Pragmatic Municipal Finance Reform: Lessons from policy in South Africa, Brazil and select experiences in India

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Prior to 1993, local governments\(^2\) in India did not have constitutional status and were subject to executive decisions of state governments. The 74\(^{th}\) Constitutional Amendment Act (CAA) enacted in 1993 gave municipalities constitutional status and aimed to strengthen municipal governance. Municipalities were to be given greater responsibilities in the provision of basic infrastructure and social services and financial power was also to be devolved.

Now, seventeen years since the passage of this constitutional amendment, the promise held out by decentralisation has remained largely unrealised. In this context, the intention of this paper is to recommend specific policy initiatives for municipal governance reform in India. In drawing up these recommendations the paper analyses three broad sources, namely the policy environments for local government in post-Apartheid South Africa and post-democracy Brazil, and specific experiences in innovative local governance and financing from India, post-1993. South Africa and Brazil could be instructive case studies because they too, like India, are trying to address the issues of widespread poverty and inequality in a democratic framework. Additionally, they are widely recognised as having created innovations in the policy framework for local government and service delivery. The specific experiences from India also serve to highlight that it is realistically possible to deliver quality local governance and services effectively if certain policies are put in place.

The paper will, more specifically, be focused on the issues relating to the revenue generation capabilities and financing options of municipalities. The final recommendations look at pragmatic changes in aspects of property tax, debt finance, community involvement, mode of service delivery and incentives as the levers of improving local governance and service delivery.

The paper begins with an assessment of the Indian municipal environment post-1993 and compares the actual results of decentralisation to the expectations raised by the policy pronouncements in the 74\(^{th}\) Constitutional Amendment Act. The next section discusses the South African experience and how some of their policies might have relevance in the Indian context. This is followed by a discussion of the Brazilian experience in local government and the specific features with relevance for India. Following this section, select Indian experiences in innovative municipal financing and governance are described, with the lessons these hold out for municipal reform. Finally, the paper looks to crystallise the learnings of earlier sections into specific points of pragmatic policy reform in India.

1. **An Assessment of Indian local government: Desired and Actual results**

A municipal or local government is the layer of government that is closest to the people. The principles of fiscal equivalence\(^3\) and correspondence\(^4\) provide a strong rationale for decentralisation on the grounds of efficiency and accountability. Correspondingly, the principle of subsidiarity\(^5\) makes the case for transfer of revenue generating powers to local governments so as to respond to their clients’ needs and provide appropriate services. The literature on local government clearly indicates that local governments are in the best position to be able to communicate with and understand the needs of the community that they represent and that they be given the responsibility to provide basic social and infrastructure services to their constituents. The responsibilities and powers of local government need to be established in a well-defined policy and legislative framework which lays out clear guidelines on important issues such as minimum services and service levels to be provided by the local government, long term service delivery planning, taxes and fees at the discretion of the local government (with conditions on when the state government can step in, for example in extreme cases when a municipality sets distortionary rates), fund

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\(^2\) The terms ‘local government’ and ‘municipality’ are used interchangeably in the paper

\(^3\) The principle of fiscal equivalence states that an overlap of the benefit area and political jurisdiction ensures the optimal provision of public services

\(^4\) The principle of correspondence states that the jurisdiction that determines the level of provision of a good should precisely include the individuals who consume that good

\(^5\) The principle of subsidiarity states that taxing and spending should be exercised by lower levels of government unless a convincing case can be made to the contrary
transfers from central and state governments, raising funds from capital markets, budgeting and financial sustainability, and community involvement in the planning process.

In India, the 74th Constitutional Amendment Act (74 CAA) of 1992 was the critical piece of legislation that heralded a shift in governance and service delivery thinking by providing a constitutional basis for local governments and also indicating the specific services that local governments could deliver⁶. Guided by the 74 CAA, state governments modified their own municipal legislations to reflect the reality of decentralisation. Local governments were now required to prepare long term plans for service delivery in consultation with the community through the creation of Wards Committees. In addition, metropolitan areas and districts were expected to constitute Metropolitan Planning Committees (MPCs) and District Planning Committees (DPCs) respectively, to prepare long term development plans. Among other provisions of the 74 CAA were adequate representation of women and weaker sections of society in local governments, regular conduct of municipal elections, and constitution of State Finance Commissions (SFC) every 5 years to make recommendations to the state government on funding municipalities. Although the 74 CAA provided a basis for state governments to amend their municipal legislations, the Indian experience in municipal governance has been a mixed bag. We will now look at some of the issues confronting local governance.

2.1 Decentralising responsibility and power

One of the critical aspects that determine the success of decentralisation is the delegation of revenue generation powers to local governments along with devolution of functional responsibilities. Based on the twin considerations of economic efficiency⁷ and equity⁸, appropriate taxing powers must be granted to municipalities. The power to levy user charges for services the municipality provides must again rest with the municipality. While it is important that local governments have the independence to decide on tax rates and user charges, this must be qualified with the caveat that this power is available to them “within limits”. This is done to ensure that means that while the municipal government has the freedom to set rates it does so in a responsible manner and not abuse this power⁹.

Mohanty et al (2007) have found that although the functions and responsibilities of Urban Local Bodies (ULBs) have increased significantly since 1992, there is no proportional increase in their resource base. SFCs have been commissioned in most states to review the financial position of ULBs, recommend the principles governing distribution of shared taxes, determination of taxes and fees assigned to municipalities and determination of grants to municipalities. Based on their assessment, the SFCs have prepared recommendations that they have presented to the state governments. The state governments have wielded the power to approve, partially approve or reject these recommendations. The levers of financial power are still clearly in the hands of the state government.

2.2 Community participation

In order to provide appropriate services, it is necessary that the municipal authorities engage the local community to establish the service requirements (need and urgency) and gauge the willingness of constituents to pay user charges. Once the community’s needs have been taken on board, the municipality must use this as a basis to plan for the provision of services.

