UN-HABITAT
FOR A BETTER URBAN FUTURE

THE CHALLENGE OF LOCAL GOVERNMENT FINANCING IN DEVELOPING COUNTRIES

United Nations Human Settlements Programme (UN-Habitat),
the City of Barcelona and the Province of Barcelona

The Challenge of Local Government Financing in Developing Countries

First published in Nairobi in 2015 by UN-HABITAT.

P. O. Box 30030, 00100 Nairobi GPO KENYA

Tel: 254-020-7623120 (Central Office)

www.unhabitat.org

HS Number: HS/031/15E

ISBN Number:(Volume) 978-92-1-132653-6

Acknowledgements

UN-Habitat gratefully acknowledges the City of Barcelona and the Provincial Government of Barcelona, Spain for financial support and collaboration.

UN-Habitat is thankful to the following individuals for preparing the background papers for the report: Jorge Martinez-Vazquez, Georgia State University, USA; Paul Smoke, New York University, USA; Enid Slack, University of Toronto, Canada; and William F. Fox, University of Tennessee, USA.

Carmen Sanchez Miranda, Head, UN-Habitat Office in Spain and the UN-Habitat team in Madrid are gratefully acknowledged for their valuable contributions. The report was compiled by Ananda Weliwita and Imogen Howells under the overall guidance of Gulelat Kebede, Coordinator of the Urban Economy Branch of UN-Habitat.

FOREWORD

Cities are assets, solutions and drivers of economic and social development. Cities possess huge untapped economic potential that can and should be leveraged to create wealth and economic opportunities for all. This requires good urban planning that supports urban compactness, integration, and connectivity. However, even the best urban plans risk ending up unused if they are not accompanied by financial and regulatory strategies for implementation. Strategic public investments must go hand in hand with strategic funding mechanisms and supporting governance systems.

Currently, many local governments in developing countries face the near-impossible task of funding the infrastructure and services required to meet the basic needs of growing urban populations, while forward-looking capital investments are not possible for financial reasons. Local financial management frequently suffers from lacking technological infrastructure and capacity, and opportunities for revenue generation are often restricted by inadequate regulatory frameworks or disadvantageous political structures. Lagging public-sector spending takes a toll on urban efficiency and local economic activity, creating a vicious cycle of budgetary shortfalls, choking urban conditions, and economic stagnation.

However, strategic governance and financing systems can provide hope for struggling local governments. There are opportunities for matching local needs with institutional frameworks and revenue-generation tools. Appropriate financial management can tap into strategies that improve efficiency of revenue collection, win public support, capitalize on urban and regional economies of scale, curb land speculation and sprawl, incentivize economic activity, and improve urban affordability for the poor. The resulting budgetary improvements can allow municipalities to make strategic investments in their cities, stimulating a virtuous cycle of growth, revenue generation, and prosperity.

This report – an outcome of an expert group meeting held on the challenge of local government financing in developing countries – documents both the challenges and solutions related to the ability of local governments to mobilize revenues from local resources. The report also identifies successful governance mechanisms for efficient and equitable provision of public services in metropolitan areas of developing countries, and shares experiences and methods to making public service provision more viable in peri-urban areas of large cities and in smaller urban centres of these countries.

Dr. Joan Clos
Executive Director of UN-Habitat

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INTRODUCTION

Local authorities in all parts of the world play an increasingly important role in the delivery of fundamental basic public services. But authorities also face great challenges. Most local authorities in developing countries are facing increasingly bigger challenges as a result of rapid and chaotic urbanization and due to the impacts of frequent natural disasters caused by climate change. The recent global financial and economic crisis has further aggravated these challenges.

The fundamental problem confronting most local authorities, especially those managing cities in developing countries, is the widening gap between the availability of financial resources and municipal spending needs. One of the main reasons for this increasing fiscal gap is the rapid growth of urban populations, which creates an ever-increasing demand for public services, new public infrastructure, and its maintenance.

Most cities in developing countries depend mostly on central government transfers, with lesser revenues derived from property taxation and service charges. The more lucrative sources of revenue potentially suitable for financing urban areas, such as income taxes, sales taxes, and business taxes, continue to be controlled by the central governments. Where local authorities are able to derive revenues from property taxes and service charges, meaningful tax increases are sometimes refused or delayed by central governments for fear of eroding political support from the urban population; or even rejected by the local authorities themselves for fear of political backlash from local taxpayers. In most countries, there are huge vertical imbalances at the subnational level in terms of sharing responsibilities and available fiscal resources. Stated differently, many central governments refuse to pay the political and financial costs of the decentralization of roles and responsibilities.

In addition to addressing vertical fiscal imbalances, two other important factors could significantly contribute to a more efficient and equitable delivery of public services: (a) introducing more responsive and accountable governance practices and (b) ensuring that public service provision becomes more viable in peri-urban areas and smaller cities and towns.

Cities are assets, solutions and drivers of economic and social development.

UN-Habitat, with the financial support of the Barcelona City Council, held an Expert Group Meeting (EGM) on 25 and 26 June 2014 in Barcelona to review the conventional wisdom and practices, and identify gaps, policy options, and capacity issues relevant to addressing the challenges mentioned above. The overall purpose of the EGM was to better understand the key elements and processes needed for local authorities to effectively use various financing mechanisms to implement city extension plans and urban development projects. While these plans and projects are urgently needed to accommodate growing urban populations, they cannot succeed without the backing of financial and regulatory strategies.

Some 40 experts and practitioners, including local government officials, participated at the conference. The conference was organized around four themes: (a) Political economy challenges facing urban authorities in generating revenues from within, and solutions to these challenges; (b) Challenges in the use of various mechanisms for mobilizing financial resources for urban

With contributions by Jorge Martinez-Vasquez, Gulelat Kebede and Ananda Weliwita development and solutions to these challenges; (c) Innovative governance mechanisms and institutions to support the efficient and equitable provision of public services in metropolitan areas; (d) Public service provision in peri-urban areas and small towns in developing countries. Each of the four themes was first introduced by a formal presentation by international experts and then followed by discussion of several case studies with participation of the entire audience. The experience of the City of Barcelona spanning over the past 30 years was included among the presented cases. This report presents the four papers that were prepared to frame and guide the discussion on the four themes. The report closes with a summary of the key messages in each of the four thematic papers.

Back to basics: Understanding revenue sources and assignments, and the reform process

For a viable and responsible fiscal future, cities in developing countries must make use of significant sources of tax revenues as well as non-tax revenues collected through user charges and fees. Sufficiency of own revenues is the key to a city's improved ability to deliver necessary goods and services and to better accountability of local officials to their constituents. Own revenues should be complemented by intergovernmental transfers to address differences in expenditure needs and fiscal capacity across cities; and also for cities to support the implementation of central government programmes. In order to effectively address the challenge of mobilizing adequate financial resources, urban authorities in developing countries should consider using mechanisms such as municipal bonds, bank loans, municipal development funds, funds from institutional investors (such as pension funds), corporate bonds, equity markets and public–private partnerships (PPP).

Borrowing from capital markets is an alternative way to mobilize financial resources for municipalities. Yet in order to borrow, cities must first demonstrate that they are creditworthy. Creditworthiness is the determining factor used by investors and banks to assess the risks involved in lending to municipal governments. A municipality's creditworthiness depends essentially on the availability of sufficient own revenues and on the stability, predictability and unconditionality of (at least some) intergovernmental grants.

The paper on Mobilizing financial resources for public service delivery and urban development, prepared and presented by Professor Jorge Martinez-Vazquez, provides an overview of both conventional and new sources of local government financing, concentrates on the important role of charges and fees in developing countries' city budgets, and addresses questions such as: what are the most suitable sources of tax revenue for cities in developing countries? What charges and fees can increase to become a more meaningful part of city budgets in developing countries? What are the ideal properties of intergovernmental transfers to facilitate revenue autonomy and financial adequacy of cities? What are some of the mechanisms available for cities to access private sector capital and other external sources of finance, to allow implementation of their urban development and infrastructure plans? What can be done to facilitate borrowing from capital markets by urban authorities? What are the necessary institutional and legal reforms?

By providing a snapshot of the available tax and non-tax sources, transfers, grants and borrowings, the paper builds a common understanding of the principles, finance instruments, and reform processes relevant to enhancing the local revenue and finance conditions of cities in developing countries.

Local authorities in all parts of the world play an increasingly important role in the delivery of fundamental basic public services. But authorities also face great challenges.

The dynamics of political economy: A key condition determining the success of reform

Reforming municipal finance is not easy. Perhaps the most significant challenges facing financing of urban authorities in developing countries are related to political economy issues. These issues are critical to understanding the consistent refusal of the central government authorities to decentralize significant tax revenues, as well as the common refusal of local authorities to adequately use the tax revenue authority they are granted.

For a viable and responsible fiscal future, cities in developing countries must make use of significant sources of tax revenues as well as non-tax revenues collected through user charges and fees.

Local authorities need the capacity and political will to implement reforms. Additionally, they should generate political support among urban constituents to introduce the necessary legal and institutional changes with the aim of generating increased revenue through greater tax rates, improved tax collection and reduced tax evasion. Moreover, central governments should offer municipal authorities more financial autonomy to restructure their tax bases and greater jurisdiction over revenue collection. These measures require conviction and commitment – they cannot happen in a vacuum, but are shaped and influenced by the political economy dynamics and the realities of each country. In that sense, each situation is unique and the reform process and design should be adjusted to reflect local and national circumstances.

Regarding the political economy of raising local revenues, a series of questions arise. What areas of the political economy dynamics affect municipal and urban finance? How have political economy issues interacted and affected the reform process in different countries? Who are the key stakeholders and forces playing in the reform process? What are some of the successful experiences of tax revenue decentralization in developing countries? What are some of the successful experiences of local revenue enhancement through a greater utilization of tax revenue authority? What are the drivers or factors of success?

