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Urban Financial Management
Phase I: Case Studies and Analysis

Executive Summary



Research Triangle Institute

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EXECUTIVE SUMMARY

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Executive Summary

1. Project Overview

The Research Triangle Institute has completed a Phase I study for the U.S.AID Office of Urban Development as part of U.S.AID's long-term program to assist municipal governments in developing countries to improve their financial management practices. The purpose of Phase I was to identify existing financial management practices in developing countries that would serve as models for other municipalities to improve their own practices. Additionally, the study was intended to develop a set of recommendations for disseminating information on those practices.

The Phase I study contained several unique features:

- from the outset, it focused on successful practices in operation -- this was not an academic exercise but a search for proven practices that could be readily transferred;
- the study examined a broader range of practices than has conventionally been dealt with in municipal finance. The study gives equal attention to practices that improve the productivity of municipal expenditures as well as those that increase local revenue generation; and
- the study identified a number of practical intervention points where improvements could be made, with particular emphasis on immediate, low-cost improvements.

The study covers eleven cities within eight developing countries.

Exhibit 1 shows the countries, cities and the practices under study.

Exhibit 1

Case Study Sites and Practices Under Study

| <u>Country and Sites</u> | <u>Practice(s)</u> |
|--------------------------------------|---|
| <u>Ivory Coast</u> | |
| Abidjan | <ul style="list-style-type: none">- computerized land registration system- betterment tax for partial cost recovery of slum upgrading |
| <u>Philippines</u> | |
| Local Water Utilities Administration | <ul style="list-style-type: none">- introduction of self-financing local water utilities- training of local officials and staffs- loan management |
| Cagayan de Oro City | <ul style="list-style-type: none">- establishment of user charge system in local water district |
| <u>Brazil</u> | |
| Lages, State of Santa Catarina | <ul style="list-style-type: none">- computerized real property tax information system- low cost self-help housing program- economic development enterprises |

Exhibit 1 continued

Korea

Daejeon

- self-financing physical infrastructure provision (land readjustment system)

Ghana

Tamale

- training of local government officials and staff
- local revenue study
- experiments in per capita tax collection system

Colombia

Medellin

- betterment levy to recover infrastructure costs

Kenya

El Doret and Nakuru

- impact of central government transfers on local finances
- management of municipal accounts

Tunisia

Sousse

- automation of property tax information system and municipal personnel records

Sfax

- low income housing program
- management of wholesale market

Tunis District

- solid waste collection system

In summary, the case study practices included:

- tax collection system improvements, focusing largely on the urban property tax and, to a lesser extent, business taxes and per capita taxes;
- cost recovery in non-infrastructure public services, covering examples of urban transit, markets, solid waste collection and housing;
- local government loan and grants management, examining factors that make loan programs viable and the impact of central government grants on local governments;
- training of local government officials and staff with emphasis on competency based training and productivity improvements.

The study concluded that there is considerable opportunity for improving urban financial management practices in developing countries and that there are proven models of successful practices in developing countries that can be shared. The study has recommended that further U.S.AID action in the area of urban financial management be concentrated in four areas:

1. Strengthening individual developing country institutions that can provide technical assistance, training and information to local governments;
2. Developing and disseminating prototype financial management tools;
3. Developing training programs specifically targeted on major groups involved in local government financial management; and
4. Selected research and information dissemination support.

2. Summary of Study Findings

There are a number of different problems that stand in the way of improved municipal financial management in developing countries. While there are many different ways to categorize these problems, the simplest way is to discuss them in terms of attitude, knowledge and instruments.

Attitude problems pervade municipal management in developing countries. The first problem is that of a dependency attitude which prevents local governments from assuming full responsibility for the services that they are mandated to provide. The problem is particularly acute with respect to municipal loan programs where municipalities often abandon responsibility for debt repayment. The second attitudinal problem is lack of responsibility toward service consumers in the quality and timeliness of services that are delivered. There is a corresponding lack of concern for productivity in service provision that results in poor services expensively delivered. This makes cost recovery through user fees difficult. The third major attitudinal problem is that of pervasive political interference in financial management which constantly overturns sound financial judgment. Political interference runs the gamut from padding local government payrolls to maintaining artificially low tax rates and user charges; in many instances, local tax operations are used to reward political allies and punish enemies.