In his review of the impact of the 74 CAA, Mathur (2007) states that Wards Committees have been formed in only nine states in India with responsibilities that encompass drafting budgets and formulating development schemes to monitoring progress and maintaining civic services. In a few states the members

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⁶ The Twelfth Schedule of the 74 CAA provides a list of 18 functions such as urban planning, water supply, public health, fire services and slum improvement among others as functions that local governments are well positioned to deliver

⁷ Taxes that have a bearing on the internal common market should be assigned to the center

⁸ Progressive redistributive taxes should be assigned to the center

⁹ Misuse could mean setting rates too high or too low due to political expediency which could lead to distortionary effects such as incentivising non payment, corruption or exclusion of low income households from service delivery
of the committees include a wide swath of opinion too: NGOs, neighbourhood groups, people with specific expertise in agriculture, industry etc. However, the committees are essentially non-functional even in the few states they have been formed, and operate effectively only in two or three states. It is therefore clear that community participation in the development process is nowhere close to where it should be. This situation is, however, not surprising considering the fact that municipalities are not as empowered as they should be and therefore have little incentive to promote community participation in decision making.

2.3 Long-term planning
The municipality must evolve a long-term holistic plan to provide for different types of infrastructure services that are required. This mandates that the planning process involve multiple stakeholders such as the water supply board, the electricity board and other entities involved in essential infrastructure service provision. What this will enable is a translation of the community’s needs into specific projects and bring out the attendant financial implications. In addition, different stakeholders can coordinate as required for the effective and efficient implementation of projects.

All projects need to be subject to stringent financial evaluation and feasibility analysis. Since projects will require both capital and operational investments, infrastructure planning exercises will necessarily need to be long-term. Based on the assessment of financial liabilities of projects against current availability of funds and the ability of the municipality to raise funds in the future, the municipality can prioritise projects. The long-term nature of the plan also makes it incumbent on the municipality to plan for growth. This requires coming up with meaningful projections on population growth, income growth, industrial growth and what this means for service provision, service levels, and ability to pay.

The 74 CAA envisages long term planning for social and infrastructure services to be done at the local government level and then consolidated as master development plans at the district and metropolitan levels. Again, Mathur (2007) finds that the performance of these initiatives on the ground leaves much to be desired. While ten states had constituted DPCs, only Kerala was found to have active and functional DPCs. As far as MPCs are concerned, only Kolkata has even constituted one. However, as of now, it is not clear that this MPC plays an important role in municipal planning. The planning exercise, envisaged as being a critical component of long term development of regions, is found to be fundamentally wanting.

2.4 Property Taxes
Property taxes form the most significant source of revenue to local governments. In order to implement a sound property tax regime, there must be a well defined valuation system based on the market value of land and developments. This ensures that the value of land is linked to economic growth of the area and therefore remains a source of buoyant revenue. In addition, it is essential that the properties be valued periodically, once in 3-5 years. The well defined valuation mechanism must be supplemented by good assessment and monitoring systems to ensure high collection efficiency. Often, municipalities do not have a database of properties that are required to pay property tax, thus allowing many properties to slip through the cracks. Implementing a Geographical Information System (GIS) can help in better assessment of properties in the city and bring property tax evaders back into the tax net. The municipality must therefore follow a sound valuation system mandated by the central government, build a comprehensive property database and set the property tax rate.

There is no unified property tax regime in India. As of now, most cities use the Annual Rental Value (ARV) system which bases the property tax on the annual rental value of the property. However, archaic rent control acts in most states lock the value of the property to unrealistically low values, leading to a suboptimal, low yielding property tax system. There has been some progress in reforming the system in recent years, with some states amending their rent control acts and cities moving to a quasi-market based Area Based system10. As a consequence of some states modifying their rent control acts, we find a wide

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10 The Area Based system bases the value of the property on the location and usage characteristics of the property
range of property tax valuation methods in use today. In addition to the ARV system in use many cities across India, some cities such as Ahmadabad and Hyderabad use the Area Based system, while Mumbai uses a modified ARV system. The state of Karnataka moved from the ARV to an area based system and now to a Capital Value system. Lall and Deichmann (2006) found that when Bangalore moved to an Area Based system from an ARV system, its revenues increased by 62%. The revenues were estimated to further increase by 33% when the Capital Value system was adopted.

As we saw earlier, the power to set property tax rates currently rests with state governments. Therefore, the only levers that cities have to improve their property tax base are monitoring and collections efficiency. In terms of monitoring, some cities have adopted GIS systems to map out the municipal area and therefore gain a better appreciation of the actual state of properties within their jurisdictions. Based on a pilot GIS implementation in Gorakhpur, Nandan (2003) estimated that the implementation of GIS to all of Gorakhpur would yield 20% hitherto un-assessed properties and a reassessment of 25% of current properties, leading to a substantial revenue fillip. The GIS exercise lead to a comprehensive database of properties and a more accurate assessment of property values. However, despite the benefits of a GIS system, very few ULBs in India use GIS for city mapping. This can be because of the fact that the state controls the levers of financial power, and therefore ULBs have no incentive to implement a system that will increase the tax burden of its constituents.

The facts, therefore, are that there is no consistency in property tax regimes across cities and states in India and that property tax yields are much lower than what they can be.

### 2.5 Intergovernmental Transfers

Grants or transfers are yet another source of funds available to municipalities and are a key component to bridge the gap between funding requirements for projects and funds raised through taxes and user charges. For sound financial planning, it is imperative that the central and state governments ensure that this source of funds is predictable year after year and that the municipality gets a consolidated grant for a year as opposed to project by project grants.

In India, as per the 74 CAA, the first SFCs made recommendations to state governments on grants-in-aid to municipalities for the next five years. This was expected to bring about clarity and certainty in annual inter-governmental grant transfers to local government and also meant to ensure that municipalities got a bulk of their funds in one transfer, rather than having to apply for project wise grants. However, the performance of the state governments in terms of actual transfer of funds has been less than encouraging. Some states have partially devolved the funds while others not at all. Yet other such as Kerala and Goa had not accepted the SFC recommendations on transfers because the states’ resource base was itself strained. The expected benefits to municipalities, both in terms of certainty in fund transfer and consolidation of funds are not being realised, thereby putting any planning exercise of local governments in jeopardy.

### 2.6 Debt Capital Markets

Yet another source of funds for the municipality is the debt capital markets. The bare minimums for a city contemplating a capital markets issue are a basic double entry accounting system, MIS capability to track projects, a financial position that allows for leverage, managerial capacity at the municipality and nature of projects to be undertaken. These factors form the basis for the credit rating process that assesses the underlying capacity of the local government to take on debt and to determine the probability of default of such debt. The higher the underlying strength of a municipality and the revenue generating capacity of the projects undertaken, the higher the rating of the debt issued. A higher rating indicates lower cost of debt to the municipality.

