

Research Article

Improving Municipal Finance for Climate Smart Cities' Governance

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Executive Summary

As the world is getting more and more urbanized, the threats to urban living are increasing and service delivery is becoming more difficult for cash strapped municipal governments and utilities. Therefore, the city governments around the world are increasing their focus on smart and resilient city development and management. However, the availability of finance is a key issue. Different reforms are being done in Pakistan to improve financial situation of municipalities with traditional and new instruments. For example, in Punjab, the automation of property tax and own source revenue generation are getting impetus while reform initiatives are under way such as Sub National Governance Programme, Punjab Public Management Reform Program, Land Records Management Information System and Punjab Cities Governance Improvement Project. Internationally, property tax collection, user fee implementation and marginal cost pricing have emerged as best practices to improve the financial situation of city governments and allied entities.

The capacity of the local governments to deal with newer challenges such as climate change and natural and man-made disasters is further constrained. However, some windows of opportunity exist to provide relief and improve the financial health of municipalities. The said tools and instruments, if applied rationally and with proper planning, can surely help increase the resilience of cities in the face of different urban challenges.

These include but are not limited to:

- Emissions Inventory Development
- Capital Investment Plans
- Green Bond Market Clean
- Technology Fund Forest
- Investment Program
- Pilot Program Climate Resilience
- Scaling up Renewable Energy
- Program BRICS Initiatives
- CAT Bonds
- Adaptation Funds

In addition, various PPP models and private funds have also popped up which can be explored by city governments to fulfil their needs and fit in their situation.

However, most of the cities face difficulties in accessing to these financial windows as they need sovereign guarantees and resistance from central governments for this purpose. Cities Creditworthiness Program of the World Bank has been initiated to address this problem and gives standardized procedure for this purpose. Besides creditworthiness, cities are also working on improving their performance and efficiency by taking various steps including the establishment of monitoring and evaluation systems.

Abstract

As the world is getting more and more urbanized, the threats to urban living are increasing and the service delivery is becoming more difficult for cash strapped municipal governments and utilities. Therefore, the city governments around the globe are increasing their focus on smart and resilient city development and management. However, the availability of finance is a key issue. In Pakistan, the capacity of the local governments to deal with newer challenges such as climate change and natural and man-made disasters is further constrained as they have limited autonomy to attract investments and generate revenues. Recently, some windows of opportunity have opened to provide relief and improve the financial health of municipalities such as Adaptation Funds and other Climate Investment Funds (CIFs). The present paper discusses these tools and international best practices in the context of the municipal finance situation in Pakistan and identifies how best cities can access these financial windows by improving their creditworthiness and performance.

Introduction

Pakistan is the 8th most climate vulnerable country in the world (Harmeling & Eckstein, 2013). The country has experienced major natural disasters and epidemics during the last decade. The high urbanization and population growth rates have further aggravated the situation and put enormous pressure on the already constrained financial resources of city governments and allied entities, resulting in deterioration of urban infrastructure and municipal service delivery systems. As we are living in an urbanized world for the first time in history, the threats to urban living especially posed by climate change are being seen as enormous in magnitude and severest in damage. Therefore, the city governments around the world are increasing their focus on climate smart and resilient city development and management. Cities are increasing their capacity in the face of chronic and emerging threats by increasing their own source revenue, government funding, private capital and different climate funds and schemes.

Background

The 18th amendment to the constitution of Pakistan heralded an era of devolution of powers from the centre to the provinces. Under the said amendment, the provinces have more flexibility and resources but at the same time, they have more responsibility to be open, responsive and transparent in expenditure on service delivery. Some political and administrative changes are catalysing this transition process such as the adoption of the right to information as a fundamental right, the consensus on local governments, and increased focus on performance based politics. Similarly, a few social changes are also happening to facilitate this process such as the increased citizen awareness, getting impetus from a free electronic media and independent judiciary. However, the economic side remains bleak in context with the provinces whereas tax collection and generation of own source revenue also remain big problems. In Pakistan, the provinces raise only 0.4 percent of gross domestic product (GDP) in tax revenues and spend almost 16 times higher (WB, 2013).