Lack of knowledge is the second major problem area. There is a general lack of information maintained by municipal governments on financial status and trends. Without such knowledge, financial decisions tend to be mere continuations of past policies. Secondly, there is a general absence of networks through which information on successful financial management practices can be disseminated. Thirdly, training in municipal financial management is a very haphazard affair, complicated by the rapid turnover in staff in the skilled finance positions. There appears to be a particular knowledge problem for small cities that have grown rapidly from farm market towns. Officials in these cities are not accustomed to providing public

services or raising revenues; they tend to lack basic training in municipal management.

There is a general lack of instruments for improving financial management and financial conditions of developing country municipalities. Prototype systems and how-to-do-it reference materials are largely absent. While municipalities may have significant revenue raising authority, they often do not have models of how to apply that authority efficiently. Agencies that serve municipalities with technical assistance and training are not well developed, except in a few countries, and there is no widespread international network for transferring information among countries. While in some countries changes in legislation may be needed to support local government financial improvements, there is much that can be done simply by improving current administrative practices and implementation of existing technology.

Our study has demonstrated that improvements in municipal financial management can be made at almost any point ranging from revenue generation to increased service delivery productivity. The following presents summary descriptions of the practices identified in the case studies by the major areas.

Tax Collection System Improvements

The case studies dealing with improvements in local tax systems have demonstrated two things. First of all, there is considerable room for improvement in the amount of revenues raised from local taxes. Secondly, local tax collection must be approached as a whole system: tax base identification, valuation, assessment, collection, enforcement.

Improvements in one aspect of the system must be matched to improvements elsewhere. For example, in Lages, Brazil the effectiveness of an excellent property tax information system has been considerably reduced by lack of effective collection enforcement procedures; notwithstanding substantial increases in the revenues from the local property tax over the past four years an estimated 30 percent of property taxes in Lages are not being paid. In Abidjan, Ivory Coast although the computerization of land records increased the identification of taxable properties, recording of tax payment and follow-up is conducted slowly by hand.

If our small sample of case study cities is in the least representative, considerable increases in revenues could be expected from improved property tax administration in general. Occasionally small improvements can make a big difference; in Nakuru, Kenya, hiring of a local property valuator (to replace the valuation services of the National Commissioner of Lands which has not kept up with the demand) is expected to expand property tax revenues considerably by simply updating the property tax rolls.

Several of our case study sites undertook major overhauls of the property tax system. Typically, a cadastral survey was undertaken (Lages and Abidjan) to create a complete property registry of the city. Secondly, an updated assessment was made, with provision for frequent reassessments. Building such an information base is costly and time consuming. It is, however, a necessary foundation for the property tax system. In many cases the development of a complete property registry is justified for more than just tax purposes. In Abidjan, the cadastral system was developed partly to

permit regularization of land titles. This, in turn, provides more secure conditions for mortgage loans in the housing market.

In the case studies of Lages, Abidjan, and Sousse, Tunisia, the introduction of computerization in property tax systems has greatly improved the efficiency of the systems. Now, the availability of cheap microcomputer systems should further extend computerization to smaller municipalities.

Even well designed information systems do not avoid the problems of interagency conflict in local government. In Abidjan, access to the land registry information system which was developed by the Finance Ministry, but also used by the planning agency, has become such a point of conflict.

While considerable improvements in property tax collections can be made by improving administration of the current system, there are instances where changes in the current laws clearly are needed. In Tamale, Ghana there is a two to three year delay between individual assessments made by the local assessors and approval by the Ministry of Local Government. The imposition of an interim assessment, recommended by a local revenue study in Tamale, would require tax code revision.