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11 The Capital Value system bases the value of the property on the value of land and improvements on it
Ideally, the state government should not explicitly or implicitly guarantee the debt raised by a municipality. It is essential that the creditworthiness of a municipality is out in the open so that it is incentivised to improve the state of its systems and capacities in order that it is accountable to its citizens and worthy of funding.

Indian municipalities have been accustomed to subsidised debt funding from Housing and Urban Development Corporation (HUDCO) for their debt needs. These have traditionally been backed by state guarantees. The 1998 bond issue by Ahmadabad Municipal Corporation (AMC) was the first municipal bond issue in India and it was not guaranteed by the state government. Since then there have been more than 10 bond issues by different municipal corporations and only two of them have been backed by the state government\(^\text{12}\). While this is a positive and encouraging trend, it must be noted that these bond issues have all been done by the stronger, richer cities. Smaller cities continue to remain untouched by the market. A Govt. of India/Water and Sanitation Program study (2008) found that the stronger and richer ULBs are trying to fund investments from their internal revenues, as they are reluctant to venture into the debt market. This reluctance is despite the fact that the investments required to fund municipal infrastructure in these cities are substantially higher than the internal revenues generated.

The major demand for debt is coming from those ULBs that are strapped for finances and have weak balance sheets. Considering that these ULBs have been completely dependent on central and state government grants, they have lacked any serious incentive to build internal capacities and systems that would enable them to become effective service providers and strong financeable entities. Therefore, they remain unlikely candidates to tap debt funding from the markets for the present.

Care must also be taken in the design of grant programs (such as JnNURM\(^\text{13}\)) that the grant funding itself does not end up crowding out debt from capital markets.

### 2.7 Accounting and Tax systems

Along with the growth in responsibility and revenue generating power of the municipality, it is important that it develops its IT systems base for accounting and tax assessment. The municipality must have a double entry accounting system in place that make it possible to assess its financial position at any point in time. External funders will look at this as a basic requirement and it will also be invaluable for proper financial planning. As previously stated, the municipality must have a database of all taxable properties in the region so as to maximise tax collection efficiency. This may require that, in addition to a GIS system, the municipal officers make a physical assessment of all properties in the region to build a comprehensive properties database. Such an assessment can be of huge value to the municipality’s balance sheet. Automation of accounts, tax assessment & collections and user fees can also play a transformational role in improving municipal governance.

A consistent problem across municipalities in India is the availability and quality of data. It is almost impossible to get reliable data on municipal finances, and therefore very difficult to get a sense of the real financial situation of municipalities. Most municipalities do not even have double entry accounting and records of properties in the area. Planned use of Information Technology can have an important role to play in municipal management. Implementation of GIS maps with information on above-ground and underground layouts of a municipality can be very useful for provision, maintenance and repair of infrastructure services. The Greater Hyderabad Municipal Corporation has digitised 250 km\(^2\) of its metropolitan area and this map is beginning to be used by the water supply, electricity, police, census and slum development authorities. Already, the city has seen improvement of 50% or more in the property tax collections in areas where the GIS mapping has been backed up by a physical survey. The use of

\(^{12}\) Bangalore Municipal Corporation and Indore Municipal Corporation were guaranteed by the respective state governments

\(^{13}\) Jawaharlal Nehru National Urban Renewal Mission
accounting and tax systems, and property databases as aids in municipal governance must be actively encouraged in India.

3 South African municipal scenario

Up until 1994 South Africa was under the ‘apartheid’ regime, a system of racial and economic segregation that created one of the most unequal countries in the world. When the democratically elected government came to power in 1995, South Africa adopted a new constitution and also set about creating the legislative and policy environment to construct the new structures of governance.

South Africa is a ‘unitary’ state and has 3 ‘spheres’ of government now: national, provincial and local. As per the Constitution of the Republic of South Africa (1996), local government is required to ensure that all households have access to at least basic services. The local government is responsible for provision of services such as water, sanitation, electricity, sewerage, solid waste and roads. Its revenue sources include property taxes, user charges and an ‘equitable share’ of national revenue, grants.

The White paper on local government (1998) was the basis for reform of municipal system in South Africa. It laid down the principle of ‘developmental’ local government and elaborated on municipal finances and service delivery, most importantly the financial sustainability of local government and the criticality of user charges.

3.1 Municipal planning in South Africa

As per the Municipal Systems Act (2000) each local government is statutorily required to prepare a holistic development plan, which is a long term (8-10 year) plan for provision of social and infrastructure services to the municipality. The result of such planning is to develop, implement, operate and maintain basic infrastructure projects based on an assessment of current socioeconomic parameters, customer categories, service provision profiles and the financial situation of the municipality and projected changes to these factors over the plan timeframe. The plan must be backed by a sound financial strategy that is practical, affordable and politically saleable.

Financial planning is a critical part of the integrated development plan as the municipality’s proposed infrastructure program must be supported by a sustainable financing structure. To this end, the Municipal Finance Services Model (MFSM) which is a financial model that can be used by municipalities to carry out the analysis related to their infrastructure investment plans and assesses the viability of their infrastructure program. However, there has also been realisation that the MSFM could only be one part of a support program for infrastructure investment planning that also includes capacity building and stakeholder engagement.

The Municipal Systems Act (2000) envisages the participation of the community as an equal partner in local government. The act requires participatory and transparent budget practices, participatory decision making in pursuing municipal service partnerships and a public process of policy development in setting municipal tax rates and tariffs. A very crucial facet of this act is that with its passage into law, central government policy cannot force a municipality to implement policies outside the requirements of the act.

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14 Gini coefficient of 0.68 in 1991. This has marginally come down to 0.65 in 2005 as per the CIA Factbook. In comparison, India’s Gini coefficient for 2004 was 0.368 and Brazil’s for 2005 was 0.567.

15 A unitary state is a sovereign state governed as one single unit in which the central government is supreme and any administrative divisions (states, municipalities) exercise only powers that the central government chooses to delegate.