Punjab, which is the most urbanized, most prosperous and most populated province of Pakistan, draws most of its funds from the federal disbursements and 80 percent of its revenue comes from federal transfers. The remaining funds are generated through different taxes as detailed in Table 1.

Table 1: The Punjab Government's Income from Taxes

Tax source	BE 2013-14 PRs in Million	RE 2013-14 PRs in Million	BE 2014-15 Estimated PRs in Million
Sales Tax on Services	62,350.000	52,000.000	95,000.000
Stamp Duty	14,697.157	13,944.739	18,937.262
Land Revenue	11,583.643	11,036.299	11,788.682
Motor Vehicle Tax	538.426	531.112	550.000
UIPT	7,254.663	5,278.268	7,750.000
Electricity Duty	4,948.518	6,035.447	6,540.500
Capital Value Tax	4,938.755	4,938.755	5,432.631
Registration	4,680.457	4,640.866	1,612.271
Excise Tax	1,782.608	1,500.000	1,782.608
Agricultural Tax	2,018.938	830.000	2,018.938
CVT on Moveable Assets	0.000	101.352	200.002
Professional Tax	583.359	583.359	583.359
Farm House Tax	17.000	0.536	15.000
Opium	6.886	0.050	0.050
Tax on Luxury Houses	0.000	44.440	500.000
Receipts under MV Acts	10,100.117	9,361.643	11,255.341
Other Indirect Taxes	1,202.272	962.128	713.600
Total	126,702.799	111,788.994	164,680.244

Source: GoPB, Finance Department

Punjab is more progressive than other provinces in bringing about fiscal and taxation reforms. Notable actions at provincial level include:

1. Punjab Revenue Authority (PRA) has been established in 2012 to improve tax collection. The PRA is mandated to introduce semi-autonomous revenue administration which is an internationally recognized doctrine of tax collection. The initial focus of the Authority is to reform general sales tax collection system. However, its primary mandate for future is to expand UIPT collection and other tax bases (WB, 2013). The effectiveness of the Authority to increase own revenue of the province is being increased through allied legislation.

Besides the strengthening of PRA, the capacity of the age old departments of Excise & Taxation Department and Board of Revenue are also being increased by bringing reforms such as plugging the leakages through computerization of tax collection systems (GoPb, 2014).

2. Sub National Governance Programme (SNG) is the flagship program being implemented by Finance Department of Punjab in collaboration with the Department for International Development (DFID). It is based on a three tiered approach developed from international best practices i.e.

- Develop policy, planning and budgeting linkage in financial management;
- Shift to a top-down approach from bottom-up budgeting;
- Bring in performance based budgeting in place of input based budgeting by linking inputs to outputs and outcomes.

SNG is assisting in creating fiscal space through better resource management, controlling expenditures and generating revenue (WB, 2013).

3. Provincial Finance Commission Award (PFCA) was established to ensure continuous and adequate financing of devolved functions after promulgation of Punjab Local Governments Ordinance (PLGO) 2001. Currently, PFCA is being re-designed on the recommendations of the study commissioned by Punjab government to assess the effectiveness, the adequacy, and predictability and equalization effects of the PFCA transfers and the sustainability of local government expenditures (WB, 2013).

4. Punjab government has also commissioned a study to analyse the proposed implementation of Needs Based Budgeting. This is being done for better planning and service delivery through allocation of funds in the Annual Development Plans on the basis of their need and demand from the constituencies of the city governments.

5. A comprehensive Expenditure and Quantity of Service Delivery Survey (EQSDS) is being conducted in the province to improve efficiency of public spending for better public service at district level.

Though, the province is trying to implement the above reforms agenda and increase its fiscal space, the city level local governance has received little attention in the devolution process and municipal revenue generation capacity is critical owing to poor financial management. Therefore, cities are heavily dependent on national and provincial disbursements for service delivery.

Recent International Trends in Municipal Finance

In developing countries like Pakistan, municipal budgets normally cover operating costs and recurrent expenditures and don't sufficiently cover capital investments. Municipal governments struggle to expand their resource base, tap missed opportunities and control over-spending on service delivery. They are expected to integrate innovative ideas and tools on expenditure management and improve their local tax collection (WB E- Institute Web Portal).