The paper Urban government revenues: Political economy challenges and opportunities written and presented by Professor Paul Smoke, addresses these questions. Political economy challenges are quite diverse and range from the interference of national-level politicians and bureaucrats to local-level political economy dynamics involving elected members of local councils, municipal staff and citizens. Various actions and interactions of these political actors influence the effectiveness of local revenue reform and fiscal decentralization. Some of these challenges could successfully be addressed by urban authorities, while others require national-level action or support.

The governance dimension with a focus on metropolitan areas

The quality of governance is one key aspect that prominently arises from discussions on the reform agenda and the political economy issues facing local governments in developing countries. This theme in itself calls for a separate EGM. The group chose, due to the importance of this theme to national economies and urban agglomerations, to focus the discussion on governance in this present EGM on metropolitan areas. In metropolitan areas, different tiers of government and numerous public enterprises are typically involved in the provision of public services. Metropolitan areas use various governance approaches in the provision of public services: some follow jurisdictional fragmentation arrangements while others use functional fragmentation. In some cases, the metropolitan governments take full responsibility for the provision of public goods.

Metropolitan areas in developing countries often have a mix of relatively wealthy areas and poor areas. Therefore, if efficient and effective public service provision were limited to wealthy areas where taxes are generated (specifically property taxes), this would lead to growing disparities in the level of service provision across the city. Investments in road networks and transport, as well as other public infrastructure that service the entire metropolitan area, typically require a concerted effort and coordination among the different actors. This makes governance and financing in metropolitan areas inseparable. Effective implementation requires institutions and governance mechanisms that will enable local governments to meet the growing demand for urban service provision, support the economic competitiveness of metropolitan areas, and ensure equitable provision of services to all constituents regardless of location.

The paper Innovative governance approaches in metropolitan areas of developing countries written and presented by Professor Enid Slack, examines these issues and highlights the different governance approaches used internationally to finance efficient and equitable public service provision and urban development in metropolitan areas. More specifically, Professor Slack's paper examines strengths and weaknesses of various governance mechanisms in terms of the efficient and equitable provision of public services in metropolitan areas in developing countries. The analysis uses standard criteria for evaluating different metropolitan governance models, finding that there is no single model that stands out above the rest and therefore can be applied everywhere. The national and local context is critical to understanding the success of different models and mechanisms. The paper also highlights that most countries would benefit from some form of regional structure, referring to metropolitan governance that both addresses regional issues and is able to adequately responds to local concerns.

Enter scale: How can small municipalities and towns finance urban services?

One of the challenges that large urban governments and metropolitan areas face is the growth of population in their peripheries and city extensions. The problem of extending services to peri-urban areas touches on both governance and technical issues, especially related to economies of scale in public service delivery. Certainly, the issue of scale is also a challenge facing small municipalities and towns outside metropolitan areas.

In the case of large urban governments, there are often significant differences in the level and quality of public services provided in different areas of the city. In most developing countries, these differences take form in the inferior provision of public services in the peripheral areas. Challenges arise from the lack of sufficient infrastructure for newly incorporated areas, which are associated with fast growth in recently migrated populations often characterized by low levels of skills and education, as well as with the lack of adequate housing. The presence of crime and urban gangs further complicates the improvement of service provision in these areas. Additionally, there is evidence that in large local authorities, policy-makers have a tendency to target policies to satisfy the needs of certain groups while they are less inclined to provide public goods to others.

International experience shows varying rates of success in addressing problems triggered by the urban periphery, and where efforts have been successful they are highly specific to both the context of the governance and the type and nature of the service.

Adequacy of own revenues is the key to an improved ability to deliver needed goods and services and to a better accountability of local officials to their constituents.

Local authorities need the capacity and political will to implement reforms.

A parallel issue is that of smaller government units surrounding large metropolitan areas. This issue has a different nature. For example, there is clear evidence that the size of local government influences the delivery efficiency of public services. While economic theory suggests that cities with larger local government units can enjoy economies of scale, very large local government units tend to experience diseconomies due to inefficiencies associated with large bureaucracies. Moreover, there is evidence to suggest that smaller local authorities enjoy greater political accountability and are more efficient in the provision of public goods. Yet other evidence suggests that smaller local authorities are associated with more corrupt behavior by government officials. This, of course, does not imply that local authorities should become larger as a strategy to promote good governance.

The issue is complex and raises a range of practical questions: What are the most effective ways to improve service delivery in these smaller, perhaps too small local governments? Should they be encouraged to be amalgamated with large units? Or can they associate with other local governments to address scale issues? Is contracting with private providers the solution? Across urban areas in developing countries, day-time population is different than the resident population. But day-time population also uses public services. What mechanisms can local authorities use to generate additional revenue from the day-time population? What would be a fair sharing of tax resources between the places of residence and the places of work?

The paper Structuring service delivery in small urban areas prepared and presented by Professor William Fox sheds light on these issues and questions. The paper discusses various strategies to improve viability of public service provision in peri-urban areas of large cities and in small urban centres in developing countries. It reviews the city government size variation around the world as well as problems with local resource mobilization and the inability of peri-urban areas and small cities to produce appropriate levels of public services due to poor revenue structure and institutional inefficiencies. It also examines the determinants of an efficient government size, and evaluates the implications of economies of scale for local government service delivery. Professor Fox's paper identifies alternative means of achieving efficient service delivery in peri-urban areas of large cities and small urban centres in developing countries.

Street Market in Chiang Mai, Thailand. @Shutterstock

MOBILIZING FINANCIAL RESOURCES FOR PUBLIC SERVICE DELIVERY AND URBAN DEVELOPMENT

THEMATIC PAPERS

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INTRODUCTION[1]

Local governments around the world increasingly play key roles in the delivery of basic public services and in the provision of public infrastructure necessary for business development. These roles of local governments are developing against a backdrop of multiple challenges in the global arena including environmental and natural resource crises, increasing urbanization, and growing backlogs of infrastructure demands, all of which are likely to aggravate the financial difficulties faced by local governments.

In order to fulfil their mandate in a fiscally responsible manner, local governments in developing countries must have significant sources of own tax revenues as well as non-tax revenues collected from user charges and fees. Adequacy of own revenues is the key to both a city's improved ability to deliver necessary goods and services, as well as to better accountability of local officials to their constituents. Own revenues need to be complemented by intergovernmental transfers to address differences in expenditure needs and fiscal capacity across cities, and also for cities to support the implementation of central government programmes. In order to effectively address the challenge of mobilizing adequate financial resources, urban authorities in developing countries require financing instruments for capital infrastructure development. These involve a mix of capital grants and borrowing from different sources. Systemic shortages in all these conventional revenue sources have led local governments around the world to try innovative sources of financing, ranging from instruments to capture increasing land value associated with capital infrastructure construction to the involvement in joint ventures with the private sector in PPP. The main objective of this paper is to provide a synthetic review of all conventional and new sources of local government financing to serve as a reference for field practitioners designing and implementing local government development programmes.

The rest of the paper is organized as follows. In the first section we review the rationale and importance of developing own revenue sources, as well as the best-suited sources of tax revenues for cities in developing countries. We also look at the potential important role of charges and fees in becoming a more meaningful part of city budgets in developing countries. In the second section,

[1] This note, in some parts, draws heavily on some of my previous work (Martinez-Vazquez, 2008 & 2014).

we review the most desirable properties of intergovernmental transfers to facilitate revenue autonomy and financial adequacy of cities. In the third section we describe some of the different mechanisms available for cities to access private sector capital and other external sources of finance to implement their urban development and infrastructure plans. In the fourth section we offer a summary and conclusions.

TAX AND NON-TAX OWN SOURCE REVENUES

The two main functions of revenue assignments: Not only revenue but also accountability

It is worthwhile to clarify the importance of developing own revenue sources, understood as those for which jurisdictions have some autonomy to modify, at the subnational level. Own revenue sources, including tax and non-tax instruments such as fees and charges, bring adequacy in financing, but so do transfers. Thus, why should we bother developing own revenue sources, especially when, as we see below, there is so much reluctance to use them at both the central and subnational levels?

The key concept is that own revenues uniquely offer an element of horizontal accountability of public officials to their constituents, on the revenue side of the budget. This accountability is fundamental to create a fiscal culture of expenditure efficiency – not wasting resources and providing what is needed and wanted by local residents, and of fiscal responsibility – providing limits to an otherwise unabridged appetite for public spending with continuous pressure for more central transfers and/or public debt. The international experience also shows that higher levels of tax autonomy at the subnational level are associated with a significant number of other virtuous effects for decentralized systems, including notably improved macroeconomic stability, overall better governance and lower corruption levels.[2]

This message is crucial to an understanding of the rationale and to justifying the considerable effort that accompanies any revenue assignment reform. If we are to achieve the benefits of increased accountability, spending efficiency and fiscal responsibility – which again cannot be delivered by a subnational financing system dominated by transfers and revenue sharing – we must focus on what is unique to revenue assignments. This is the discretion that subnational governments should have in collecting their own revenues. It is this responsibility that creates a link with accountability.

Yet political economy issues can hamper the use of own revenue sources

As strongly emphasized in another paper at this conference by Professor Paul Smoke, commonly present incentives lead many countries to make a low use of own sources. In particular, central governments are reluctant to devolve taxing powers for fear of having to compete with local governments for the same tax bases and/or fear of losing control of fiscal policy. At the same time, local authorities tend to be reluctant to take on the responsibility of making politically unpopular decisions to raise their own taxes. Revenue sharing and other forms of intergovernmental transfers come out as the winners and the most preferred solution for financing subnational governments.

[2] Ironically, ministries of finance are often opposed to granting greater subnational revenue autonomy for fear of losing macroeconomic control.

If effective fiscal decentralization requires meaningful revenue autonomy, which taxes should be allocated at these levels? How much revenue autonomy is needed?

These two questions amount to what is known as the tax assignment problem in public finance. [3] Answering the second part first, different rules have been used but a well-accepted one is that the degree of revenue autonomy should allow the wealthiest subnational governments – those with the largest tax bases – to finance most of their expenditure responsibilities with own revenues. This means that relatively poorer subnational governments will be in need of receiving central government transfers to equalize their ability to provide adequate services.