16 Equivalent to Central, State and Local government in India.
3.2 South African policy and relevance for India

3.2.1 Property Tax reform

Property taxes and user charges are the municipality's own sources of revenue and recognising the importance of a uniform property taxes regime in keeping municipal revenues buoyant, South Africa passed the Municipal Property Rates Act in 2004. This act has reformed many aspects of the property tax environment in South Africa. Firstly, it allows municipalities to set their own tax rates and requires them to conduct an annual review of the rates policy. The act has specified that valuations of property must be based on market value and done once every five years. It has also broadened the tax base by removing many exemptions and applying the tax to previously untaxed areas. While the municipality can set its tax rates, the Act does not give it unfettered power in doing so. The act stipulates "constitutionally impermissible rates", which it describes as rates that would unreasonably prejudice national economic policies, economic activities across the municipality's boundaries or the national movement of capital labour, goods and services. There is also a provision that there can be limitations placed on the ratio between rates on different categories of property. These restrictions have been put in to ensure that tax rates are not increased or decreased beyond reason and that some amount of equity is achieved.

We had discussed earlier the haphazard nature of the Indian property tax regime: lack of a uniform valuation methodology, number of exemptions available and lack of rate setting powers of municipalities. The Property Rates Act of South Africa addresses these issues and creates a national framework for the evaluation of properties and elaborates the guidelines within which municipalities have the discretion to set their rates, thus ensuring them flexibility for their revenue generation efforts, but at the same time guarding against unfettered use of the right to tax.

3.2.2 Definition of Minimum Service Levels

In South Africa, under the Free Basic Services policy, water supply, electricity, sanitation and waste removal services of a certain minimal quality and quantity are to be provided by local governments to all households free of cost. A minimum level of service is also explicitly defined. For example, under this policy, the Department for Water Affairs and Forestry (DWAF) stipulates that all households must have access to 6000 litres of clean water per month for formal connections or 25 litres of potable water per person per day within 200 m from dwelling, with at least 98% reliability and a minimum flow rate of 10 l/min. As far as electricity is concerned, each household should have access to 50 kWh of electricity per month, which is the amount of energy necessary for a month of basic lighting, small black and white TV, small radio, basic ironing and basic water boiling through an electric kettle. The funding for minimum basic services is a part of the unconditional grant from the central government to municipalities.

One of the key challenges for India is to implement minimum standards of basic services such as water supply and sanitation, sewerage and solid waste management across all ULBs. While what the basic minimum standards for each of these services should be is open for debate, the fact that there needs to be transparent minimum standards is not. Equally important is the fact that, unlike South Africa, the minimum service standards must be tied to conditional grant funding programs such as the JnNURM. Such grant funding programs should incentivise attainment of minimum service standards across urban centres by using the performance of ULBs on delivery of minimum levels of service as a critical criterion in formulating transfers.

3.2.3 Corporatisation for efficient service delivery

Municipalities have responsibilities for service provision, but it is not essential that they need to be the service providers. This distinction is very useful in that it is the basis for cities to explore more effective and efficient ways to deliver services.

Corporatisation refers to the separation of service delivery from policy and regulation, with the objective of providing for greater accountability and countering overt political interference in the day-to-day
provision of services. The underlying philosophy envisages a shift from political interference to political oversight.

Service units which are corporatized will have their budgets separated or ‘ring-fenced’ from the rest of the municipal budget. They will be managed as operationally autonomous units. Corporatisation allows the municipality to set policy and service standards and hold the entity to account against those standards. Reporting requirements and accountability mechanisms must be clearly defined by the municipality. It also offers greater autonomy and flexibility to the management of the corporatized entity to introduce commercial management practices to the delivery system.

Johannesburg Water (JW) was formed in 2002, a result of the iGoli 2002 transformation plan of the former Greater Johannesburg Metropolitan Council to turn around the city’s financial situation after bankruptcy in 2001-02. The iGoli 2002 plan required the government to sell non-core assets, restructure certain utilities, and required that all others become self-sufficient. JW was structured as a corporate entity, wholly owned by the City of Johannesburg, and was mandated the responsibility of providing water and sanitation to the three million residents of the City of Johannesburg, supplying some 650,000 domestic, commercial and industrial customers. In the subsequent years it has undertaken major projects to reduce unaccounted for water by repairing and upgrading networks throughout Johannesburg and installing prepaid meters to ensure more efficient use of water. JW has carried out these capital works in addition to its regular operations and maintenance of the city’s water infrastructure. The important thing to note is that while JW has been able to provide affordable, clean water to the residents of Johannesburg as per the mandate from the City of Johannesburg, it also remains a financially sustainable entity.

Corporatisation may be particularly appropriate for municipalities with large areas of jurisdiction and large populations in India. However, smaller cities can pool together to form create regional corporatised entities, in order to capture the economies of scale that larger cities have. The state government can play a facilitating role in helping set up such regional entities.

Cities (or groups of cities/towns) can certainly benefit from corporatised entities owned by the city (or jointly by a group of cities) that provide services mandated by the city and yet retain their management focus and autonomy, resulting in high quality and uninterrupted service delivery. The corporatised entity can be compensated by the city for the services it provides and any cross-subsidisation or free provision of service is borne by the city’s balance sheet. The hard constraint for the city is the balancing of its own balance sheet. It is also important that the management of the corporatised entity be given contracts with appropriate incentives for achieving desired levels of service delivery.

3.2.4 Market development participant for debt capital access

The South African government stopped providing guarantees for municipal debt which forced lenders to actually analyse the municipalities and get a sense of the actual credit risk involved. Subsequent to this move, activity in the municipal debt market ceased. Now, the Municipal Finance Management Act (2003) shapes and directs the basis for municipal borrowing. There are two important players in the municipal debt market: Development Bank of Southern Africa (DBSA) which, as Savage (2007) notes, has moved away from being primarily a lender to the larger municipalities to supporting market development through lending to smaller municipalities and introducing new financial instruments (such as partial credit guarantees); and the Infrastructure Finance Corporation (INCA), a private sector player formed at the behest of the South African government, which has become a source of funding to many municipalities by swapping the municipal investment portfolios of insurance companies and pension funds for INCA bonds.

