached 40 per cent in 1998. Regional and local governments were considered financially too weak to benefit from the regulatory framework authorizing sub-national entities to borrow on the financial markets. In the period leading to the 1997 financial crisis, private investors preferred to seek concessions and build–operate–transfer (BOT) contracts, fuelling a risky reliance on offshore financing. The weakness of local government finances and their reliance on transfers and shared revenue prompted the Indonesian Ministry of Finance to prohibit all new borrowing from both domestic and foreign sources. The only exceptions are borrowing through on-lending institutions for short-term working capital or profitable locally owned enterprises. Since local governments have not yet been authorized to levy new sources of revenue, their financial situation remains weak.

Sub-Saharan Africa

In sub-Saharan Africa, South Africa and Zimbabwe have led the decentralization process. Regional local governments in the two countries are empowered to borrow in order to finance capital investments. In Uganda, local authorities are allowed to borrow, but have refrained from doing so due to the lack of a municipal development bank such as South Africa's Development Bank of Southern Africa (DBSA). In most other countries, current debt burdens and legal constraints impede the development of municipal financial institutions.

Source: Chernyavsky, undated (Russia); World Bank, 2003a; Menon et al, 2003 (Indonesia); Lewis and Chakeri , 2004; Freire et al, 2004 (sub-Saharan Africa).

have raised capital on the strength of their own credit rating.[16]

Income-generating enterprises

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

In China, formal government budgets account for only half of local government financial activity due to the importance of off-budget finance. Own-revenue sources consist of special fees, taxes, profit distributions from locally owned enterprises, land leases and taxes on business enterprises (VAT and income). The property tax on urban and rural land generates a meagre 2 per cent of local revenue, while the business tax contributes 34 per cent but exacts a heavy burden on businesses, representing about half their profits. As they have no borrowing power, municipalities have resorted to the ingenious mechanism of creating independent wholly owned companies, whose activities are off-budget, to finance the capital financing of development projects, particularly infrastructure. These so-called special purpose vehicles (SPVs) are allowed to borrow on the capital markets and use their revenue to amortize their debt. They have become a key instrument in implementing large-scale urban development projects (see Box 3.3).

Municipal development funds

Many countries have established municipal development funds (MDFs) that provide regional and local governments with needed capital

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

An alternative approach has been for groups of municipalities to obtain pooled financing as members of specialized sub-national entities, such as Sweden's Kommuninvest Corporation, or by virtue of their regional location – for instance, Virginia's Resources Authority in the US. Both approaches are based on a financial intermediary whose size and managerial capacity allows it to access financial markets on better terms than its individual members. The resulting savings are passed on to the municipalities. Initially developed in Europe and the US, this model has been successfully adapted in the case of India's Tamil Nadu Urban Development Fund (TNUDF) (see Box 3.6).

Other sources

There are other sources, including social investment funds, environment funds and special funds financed by debt swaps. Social investment funds were introduced in several countries in Latin America, Asia and Africa over a decade ago to finance projects aimed at social development and poverty reduction. Environmental funds are similarly structured, but focus on environmental management, pollution control and the preservation of natural resources.

Bolivia has tried to improve the performance of its social investment fund by integrating it within the system of intergovernmental fiscal transfers aimed at promoting decentralization and redistributing fiscal revenues to the poorer areas. The country also has a programme which blends grants and loans to implement strategic actions that support decentralization, increase local resources and foster a sound fiscal management, while promoting the involvement of the private sector in municipal finance. To achieve these objectives, the programme helps to build the technical and managerial capacity of municipalities with a special emphasis on fiscal management and the administration of property cadastres and tax rolls. It is also sponsoring credit rating for the major municipalities in order to prepare them to issue bonds.[17]

Even though still an exception, targeted funding of poverty reduction and environmental projects is growing in importance, particularly in Latin America. Funding tends to be either through external donations or through debt swaps under the Heavily Indebted Poor Countries (HIPC) initiative of the Bretton Woods institutions. In a formal sense, as commonly used in financial markets, debt swaps are employed by two or more partners to exchange legal liabilities for already incurred debt. Each partner carries financial obligations; but the transaction is mutually advantageous in terms of meeting some strategic objective.

The Bolivian Strategy for Poverty Reduction, within the HIPC initiative, gives an important role to local authorities as a way of increasing the efficiency in services delivery to impoverished populations and to promote local development. It relies upon municipalities to develop and implement action plans to reduce poverty. An amount of approximately US$20 million annually is transferred to local authorities to invest within the eight national priority sectors.[18]

Governments to whom debt is owed can also agree to discount the debt and allow indebted governments to repay the balance in local currency. The debt service proceeds of these 'swap' arrangements are deposited in a fund to support new local capital investments or to promote strategic social and environmental objectives. One of the first such swaps involved Costa Rica's debt and helped to preserve the rich ecosystem of the national rainforest reservations. More recently, swaps have been used to fund poverty alleviation initiatives in accordance with the country poverty reduction strategy (PRS). In general, an agreement on social objectives requires compliance with national priorities and stipulates that projects be undertaken by NGOs.