The answer to the first question – which taxes should be allocated to subnational governments – is more complex, if we want to understand the full rationale. The classic answer to taxation at the subnational level has been the benefit principle: those that use the service should pay for its costs. The power of the benefit principle is that at least in theory it tells us how services should be priced, who should pay for them, and how much of the service should be provided. That could answer our question. However, the power and simplicity of the benefit principle, when put in practice, are rapidly reduced by the complexity of institutional intergovernmental arrangements (as emphasized in the companion paper by Enid Slack) or by the difficulties in identifying the users of a service. In addition, equity considerations – the different abilities of various jurisdictions or individual users to pay – or even the existence of externalities across jurisdictions, further limit the practical application of the benefit principle. Therefore, the challenge is to find tax instruments that would make the benefit principle operational.

In practice, the implementation of tax autonomy requires that we address two questions: (a) What type of revenue autonomy is desirable? (b) What kind of tax instruments should be used to provide that tax autonomy?

What form of tax autonomy is desirable?

With respect to the form of tax autonomy, four dimensions are typically looked at: [4] (a) Who selects the taxes to be used by subnational governments? (b) Should tax bases be exclusive to each level of government or could they be cohabitated by several levels? (c) Which level of government should legislate on tax base and tax rate? And (d) what level of government should administer the tax?

(a) With respect to the selection of taxes, there are good reasons to partially limit the ability of subnational governments to introduce taxes and levies. [5] Two general approaches are followed: an open list of taxes from which – with general limits and restrictions – subnational governments can choose; or a closed list of allowable taxes determined at the national level from which subnational governments can make their own selection. Even though a closed-list approach is more restrictive in terms of autonomy, it may be preferable because it can avoid the introduction of highly distorted taxes or nuisance levies by subnational governments or the fragmentation of the national domestic market. The choice of approach is often specified in the constitution. Closed lists are used more frequently in unitary systems of government. Open lists are used in some federal systems. However, a number of federal countries (such as India, Pakistan or Switzerland) also clearly delineate what taxes can be used at different levels of government. [6]

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[3] For further discussion see, for example, McLure (1998), Bird (2000), Martinez-Vazquez, McLure & Vaillancourt (2006), Martinez-Vazquez (2008 & 2014), and Martinez-Vazquez & Sepulveda (2011).

[4] See Musgrave (1983), Boadway (1997), or Bird (2000).

[5] Even in the United States, probably the most liberal system regarding these matters, the Constitution prohibits the states to use any internal tariffs for domestic trade.

[6] Where those choices have not been updated in many decades, such as in India and Pakistan where the federal governments can tax services but only the subnational government can tax goods, this has led to significant difficulties in the implementation of functional VATs.

(b) Regarding whether the base of specific taxes should be used exclusively by one level of government or whether several levels of government can use these bases simultaneously: Cohabitation has the advantage of providing subnational governments with more choices and meaningful sources of revenue, which may otherwise be monopolized by the central government. It has the disadvantage of introducing vertical tax externalities due to the fact that one level will not typically take into account the impact of its policies on the tax base and revenues of the other level of government. In the international experience, when an open-list approach is chosen, it is generally the case that cohabitation of bases is allowed. In fact it is often the case that the selection of a closed list is made precisely to eliminate cohabitation of tax bases. All things considered, it appears that a hybrid approach of a closed list allowing for the cohabitation of tax bases may be preferred.[7]

(c) The next step in the design of tax autonomy is to assign authority to change the structure of the tax bases and tax rates. In general, autonomy to define tax bases is much less desirable than autonomy to set tax rates. Variations in the definition of the tax base, either through exclusions, deductions, or credits, can lead to more complexity and higher compliance costs across jurisdictions. Autonomy to set tax rates is generally more manageable for taxpayers and administrators in multi-jurisdiction settings. It is also more transparent in inducing political accountability of subnational officials.

(d) The last dimension of tax autonomy considers which level of government should be charged with administering the various taxes. Subnational administration of own taxes can enhance accountability of subnational governments, but can be less cost effective due to economies of scale associated with centralized administration. This efficiency–accountability tradeoff differs for different taxes and administrative capacity and so the assignment of administration responsibilities is country and context specific.[8] Where low levels of administrative capacity are present, it is good common sense to entrust the collection of subnational taxes to the central tax administration. Autonomy is still maintained through the setting of tax rates. This type of arrangement typically requires incentives to the collection of subnational taxes which otherwise may be given second priority by the central tax authorities.

What characteristics should subnational taxes have?

Beyond financing the provision of public services, taxes can also be used as policy instruments to achieve other government objectives, such as income redistribution or macroeconomic stability. Yet for these other objectives, there is broad consensus that they are better pursued by central governments alone. At the subnational level the focus needs to be on efficiency of allocation (how to best use the resources available to provide goods and services) in attempting to apply the benefit principle.

Besides their suitability to approximate the benefit principle, there are several properties for all taxes which are also desirable at the subnational level: (a) being buoyant, with revenues roughly changing in proportion to the economic base; (b) being horizontally equitable: providing equal treatment to tax payers in similar circumstances; (c) being relatively efficient, causing low distortions in economic activity; (d) being relatively low in administration and compliance costs; and (e) being politically acceptable.

> ***Local governments around the world increasingly play key roles in the delivery of basic public services and in the provision of public infrastructure necessary for business development.*** – Jorge Martinez-Vazques

[7] This assumes of course the use of intergovernmental transfers to correct for vertical externalities.

[8] Martinez-Vazquez & Timofeev (2010).

Other desirable properties of subnational taxes make them more adaptable to the benefit principle: (a) being geographically neutral: not distorting the location of economic activity, not interfering with domestic or international commerce, and not exportable so that the burden is not borne by residents of other jurisdictions, unless matched by benefits to non-residents;[9] (b) having evenly distributed tax bases across jurisdictions; (c) having relatively immobile bases; (d) having relatively stable tax bases over the business cycle; (e) being highly visible and transparent, to increase accountability; and (f) being administratively feasible.

Selecting specific tax instruments

Few revenue sources fulfil all the desirable properties and a compromise is generally needed; the criteria reviewed above allows us to select the better local tax assignments.

Charges and Fees: There is ample consensus that user charges and fees are the most appropriate source of revenue for local governments, in particular because they best fit the benefit principle. A considerable array of services are amenable to being financed with user charges and fees, including water and sewerage, electricity, parking, garbage collection, urban transportation and road use, kindergartens and residential care for the elderly, museums, parks, and sport facilities. Other services, such as health and education, can be partially financed with user fees. Additionally, user fees can be charged to cover the public costs of registration and monitoring of a wide range of activities including business establishment, real estate titling and registration, and driving permits.

Apart from the economic efficiency advantages of benefit charges, from a political economy perspective they also offer the advantage of not directly competing for any tax base with central governments; and therefore central authorities tend to be much more generous in granting autonomy to subnational governments to set charges and fees. One disadvantage is that these charges and fees may be perceived as unfair to the poorer groups, and therefore fees and charges for excludable services (such as water and sewerage) in developing countries are often set below full cost recovery for service provision. This low user pricing leads to resource waste and unnecessary subsidies for higher-income residents; thus squandering one of the few good sources of revenue for local governments.

Property taxes: There is also broad consensus that property taxes and betterment levies are the closest to being a benefit tax, entirely appropriate for local government financing. Almost without exception, revenues from property tax are assigned to local governments as opposed to intermediate level or regional governments. The degree of discretion given to local governments in manipulating this tax may vary but the agreement that this tax belongs to local governments seems well entrenched. [10]

Several features make property taxes especially attractive as a subnational tax. Most importantly, property tax is a visible tax and thus conducive to political accountability. In addition the tax, for the most part, falls on an unmovable base. The more homogeneous the property and population, the closer the property tax comes to being a benefit tax. However, depending on how the property tax is structured, it can move away from the benefit link; this may be the case for example if the tax burden falls just on a few classes of property, such as non-residential property.

Other advantages of property taxes are their revenue potential and stability. Note also that from a vertical equity viewpoint the property tax can be progressive in developing countries, and therefore can increase the overall vertical equity of the tax system, although in practice it can be made regressive by exemption policies that benefit wealthier households. [11] Another desirable feature of the property tax is that much of the tax burden is quite

[9] Tax exporting is generally undesirable because it can lead to an over-expansion of the public sector and to inequities in the distribution of tax burdens.

[10] Despite the wide agreement on the advantages of the property tax as a subnational tax, many developing countries make relatively little use of it. On average, developing countries raise property tax revenues that are equivalent to only about 0.6 per cent of GDP compared with two per cent in developed countries (Bahl & Martinez-Vazquez , 2007) for a discussion of potential reasons for this..

[11] Bahl & Linn (1992) and Sennoga, Sjoquist & Wallace (2007).

likely borne by residents in the jurisdiction where the services financed by property taxes are provided. The property tax also has the advantage that it imposes a relatively low compliance cost on tax payers because their intervention in determining tax liability is minimal, except in the case of appeals. Finally, a part of property tax might be considered as a charge for land, which can lead to significant improvements in the quality of land use.

The main drawback of property tax is that, perhaps due to its visibility, it is often unpopular with taxpayers and, as a result, also with public officials. Other drawbacks include the fact that it can lead to liquidity problems for homeowners with valuable real estate assets but low incomes. [12] In addition, the property tax administration requires costly revaluation of property on a regular basis, and it is difficult to enforce, because the confiscation of property may be considered too extreme because of the political fallout. Finally, the property tax lacks revenue elasticity, meaning that the tax typically exhibits little automatic revenue growth.

In practice there are several forms of property tax. For example, some countries separate the taxation of land and improvements, or structures; while others tax only land values or rents. Although taxes on land tend to be more efficient, they also have less revenue potential and it are generally more difficult to administer properly, for example in terms of valuation or assessment of properties. There are different modalities for the administration of property tax, including centralized or central oversight over cadasters and re-evaluation processes, which can make this type of tax even feasible in developing countries. Note that tax autonomy is largely preserved as long as subnational authorities are given some discretion over rate setting. [13] Varying forms of administrative devolution can be considered over time depending on emerging capacities.