In the Indian context, we looked at the specialised lender HUDCO which provides cities with access to subsidised debt on the back of state government guarantees. Instead of subsidising debt, HUDCO could become a market maker in municipal bonds, providing guarantees or investing in lower rated municipal debt, while private investors can invest in the higher rated portion. On the one hand, this would expose
the municipalities’ true creditworthiness to the market, thus providing for transparency and incentivising municipalities to address their governance and service delivery issues. And on the other, because of HUDCO’s market making role, it can still attract private funds into investing in credit enhanced municipal debt, allowing lower rated municipalities to access the debt market. Therefore, as a market maker, HUDCO would be able to leverage its funds, using its capital sparsely in the higher risk portion of the capital structure and inviting private debt to fund the highly rated part of the capital structure. This leverage achieved through the efficient usage of HUDCO’s funds could help in bringing in much more debt into financing municipal infrastructure than if HUDCO looked at funding the entire capital structure by itself.

3.2.5 Disincentives for financial misconduct by municipal officers
The Municipal Finance Management Act (2003) in South Africa stipulates punitive disincentives for financial mismanagement by municipal managers. It explicitly states that municipal officials found guilty of financial misconduct will face criminal proceedings and could spend up to five years in prison.

Just because the term of a local government is only five years, municipal officials should not set their horizons only for that period. The decisions made by each successive local government will have repercussions well beyond their tenure. In this situation, it is essential that all funds in the municipality’s control be spent only as documented in the development plans, which are prepared after due consultation with multiple constituents. One way to ensure this compliance to the approved plan would be the threat of criminal proceedings against municipal officials for any financial impropriety. This would act as a strong deterrent to any financial misconduct. However, this will have to be backed up by strong community involvement that holds the municipal officials accountable. This pressure from both the legal side and the community could have a positive effect on the financial management and performance of municipalities.

3.2.6 Incentivise cities to compete on service provision
Once the minimum service level has been established in a city, it must be incentivised through a reward based system to provide higher level services, while not compromising on fiscal discipline. One such incentive for performance can be competition between cities on better quality and level of services. This can be done through a formal benchmarking exercise carried out annually, where the service provision status of different cities is compared. In South Africa, this has resulted in a situation where cities such as Johannesburg and Durban compete with each other on the quality of their services. Cities managed under a system of true decentralised governance, backed up by an environment that incentivises fiscal discipline have the potential to become self-financing.

In India, the challenge is to make cities compete in the provision of basic levels of service, as even these are lacking in large parts of our cities. Ratings of cities by a government sanctioned institution on the basis of service provision parameters can be a tool to drive cities towards achievement of service delivery parameters and doing so would also mean increased access to commercial finance and strong balance sheets.

4 Brazilian municipal scenario
In 1987, Brazil made the transition from 20 years of military dictatorship to a federal democracy. The social force behind dismantling of the dictatorial regime was provided by localised community movements in different regions of Brazil and after the change to a democratic regime, it was the leaders emerging out of these local movements who were influential in the design of the new constitution. One of

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17 The Brazilian constitution defines the ‘federation’ as the sum of three tiers: the central government, the state governments and local governments. The constitution entrenches the nature of states and municipalities and this cannot be altered by a unilateral decision of the central government.
the top priorities of the National Constituent Assembly was to strengthen the federation, which had been subject to a long process of political and fiscal centralisation under the military.

The landmark 1988 constitution gave a strong push to the agenda of decentralisation by promoting the decentralisation of revenues and fiscal autonomy of local governments. Taxes were devolved to state and local government and revenue transfers (from centre to state as well as state to municipalities) were clearly defined and mandated. Education and health care were to be the most important functions of local governments. However, in practice, the devolution of finances was not coupled with a clear devolution of responsibility. For example, multiple tiers of government continued to be involved in the provision of education and health services, but the role of each tier remained unclear. This led to confused and chaotic service delivery. The central government took on most of the expenditures incurred and the spending program of municipalities went unchecked, leading to a lack of accountability.

The financial crisis in the early 1990s, when inflation soared and municipalities found themselves unable to repay their debt, provided the setting for putting right the imbalance created by the devolution of powers without clear responsibilities. Using this opportunity, the central government pushed through a process of fiscal reform, holding local governments accountable for their revenue transfers. This resulted in much better outcomes in local government service delivery. For example, in education and health, the service delivery by local governments showed a marked improvement once their funding was tied to achievement of service levels. Under the ‘Funds for Maintenance and Development of Primary Education and Valorization of Professorship’ (FUNDEF) education program, there was a clear demarcation of roles, with local governments responsible for the provision of primary education and state governments responsible for secondary education. It also required local governments to spend 15% of their budget on primary education. Expenditure is thus clearly tied to specific service delivery. Mora and Varsano (2001) indicate that under the FUNDEF program enrolment in primary schools increased by 8% from 1996 to 2000, enrolment in municipal schools went up from 33.3% to total enrolment to 47%, and that the number of teachers and their qualification increased. Wilson (2006) points out that the health program, ‘Sistema Unico de Saude’ (SUS), tied transfers from central government with health services provided by local governments. The program advocated a preventive care approach, with broad federal guidelines but with policies and priorities defined by local government. Luna (2008) indicates that the SUS program was able to increase coverage against influenza from 73% in 2000 to 87% in 2007, increase vaccine coverage for measles to 100% and reduce infant mortality by 50%.

The Fiscal Responsibility Law passed in 2000, aimed at creating greater stability, sustainability and transparency in municipal financing, was the next step in the Brazilian decentralisation program. The important tenets of the law included limitations on payroll expenditures and ability of the central government to block automatic transfers if a state spent itself into a deficit. What this essentially did was to impose a hard budget constraint on municipalities, something that was missing in Brazil before.

4.1 Brazilian policy and relevance for India

4.1.1 Participatory Budgets

The 1988 constitution recognised the historical importance of community activism and grassroots movements in Brazil, and provided mechanisms for citizen participation in decisions and oversight of local public matters. These mechanisms were designed to link civil society to formal political structures.