In Egypt, a special fund for debts owed to Switzerland, Italy and Germany was set up to finance rural development, job opportunities for women and environmental improvements. Projects are to be implemented by private enterprises and civil society organizations.

MUNICIPAL SPENDING PATTERNS

Local government budgeting

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

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

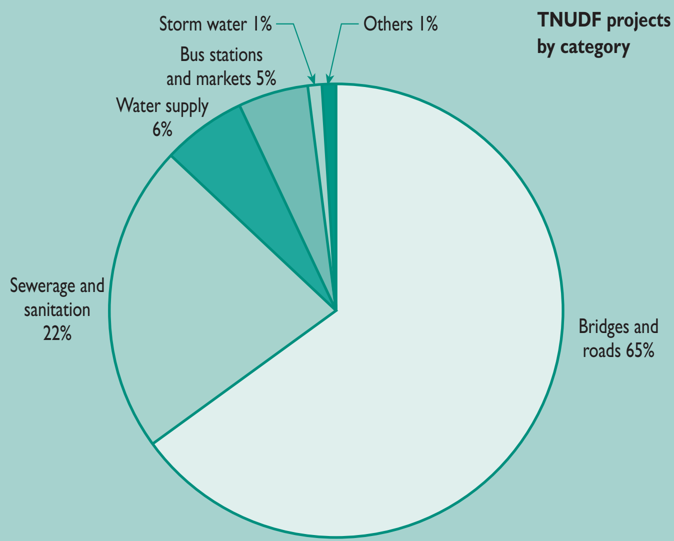
Second, in most countries in Africa, Asia and Latin America, municipalities are not able to borrow long-term funds on the capital markets and have to rely upon targeted transfers for their capital investment. But local authorities in many of these countries have limited understanding of the redistribution formulae governing central transfers. As a result, there is a tendency to consider them grants to balance the local budget irrespective of their economic or social purpose.

Third, most local capital budgets reflect immediate needs or political expediency rather than a long-term development strategy. Brazil's participatory budgeting is a notable exception and is being widely emulated. Thanks to a transparent process, it addresses immediate as well as strategic needs and provides significant infrastructure and service improvements to poorer communities. Some cities have also been able to devise coherent strategies to ensure

Box 3.6 Tamil Nadu Urban Development Fund (TNUDF), India

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

In 1996, with the aim of achieving managerial efficiency and attracting private capital for urban infrastructure, it was converted into an autonomous financial intermediary. Established as a trust fund with private equity participation, it was the first public–private partnership in India that provided long-term municipal financing for infrastructure without guarantees. Instead of merely channelling public funds, its purpose is to attract financing from the private sector. It also manages a separate grant fund owned by the state government to finance poverty alleviation projects.



The TNUDF is managed by a private corporation: Tamil Nadu Urban Infrastructure Financial Services Ltd. Financial institutions have committed to contribute an amount equal to 44 per cent of the initial contribution of the Tamil Nadu state government. The fund's management board comprises representatives from the state government and participating financial institutions. Borrowers are required to follow conservative financial management practices and to meet performance targets, including for debt service reserves and making appropriate sinking fund contributions.

The TNUDF's debt financing depends mainly upon the surpluses of the municipal borrowers, a situation similar to revolving funds in Europe and the US. The TNUDF is making an important contribution to capital investment needs for large, lumpy and non-revenue-generating projects. For many small local governments that are unable to access the markets directly, the fund provides a pooling mechanism and indirect access to the market, together with enhanced credit. Such arrangements can be especially useful for sewerage projects that require substantial funds with repayment periods of 20 years or more.

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

Source: World Bank, 2004d; Singh Maini, 2004; World Bank, 2003b; Freire et al, 2004. Research on this case was also undertaken by the Center for Urban Development Studies (CUDS) team member Shannon Bassett.

Box 3.7 Participatory budgeting in Brazil

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

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

The PB concept embodies four key features:

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

Participatory budgeting is primarily an instrument of empowerment and social inclusion. Participation and social impact are its most important dimensions. It covers all capital investments, which range from 5 to 15 per cent of the total budget in Brazilian municipalities. It is a flexible instrument since the rules can be amended at the end of each budget cycle, but cannot be changed during the cycle.

Popular assemblies are the cornerstone of the PB process. Attendance has grown steadily over the years in parallel with the growth of capital investments and as the importance of participation becomes evident to a wider spectrum of the population. The dynamics of attendance are complex and reflect the strategies and tactics of grassroots organizations and social movements, the mobilization efforts of groups who want to press for specific demands, and the degree of coordinated action at the community level. Outreach at the community level is needed to foster participation of lower income groups for whom the cost of attendance is high. This entails a significant commitment of resources on the part of the municipality, particularly in terms of personnel.

Source: Serageldin et al, 2003a,b.

that a stream of relatively small annual capital improvements becomes an integral component of a long-term development strategy.