In some cases, local governments may be using inappropriate tax collection systems or devoting resources to tax sources that are not worth the effort. In collecting the local head tax in Tamale, Ghana, a once a year canvass of the local district by agents paid on a bounty basis has proven to be much more effective than the previous system in which individual revenue collectors pursued lists of district residents. In general, local governments have not been able to exploit local business taxes except in the relatively more advanced countries in the case study set

(Korea, Brazil and recently Tunisia). It is clear that most local governments do not have the staff or information collection systems to monitor business receipts and sales. In Brazil and Tunisia, the business taxes are collected by higher level government and refunded to the municipality. Because of the effort needed to maintain information on business tax bases, local governments may be better served by replacing receipts-based business taxes with more extensive licensing systems or presumptive assessments.

Although there is considerable debate over which taxes should be best administered locally, there is a strong consensus that great improvements can be made by simply improving the management of what currently exists. Indeed, given the shortages of trained finance staff, radical changes in tax authority will most likely be disruptive.

Financing Physical Infrastructure

A second major grouping of the case studies has examined the financing of physical infrastructure provision in municipalities. Financing physical infrastructure is a major concern of local government for several reasons. First of all, physical infrastructure construction requires considerable capital investment prior to realizing any benefits of the investment. This raises issues of both capital borrowing and long term financing, including long term cost recovery from project beneficiaries. Secondly, the provision of physical infrastructure services carries with it the need for long term maintenance and replacement, which places particular demands on fiscal management. Thirdly, provision of physical infrastructure can greatly increase the value of raw land, producing several different types of

opportunities for local government to benefit financially from the value that it helps to create.

Several different models of cost recovery have been developed for provision of physical infrastructure that can serve as useful models for other developing countries. The case studies examined four different examples of infrastructure financing. The Colombia case study examined the recovery of the cost of infrastructure (primarily road construction) through the imposition of betterment levies that allocate cost of construction to affected land-owners on a proportional basis. In Korea, the system of "land readjustment" was studied by which the municipality acts as the developer to convert urban fringe land to fully serviced lots by providing all the physical infrastructure. In this system, the cost of providing infrastructure is recovered by withholding a fraction of land from each land-owner to sell on the open market to recover all costs of development. In Abidjan, the municipality is recovering a portion of the cost of providing infrastructure in slum upgrading projects through a betterment levy attached to the property tax. In the Philippines, local water districts are being established with the assistance of a national organization, the Local Water Utilities Authority, which provides loan funds, technical assistance and training to help establish totally self-financing local authorities.

In all of these cases, the operating principle is that the beneficiaries of the service pay the cost of its installation and operation. In Colombia, Ivory Coast and the Philippines the costs are paid directly through special levies or monthly charges. The land readjustment system in

Korea represents a more radical departure in that the municipality, or development agency, takes land in lieu of cash payment.

The process of urbanization (i.e., creating land with public services) greatly increases the value of raw land. While municipalities in many countries have moved to capture some of this increased value in order to pay for the cost of providing infrastructure, almost none appear to have fully exploited the value that they are, in part, creating. Even in the Korean land readjustment system, the municipality is limited to recovering only its actual costs through the sale of land it has taken as payment - surpluses must be reinvested in the individual infrastructure projects. If a municipality does not benefit directly from increased land values created by provision of public services, its main alternative is to recapture some of the value through increased property taxes. However, the poor efficiency of most property tax systems in developing countries renders this an ineffective mechanism for exploiting rising land value.

Controlling Costs in Public Service Expenditures

A number of the case studies dealt with aspects of cost control in municipal service delivery systems. In particular, the case studies addressed a number of different points in the service delivery process which affect cost of services. Several municipalities have undertaken programs aimed at reducing overall demand for public services. The city of Lages has several programs aimed at improving the income of rural inhabitants of the municipality to stem the pressures for migration into the city center. The city of Tamale has undertaken a program to channel residential growth into desired patterns (and away from haphazard squatter settlements) to reduce

the cost of "retrofitting" squatter settlements with urban services. The city of Daejeon, Korea, is working to maintain provision of public transportation services entirely in the private sector so that that city, unlike Seoul, does not have to provide public transportation or subsidize existing companies.