The Participatory Budget (PB) is a process of consultation and debate between citizens, civil society groups (labour unions, community organisations), technocrats and local government officials to decide on the priorities, plans and actions that need to be undertaken by local government to improve infrastructure and service delivery. This then drives specific decisions on investment and expenditure. There are different levels of meetings with the involvement of different stakeholders, and the process is designed in a way that tries to ensure that while the voice of the people is heard clearly, at the same time the process does not become too unwieldy. PBs in Brazil are credited with paving the way for democratic
and transparent administration of resources and are also seen as being instrumental in curbing corruption and misappropriation of public funds. A UN-Habitat study estimated that within 10 years of its inception, PBs had cleared investments of more than USD 700 million for urban infrastructure and service delivery. As of 2004, PBs were being practiced in close to 300 municipalities in Brazil.

The experience of Porto Alegre is instructive of the power of PBs as a tool to promote better governance. Porto Alegre is the capital of the southern state of Rio Grande do Sul and has a population of 1.4 million as of 2008. This was the first city in Brazil to experiment with the concept of PBs. It was a city of extremes of wealth, with a third of its population living in slums without access to water, sanitation and medical facilities. In 1989, the city started with the PB process to ensure that growth was inclusive and that the marginalized had a voice in the development process. As a result of this collaborative development process, the poor were able to influence decisions related to provision of public infrastructure and basic delivery of services. The impact of PBs can be seen in the improved urban infrastructure and service delivery statistics of Porto Alegre. A World Bank case study indicates that coverage of water supply and sewerage connections went up from 75% in 1988 to 98% in 1997, number of schools quadrupled with enrolments doubling, and health and education budgets increased from 13% to 40%. The enhanced inclusive nature of decision making can also be judged from the increased participation of citizens, up from a mere 1000 in 1990 to about 40,000 at the end of the millennium. Participation included substantial representation from low-income groups. The PB forced transparency and accountability from the municipality and made public spending much more efficient and effective.

In India, the 74th CAA mandates the creation of Area Sabhas, Wards Committees etc. with the intention of increasing public participation in the decision making process, but as discussed earlier these are for the most part not functional. The example of PBs is Brazil stands to highlight the quality and magnitude of local change that can be brought about by the involvement of citizens and communities. Such mechanisms of participation become especially critical in the case of low-income groups who will otherwise remain at the fringes of the development process.

4.1.2 Property Taxes

Municipalities in Brazil use the Capital Value method to assess the value of all land and buildings in urban areas. The tax is administered by each municipality and all municipalities enjoy the freedom to set the tax rate and collect the tax. Afonso and Araujo (2006) indicate that property tax rates in Brazilian municipalities vary between 0.2% and 1.5%. Municipalities have been in the process of updating their property tax databases with unaudited properties and also valuing them based on cost of land and improvements. Property valuations are adjusted each year for inflation. Property taxes and tax on services constitute the bulk of the municipality’s own source revenues, about 60% (which works to about 17% of total revenues).

As discussed earlier, there is no consistent property tax system in municipalities across India. This had led to a situation where property taxes, to a large extent, remain an ineffective source of revenue to municipalities. Like South Africa, Brazil has put in place a consistent property tax regime across municipalities while, at the same time, allowing for municipal autonomy in the administration of the tax.

4.1.3 Mandatory Inter-governmental Transfers and Shared Taxes

Brazil has a well defined system to mandatory transfers and shared taxes from the federal and state governments to local governments. The system is formula-driven and therefore provides for a predictable and periodic flow of resources to local government, thus making it conducive for long-term local planning.

a) The Federal Equalisation Transfer: The ‘Federal Equalisation Transfer’ was created to compensate for differences in development and population among municipalities. It is designed such that larger per capita transfers are made to smaller and poorer municipalities. The equalisation transfer is made from the Municipal Participation Fund, which is created out of 22.5% of the federal government collection of income tax and industrial products tax.
b) The Cooperation Transfer: The ‘Cooperation Transfer’ is made to municipalities from: i) federal industrial products tax collections and distributed based on the municipality’s contribution to the tax base; ii) federal contributions levied on fuels and distributed based on national law; iii) fund for improving elementary education and distributed in a manner ensuring achievement of minimum spending per student in primary schools; iv) payroll social contributions collected from private companies; and v) royalty contributions for exploitation of petroleum, natural gas and minerals.

c) Shared Taxes: Municipalities are entitled to the following shared taxes: i) 25% of state tax on operations; ii) 50% of state tax on motor vehicles; iii) 50% of federal tax on rural land and property; iv) 70% of federal financial operations tax on gold; and v) 100% of income taxes withheld at source for income paid by local governments.

Since the transfers and the shared taxes are so well defined, municipalities in Brazil can anticipate the quantum of transfers they will receive on an annual basis and plan for their investments and expenditures accordingly. Afonso and Araujo (2006) estimate that the mandatory transfers and shared taxes together constitute 60% of total municipal revenue.

Inter-governmental transfers in India, as discussed earlier, are still characterised by uncertainty and delay. Also, there is still the lingering culture of project-by-project approval of grants which makes any long-term planning exercise by municipalities fraught with risk. As seen from the Brazilian experience, it might be prudent to consolidate annual transfers to local governments under one or two windows, making the criteria for transfers transparent and ensuring that the transfers happen regularly and periodically. A programme like the JNNURM could become the single window for inter-governmental transfers from central government annually, based on the long-term development plans of cities and other transparent parameters such as population, per capita income level etc. Such a focused approach to inter-governmental transfers can serve to increase accountability, predictability and regularity.

5 Selected Indian experiences and lessons

In this section, we look at two examples of innovative mechanisms to improve municipal governance and accountability and the lessons they hold out for broader policy reforms.

5.1 Debt Markets Access for small municipalities through Pooled Finance

The Water and Sanitation Pooled Fund (WSPF) is a pooled financing scheme set up by the Tamil Nadu Urban Development Fund (TNUDF) with the objective of helping smaller ULBs in Tamil Nadu gain access to debt capital markets and also to build the ULBs’ capacity to finance and manage infrastructure projects. These ULBs would otherwise find it difficult to access the debt markets because of the small size of their debt requirements and the lack of track record in accessing debt. Pooled financing allows such entities to pool together their projects and access the market with one single bond issue backed by the cash flows from all the underlying projects. The size of the pooled issue is large enough to attract institutional investors and the technical expertise in structuring such a transaction is provided by TNUDF, the financial intermediary. TNUDF also works with the ULBs to improve the quality of their systems and processes, thus incentivising them to improve their capabilities in order to be able to tap the markets again to access further external debt.