Fourth, the efficient collection of taxes is a daunting problem, particularly in parts of the world that are experiencing rapid urbanization. The lack of up-to-date records, inadequately trained personnel and the prevalence of informal housing and of unstructured floating economic activities are major obstacles to an increased financial self-reliance of local governments. This has prevented the preparation of multi-year capital investment budgets that are indispensable in ensuring an adequate supply of serviced land and the delivery of improved services and, generally, in meeting the goals of sustainable urban development.

Participatory budgeting

Democratic local governance has fuelled growing demands for accountability and transparency in municipal budgeting and financial management, particularly with regard to the allocation of scarce local resources and their utilization. There is a marked trend for more rigorous financial management, clear procedures for the allocation of resources and the participation of residents in decisions affecting their communities. Of particular interest is the transparency mandated by Brazilian legislation and the spread of participatory budgeting – first instituted by Porto Alegre (see Box 3.7) – to municipalities in Brazil and other Latin American countries.

Multi-year capital budgeting

Capital investment budgets are a major undertaking for local governments. These budgets are often not well linked to development strategies and spatial plans, or such plans may not exist or may be mere wish lists of projects. There are many criteria for prioritizing capital expenditure: urgency of need; political importance; economic efficiency; availability of funding; implementation capabilities; and operation and maintenance costs of the completed assets, or life-cycle costing, to ensure that the assets and related activities will continue to operate over longer time periods. In many infrastructure projects, the relation between capital investments and operation and maintenance costs is not adequately considered and is hardly ever accounted for in choosing among options.

The rolling four-year capital investment programme of Szczecin in Poland allowed the city to improve its financial management standards to a level that enabled it to attract local and foreign investors, and to obtain a credit rating and borrow from commercial financial institutions (see Box 3.8).

Lack of funds for maintaining existing assets

In developing countries, asymmetrical decentralization has led to serious fiscal imbalances. In many such countries the funding provided barely allows for the delivery of services or coverage of settlements within the jurisdiction, thus undercutting shelter delivery. Local governments must look to other sources, domestic and external, to supplement their own.

Because they immediately impact upon day-to-day activities, operating expenditures are almost always perceived as the most urgent. Priority operating expenditures and financial constraints frequently lead to deferment of expenditures on maintaining existing assets. Unlike capital investments for which a variety of external sources of finance can be found, funding for the maintenance of existing assets is lacking. Even as it continues to perform, existing infrastructure deteriorates and becomes less efficient with the passage of time. Preventive maintenance is increasingly converted into crisis management, impairing the functional efficiency of many cities in the developing world. Particularly in the larger urban centres, authorities have to purchase expensive parts from current revenue and delay the renewal of plants, facilities and networks. When infrastructure projects carry outstanding debt, debt service often pre-empts necessary maintenance of the assets.

Managing municipal expenditures

As recurrent expenditures have increasingly dominated budgets, techniques for determining expenditures and measuring actual performance have been developed and incorporated within budgetary processes. Best practice demands that capital expenditure is budgeted and accounted for separately from recurrent operating expenditures; that operating expenditures be financed from fees, charges, regular taxes, regular shared revenues and recurrent government grants and not allowed to exceed these current revenues; and that borrowing, when permitted by law, be restricted to financing capital investments, with the possible exception of covering temporary cash-flow shortages. These principles of financial management are increasingly incorporated within legislation on national finance systems relating to state and local budgeting and provide a framework for financial management and assessment of performance, where local officials and elected representatives are held accountable for their own actions.

From 1999 to 2002, local government expenditures in Indonesia rose by a factor of 3.3 at an average rate of 55 per cent annually, in nominal terms. Capital spending increased by 60 per cent annually, slightly outpacing operating expenditure that rose by about 52 per cent. However, the structure of local government expenditure has barely changed (see Figure 3.1). Wages still constitute the most dominant component, although their share has decreased slightly from over 50 per cent to less than 45 per cent of total expenditure. Conversely, other recurrent expenditures have increased somewhat from 17 per cent to about 21 per cent of the total.

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

In South Africa and Brazil, municipalities have constitutionally defined authority and fiscal resources. This privileged status gives them wide decision-making powers and discretion in the use of their revenues. In Brazil, dynamic mayors used their new constitutional authority to institute reforms and innovate in areas critical to sound municipal governance, including participatory planning and management, and partnerships with private enterprises, NGOs and CBOs for economic and social development initiatives in Santo Andre, Belo Horizonte and Recife, among other cities. Unfortunately, many more did not manage their affairs responsibly, forcing the federal government to intervene and rein in their runaway finances (see Box 3.9).

Box 3.8 Multi-year capital investment planning, Szczecin, Poland

During the transition towards a market economy, priority was placed on capital investments that structure and support the local economy and enhance local development, including road construction and maintenance; water supply and sewerage systems; revitalization of communal housing; and improving education and healthcare facilities. Szczecin was the first Polish city to link its city development strategy to a four-year capital investment programme (CIP). Approved by the city council in 1997, the CIP proved to be one of the most important instruments of financial management during the transition. It allowed the city to determine its financial and development capacity, and to prepare forecasts for local and foreign investors.