Betterment levies: This is another form of property taxation that takes the form of lump-sum payments exacted upfront by subnational governments from land and housing developers and also from homeowners as a charge for public service improvements, such as road paving, drain infrastructure, sidewalks, and street lights, all of which offer apparent benefits to property values. [14] Betterment levies can be useful in providing subnational governments with liquidity to invest in needed infrastructure; they also have the advantage of being more directly contractual than property taxes, therefore reinforcing the benefit principle feature in subnational government.

Vehicle and transportation taxes: These are generally an attractive form of local taxation because of the strong link between vehicle ownership and the use of local services and infrastructure (particularly roads). In addition, vehicle and transportation taxes offer the advantage of being green taxes with the double dividend of reducing negative externalities associated with traffic congestion and air pollution in the local area. These are also revenue elastic, relatively stable, and non-exportable taxes. [15] On the negative side, owners will tend to register their cars where it is cheapest; and it will generally be difficult to prevent this through ordinary enforcement measures. Motor vehicle taxes remain underutilized relative to the potential and the advantage of a tax handle that they represent, especially in developing countries. The reasons for this are not clear, but are probably a combination of political opposition by automobile owners combined with an interest of central governments to keep this tax source central.

Local business taxes: As a rule, resident taxes should pay for services to residents and business taxes should pay for services to businesses. Business taxes and business license fees are justified

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12 Being "house rich and income poor" can be a problem for elderly people with low incomes. To address this problem, some countries use special exemption schemes ("homestead exemptions" or "circuit breakers") to increase equity in the implementation of property taxes.

13 For international experience with the property tax, see Bird & Slack (2004) and Bahl &Martinez-Vazquez (2008).

14 For example, betterment levies are exacted from property owners in places such as Canada, Poland, Colombia, Argentina and Mexico, and from developers in Canada, Australia, and Mexico (Bird & Slack, 2004).

15 Some of those properties make them also attractive to central governments; in some developing countries vehicle taxes are wrongly assigned at the central level.

levies at the subnational level as an indirect but administratively easier way to tax income of business owners, but acting as a benefit tax for the services and infrastructure provided by subnational governments. These levies range from several forms of broad-based taxes to operation licenses and charges. Broad-based levies that are neutral toward the factor mix in production are most desirable, as in the case of the origin-based business value tax (BVT). [16]

The closest experience of a BVT was Italy's regional business tax (known as the IRAP) prior to the elimination of payroll from the tax base in 2003. [17] More often what we observe is different types of business license levies, which may vary by type, size, or location of the business. For example, some South American countries use local business taxation estimated on the basis of annual turnover.

responsible for health care) and on vehicles and fuel (to the extent of subnational government involvement in road construction and maintenance).

Another attractive form of excise at the subnational level is the taxation of public utility services. There is significant revenue potential in some of these services, as in the case of electricity and phone services. Besides their revenue potential, excises on public utility services can fit the benefit principle well because electricity and phone service consumption tend to be good proxies for local public service use by households and businesses. Compared to other commodities, taxation of public utilities would be associated with relatively low distortions because of low price elasticity of demand. Their relatively high-income elasticity tends to yield revenue buoyancy and some elements of progressivity (Linn, 1983).

In order to effectively address the challenge of mobilizing adequate financial resources, urban authorities in developing countries require financing instruments for capital infrastructure development. – Jorge Martinez-Vazques

Excises and sales taxes: Subject to the constraints imposed by the size of the jurisdiction and cross-border trade and smuggling, excise taxes have potential as piggyback or special taxes at the subnational level. The extent to which excise piggyback surtaxes can be used at the local level depends on the size of the jurisdiction, the technology of product distribution, and points of sales. Excises tend to be more politically acceptable, can be easily administered in coordination with national wholesalers as withholding agents, and allow for rates differentiated by jurisdiction. Moreover, the benefit principle accords well with the assignment of destination-based excises on alcohol and tobacco to the subnational level (to the extent that the latter is

Final retail sales taxes can also provide an elastic and high yield source of revenue for local governments. However, final retail taxes, as opposed to the distorting general turnover sales taxes, which are not recommendable, can be difficult to implement. More generally, local retail sales taxes can conflict and complicate the operation of the central VAT, which most countries in the world have adopted.

Flat-rate piggyback income taxes and other income taxes: There is broad consensus that progressive income taxes are best assigned at the central level because, given the mobility of taxpayers, the goal of income redistribution is best pursued by

[16] The base of the BVT would resemble that of the VAT although in contrast to the destination-based VAT, the BVT would be origin-based, therefore taxing exports (and not imports). This better serves as proxy for the benefits businesses receive from subnational government services accruing at the place of production (not consumption). Also, in contrast to the typical VAT calculated by the credit method (the tax on gross receipts minus the tax paid on intermediate goods and services), the BVT would be calculated by adding payroll, interest, rents, and net profits on the basis of annual accounts (Bird, 2003).

[17] The IRAP (Imposta Regional sulle Activita Productive) is origin-based and actually calculated by a subtraction method (sales minus the sum of material purchases and depreciation). It is centrally administered and the regions have discretion on rates. Despite its many good features, this has proven to be quite unpopular with taxpayers (Keen, 2003).

the central government. Another reason for this assignment is that progressive income taxes tend to act as automatic economic stabilizers and macroeconomic stabilization should primarily be a responsibility of the central government. However, there are several possibilities for the taxation of individual income by subnational governments. The most commonly used form of subnational income taxation internationally is a flat-rate income tax as a surtax or piggyback tax on the base (not the tax liability) of the central government individual income tax. This type of tax is almost always collected by the central government and the revenues allocated to subnational governments on a derivation basis. [18] To enhance revenue autonomy, local governments are allowed discretion in setting the flat rate, often between centrally legislated minimum and maximum rates. [19] A flat rate local piggyback income tax easily satisfies the benefit principle and, being quite visible, it promotes political responsibility and accountability at the subnational level. This is also an elastic source of revenue.

Another form of income taxation is a payroll tax as implemented in Mexico City, or in a wider form, a tax on labour income. However payroll taxes have the drawback of being potentially more distorting. Subnational payroll taxes can yield high revenues even at low rates and are not difficult to administer. In particular, payroll taxes may be easier to administer and enforce than general income piggyback taxes in some developing countries with less advanced tax administrations. However, these taxes tend to distort optimal factor composition in production and also to discourage employment in the formal sector, an issue of high importance in most developing countries. The tax base of payroll taxes can be quite mobile, especially if they are not applied in a metro wide area. This tax base is also carefully protected and already highly taxed by most central governments in the form of social security taxes.

Natural resource taxes (when resources are evenly distributed): There is at least a partial link between taxes on natural resource extraction and the benefit principle at the local level. Extraction activities use local infrastructure (such as roads), place stress on other local infrastructure (temporary worker camps, health facilities, and so on), and pollute the environment. But there are also arguments against the local taxation of natural resources. When economically significant resources (such as petroleum) are geographically concentrated, which is usually the case, local taxation could cause extensive horizontal fiscal imbalances, inefficient population migration and location of business, and internal conflict. Also, given the high volatility of world commodity prices, the yield of natural resource taxes can be highly unstable and thus not appropriate for local governments.[20] Overall, natural resource taxes are generally less relevant to metropolitan areas.

Bad choices for subnational taxes

The theory and practice of tax assignments also help us identify those taxes that will not be good choices for assignment at the subnational level. As pointed out, a progressive individual income tax is not recommendable at the subnational level.

Another tax that is ill-equipped for application at the subnational level is the corporate income tax or profit tax. Some of the reasons — its role in income redistribution and macroeconomic stabilization – are identical to the case of the progressive individual income tax. In addition, it is unlikely that incorporated businesses benefit more from public services than unincorporated ones or that the benefits received vary with profits. At an operational level, it is extremely difficult to apportion the profits of enterprises across subnational jurisdictions where they operate. [21] The VAT is also generally thought to be a poor choice for assignment to the subnational

[18] Generally speaking a local income tax should be levied at the place of residence because that is where most taxpayers consume subnational government services. However, because of administrative convenience subnational piggyback taxes are often withheld at source at the place of work by employees. However, it is often quite feasible to distribute the funds according to where workers reside.

[19] Other (less desirable) forms of tax autonomy are practiced, such as the ability to modify tax bases by providing additional deductions, exemptions and so on.

[21] To this end, some countries use apportionment formulas, for example a weighted index combining the geographical location of workers, assets, or sales. At the end, the allocation of profits remains somewhat arbitrary. In some cases, if not correctly performed, the apportionment of taxes tends to benefit the jurisdiction where the business headquarters are located.

level. Since the debiting and crediting of the VAT is likely to take place in different jurisdictions, the apportionment of revenues is arbitrary, generally favoring the location of headquarters. One problem raised was the lack of a good way to handle the issue of inter-jurisdictional trade. These difficulties may be aggravated with autonomy to introduce differentiated tax rates.[22] Nevertheless, more recently there have been developments in both the theoretical level and in practice, demonstrating that subnational VATs on a destination basis using the invoice–credit method are feasible, provided the central government levies a VAT.[23]

There are also other directly outright bad choices of taxes. This list would include the Octroi, a local border tax, popular in India in recent times, or general subnational turnover sales taxes, as in the case of Colombia and the Philippines. Because these taxes tend to be quite productive in terms of revenues, they are very difficult to eliminate once they are introduced.

Ranking and scoring the different subnational taxes

How do we ultimately rank the different choices of subnational taxes discussed above? The answer depends greatly on how we score each tax on a long list of desirable properties such as revenue potential, ability to fit the benefit principle, non-exportability, and so on.[24] Still, it is safe to say that a good and productive tax structure at the local level would have a basket of many, if not all, the instruments we reviewed above as good choices; starting with a substantial role for fees and charges, and with property taxes and piggyback personal income taxes also playing major revenue roles.