The municipalities need to identify new resource generation areas and strengthen the existing ones. For example:

i. UIPT has a great potential to increase the municipal revenue and municipalities in some countries like Canada use it as their main source of revenue. However, other municipalities like New York, Tokyo, Paris and Chicago levy 20 to 30 different taxes.

ii. Municipalities should turn to marginal cost pricing for services to meet the cost on service delivery infrastructure. This will provide an incentive to locate closer to existing services and development and would reduce sprawl.

iii. User fee for water supply and waste collection is another instrument which should be marginally priced to motivate people to reduce their water usage and garbage generation (Slack, 2014).

However, in the climate era, the traditional financial outlays would not sufficiently provide for the infrastructure needs of cities which have to bear up to 80 percent of the expected US\$80-100 billion per year adaptation costs. The infrastructure needs of cities in developing countries exceed \$1 trillion a year while they are currently getting \$125 billion only as official development aid (WB, n.d.). The cities need to learn how to integrate climate resilience into planning and product design. For initial resilience upgrading, they would need emerging non-conventional financing instruments. For example:

1. The low carbon town planning and urban development yield financial dividends for municipal governments and utilities. Activities for smart city planning include greenhouse gas inventories development and tools for emission reduction potential.

The World Bank estimates that up till now, only 30 largest cities of the world have gathered the necessary analytics for low-carbon planning. An accreditation program has therefore been started internationally to train officials and private sector professionals of the cities intending to conduct greenhouse gas inventories. For this purpose, Global Protocol for Community Scale Emissions methodology is used. The inventory development helps cities to profile their emissions and identify the right mix of policies and investments and tap the emissions reduction potential completely (WB Press Release, September 25, 2013). Some international best practices exist for emissions inventory development. For example, the city government of Rio de Janeiro has developed a greenhouse inventory and a modern operations centre besides implementing a range of low carbon measures such as bike sharing scheme, cycling paths and sanitation schemes. These measures will reduce emissions, increase resilience to climate change and above all help it to access capital available under different carbon markets (WB Feature Story, September 25, 2013).

An important policy tool promoted recently is the capital investment plan which helps local governments to forecast their future capital procurements and project implementation needs and prioritize them according to their demand and benefit. A well-designed plan also increases the credit and bond rating of municipal governments and puts lesser burden on their finances in terms of debt servicing. This method is also helpful in climate smart city development through which the local authorities can choose the most carbon and cost effective options (WB Feature Story, May 15, 2014).

2. The World Bank and IFC have helped pioneer the green bond market which is 20 billion dollar international market to provide private finance for climate mitigation and adaptation. Green bonds are

fixed income, liquid financial instruments that are used to raise funds for green growth projects around the world. Since 2008, the World Bank has issued more than \$7 billion in green bonds in 17 currencies, and the International Finance Corporation has issued \$3.7 billion in green bonds. Other issuers are also coming in the market in new currencies and with innovative structures. This initiative has been taken because in the climate change era, the cities are in critical need of finance to remodel the existing and build new infrastructure in virtually every sector such as water supplies, energy, transport, farms and food supplies, schools and hospitals. Climate change poses increased risk to global supply chains without new investments.

Green bonds increase the access of the governments to the \$80 trillion bond market and channelize the private investment to climate-friendly projects worldwide. This market was initiated in 2013 and since then it has seen exponential growth to fund environment friendly growth. They are the first market based simple investment tools that are dedicated to adaptation and mitigation projects. They are fixed income, liquid financial instruments that provide investors lucrative monetary and reputational benefits. The proceeds from institutionally backed green bonds are further invested in activities that support green growth such as renewable energy, energy efficiency, sustainable transportation, forest and watershed management, and flood resilient infrastructure.