The first four-year CIP (1997–2000) coincided with the rapid expansion of the responsibilities of local governments as a result of devolution. In March 1998, the city council adopted a resolution detailing the principles governing the preparation of the CIP and established procedures and criteria for prioritizing and selecting projects to be funded. These included assessment of existing needs; linkages to the city development strategy; technical aspects of projects; implementation costs; financing capacity based on the city budget; and sources and conditions of potential external financing.

The programme identified each capital expenditure by year – disaggregated by project, programme and responsible department, and funding sources for each category – and proposed methods of financing. The rolling four-year CIP is submitted to the city council for annual approval. The first year's capital investment programme is integrated within the city budget.

Source: Center for Urban Development Studies, 2000; Serageldin et al, 2004.

Accountability and transparency

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

Demands for greater accountability and transparency by voting and taxpaying constituencies have combined with the constraints on the financial resources available to the

Figure 3.1

Structure of local expenditure in Indonesia, 1997–2002

Source: Lewis and Chakeri, 2004

Box 3.9 Brazil's law of fiscal responsibility

In Brazil, the privileged status of state and municipal governments under the 1988 constitution strengthened the role of mayors and governors in the national administrative framework. However, these same constitutional guarantees provided an impetus for municipal mismanagement and the multiplication of municipalities through fragmentation, to reach 5559 municipalities in 2003. Dependency upon central transfers and shared revenue, and excessive politicization of local governance accounts for a focus on the short term and a general lack of coherence and continuity in municipal management. The constitutional amendment, enacted in conjunction with the fiscal stability programme adopted in October 1998, established rules for responsible fiscal management, and the passage of the Fiscal Responsibility Act in May 2000 set further rules and standards for responsible fiscal management. For the three levels of government, the law mandates multi-year budgeting with fiscal targets, contingent liabilities and cost controls, and also introduces balanced-budget principles and incentives for mobilizing own resources.

The law caps expenditures on personnel at 60 per cent and relates them to tax revenue. It mandates expenditures on education at no less than 25 per cent. It limits borrowing to the financing of capital expenditures, with the setting aside of adequate reserves to offset increases in long-term financial obligations. The law also mandates public access to fiscal and budgetary information. In 2001, the Statute of the City established general directives for urban policies and mandated regularization of informal settlements and upgrading of the living environment in areas housing lower income communities. These national priorities are, in turn, reflected in the municipal budgets.

Source: Serageldin, et al, 2003a.

public sector to exert political pressure to improve municipal financial management. Reforms of existing systems and the introduction of newer concepts and techniques have provided useful alternatives in financing and operating public services. They have also opened the public sector more widely to many innovations and efficiencies, hitherto largely confined to the private sector, prompting governments to improve their accounting and budgeting practices.

Until very recently, practices have varied in their application and enforcement among different countries. Accounting systems for activities to be funded from general revenues are often much simpler in form, but cover a large variety of activities. Unfortunately, in many countries, particularly in developing countries, local financial systems typically fall far short of the structure and rigour needed to provide instruments and indicators for policy formulation, resource allocations and strategic investment decisions. With many accounting systems currently in use in state and local governments in different countries, incompleteness is common. Therefore, unit costs and other indicators derived from these accounts will not usually account for the totality of the resources committed or consumed.

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

Box 3.10 Accounting for the financial cost of urban services

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

Currently, more recognition is being given to the need for comprehensive cost analysis and accounting for fixed assets. Depreciation costs are charged in operating statements. The net worth of fixed assets is periodically revalued to its current value and the operating statements are charged with notional interest, reflecting the opportunity cost of capital invested. Reform of existing systems and the transition to newer financial systems usually take several years to implement. To prepare and update an inventory of fully recorded and valued fixed assets, the local government or other service delivery unit requires specialized personnel whom local governments may not necessarily have in house. They must either build this capacity or procure the services by contracting out.

Worldwide, progress is being made on the institution of more transparent systems in local financial management. For example, two of the world's largest countries, Russia and Indonesia, have very different cultures and histories. Yet, in each one, during the past few years, laws have been promulgated that will require the use of full accrual accounting in state and local governments. St. Petersburg in Russia and a few other major cities began this reform during the 1990s. As housing and shelter are among Russia's most pressing social concerns, financing and budgeting for this sector need to undergo a complete overhaul. In Indonesia, capacity-building is helping local authorities to implement accrual-based budgeting; but progress is still slow.

Less ambitious trends have appeared in smaller countries. For example, in 2003 Macedonia conducted a series of national seminars sponsored by the United Nations Development Programme (UNDP) on 'Strengthening Local Self-governing Institutions in Macedonia, through Capital Development, Transparency and Financial Accountability', to build capacity as a first step in the reform of local financial systems. In the poorer countries, donor-sponsored fiscal decentralization includes the development and institutionalization of accounting reforms to ensure that the systems meet donor requirements. Capacity-building is extended to local governments to ensure proper implementation of the new systems, often starting with pilot initiatives.