Girona, Spain @Shutterstock

[22] However, it is perfectly feasible to share VAT revenues with subnational jurisdictions using a formula; for example, the VAT can be shared on the basis of population (as in Germany), or on the basis of the regional shares in aggregate consumption (Japan or Spain). But, of course, tax sharing does not allow revenue autonomy among subnational governments.

[23] See also Martinez-Vazquez (2008), for a discussion of this literature and the experiences of Brazil, Canada and India with subnational VATs.

[24] This type of scoring exercise is, for example, carried out in Martinez-Vazquez (2014).

INTERGOVERNMENTAL TRANSFERS: ADDRESSING VERTICAL AND HORIZONTAL IMBALANCES

Fiscal imbalances

No design of a decentralized system of finance ever reaches a perfect balance between expenditure assignments and revenue assignments.

Horizontal imbalances can be caused by differences in local economic activity, wealth or resource endowments; or due to differences in expenditure needs. These latter differences may arise from either different prices or costs of service provision due to geographical or climatic conditions, or from adverse demographic profiles such as population groups with special needs. Horizontal imbalances can be enlarged from physical and institutional impediments to population migration or the mobility of capital across provinces, and from government policies that implicitly or explicitly favor some areas of the country over others. The typical measure of horizontal fiscal imbalance involves the comparison between fiscal capacity measures and expenditure need measures.

Vertical fiscal imbalances are also an issue for most decentralized countries. Vertical imbalances arise when the revenue sources assigned to each level of government do not broadly correspond to their assigned expenditure responsibilities. These include not only central–provincial relations but also provincial–local relations. In most cases vertical imbalances are against subnational governments with expenditure responsibilities and needs exceeding their revenue sources. However, measuring the lack of correspondence between expenditure responsibilities and available sources of revenue is made difficult by the ambiguity surrounding measures of expenditure needs. [25]

Vertical imbalances have been sometimes associated with the existence of structural budget deficits. But this is an imperfect measure because, by law and practice, in most countries budget deficits have been consistently higher at the central than at the subnational level. Local governments in many countries are not allowed to run deficits and in some cases they are also not allowed to borrow for capital spending. A more accepted and sound approach to measuring vertical imbalance is to identify the ability of different levels of government to finance expenditures from their own sources of revenues.

Transfer systems generally use three types of grants to address those vertical and horizontal imbalances: tax sharing, unconditional equalization grants, and conditional grants.

Tax sharing

Central governments typically allow subnational governments to participate in the collection of certain central-government-assigned taxes. This is typically done on a derivation or origin basis. Because of the use of the derivation principle, there are some taxes, such as the personal income tax, that are easy to share; while some others, such as the corporate income tax and the VAT, are much more problematic due to the difficulty of determining the tax base in any particular region. The share retained by the subnational government is a percent of the tax revenues collected in the jurisdiction. Tax sharing is very commonly used to close the first stage of the vertical gaps left by the insufficiency of revenue assignments. Even though this is seen as a form similar to revenue assignments, there is a fundamental difference between the two in that tax sharing does not involve any form of autonomy and therefore it does not create any direct link to accountability.

Quite often the justification for giving preeminence to revenue sharing arrangements over other forms of transfers is that, supposedly, revenue sharing on a derivation basis provides incentives to subnational governments to develop their local

[25] Several approaches can be used to reduce that ambiguity. One approach is to prepare a list of standards (or norms) for the provision of public services at all levels. The norms can be quite general or exhaustive and detailed. A more complex approach is to measure the expenditures required for explicitly stated and agreed levels and quality of public services and, finally, compare them to available resources for each level of government.

economies. Yet if this rationale is actually valid, then these same incentives would be present in an enhanced way with the assignment of own revenues, as opposed to revenue sharing.

Even though tax sharing is a convenient instrument for subnational finance, it can also carry significant problems. Not least is the creation of a soft budget constraint mentality where all local financing problems can be addressed by increasing the tax sharing rates, instead of local governments using their autonomy to raise own revenues. Tax sharing also has the disadvantage of increasing horizontal inequalities. However, these problems can be reduced when the allocation of tax sharing proceeds is according to a formula, for example in proportion to population – as opposed to using the derivation principle.

Unconditional equalization grants

The essence of an equalization transfer system is to compensate for horizontal fiscal disparities across local governments arising from differences in fiscal capacity and/or expenditure needs. The higher the importance of revenue autonomy, the more important equalization grants become as part of subnational governments' financing systems. Usually equalization grants are unconditional, meaning the subnational governments can use the funds in an unrestricted manner, as if they were their own funds.

The major challenge in the design of these grants is the appropriate measurement of tax capacity and expenditure needs. Tax capacity should ideally be measured as the revenue that tax bases available to subnational governments would yield under standard tax rates and administration effort. A variety of methods are used around the world to measure fiscal capacity of subnational governments but none of them is easy, due to scarcity of necessary data. Regardless of the difficulties, actual collected revenues should never be used as a proxy for fiscal capacity because that would introduce powerful negative incentives to own tax revenue effort.

Expenditure needs can be defined as the funding necessary to cover all expenditure responsibilities assigned to the subnational government at a standard level of service provision. In practice, this can be measured with expenditure norms (from the bottom up or top down), but a more commonly used approach is to estimate some type of index of relative expenditure need as the weighted sum of population and other demographic factors, and differences in the costs of providing public services. The use of actual expenditures or measures of existing facilities should be strictly avoided to exclude the presence of perverse incentives regarding spending discipline and efficiency. The design of the formula should be such that neither the central government authorities nor the local governments would be able to affect the final results or actual transfers by either manipulating the information or by changing behavior.

Conditional grants

Central governments typically also play a supporting role for subnational governments through the implementation of conditional grants, which are funds transferred with strings attached. Subnational governments can only use the funds according to rules imposed by the centre. Tied or Specific Grants, as they are also called, are used for example to ensure the provision of minimum standards of service for delegated functions, for example in education and health, throughout the national territory. They are also used for other specific needs, in some ways reflecting national interests (such as reducing poverty) or addressing significant spillover effects across jurisdictions (such as clean air and water), inducing subnational governments to increase spending in those areas.

The use of matching arrangements for the transfers of the funds (the central government contributes a certain part and local governments contribute the rest) can increase the leveraging and effectiveness of the transferred funds since local governments are given a specific incentive to contribute their own funds to the particular programme. Conditional grants are best implemented (when feasible) on a capitation basis (for example, per inhabitant or per student). The per capita basis could be modified, if needed, by some adjustment coefficient to reflect different costs of provision or needs, but only as long as these adjustments can be made by formula and do not involve negotiation among central and local authorities.

Capital grants

Most countries use some form of capital transfers in support of subnational governments for specific infrastructure expenditure areas such as roads, water and sewerage treatment plants, transportation, housing, education, health, and so on. Country experiences vary regarding the allocation mechanisms, which range from ad hoc allocation decisions to formalized approaches using pre-established formulae. Similarly, country experiences vary regarding the flexibility in the use of funds from the least flexible project-based grants to unconstrained funds provided as part of a general revenue transfer. Often the sum of a capital grant has to be matched with locally raised resources and the matching rate is sometimes inversely related to the local income. The range of objectives for capital transfers includes closing disparities in local infrastructure stocks, subsidizing capital projects with cross-jurisdictional spillovers of benefits, addressing vertical imbalance in the assignment of revenue sources, addressing lack of credit availability, and others.

One simple general reason for the widespread use of capital grants is that in real-world decentralized systems of government the lack of taxing powers affects the ability of subnational governments to finance their capital investments in the same manner as their ability to finance their operating costs. Another significant reason for the prevalence of capital grants is that central governments tend to treat capital development in a more centralized manner than recurrent programmes. However, across the world, subnational governments account for almost two-thirds of public investments in infrastructure, of which only one-third is financed with capital grants, which in turn accounts for one-fifth of intergovernmental transfers. Typically the share of subnational governments in capital expenditures of a country is twice their share of recurrent expenditures. [26]

BORROWING: FACILITATING CAPITAL INFRASTRUCTURE DEVELOPMENT

Disciplined access to credit is an appropriate source for financing subnational government capital investment responsibilities. The use of borrowing to finance this type of activity is justified because of the bulkiness of some projects and the lack of liquidity of subnational governments; and because the repayment of credit over time represents a fairer distribution of infrastructure costs among the different cohorts of users during the useful life of the infrastructure. However, borrowing at the subnational level is risky because local officials can be easily tempted to overspend and shift the repayment of debts to future governments and taxpayers. Therefore, there is a need for balance between access to borrowing by subnational governments and institutional mechanisms that preserve fiscal discipline. A good rule for assessing the need for long-term financing is that today's services should be financed by today's taxes and user fees, and future services should be financed by future taxes and user fees facilitated through the issuance of public debt (Inman, 2010).

Promoting an orderly and effective borrowing mechanism requires good design from both the demand and supply sides. On the demand side there is a need to control and monitor borrowing practices. Internationally there are two types of control mechanisms that are relied on: first, a set of rules and regulations for subnational borrowing established and enforced

[26] Martinez-Vazquez & Timofeev (2012)

by central government authorities; and second, private credit markets discipline. Since the second mechanism requires developed private financial markets, most developing countries must rely on rules and regulations set by the central authorities.

Controlling borrowing through rules

Some of the rules used in international practice to limit borrowing at the subnational level include:

- The Golden Rule, which states that borrowing proceeds can be used only for capital investment purposes, or put differently: no borrowing or credit proceeds can be used to finance current expenditures
- Borrowing in any year cannot exceed a certain per cent of subnational revenues in that year
- Total debt cannot exceed a certain per cent of subnational revenues in any year
- Expenditures on debt service (interest and repayment of principal) must not exceed a certain per cent of subnational government revenues in any year
- All subnational debt must be registered with the Ministry of Finance who shall control and monitor compliance
- Subnational debt cannot be guaranteed by the central government except as approved by the national parliament
- All borrowing by local governments is subject to approval by the Ministry of Finance
- Total local borrowing will be limited annually in the State Budget.