The Green Bond Market is getting momentum and has great potential for populated and finance hungry cities in the developing countries. This is because, the Green Bond Market has the backing of IFC and World Bank which provides the credibility, security, development mandate, awareness and assurance to the investors that proceeds will be used for the stated purpose and environmental impact and that the investors have climate-friendly opportunities at their disposal. The municipalities and utilities are making an increased use of this financial instrument and even issuing their own bonds. For example, the French utility GDF Suez has issued the largest green bond to date (\$3.4 billion) to fund renewal energy projects. This was very well received and

over subscribed. Earlier record was of \$1.7 billion set by Électricité de France last year, 25% proceeds of which will go to solar energy projects. The market is getting further impetus with the growth of asset managers such as Black Rock in the market with the mandate to increase and manage green bonds.

Successful projects being carried out with green bond proceeds include a geothermal project in Indonesia that has been designed to increase access to affordable and clean energy that will reduce 1.1 million tons of greenhouse gases annually. Another energy efficiency project is being carried out in Chinese factories with a potential to cut greenhouse gases by four million tons a year. A large-scale solar power facility has been erected in Mexico to meet the energy needs of 164,000 people without government subsidies while in India, a company is using the proceeds from the green bonds to set up an establishment to recycle e-waste consisting of electronic gadgets (WB Brief, October 23, 2014).

3. Cities can work with provincial and federal governments to get project funding under the following Climate Investment Funds. For example:

a. Clean Technology Fund worth \$5.3 billion has been operational since 2008 to provide a funding window for the demonstration, deployment and transfer of low carbon technologies and reduction of long-term greenhouse gas emissions in middle income countries. This is concessional financing for large-scale projects in renewable energy, energy efficiency, and transport.

b. Forest Investment Program is \$602 million pilot initiative to support REDD+ efforts such as reduction in rate of deforestation and forest degradation, promotion of sustainable forest management and enhancement of forest carbon stocks.

c. Pilot Program Climate Resilience provides a funding window of \$1.2 billion as part of Climate Investment Funds to integrate climate resilience into development planning. The program not only builds on existing efforts under National Adaptation Programs of Action (NAPAs) but also offers funding for piloting innovative initiatives to manage climate risks.

d. Scaling up Renewable Energy Program (SREP) offers \$524 million to Low Income Countries (LICs) for deployment of renewable energy options, increasing energy access and creating economic opportunities. SREP aims to demonstrate the economic, social, and environmental viability of low carbon development pathways building on existing energy initiatives of these countries (CIF Web Portal).

e. OECD countries give 25.6 billion USD annually through bilateral (85%) and multilateral arrangements (15%) as climate related aid to low and middle income countries. Under bilateral aid arrangements, about 11.4 billion is given for adaptation activities, 6 billion for adaptation and 4.1 billion for overlapping activities. Some of the funds besides those mentioned above include:

- Global Environment Facility (4.4 Billion USD)
- Global Energy Efficiency and Renewable Energy Fund (0.2 Billion USD)

- Least Developed Countries Fund (0.9 Billion USD)

Global Climate Change Alliance (0.4 Billion USD)

- (UNDP MDG Carbon, 2014)

4. Municipalities can work with local businesses to get investment for climate smart city development in different PPP models. A survey released by The Economist Intelligence Unit (EIU) in December 2014 shows that 90% of business leaders believe they can help prepare cities for the effects of climate change, with 51% saying that investing in climate change resilience gives them a competitive edge. For business, the biggest perceived market and operational risk from climate change is the disruption of energy supplies, which could severely impact on a company's ability to operate. Increased competitiveness, improved employee health, greater productivity and lower absenteeism and cost savings are other drivers for corporate investment in climate resilience building.

5. International Development Association's (IDA) adaptation funds are an instrument to finance

preventive maintenance, monitoring and emergency management systems. The fund is financed from different sources especially the clean development mechanism project activities and finances adaptation projects in developing countries participating in the Kyoto Protocol.

6. Catastrophe (CAT) bonds are an innovative scheme that came in the market in response to increased frequency and damages of hurricanes in the US cities almost two decades ago. They were a kind of reinsurance to diversify the risk through a managed pool of re-insurance policies. Currently, they are designed to pass the extreme risk to a pool of private investors in exchange for a potential heavy substantial interest on their investment. Governments have started issuing their own CAT bonds such as Mexican government issued catastrophe bonds in 2006 to generate funds for disaster response. The World Bank has also established a Multi-Catastrophe Program five years ago to help governments against multiple kinds of catastrophe risk. The active use of the CAT bonds is to spread the risk across a number of cities and invest the proceeds in risk reduction measures in the cities. The passive use is to hold the proceeds for disaster response in case of extreme event (ICLEI, 2011).