Source: Serageldin et al, 2004

Accountability requires some measurement of performance, and – since the mid 1980s – local governments in Western Europe, the UK and the US have started to measure the real costs of delivering public services. Accrual-based multi-year budgeting provides more or less robust indicators of performance and is becoming a more common alternative to the traditional cash flow-based local budgets (see Box 3.10). In developing countries, most municipalities lack the capacity and resources to implement sophisticated monitoring of financial performance. Nevertheless, publicizing even crude, quantitative and qualitative indicators enhances community understanding of urban management and development challenges and promotes citizen participation in local governance.

PRIVATIZATION OF MUNICIPAL SERVICES

Key features

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

During the early years, there were massive privatizations of public utilities, in the electric power, telephone, transport, gas and other industries throughout the world, with little regard for the impact of the change of ownership upon the poor; nor was it adequately taken into account that some utilities were natural monopolies where the discipline of competition, a major justification for privatization, was substantially absent. Most of these outright privatizations concerned industries that were controlled by national or state governments. In many instances, along with its service delivery capability, the private sector has been able to supply much-needed capital investment raised by using practices that were closed to the public sector or methods that the public sector was legally barred from using, such as borrowing.

Privatization of local services entailed modifications in existing procedures and the introduction of new modalities of supply and delivery of services, including the contracting out of all or part of individual services; public–private partnerships; franchises; and forcing internal service units to compete on a commercial basis, as happened in Eastern Europe. However, the scope for privatization at the local level was limited to a relatively small number of services. These included public transport; water supply; solid waste management; a number of activities including janitorial and cleaning services; information processing and accounting; landscaping; and vehicle and plant maintenance. The success of the outcomes depends upon the particularities of each situation and the viewpoints of key stakeholders.

In both developing and advanced economies, privatization has resulted in revenue-producing services, including water supply and solid waste management being gradually taken over in the larger urban centres by specialized multinational firms serving many local government units. Although not complete monopolies, the sizes of many firms allow them to resort to predatory pricing to secure contracts in new locations and to exact costly indemnities and guarantees from local governments. Many of the activities are capital intensive and the high entry and exit costs make it difficult for potential competitors to compete against entrenched interests. Concessions granted to foreign enterprises also inhibit any substitution since the cancellation of the contract for unsatisfactory performance carries heavy political and financial risks. The contractor must usually be indemnified and the sponsoring foreign government placated, as occurred in Argentina.

Challenges of privatizing urban services

It becomes incumbent upon each locality to consider whether it should separately manage each of the services it delivers, or combine some services with one or more of its neighbouring units. Local authorities, separately or jointly, can outsource the management and delivery of one or more services to private operators, non-profit organizations or community groups. In Europe, there are strong incentives for inter-communal compacts; in some instances, as in France, national legislation mandates cooperation. In transitional and developing countries, local authorities are reluctant to engage in joint action, which typically requires some delegation of powers and sharing of revenues. In Latin America, political affiliations create divisive forces that impede the development of joint activities.

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

The experience of formal privatization in many cities is that it has not benefited lower income communities

The experience of formal privatization in many cities is that it has not benefited lower income communities, pointing to the need for the public sector to have a role in delivering essential services, especially within slum areas. The abolition of social rates and other forms of subsidization of minimum consumption levels for basic services has worked against the urban poor. Some NGOs have argued that poor urban families are unable to pay even the minimum charges required for access to basic infrastructure and

Box 3.11 Granting concessions for the operation of revenue-earning services: the experience of Abidjan, Côte d'Ivoire

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

A French water company, la Société de Distribution d'Eau de Côte d'Ivoire (SODECI), had the concession for operating the water supply system. It was also awarded a contract for maintaining the sewerage and drainage system. These contracts contained clauses that shielded the company and shifted any risk involved in the operation of the system to the government. Even then, subsidized connections for poor households were abolished under the structural adjustment programme, and the vast majority of lower income renters now purchase their water from property owners, shopkeepers and water vendors. Despite the fact that its contract contained a clause entitling the company to compensation for any discrepancy between actual consumption and the estimates developed by the Water Directorate (the basis for negotiating concession contracts), the company contended that the maintenance of underutilized systems is inefficient, and periodically shuts off the mains supplying areas with high concentrations of low-cost rental housing and squatter settlements in a futile attempt to put the water vendors out of business.

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

Abidjan's solid waste management was also privatized. The different companies that were contracted covered the primary road network system and the main market areas. Their trucks were ill adapted to the high organic content of the wastes. They collected trash and garbage deposited in bins and dumpsters. The service was too infrequent for an equatorial country. Waste spilled from overflowing dumpsters was not collected.

Source: Serageldin, 1990; Center for Urban Development Studies, 2000.

services, prompting the emergence of parallel systems ranging from well-managed facilities sponsored by NGOs and charitable foundations to highly inadequate, poorly run initiatives operated on an *ad hoc* basis by local groups with or without outside support.