One of the challenges that large urban governments and metropolitan areas face is the growth of population in their peripheries and city extensions. – Jorge Martinez-Vazques

There is probably no need for all these instruments to impose limits on subnational borrowing since depending on the percentages chosen, not all constraints will be binding at the same time. It is probably desirable to start with conservative limits and reduce them over time, as fiscal discipline routines set in and it becomes well established that the central government will not act as guarantor of subnational debt nor act as a lender of last resort. The biggest threat to fiscal discipline is the perception that there is a soft budget constraint and that eventually central authorities will rescue overextended bankrupt subnational governments. Therefore, having explicit procedures to deal with bankrupt jurisdictions can also help strengthen the budget constraint.

Enhancing the availability of subnational credit

Although it is common to put emphasis on controlling the demand for credit by subnational governments, actually the problem may be not so much on the demand side but rather on the supply side. Often subnational government borrowing may be too low given their expenditure responsibilities for infrastructure and given also the low levels and high needs for capital infrastructure. Thus, in most countries there is a need to study how a subnational credit market can be developed. Subnational governments usually lack creditworthiness (the financial ability to repay loans over time and the technical capacity to manage the debt) and therefore lack the ability to issue bonds or borrow from financial institutions. Creditworthiness can be improved through more transparent budgeting and accounting, and development of autonomous sources of revenue for subnational governments. But even if local government revenues and creditworthiness are significantly improved, the necessary levels of subnational borrowing may not take place because of market failure on the supply side.[27]

[27] Government policies may encourage lending by financial institutions. An example is provided by the practice of intercepting subnational government sources of revenues; the ability to intercept intergovernmental transfers can be seen by creditors as the most secure collateral. At the same time the right to intercept intergovernmental transfers can discourage lenders' efforts to monitor local government finances, and in some cases could be interpreted by these lenders as a promise of central government bailout. For example, Mexico has recently abandoned the practice of the intercept for these same reasons.

Ideally, private financial markets will provide creditworthy local governments with all their needs for long-term financing and help create fiscal discipline among local governments. However, most developing countries' financial systems and capital markets remain underdeveloped. In the shorter term, the lack of development of financial and capital markets leaves governments with very few options to support subnational government borrowing and capital expenditures. Lending from the Ministry of Finance or the National Treasury is not a good option because of the possibility of generating a soft budget constraint and moral hazard.

Central governments have the option of creating local credit facilities or local credit banks. [28] But this option is also full of dangers. In practice, central government-run financial intermediation can create moral hazards, if the soft financial assistance from the centre is institutionalized, and also a culture of long-term dependency. It can also impede capital market development. Such institutions would need to operate using strict banking criteria, operate with independence from political pressures and politically motivated project selection and lending criteria, and be prepared to manage default risks – the inability or unwillingness to pay debt service.[29] Credit enhancements are another mechanism that can help mitigate the risks associated with lending to local governments. Some typical forms of credit enhancements are comprehensive and partial credit guarantees.

The first form covers principal and interest payment regardless of the cause of debt service default. In the partial credit guarantees, the guarantor shares the risk of debt service default with the lenders, and guarantors will examine much more carefully the credit of the borrower since its own capital is on the line.

But even in these cases small local governments may lack access to capital markets. As we saw above, capital grants are one of several alternatives to private sector borrowing for financing local capital development in smaller jurisdictions.

INNOVATIVE APPROACHES TO FINANCING INFRASTRUCTURE

Conventionally capital grants and subsidies from higher levels of government and borrowing have been used or at least recommended as the way to finance new infrastructure projects for local governments. But as the recent economic downturn has painfully illustrated again, local governments cannot always count on the availability of these conventional sources.

In face of these difficulties, local governments have been increasingly looking for innovative and non-traditional sources to improve their ability to finance infrastructure projects. One of these innovative avenues captures the increment in land value resulting from public investments. The basic notion is that public investments including roads, sewage and sanitation, water supply, and transit systems are immediately capitalized into surrounding land values (Peterson, 2009 & Walters, 2012). But land value is determined of course by other things besides public investment in infrastructure, such as population growth and private investments, or even changes in other public policies such as land use regulation. Accordingly, there has been controversy about who should benefit from the land value increments resulting from population growth and even changes in land use regulations. There is strong consensus, however, for

[28] Although international practices vary substantially between countries, an intermediary institution can borrow in its own name and use the proceeds to purchase debt instruments of local governments. Alternatively, financial intermediaries that serve local governments might assemble and repackage municipal debt instruments and make them available to the market (by for example creating local bond pools). Such intermediaries can provide access to capital markets for smaller governments that otherwise would not get credit. Moreover, intermediation brings savings on the fixed costs of debt issuance thanks to standardized borrowing procedures and documentation, and technical assistance to local governments with capital planning, cash flow projections, and pre-structuring of loan packages (Freire & Petersen, 2004).

[29] Weist (2002) identifies several strategies to manage default risks: strengthen intergovernmental fiscal system; apply administrative controls; implement rule-based framework; establish market-based system and impose other controls.

local governments to recover the public investment costs by capturing at least part of the improvement in the value of land associated with the public investment. [30]

Below we discuss some of the popular methods of Land Value Capture (sometimes also called Benefit Value Capture) that has been practiced or attempted over the last few decades at the local government level in the United States and elsewhere. One of these, the betterment levies, was already discussed among the conventional local taxes.

Tax increment financing (TIF)

TIF is a mechanism for capturing the gain in tax revenue from the increase in economic property value resulting from public investment within a specified district, as a way of financing public investment. Most US states allow the use of some form of TIF; the property value increment is simply estimated equal to the total assessed property value in the TIF district minus the base property value, with the difference assumed to arise as a consequence of the public infrastructure project and other development activities. The TIF revenue is generally earmarked for the TIF district for a specified period of time (generally 20–25 years). After this period elapses the revenues revert back to the overlying local governments. As Sjoquist & Stephenson (2010) correctly note, TIF is just a complicated means for earmarking revenue for financing public improvements. It works as a permanent tax whose revenue is earmarked for a specified period and which reverts to the general property tax revenue at the end of this period.

Development impact fees

Also very common at the local level in the US, these are one-time monetary levies that are charged during the building or development permit approval process (Jeong, 2006). The fee is calculated based on the proportional share of the capital costs of providing major facilities, including arterial roads, interceptor sewers, sewage treatment plants, and regional parks. The rates should be predetermined by the local government unit. Impact fees have been in use for a while, but have seen a recent surge in popularity (Burge, 2010).[31]

Betterment levies

As we have seen, betterment levies are direct charges to capture the increment in land value resulting from public investment. Usually the betterment taxes or levies are a one-time, upfront charge on the land value gain; but in the US a variant, which is levied as an annual charge, is often used. In practice only a part of the gain in land value is captured by the betterment levies as the rate ranges between 30 and 60 per cent of the value increase.

Certificate of additional construction potential (CEPAC)

This instrument is a mixture of impact fees and the special relaxation of zoning regulations. It is also known as the Floor Space Index (FSI). Through the FSI, governments sell development rights for increasing floor space, with their value to be enhanced by public infrastructure projects. Areas within cities have zoning regulations and other departmental regulations, which determine the setback from boundaries (how much empty land should be left between the boundary and the building), landscaped areas, parking areas, and also the built-up floor area or the Floor Area Ratio (FAR). The most well known use of the FSI is the Sao Paulo CEPACs, which are auctioned off at the Sao Paulo Stock Market Exchange by the Sao Paulo city government (since 2004). The CEPAC gives the purchaser the right to build larger floor area ratios and also change the use of the plot (Sandroni, 2010).

[30] Note that there has always been at least some form of indirect capture of land value improvements through conventional property taxes and other. But given that in many cases public investment in infrastructure improves land value, there is questioning why this relationship has not been more widely used to finance infrastructure. This is called the Shoup Anomaly, which asks, "Why is it so difficult to finance public infrastructure given that the increase in urban land value is much greater than the cost of the infrastructure?" Part of the answer lies in the practical difficulties of capturing back land value improvements. In addition, we cannot take for granted that all public investments would increase land values. For example, building a jail facility may not affect other surrounding land values positively.

[31] In the absence of impact fees government officials are likely to face criticism from existing landowners who see that their property tax revenue is being used for providing expanded services to new developers (Ladd, 1998). The alternative to impact fees is the use of zoning and restrictive land use practices.

Fee booths in Western High-Speed Diameter (WHSD) tollway. The route to Scandinavia @Shutterstock

Other innovative instruments for financing infrastructure

A variety of other approaches have been used in the international practice. [32]

- Developer exactions. These require developers to install on-site public infrastructure at their own cost or otherwise compensate local government.
- Acquisition and sale of excess land. Here subnational governments acquire land surrounding a specific infrastructure project with the perspective of selling this land at a profit when the project is completed and land-value enhanced.
- Sale or lease of publicly held land. In this case local governments sell land benefiting from the new infrastructure, and use the proceeds to finance infrastructure investment.
- Different modalities of PPP including private investment in public infrastructure where developers build the infrastructure in exchange for public land.

All these techniques for land value capture offer opportunities for increasing local government revenues and abilities to finance infrastructure projects. Two general qualifications are in order. First, these sources should not be seen as substitutes for the conventional budget financing instruments that we discussed above. The bulk of recurrent service expenditures and a good part of infrastructure will need to be financed out of those conventional sources, including borrowing. Second, the large revenues potentially involved with the introduction of these measures are likely to create opportunities for favoritism, corruption and abuses of governmental power so additional anti-corruption measures are called for (Peterson, 2009).

32 See, for example, Peterson (2009).

CONCLUSIONS

The main objective of this paper is to provide a synthetic review of all conventional and new sources of local government financing to serve as a reference for field practitioners designing and implementing local government development programmes.