Overcoming the Bottlenecks

There are many bottlenecks to access the non-traditional finance such as the sovereign guarantees (issued by the federal government). City governments are considered high risk borrowers by private and international lenders which increase their cost of borrowing. In order to increase their credibility, new mechanisms are emerging which are framed and promoted particularly by the World Bank. Credit rating systems have been developed through which a city entity can get confidence of the lenders, reduce their cost to access available funding streams and become independent from the federal government. However, before obtaining formal credit rating, the city governments need to address some issues and improve some areas. These include:

1. Cities need to improve their creditworthiness. The World Bank analysis show that only 20 out of 500 major cities in the developing countries are

deemed creditworthy in international financial markets while another 100 more in local markets. For low carbon and development and erection of climate smart infrastructure, the cities need to be attractive for private lenders and investors and they should have free access to financial markets. Therefore, a City Creditworthiness program has been designed by the World Bank and its associates. The program facilitates the financial departments of the city governments to review their revenue management systems and conducts the training of their staff. The initial assessments are very promising and it is estimated that the investment in creditworthiness program will mobilize 100 times more private sector financing.

Some cities have started their journey to get credit ratings. This is rather a long and continuous process and on an average consumes 3-5 years. The World Bank assists the aspiring cities to develop innovative solutions and mechanisms and attract private financing. One of the possible solutions is to pool resources of city governments requiring the same type of investment and development programs (WB Feature Story, September 25, 2013).

Some of the international best practices are given below to draw lessons to get improved credit rating for better city governance in Pakistan:

a. The city entities of Swaziland have increased their creditworthiness by seeking assistance of Public Private Infrastructure Advisory Facility (PPIAF). The Public-Private Infrastructure Advisory Facility (PPIAF) is a multi-donor trust fund that helps developing countries to develop the enabling environment for private investment by improving their legal and institutional framework and government capacity. Under this program, different activities were conducted including the capacity building workshops in different cities and a creditworthiness guide to give an overview of the technical and management issues. This helped different cities including the Matsapha Town Board and the Manzini City Council to get long term credit rating. (PPIAF, 2012)

b. Six municipalities in Peru sought the assistance of Sub-National Technical Assistance (SNTA) Program of PPIAF six year ago to get credit

ratings. This resulted in securing a 70 million dollar commercial bank loan by the Municipality of Lima and a \$10 million commercial bank loan by Arequipa without a sovereign guarantee.

c. In the year 2009, some Latin American countries have been able to improve their creditworthiness through the Regional Credit Rating Improvement Program. Three Mexican sub-national governments carried out Credit Diagnostic Assessments and successfully obtained credit ratings. These credit ratings secured commercial bank loans of \$79.5 million and \$10.9 million for the states of Guerrero and the Municipality of Puebla respectively (PPIAF Web Portal).

2. Performance improvement is the next most important aspect on the journey to improve sub national and municipal finance. The first step is to take focused steps to eliminate the issue that pinch the lenders. The typical financial performance improvement activities range from small steps to improve auditing and reporting to more ambitious work such as restructuring of a utility. The technical assistance for performance improvement is also provided under PPIAF's SNTA program which helps city governments to develop financial sustainability plans, strengthen revenue flows and monitoring mechanisms, diagnose problems and increase transparency. Following are some of the success stories achieved under SNTA program:

a. In 2008, the organization of La Promotora of the Colombian city of Pereira improved its credit rating through placing risk management system, improved costing system and strategic planning initiatives and extended \$6.5 million loans for infrastructure improvement projects in Pereira. In the same year, the city of Dakar reviewed its public financial management system using Public Expenditure and Financial Accountability (PEFA) methodology. The results of this exercise helped this African municipality to improve the fiscal management, resource allocation of resources and municipal services delivery mechanism. These improvements also increased creditworthiness of the city and a €10 million loan was extended by a private bank to finance a public lighting program of the municipality.