Côte d'Ivoire illustrates the challenges of privatizing water and sanitation services in a developing country and the difficulties of addressing the needs of lower income communities (see Box 3.11).

Joint funding of infrastructure and urban services

In China, provincial and local authorities increasingly look to public–private partnerships as an option to fund or implement infrastructure and urban development projects. Partnerships with private investors range from the granting of concessions, to joint venture agreements, to build–operate–transfer (BOT) or build–own–operate–transfer (BOOT) schemes. The public sector provides land for urban development and the construction of infrastructure and facilities (mostly new high-grade highways and toll roads). They also contribute repayable equity or loans. The private partners provide equity and shareholder loans. Concessions and BOOT agreements are more attractive to private investors – and foreign investors, in particular – because they can offer security in the form of guarantees of minimum revenue or profit, loss protection, repayment of capital, tax exemptions and other fiscal incentives, and preferential loan repayment terms. Provincial authorities can use assets and revenue-backed securities to finance their share of the investment.

Of special interest to poorer countries are solutions based on partnerships between municipalities, NGOs and CBOs. In these countries, integrating poorer communities within the city fabric and giving the poor access to basic services is hampered by the spread of chaotic urbanization, the mounting densities in the central zones, the obsolescence of existing conventional systems, and the lack of resources to maintain and upgrade existing systems.

To improve living conditions in the under-serviced communities, systems and networks using different technologies and serving different population groups and geographic areas must somehow be interlinked. Solid waste management is one of the services most affected by the need to merge traditional solutions with modern technologies. In West African cities, potable water supply could also benefit from this approach. Cotonou's (Benin) award-winning programmes demonstrate the importance of linking formal and informal service providers.

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

Microcredit institutions have largely focused on giving microentrepreneurs the credit they need to start up and expand their businesses (see Chapter 6). Recognizing the importance of home-based income-generating activities, particularly for women, these institutions have started to offer loans for housing. They have progressively expanded their lending to help poor families access land and basic infrastructure services. Today, they have become key partners in municipal initiatives to improve the living conditions of poor households in both urban and rural areas. The experiences of Guatemala's Genesis Empresarial PROMUNI programme and the partnership between the Ahmedabad Municipal Corporation and the Self-employed Women's Association (SEWA) Mahila Trust to upgrade slums through the Parivartan programme illustrate the potential of these partnerships.

New trends in partnerships for local development

In developing countries, where decentralization is a recent or ongoing reform, municipalities are particularly reluctant to delegate authority or share revenue with their peer entities. This reluctance accounts for the difficulties encountered in getting municipalities to collaborate on joint initiatives. Formalizing collaboration through negotiated agreements and inter-municipal compacts is an even more challenging task as there are no institutional incentives that foster strategic associations other than through external aid entities. The successful initiatives mostly focus on economic development, as in the case of the ABC Region[19] in Greater São Paulo, Brazil, where seven municipalities have to cope with economic restructuring and the rebuilding of the local economy based on new growth sectors following the decline of the automotive industry.

The difficulties encountered in mobilizing and structuring alliances of stakeholders to promote local development are illustrated by the experiences from Central America. It has become clear that in poor regions bypassed by development, programmes promoting development must also foster social inclusion. Inter-municipal initiatives can significantly enhance the effectiveness of these efforts, as in the case of the Valle de Sula Metropolitan Area strategic association in Honduras. The challenge is to overcome distrust and apprehension. The participatory process required to reach consensus on objectives, operating modalities and action plans takes anywhere from two to three years, and the institutional framework must be organized before any activities can be initiated. Implementation of partnership agreements often requires the creation of a large number of assemblies, committees, boards and delegations that may become cumbersome to the point of reducing the effectiveness of the alliances. San Andres Valley, San Salvador, illustrates the benefits of forging stakeholder alliances.[20]

SUMMING UP: ASSESSING THE EFFECTIVENESS AND IMPACTS OF MUNICIPAL FINANCE SYSTEMS

Municipal finance and sustainable urban development

Municipal finance heavily influences the ability of local governments to meet the environmental and social goals of sustainable urban development and, in particular, to address issues of shelter delivery, poverty reduction and social inclusion. Sustainable urban development requires significant capital and operating expenditures, especially in situations where urban expansion depends upon the periodic extension of infrastructure systems. In particular, making services available to low-income families necessitates substantial subsidies that municipalities have been unable to generate from their own revenues. Unless the inequities generated by globalization, decentralization, central–local fiscal relations, and the dynamics of urban growth are addressed, the sustainability of urban development and shelter delivery, primarily in developing countries, will remain highly problematic.

In many parts of the world, including advanced economies, globalization has affected the financial resources of both national and local governments as taxable economic activities move to other locations. The situation is further aggravated by the increased local fiscal burden resulting from the shifting of responsibility for infrastructure investment and the delivery of services to local governments. Additional complexity is introduced by new developments that overlap municipal boundaries and impose an unexpected financial burden on the localities housing poorer populations or receiving migrants. Households in these under-serviced communities and outlying areas have to pay more per unit cost for inferior-quality services.