Some of the case studies deal with the selection of low cost models of public service delivery. In Lages, the municipality has undertaken a self-help public housing program that trains would-be homeowners to construct their own houses and lends them the building materials that are financed on a ten to twenty year mortgage. The program produces housing units at a much lower net cost than commonly found in housing programs throughout Brazil. In Iamale and Sfax municipal government is providing serviced housing sites with house construction left to the individual residents. In the Philippines, the Local Water Utilities Administration conducts very careful feasibility and marketing studies prior to the design of local water systems; the emphasis is on the provision of an appropriate level of service geared to the resources of the target population. In the case of the Philippines, particular attention is paid to the ability to maintain and expand local water systems in the system design and water rate setting.

Concern for service productivity is notable in the case study in Iagayan de Oro City, Philippines. The local water district maintains close watch on worker productivity and provides a range of incentives for good performance. Consequently, the ratio of service consumers to employees is more than twice that of other local water districts in the Philippines.

Service productivity has also been one focal point of the training programs developed by the Economic and Rural Development Management (ERDM) program in Ghana. The ERDM project, which trains local government officials and staffs through mobile training seminars, has resulted in a number of productivity improvements in local governments in Ghana ranging from the creation of performance incentive schemes to the reduction of unnecessary staff positions. Worker productivity in public services is particularly important since personnel costs have been shown to be the largest item of local government budgets everywhere. Where data exist for comparison, personnel and administrative costs appear to be rising rapidly as a proportion of total local government expenditures. In Sousse, Tunisia, the centralization of personnel records through a single personnel department and the computerization of the records permitted the town administration to speed up the payroll process while reducing the potential for fraudulent pay claims.

Putting Local Services on a Self-Financing Basis

A number of public services can be run on a total cost recovery basis. In addition to the infrastructure services discussed above, several local governments in the study were found to provide a number of other services on a self-financing basis. These include solid waste collection, markets, slaughterhouses and industrial parks. Typically, these services are funded through separate accounts in order to keep them distinct from general fund expenditures of local government. In some instances, however, these accounts may be merged into the local general fund, as is the case with solid waste collection in El Doret and Nakuru, Kenya and in Daejeon, Korea. While separate accounts for these enterprises may be kept, this does not

mean that all costs associated with the enterprise are necessarily charged against the account. Oftentimes, staff time, equipment use, capital investments and other costs are not included in the accounts, presenting a distorted picture of "profitability".

For services operating on a cost recovery basis, there are a number of considerations that mirror those of any private enterprise. The case study of the Cagayan de Oro Water District examined in detail procedures for: (a) generating increased demand for fee bearing water services, (b) expanding the customer base to make efficient use of fixed capital investments, and (c) aggressive fee collection.

Training of Local Government Officials and Staff in Financial Management

Two case studies examined training in various aspects of local administration and financial management. The ERDM program in Ghana trains local officials and staffs in management through a network of regional training teams that provide training sessions in the home sites of the trainees. Training is carried out through a series of workshops which take place over one to two year periods. The training focuses on problems identified by the local officials and is customized to help the trainee group develop practical solutions to their problems. A number of the training sessions have focused on financial management issues, ranging from fee collection in water services to budgeting procedures.

The Local Water Utilities Administration devotes considerable resources to training local officials/staffs in water district formation and management. The LWUA has developed a number of customized competency based

programs for the different groups of actors involved in running local water districts: local officials, general managers, engineers, finance officers, construction supervisors and maintenance personnel. LWUA has recently expanded its training program to utilize well established local water districts as regional training sites. This will provide closer contact to local water districts and further strengthen LWUA's "hands on" approach to training.

In summary, the case studies reveal a breadth of innovative practices in dealing with financing local government operations. The case studies point out that improvements can be made at virtually any point in the process. Public services can be delivered efficiently by local government. Local staff can be trained to operate service delivery and financial management systems. Communities can raise and manage sizeable financial resources. Furthermore, there is considerable receptivity on the part of local officials to making these types of improvements.

While the case studies point up what can be done, it is evident that these practices are not widespread. The initial stumbling block seems to be one of ignorance - local governments officials simply do not have information on what they can do and how to do it. The program outlined in section 1.1 above, strengthening local institutions to provide technical assistance, prototypes, training and information is a necessary first step to improving municipal financial management in developing countries.

The complete report on the phase I case studies is presented in the companion volume to this Executive Summary entitled Urban Financial Management Phase I: Case Studies and Analysis Final Report.