The first WSPF pooled bond issue for Rs 30.4 cr, happened in 2002 and it pooled together projects from 13 ULBs. The AA rated bond was backed by underlying project revenues and credit enhancement through escrow of property tax and other collections, a Bond Service Fund18, a USAID guarantee19 and

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18 Rs 6.9cr provided by Govt. of Tamil Nadu
19 50% of principal amount
interception of SFC devolutions. Banks and insurance companies invested in the bond and there has been trading in the secondary market also. A similar bond issue was done in Karnataka also.

Encouraged by the response to these pooled finance issues, the Govt. of India set up the Pooled Finance Development Fund (PFDF) aimed at infrastructure of small and medium towns. This made available a sum of money under the Credit Rating Enhancement Fund (CREF) that state pooled financing entities could access for providing credit enhancement on their pooled finance issues. The PFDF also made available a grant for implementing reforms\(^\text{20}\) at ULBs. While this scheme was expected to kick-start the nascent pooled financing movement in India, it has not been able to do so. This has been mostly attributed to a condition in the PFDF guidelines that requires any pooled bond issue looking to access the CREF must be issued tax-free with an interest rate cap of 8%.

The second WSPF bond issue by TNUDF was planned to be a Rs 45 cr. issue. However, the AA rated issue failed to generate interest among investors due to the coupon rate of 7.25%. Despite the tax-free status, the capping of the return to 8% had made it uneconomical for investors to subscribe. The Rs 45 cr. issue found subscribers worth only Rs 6 cr. and the issue was shelved.

Pooled financing, as a concept, has been proved with the two successful bond issues in Tamil Nadu and Karnataka. The PFDF guidelines need to be relooked at, especially the guideline on the fixed interest rate cap of 8%. Such a hard cap fails to take into account market realities, and a better way of designing the cap would be to link it to a spread over a benchmark rate such as the Government Securities rate. In its current form, this guideline has lead to a moribund pooled finance debt market.

### 5.2 E-Governance reform for ULBs in Karnataka

Karnataka has been at the forefront of incorporating e-governance into municipal administration since 2003. Prior to 2003, municipalities in Karnataka used cash based accounting which gives no indication of the actual financial position of the municipality. In addition, citizens’ right to information necessitated the keeping of records, and the push to become stronger entities that can access commercial debt markets meant higher transparency and fiscal discipline. Also, property tax collections, the largest component of municipal revenue, suffered from poor assessment and collection efficiency. These factors, along with policy directives, drove the adoption of e-governance to implement an accrual based accounting system, a budgeting and an MIS system. Rupanagunta (2006) points out that the implementation of the system involved the active participation of multiple stakeholders, viz. the state government who championed the project, the municipal administrations who were to be the users of the systems, a nodal consulting firm to advise in the transition phase, the software developers and the field level consultants who implemented the systems at the ULBs and were required to work with the municipalities to help build skills and capacities for a year.

The e-governance system was designed to be not just a tool to improve internal operation of the municipality, but also a window to service multiple parties who would benefit from the system. Citizens can view financial information and performance, and city management reports with financial and social indicators of performance. State governments can view periodic data analysis from the cross-section of ULBs, facilitating decision making.

Today, 50 municipalities in Karnataka use the e-governance system in their day to day functioning. All of them have online accounting systems compliant with the National Municipal Accounting Manual\(^\text{21}\). This standardisation allows for comparison across municipalities and is an important tool for state government decision making as well as municipalities themselves to see where they stand with respect to other municipalities. In addition to an accounting package, the system also has a GIS package in order to map the municipality through a physical property survey and assess the properties based on Karnataka’s

\(^{20}\) Accounting, user charges, e-governance and collection efficiency reforms

\(^{21}\) Published by Comptroller and Auditor General of India (CAG) and Ministry of Urban Development, Govt. of India
Capital Value guidelines. The city map is updated with this property’s spatial and assessment information. About 80% of the cities have completed the GIS mapping and almost all have seen an increase in property tax collections, some seeing a doubling of revenue. The system also has a works management module that provides online and real-time works data (contracts for service delivery, maintenance, repairs etc.) to citizens. All 50 ULBs put out their works data on the internet.

With the Right to Information Act taking hold, such e-governance systems will need to be in place in all ULBs to mine for all information demanded by citizens. Also, ULBs can be viewed as being open and transparent if they use these systems to proactively provide information and reports to citizens and civil society groups.

6 Recommendations for local government policy reform

Based on the discussions in the previous sections, we now turn to the specific recommendations for local government policy in India

6.1 Constitutional reforms

a) Municipalities should have the power to set tax rates and levy user charges

In India the financial levers of the municipality are still controlled by the state government and this is not conducive to effective municipal governance. Municipalities must have the power to set property tax rates and user tariffs to control their revenue sources so that they can plan effectively for infrastructure service provision. However, as we saw in the case of South African policy, there must be restrictions on misuse of these powers by municipalities, and the state municipal legislations must provide guidance on the limits within which the municipality can fix tax rates and charges.

b) A uniform Property Taxation code to mandate a move towards a uniform method of property valuation across the country

Although the municipality should have the power to set the tax rate, the method of property valuation must be uniform across the country. As we saw earlier, there are large differences in methodology of property assessments in different states in India. Lall and Deichmann (2006) suggests that an Area based system can be adopted initially across the country as this tends to be an improvement over the current ARV system in terms equity as well as an increase in the property tax base. The act should also aim to broaden the tax base and do away with as many exemptions as possible.

c) Stipulation of punitive disincentives for financial misconduct by municipal officers

In order to ensure that municipal officers act in the best interests of their constituents they need to be disincentivised through the threat of criminal proceedings and prison terms. In addition to pressure from citizens and civil society, this will serve as a tool to ensure appropriate management of municipal finances.

d) Enumeration of minimum service quality and quantity levels for basic infrastructure services

There should be clear, well defined benchmarks for minimal service provision benchmarks for basic municipal services such as water supply, sanitation, sewerage and solid waste management. While the enumeration of benchmarks will be an essential step forward, we need to ensure that ULBs are appropriately incentivised to meet these targets. This can be done by tying the achievement of minimum service delivery targets to accessing funds from central infrastructure grant programs. The conditionality of funds will also lead to competition between cities in service provision and this could have positive spin offs in terms of the speed of service delivery and provision of higher level services.
Making the minimum service standards public will also ensure citizen participation in applying pressure on the ULBs to deliver.