Municipalities are faced with a mismatch between their newly acquired responsibilities to provide services and fund capital improvements and a lack of control over their revenue sources. The resulting scaling-back of public expenditures on both capital investment and social programmes is having an adverse effect on urban development and is impeding the achievement of the Millennium Development Goals.

Municipal finance heavily influences the ability of local governments to meet the environmental and social goals of sustainable urban development

In the poorer countries, the deterioration of existing infrastructure and the inability to meet the demands created by rapid urbanization have led to chaotic urbanization, the proliferation of informal settlements and the emergence of informal providers of basic services. This has been particularly the case for water supply in Tanzania, Botswana, Kenya, Mauritania and Benin. As will be shown in Chapter 7, NGOs have contributed to the alleviation of hardships endured by the poor and provided them with some services. Their interventions have targeted specific communities selected in accordance with their own objectives and criteria.

Programmes addressing the social dimension of urban development are still largely dependent upon intergovernmental transfers or international aid. Debt swaps and discounted debt under the Heavily Indebted Poor Countries initiative are only beginning to be used to finance environmental and social programmes, mostly through local NGOs and CBOs. Bolivia is an exceptional case where funds are channelled through local authorities. The integration of these new sources into the pool of resources available to finance urban development could open up new opportunities well worth exploring.

Municipal finance and the delivery of land and services

The effectiveness of municipal authorities to improve the supply of serviced land and to deliver basic services is clearly a function of both the pace of the development they face and the country's level of economic development. Generally, the advanced and some transitional economies have both the financial and administrative resources to manage development and provide urban residents with services ranging from adequate to good. Stable or declining populations have facilitated this task. In contrast, the poorer countries have, for the most part, been unable to keep up with the demand for serviced land or provide adequate basic services to a growing percentage of their rapidly expanding urban populations. The major obstacles they face are:

Globalization has affected the financial resources of both national and local governments as taxable economic activities move to other locations

- inadequate financial resources to pay for the delivery of services to a growing population;
- limited or no access to capital resources to finance investments in infrastructure; and
- lack of institutional capacity to prepare mid- and long-term development strategies and the capital improvement programmes necessary to implement them.

Few municipalities have complete authority over taxation. In many countries, high-yield tax bases are still largely controlled by the central government and are not likely to be turned over to the local level in the near future, as stated earlier. Even though local governments are nominally responsible for managing their affairs, their real autonomy is restricted by the dominant role the national government continues to play in determining the local tax base, and in the collection and redistribution of tax revenue.

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

Financial constraints are reflected in two generalized trends: the lack of funds for maintaining existing assets and the inability of many municipalities to undertake the capital improvements needed to keep up with urban growth, let alone guide urbanization and development. While some countries, such as South Africa, have provided grants for capital investment in infrastructure, central funds are generally in short supply in most parts of the world and are often channelled to larger cities. As a result, it is not uncommon for existing infrastructure to deteriorate as a result of a lack of maintenance.

Despite adverse economic conditions, local authorities in East and West Africa have managed to increase the contribution of locally collected taxes

To circumvent legal, regulatory and fiscal constraints on their budgets, local governments in both advanced and developing countries are developing means to finance urban development and public improvements as off-budget expenditures through special purpose vehicles, as in China, and assessments and impact fees requiring private developers to pay part of the public infrastructure needed for their projects – a common practice in the US and some transitional economies.

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

Strengthening the capacity of municipalities to plan and manage their economic, spatial and social development, disseminating information on successful approaches, and providing the institutional framework to support reform initiatives remain a major challenge worldwide. In adverse economic conditions or institutionally fragile environments, building the capacity of weak municipalities requires longer-term support that has to be provided by strong locally based institutions. Sponsoring local capacity-building institutions is an effective mechanism fostering the achievement of the MDGs.

Impact of decentralization upon municipal finance and service delivery

With the exception of the advanced economies where at least the larger cities have substantial experience in managing their finances, the devolution of functional responsibilities has presented local governments with a major challenge, often compounded by adverse economic and political conditions. In Eastern and Central European countries, local political autonomy, links to the West and participation in regional and international networks, and hopes of eventual accession to the EU help to cushion the burdens of devolution. Grants extended to promote social, economic and environmental objectives have provided needed funding for urban projects.

In Africa, Asia and Latin America, transfers from central governments have declined steadily, particularly for larger cities, and charting an appropriate course for decentralization without disrupting the delivery of basic services devolved to the local level has proved to be a difficult task. Only a few countries have formulated successful policies to redistribute resources that are more efficiently collected at the national level and have equalized the burden on municipalities that are economically weak or face higher per capita expenditures. Effective instruments used to foster a smooth decentralization include:

- local statutory rights guaranteed by the constitution or by national legislation;
- the mandatory transfer of shared tax revenues;
- formula-based redistribution favouring smaller and fiscally weaker municipalities;
- the sharing of fiscal revenue through formulae that take into account concentrations of poverty; and
- intergovernmental agreements and inter-municipal compacts and joint initiatives.