In order to fulfil their mandate in a fiscally responsible manner, local governments in developing countries must have available significant sources of both own tax revenues and non-tax revenues in the form of user charges and fees. Adequacy of own revenues is the key to an improved ability to deliver needed goods and services and to a better accountability of local officials to their constituents. The key concept is that own revenues — unlike tax sharing and other transfers – uniquely offer an element of horizontal accountability of public officials to their constituents on the revenue side of the budget.

Given that effective fiscal decentralization requires meaningful revenue autonomy, we must first ask how much revenue autonomy is needed. The desirable degree of revenue autonomy should allow the wealthiest subnational governments – those with the largest tax bases — to finance most of their expenditure responsibilities with own revenues. Then we need to decide which taxes should be allocated at the subnational level to implement that autonomy.

The classic answer to taxing at the subnational level has been the benefit principle: those who use the service should pay for its costs. The power of the benefit principle is that – at least in theory – it tells us how services should be priced, who should pay for them, and how much of the service should be provided. However, the benefit principle is very difficult to implement for technical and perceived equity issues. Therefore we must find tax instruments that can best emulate this principle.

The most desirable form of autonomy at the subnational level is to allow elected authorities to set the tax rates of the selected taxes. This is the simplest and most transparent way for inducing political accountability. Selecting taxes is more complex, but can be guided by desirable qualities of these taxes – such as a fairly immobile tax bases and being quite visible to taxpayers. As for the particular revenue instrument, there is broad consensus that user charges and fees are the most appropriate source of revenue for local governments. Among tax instruments, the list is quite long and includes property taxes and betterment levies, vehicle transportation taxes, local business taxes, flat-rate piggyback and income taxes. For specific technical reasons there are also bad choices for subnational taxes; examples include the corporate income tax and the VAT.

No design of a decentralized finance system ever reaches a perfect balance between expenditure assignments and revenue assignments. Horizontal imbalances are caused by differences in local tax bases or due to differences in expenditure needs. Vertical imbalances arise when the revenue sources assigned to each level of government do not broadly correspond to their assigned expenditure responsibilities. Transfer systems generally use three types of grants to address these vertical and horizontal imbalances: tax sharing, unconditional equalization grants, and conditional grants.

Tax sharing is very commonly used to close the first stage of the vertical gaps left by the insufficiency of revenue assignments. Even though this is seen as similar to revenue assignments, there is a fundamental difference between the two in that tax sharing does not involve any form of autonomy and therefore it does not create any direct link to accountability. Tax sharing can create a soft budget constraint mentality among subnational governments. The essence of an equalization transfer system is to compensate for horizontal fiscal disparities across local governments arising from differences in fiscal capacity and/or expenditure needs. The higher the importance of revenue autonomy the more important equalization grants become as part of subnational governments' financing systems. Central governments typically also play a supporting role for subnational governments through the implementation of conditional grants. Significantly among these are capital transfers in support of specific infrastructure expenditures.

Disciplined access to credit is an appropriate source for financing subnational government capital investment responsibilities. Borrowing addresses the bulkiness of some projects, the lack of liquidity of subnational governments, and offers an equitable solution over the different generations of taxpayers. However, borrowing at the subnational level can be risky because local officials can be easily tempted to overspend and try to shift the repayment of debts to future governments and taxpayers. Therefore, borrowing activities are controlled either by market forces (least common) or explicit government rules (most common). These include the Golden Rule (borrowing proceeds can only be used for capital investment purposes) or, for example, limits on expenditures on debt service (interest and repayment of principal) as some percent of subnational government revenues in any year.

Yet in fact, the problem with subnational borrowing may not be so much on the demand side but rather on the supply side. Often subnational government borrowing may be too low given their expenditure responsibilities for infrastructure. Facilitating borrowing presents challenges. Lending from the Ministry of Finance or the National Treasury is not a good option because of the possibility of generating a soft budget constraint and moral hazard. Central governments have the option of creating local credit facilities or local credit banks, but this option is also full of dangers. Public financial intermediaries need to operate using strict banking criteria, and independently from political pressures and politically motivated project selection and lending criteria; and to be prepared to manage default risks – the inability or unwillingness to pay debt service

The paper concludes with a review of innovative approaches to financing infrastructure. The recent economic downturn was a painful reminder that subnational governments cannot always rely on the availability of capital grants and borrowing to finance their infrastructure needs. One of the innovative avenues presented is the development of methods for capturing the increment in land value resulting from public investments. The basic notion is that public investments in infrastructure are immediately capitalized into surrounding land values. So the question is how subnational governments can benefit from the increase in land values. Different instruments have been used including Tax Increment Financing (TIF), Development Impact Fees, Certificates of Additional Construction Potential (CEPAC), Developer exactions, Acquisition and sale of excess land and different modalities of PPP including private investment in public infrastructure where developers build the infrastructure in exchange for public land.

All these techniques for land value capture offer opportunities for increasing local government revenues and abilities to finance infrastructure projects. But these alternative revenue sources cannot be seen as a long-term solution to the shortage problems for operating budgets, which need to rely heavily on the conventional revenue tools discussed in this paper.

The most desirable form of autonomy at the subnational level is to allow elected authorities to set the tax rates of the selected taxes. – Jorge Martinez-Vazques

Tourists travel on cable car in Malaysia. It is a gondola lift connecting Gohtong Jaya and Resorts World Genting. @Shutterstock

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2

URBAN GOVERNMENT REVENUES: POLITICAL ECONOMY CHALLENGES AND OPPORTUNITIES

THEMATIC PAPERS

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INTRODUCTION

Public sector decentralization – administrative, fiscal and political – has proven to be a challenging reform in many developing countries during the more than three decades it has been popular and widespread. Fiscal decentralization has been particularly disappointing considering how much consensus there has been on specific reform advice, with weak own source revenue generation being among the most problematic of fiscal concerns. Available empirical literature strongly indicates that subnational revenue generation, more often than not, falls short of needs and expectations. [33]

This may seem rather surprising. There is a well-developed set of public finance (fiscal federalism) principles for choosing and designing local revenues, and it is often used as the anchor for fiscal reform. Yet even where recommended principles have been (or seem to have been) followed, performance is usually mediocre or worse. This paper argues that this situation persists both because mainstream principles do not adequately consider certain key factors that influence revenue generation and because the principles are improperly used. Underlying both of these problems is a set of complex political economy considerations that rarely receive sufficient attention.

This paper focuses on neglected political economy challenges to local government revenue generation and their implications for pursuing more successful reforms. The relevant challenges are diverse, ranging from the incentives and behaviors of national level politicians and bureaucrats, who shape the rules of the intergovernmental fiscal game and how they are implemented, to the local-level political economy dynamics among elected local councilors, local government staff and citizens. These various interactions play out in a broader context that also contributes to shaping options for effective local revenue reform and decentralization in general. Insufficient understanding of – and attention to – these dynamics, can undermine reform design and implementation. Some independent remedial actions can be taken by urban governments, but others require national-level action or support. Even in the former case, local officials must be mindful of the interdependencies of the elements of the fiscal system; pursuing a state-of-the-art, revenue-specific reform without attention to other relevant factors is far from guaranteed to result in improved local revenue performance.

The next section provides an overview of the broader context of fiscal decentralization in developing countries. Four subsequent

[33] Selected references include Bahl & Linn (1992), Shah (1994 & 2004), Prud'homme (1995), Tanzi (1996), Ter-Minassian (1997), Bird & Vaillancourt (1998), Litvack, Ahmad & Bird (1998), Smoke (2001), Ahmad & Tanzi (2002), Ebel & Yilmaz (2003), Bardhan & Mookherjee (2006), Bahl & Bird (2008), United Cities and Local Governments (2010), Bird (2011), Bahl, Linn & Wetzel (2013), Smoke (2014).

sections respectively focus on key political economy dynamics: the national political arena, the national administrative arena, the local level, and the behavior of international development agencies (in aid dependent countries), all of which often constrain local revenue generation. This is followed by a section arguing that better appreciation of these factors could support crafting and executing viable reforms. The closing section provides summary comments on how to better incorporate political economy thinking into local revenue analysis.

RECOGNIZING THE ROLE OF FISCAL FEDERALISM AND THE BROADER CONTEXT

Although political economy is the focus here, it is important to acknowledge the importance of mainstream fiscal decentralization (public finance) principles and the broader context in shaping reforms. Basic principles, including those specific to revenue, are well known and relatively clear. There are, however, constraints on their effective application, and there are tradeoffs among principles that require prioritizing objectives (fiscal–local revenue principles are covered in the Martinez-Vazquez paper in this volume).

At least four different primary approaches to intergovernmental fiscal arrangements are possible, each of which has different implications for local government revenue autonomy: (a) empowering local governments to set up their own tax systems; (b) central retention of all taxes with proceeds shared with local governments through transfers; (c) assigning selected taxes exclusively to local governments; and (d) sharing revenue from specific centrally-collected sources with local government.[34] Many systems are in fact hybrids of these various approaches.

The choice of system in a given country depends on various factors, including the technical concerns embedded in fiscal federalism principles, historical paths, demographic, economic and geographic considerations, and political forces. Different countries may have different priority goals for decentralization (at least initially), such as nation building, economic development, or democratization – that make the use of a particular system more or less appropriate. The role of local governments in revenue generation will clearly depend on decisions about the overall system structure.

Within this larger context, the ability of local governments to successfully and sustainably use revenue powers depends on having an appropriate multi-dimensional constitutional–legal–administrative framework. The required framework, however, goes well beyond typical fiscal mandates, such as local government legal status, functions and autonomy. [35] The nature and enforcement of property rights, for example, affect the use of the property tax, and legal protections for local governance (elections and beyond) and civil society (such as the right to information, participatory mechanisms, or redress schemes) create an environment in which citizens are better able to hold local governments accountable and will be more likely to pay local taxes. [36] All of these considerations are, of course, deeply affected by prevailing political economy realities.

[34] See Tanzi (2010) for a fuller discussion of the various systems.