b. The city of Ouagadougou in Burkina Faso

conducted a Public Expenditure and Financial Accountability study in 2009 and an action plan in 2010 to increase the transparency in its financial management systems. As a result of this exercise, the city received major financial tranches as loans and grants from the French Development Agency to finance the rehabilitation of its public transportation management system.

c. The water utility of DESO owned by Sergipe state in Brazil improved its financial performance after collection of financial and operational information to provide to lenders and impact assessment of its institutional development program. As a result, DESO obtained an \$11 million loan from the International Finance Corporation for a non-revenue water reduction project (PPIAF Web Portal).

Conclusion

With an improved municipal finance system, achieved through a right mix of local and international best practices, climate smart cities can be developed and maintained in Pakistan under the existing institutional framework of the country. Furthermore, the city governments are required to come with increasingly sophisticated responses for mobilizing and utilizing their financial resources in the climate era. These include human resource development, performance measurement, management of revenues & expenditures, local assets and services, and external resource mobilization.

The municipalities in Pakistan are working with World Bank and other development agencies in all but the last of these areas. This is because; the external resource mobilization is the trickiest area and requires that a municipal borrower has sufficient management and administrative capacity to properly manage the loan obtained on affordable terms. It also has to ensure that the interests of the municipality are protected in the lending agreements. In order to avoid the vicious circle of debt servicing, all the areas of financial and revenue management are streamlined to avoid delays and penalties. The annual budget should reflect these payments transparently and regular financial reporting must be carried out to explain any anomalies to the people and other stakeholders.

The borrowed money is a costly way of financing but it has its own benefits if properly managed, utilized on priority infrastructure and paid back on time. Perhaps the most important issues relate to the use of the borrowed funds. Furthermore, it must be ensured that proper planning and homework is already done before receiving loans to avoid unnecessary interest payments. This can only be done once the municipality has developed its financial management capacity to a certain level and shown commitment to spend the borrowed funds as per international best practices (PPIAF, 2009).

Abbreviations and Acronyms

AIIB	Asian Infrastructure development bank
BRICS	Brazil, Russia, India, China and South Africa
CAT	Catastrophe
CDG	City District Government
CIF	Climate Investment Fund
CRA	Contingent Reserve Arrangement
CTF	Clean Technology Fund
CVT	Capital Value Tax
DESO	Companhia de Saneamento de Sergipe
DFID	Department of International Development
EIU	Economist Intelligence Unit
EQSDS	Expenditure and Quantity of Service Delivery Survey
E&TD	Excise and Taxation Department
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
GoPb	Government of Punjab
ICLEI	International Council for Local Environmental Initiatives
IDA	International Development Association
IDAMP	Integrated Development and Asset Management Plan
IFC	International Finance Corporation
LICs	Low Income Countries
LWMC	Lahore Waste Management Company
MDG	Millennium Development Goals
MIS	Management Information System
MFSA	Malta Financial Services Authority
MV	Motor Vehicle
NAPA	National Adaptation Program of Action
NDB	National Development Bank
OECD	Organization for Economic Co-operation and Development

OSR	Own Source Revenue
PBIT	Punjab Board of Investment and Trade
PCGIP	Punjab Cities Governance Improvement Program
PEFA	Public Expenditure and Financial Accountability
PFCA	Punjab Finance Commission Award
PHA	Parks and Horticulture Authority
PLGO	Punjab Local Government Ordinance
PPP	Public Private Partnership
PRA	Punjab Revenue Authority
PPIAF	Public Private Infrastructure Advisory Facility
PPRA	Punjab Public Procurement Regulatory Authority
REDD	Reducing Emissions from Deforestation and Forest Degradation
SNG	Sub National Governance Program
SNTA	Sub National Technical Assistance
SOP	Standard Operating Procedure
SREP	Scaling up Renewable Energy Program
TIF	Tax Increment Financing
TMA	Tehsil Municipal Administration
UIPT	Urban Immovable Property Tax
UNDP	United Nations Development Program
USD	United States Dollar
WASA	Water and Sanitation Agency
WB	World Bank

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