The experiences of Brazil, Bolivia and South Africa stand out in this respect. Other countries, such as Indonesia, have had to undertake successive adjustments to correct serious imbalances that affect the economic and social life of their citizens. Even municipalities in the poorest countries have made considerable efforts in reducing their reliance upon dwindling transfers from central governments. Despite adverse economic conditions, local authorities in East and West Africa have managed to increase the contribution of locally collected taxes. In the countries of the West African Economic and Monetary Union, these taxes now account for close to 50 per cent of municipal revenue, a significant increase over a relatively short time. In Burkina Faso, 'communes' do not receive any transfers from the national government.

A growing demand for accountability and transparency in municipal budgeting has accompanied political and fiscal decentralization. There is a marked trend for more rigorous financial management, clear procedures for the allocation of resources and the participation of residents in decisions affecting their communities. Of particular interest is the transparency mandated by the Brazilian legislation and the spread of participatory budgeting.

Impact of privatization upon municipal finance and service delivery

Privatization of public service delivery requires many years of operation for comprehensive and robust evidence to emerge regarding the extent of success or failure. But there is evidence that the outcomes have not always matched the expectations. More rigorous analysis is needed to determine in each situation whether private profits are engendered by genuine economic efficiency of operations, or by allowing the plant and equipment to continue deteriorating, or by raising prices to levels beyond the means of lower income communities, as happened in some Latin American countries. Moreover, the ability of private operators to cash out or withdraw allows them to increase profits by under-funding or deferring expenditures on replacement and preventive maintenance. When the private contractor walks away from essential services, the public sector has to pick up the operations.

Reversing or modifying a particular mode of service delivery – publicly or privately provided, or contracted out – is not simple. Many activities are capital intensive or have significant institutional implications. These entry or exit costs can be quite high and make it difficult for potential competitors to compete against entrenched interests, as happens in many concession situations in developing economies. Privatization and, in particular, the awarding of concessions have not been devoid of corruption, including lower initial bid prices to win, followed by later requests for contract amendments.

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

At both the national and local levels, privatization provides an expedient way around constraints on other types of financing, especially for capital expenditures where restrictions on public-sector borrowing exist. Privatization has, to some extent, shaken local government financial management from an earlier complacency about budgetary rigour and accountability. It has forced a much greater attention upon cost recognition and control, leading to improved accounting practices and a greater concern for the recovery of costs and the collection of payments when it was previously assumed that shortfalls would automatically be covered from general public revenues.

The financial discipline and commercial outlook of competing private enterprise has forced public administrators to lower costs, achieve greater efficiency and improve the quality of outputs. Opening up public services to market participation has created more opportunities for competition in the delivery of these services. The private sector has introduced useful new products, more successful activities and labour-saving technologies to gain a greater 'return' on the huge sums of money invested in public services. While privatization has forced governments to examine entrenched practices and to consider alternatives for their modification or replacement with considerable success, it is not a panacea. There are many ways of involving the private sector in public service delivery on a rational basis short of outright privatization.

Opening up public services to market participation has created more opportunities for competition in the service delivery

Public–private partnerships require significant delegation of authority but can be very productive. Locally based partnerships involving CBOs and microenterprises have provided successful means for empowerment and social inclusion. Solid waste management and recycling have become prime mechanisms to simultaneously promote environmental and social objectives. There are numerous award-winning schemes worldwide such as Santo Andre, in Brazil, and the Scavenger communities, in the North-West Province, South Africa. Furthermore, in the poorest countries, labour-intensive activities are important in providing productive employment to impoverished populations. Partnerships between local governments, communities and microenterprises can help to achieve these objectives.

NOTES

1 This chapter is based on drafts prepared by a team of experts led by Mona Serageldin, Harvard University, US.
2 UN-Habitat, 2003a.
3 See UN Millennium Project (2005b) for detail.
4 See www.bestpractices.org.
5 UN-Habitat, 1998.
6 UN-Habitat, 2003a.
7 Alm et al, 2002; UNCHS, 2001.
8 UN-Habitat, 1998.
9 UN-Habitat, 1998.
10 Shah and Thompson, 2002.
11 See, for instance, Litvack et al, 1998.
12 See, for instance, Steffensen and Tidemand, 2004.
13 Mosha, 2004.
14 Freire et al, 2004.
15 Freire et al, 2004.
16 Mathur et al, 2004.
17 Brakarz, 2003.
18 Brakarz, 2003.
19 In 1990, the seven municipal governments of the Region established the Intermunicipal Consortium of the Greater ABC. The Greater ABC region is located in the southeastern part of the Greater São Paulo metropolitan area (Brazil) and has a population of 2.4 million inhabitants, according to the IBGE Census of 2000. Its seven municipalities are: Santo André, São Bernardo do Campo, São Caetano do Sul, Diadema, Mauá, Ribeirão Pires, Rio Grande da Serra.
20 See the Statistical Annex in Part IV for detail.