6.2 Innovative service delivery

a) Corporatisation for more effective and efficient service delivery in cities

As the Johannesburg Water example showed, corporatisation of water supply or electricity supply entities as service providers under the ownership of the city with a clear mandate on providing quality and affordable services, can serve large cities well. The corporatised entity remains focused on service delivery and all equity concerns are handled by the ULB on its own balance sheet, which is separate from the corporatised entity’s balance sheet. An additional link of accountability can be designed through the sale of a stake in the corporatised entity to citizens of the ULB. This will build a direct link between the service provider and citizens, who will now be both consumers and part owners.

b) E-governance for greater efficiency and accountability in cities

As the Karnataka experience with e-governance shows, basic systems for accrual accounting and MIS are essential to build capabilities at the ULB. Also, the availability of a comparative ranking of different ULBs in the system should be made public periodically so that this information is available to citizens who can then effectively benchmark their city against others and demand better service delivery.

ULBs should also look at the possibilities of using GIS. As discussed in the Gorakhpur and e-governance examples earlier, GIS offers clear benefits to property tax assessments and collections. In addition, as the Hyderabad example shows, it can be used by many different entities such as water supply board, electricity board and police to improve their service delivery.

Citizens and civil society groups that demand accountability and transparency will incentivise ULBs to invest in e-governance systems that can store and mine useful information in meaningful ways and make them available to citizens on demand.

6.3 Vibrant Municipal Debt market

a) A government promoted entity like HUDCO could play the role of market maker rather than subsidised lender

The municipal debt market can be expanded if HUDCO took on the role of a market development through providing guarantees or taking part in the mezzanine portion of the capital structure, rather than being the sole financier backed by state government guarantees. This new role will lead to more efficient usage of funds and help bring in additional private debt into the municipal debt market. Additionally, this will encourage more municipalities to come out with bond issues to finance their infrastructure needs.

The municipal debt market can also be a source of citizen participation in governance and the demand for accountability. If a portion of every bond issue is made available to the public of the city raising funds, it will enable citizens to take part in directly financing the infrastructure that affects them while at the same time building on the relationship that the citizen has with his or her city. In addition, a citizen’s financial stake will also increase the demands for accountability and can serve as a source for citizen participation in governance.

b) Modifying the interest rate cap guideline in the PFDF guidelines can breathe life into the pooled finance market for small municipalities

The hard cap of 8% on the tax free pooled finance bonds should be modified to represent a spread over a benchmark rate so that it is linked to market realities. As we saw, the second WSPF pooled finance issue refused to take off due to lack of investor appetite in the low yielding pooled finance paper. In fact, since...
the first two issues by WSPF and Karnataka WSPF, there has been no activity in the pooled finance market.

c) Municipal and Pooled bonds should be made eligible investments under RBI’s ‘Priority Sector’ norms and IRDA’s ‘Social Infrastructure’ norms

Both municipal bonds and pooled finance bonds should be made eligible investments under ‘Priority Sector’ investments for banks and under the ‘Social Infrastructure’ category for insurance companies. Since these investments are critical to the development and economic growth of India, there is a strong rationale to incorporate municipal bond and pooled bond investments under these categories.

6.4 Citizen participation and activism

a) Invigorating Ward Committees and Area Sabhas to become vibrant associations for true participatory democracy

At the base of all reform of municipal governance lies citizen participation and activism. As we saw in the Participatory Budgeting example from Brazil, systematising the process of citizen participation can be a powerful tool in directing the path of development towards greater inclusiveness, prioritising the pressing needs of the people and yielding more effective and efficient allocation of resources. The 74th CAA envisions the Wards Committees as the vehicle of participatory democracy and it is imperative that these committees be made functional. This could be achieved through choosing a few cities that have a history of citizen activism and actively pushing the formation and functioning of these committees. The positive outcomes from these initial cities could be publicised widely to incentivise other municipalities to follow suit and make participatory democracy a reality.

b) Information dissemination as a tool to encourage citizen participation

Devarajan, Khemani and Shah (2007) point out the criticality of citizen participation as a necessary condition for successful decentralisation. Regular information dissemination regarding the responsibilities of municipalities and the funds allocated to them for various projects can be useful tools in generating strong community involvement in local governance. When information is available publicly, citizens can hold local governments responsible for delivery of services. This thrust towards continuous and regular dissemination of information could come from central and/or state governments. For example, the national government in Brazil launched an anti-corruption drive in 2003 which involved the random audit of municipal government budgets by an independent public agency and releasing these results to the public. This disclosure of information led to a significant reduction the re-election rates of mayors found to be corrupt. As this example shows, information dissemination can be a powerful tool to drive improved governance.

Schemes such as the JNNURM can mandate information dissemination on projects that have been approved and are ready to be implemented. Using press and media outlets, especially in the beneficiary city, such information should be made widely available. This could serve as a novel monitoring mechanism with citizens being made aware of the nature of the project and its specific expected benefits (such as additional population covered and quantum of improvement in service delivery), so as to hold the city accountable and ensure delivery of the services promised.

7 Conclusion

The 74th Constitutional Amendment Act of 1993 paved the way for municipal governance reform in India. While there have been some major improvements in the realm of municipal government, there is still much that needs to be done. South Africa, with its history of racial and economic segregation, elected a democratic government in 1995 and set about on its own path of reforming its governance structure. It has managed to create an enabling policy and legislative environment for a development oriented local
government. Brazil's tryst with military dictatorship ended with the emergence of strong community grassroots movements and its transition to a democracy was expectedly accompanied by a substantial degree of decentralisation. While there are many differences in context between these two countries and India, there are some lessons India can draw from the South African and Brazilian experiences as detailed above. India has seen its own share of innovative urban governance and financing initiatives such as in the areas of pooled financing and e-governance. Assessing the South African and Brazilian policy environments and the Indian experiences discussed in the paper, we can draw useful recommendations for municipal policy in India. Through constitutional reforms, innovative service delivery mechanisms, active citizen participation and a vibrant debt market, the Indian municipal governance scenario can move towards a future of greater accountability and effectiveness.
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