[35] Perspectives on the framework are provided in Shah (1994& 2004), Ahmad, Litvack & Bird (1998), Ebel &Yilmaz (2002), Roddenet et al. (2003), Ebel & Taliercio (2005), Smoke (2006 & 2007), Boex & Yilmaz (2010), Bird (2011), Martinez-Vazquez & Vaillancourt (2011), Bahl, Linn & Wetzel (2013).

[36] Yilmaz, Beris & Serrano-Berthet (2010) synthesize key local accountability requirements.

NATIONAL AND INTERGOVERNMENTAL POLITICAL ECONOMY FOUNDATIONS

As noted above, the revenue system available to local governments has both political and technical foundations. In policy circles, the role of politics is often loosely framed around whether there is sufficient political will for reform. [37] The term political will implies the consensus and commitment of a benevolent central government to empower local governments for the common good. In reality, the main motives for decentralization are usually complex and some may be rather less principled. [38] Moreover, even strong (or apparently strong) political will may not be sufficient. Many countries with strong constitutional and/or legal provisions for decentralization have not fully designed and implemented them.

The core paradox of decentralization is that it involves the voluntary sacrifice of power and resources by central government actors. This depends on their incentives to empower local governments faced by national legislators, political parties and government administrators. The motivations may in fact be unrelated or tangential to mainstream fiscal norms or official justifications. Politicians and political parties want to build coalitions and win elections. Decentralization – both general and revenue specific – may serve such purposes. In many cases, decentralization efforts in developing countries have occurred as a response to domestic crises that create demands and opportunities for major change. [39] In the heat of a crisis, it is hard to develop genuine consensus on the need for decentralization and the form it should take. Limited debate and weak consensus may imply a poor grasp of the true nature of decentralization, and the pressure to act can result in improperly designed frameworks, deficient attention to implementation, and apathy or opposition from key actors who may later decide that reform is not in their best interests.

In the process of developing reform, there can be clashes among groups in the national legislature (based on political affiliation, factional tensions within political parties, ethnicity, or regional allegiances), and these can compromise proper use of principles. On the other hand, national politicians may promote decentralization to consolidate power or gain support, and intergovernmental politics may also be in play. Local governments tend to be weak political actors, but if they or their associations are influential, as in some Latin American countries, they may capitalize on an emerging national crisis to press the central government to empower them. There are many examples of how these political dynamics shape both the extent of reform and its framing. Indonesia, for example, pursued a big bang decentralization to deal with a political crisis in the wake of the 1997 Asian financial crisis, the demise of the Suharto regime, and the secession of the former province of East Timor. In this case, the reform empowered cities and districts and initially marginalized formerly powerful (deconcentrated) provinces in the hope of averting further secession. Ethiopia also faced a secessionist crisis after it lost the former state of Eritrea, but reform consciously empowered ethnically-identified states to hold the country together, and did not deal with municipalities and other local jurisdictions until many years later.

Fiscal decentralization has been particularly disappointing considering how much consensus there has been on specific reform advice, with weak own source revenue generation being among the most problematic of fiscal concerns. – Paul Smoke

[37] For a more detailed discussion of this issue, see Smoke (2003).

[38] A synthetic review of much of the literature on decentralization incentives is provided in Eaton, Kaiser & Smoke (2011).

[39] A range of literature on the origins of decentralization in various countries is discussed in Eaton (2004), O'Neill (2005), Smoke, Gomez & Peterson (2006), Eaton, Kaiser & Smoke (2011), and Faguet (2014).

Another interesting contrast is a comparison of two federal systems, India and Brazil, where states are the primary subnational governments and have some jurisdiction over local governments. India amended its constitution to push states to empower local governments, but this process stalled in many states and many urban governments can do little without state approval. In contrast, Brazil's federal government has stronger direct relations with municipalities, reducing the role of states in constraining local government. There are many other examples demonstrating that national–intergovernmental political economy factors can profoundly impact local empowerment, including revenue access. A final critical point regarding national–intergovernmental political economy dynamics is that these can shift rapidly and consequentially. If a crisis suddenly emerges or abates, even in a country with limited political competition, incentives for the regime to support or undermine decentralization may change. Reversals can also occur in more politically-competitive environments, in which the opposition makes the empowerment (or disempowerment) of local governments a central issue in an important national election.

THE INFLUENCE OF NATIONAL AGENCIES AND THE BUREAUCRATIC ENVIRONMENT

Although decisions about the basic parameters of a decentralized system usually rest with national politicians, most responsibility for detailed design and management of the implementation rests with government agencies. These, however, rarely have harmonious perspectives on local governments and therefore may not agree on the system and what their individual role in it should be, even if there appears to be a broad national consensus for reform. Moreover, it is rare that the diverse set of national bureaucratic actors with different roles and perspectives is well coordinated. [40]

A multiplicity of diverse central agencies often has a role in shaping, implementing and supervising decentralization. These may include dedicated local government oversight ministries (such as the local government, home affairs, and interior), which are tasked with supporting local governments but may also have other explicit or unstated goals; cross-cutting agencies with a national mandate to manage some aspect of operations (including finance, planning, and civil service), who may see empowered local governments as a threat to their mandates, for example a finance ministry may feel that strong local governments threaten their ability to maintain macroeconomic stabilization and fiscal responsibility; and sectoral ministries (such as agriculture, health, and transport) who are likely to be more concerned with service delivery than with empowering local governments.

In the absence of a robust and empowered decentralization coordination mechanism or strong incentives for individual agencies to work together, there is a danger that these various actors will act inconsistently (whether or not they support decentralization), and this can occur in terms of overall policy or how they deal with individual local governments. The situation can be even worse if key agencies are overt rivals and engage in competition over the control of the local government agenda.

The core paradox of decentralization is that it involves the voluntary sacrifice of power and resources by central government actors. – Paul Smoke

[40] Various aspects of the bureaucratic dynamics surrounding decentralization are elaborated in Smoke & Lewis (1996), Tendler (1997), Litvack, Ahmad & Bird (1998), Cohen & Peterson (1999), Smoke (2007), and Eaton, Kaiser & Smoke (2011).

The situation might seem less problematic with respect to revenue, since oversight of fiscal matters is likely under the ministry of finance and/or local government. While this could be largely true, other factors come into play. Some local revenues, such as user charges or commercial licenses, may be influenced or controlled by another ministry (for example, water tariffs by a ministry of water or trade licenses by a ministry of commerce). In addition, if roles of specific ministries are poorly specified and/or coordinated, problems can arise; for example, Cambodia, Indonesia and Uganda have all experienced situations in which local government fiscal regulations were issued both by the ministry of finance and by the agency with primary responsibility for local governments. [41]

Other central agencies can also play a critical role in fiscal decentralization. There are many examples: the ministry of planning manages development budgets while the ministry of finance manages recurrent budgets; civil service commissions heavily regulate local government employment; sectoral ministries control service standards and funds for resources under their mandate; special districts, parastatals or contracted private actors control or heavily manage the delivery of and revenue generation associated with specific services, and so on.

A consequential manifestation of fragmented bureaucratic environments is weak attention to links between decentralization and other public sector reforms (such as financial management, civil service, or sectoral). [42] There are many instances, for example, of such reforms (managed by different ministries and agencies) that – intentionally or inadvertently – undermine the formal legal role of local governments. Community-driven development and other efforts to strengthen civil society, while not strictly public sector reforms, are crucial for developing local governance, and how they are framed can affect the degree to which decentralization reforms can meet their objectives. Not all of these examples of central agency roles in local activities directly affect revenue generation, but they can compromise local governments' autonomy, weaken accountability links with their constituents, and undermine their incentives and ability to collect local revenues.

It is important to emphasize that the potential problems do not suggest that central government agencies have no role to play in regulating local governments. Even in the most advanced decentralized countries, the importance of such measures – including national standards for public finance management, service delivery, revenue generation, reporting and monitoring mechanisms – is well recognized. When based on solid principles and well designed, these are legitimate in a well-designed intergovernmental system. Problems arise when oversight provisions are arbitrary, unduly limit local autonomy, or are poorly coordinated and create inconsistencies. For example, if certain functions are devolved but regulations from different central agencies that govern user fees or staff compensation do not support their sustainable delivery, the system will fail. Similarly, if a revenue base is formally devolved but there are onerous regulations and arbitrary central interference, revenue productivity will likely be limited.

In some cases, there is even weak intra-agency coordination. Different departments within a ministry may have responsibilities for different functions and can compete to control policy agendas and funding. Within a ministry of finance, various aspects of fiscal reform – budget, local revenues, transfers and lending – may fall under different semi-autonomous departments, resulting in policy incoherence. Directorates in the Indonesian Ministry of Finance, for example, were long a key factor in obstructing property tax decentralization (which occurred in 2009) and borrowing reform, both recommended by the directorate in charge of local finance. [43] There are many instances of poorly coordinated elements of the subnational fiscal system – intergovernmental transfers that create disincentives for local revenue generation and/or borrowing – that fall under the same agency and have been very challenging to overcome.

[41] Smoke (2008) provides these examples with more information and references.

[42] The political economy of decentralization in the context of broader public sector reform is discussed in Eaton, Kaiser & Smoke (2011). Decentralization in the context of civil service and public financial management reform is respectively considered in Green (2005) and Fedelino & Smoke (2013).

[43] Smoke (2008) and Smoke & Sugana (2012) discuss this case.

THE POLITICAL ECONOMY OF DEVELOPMENT ASSISTANCE

The role of international development agencies as partners of government bureaucracies in supporting fiscal decentralization and other public sector reforms should not be underestimated, especially in aid-dependent countries. [44] Although they have modified their behavior over time, many donors have long supported primarily technical approaches to decentralization, often through parallel mechanisms that were not politically and institutionally sustainable. There was also long a (now reduced) propensity to draw on experiences of other, sometimes dissimilar countries, thus recommending reforms that were inappropriate or difficult for some countries to implement successfully.

Perhaps most importantly, international development agencies compete with each other and even internally across departments of large agencies. Such dynamics may reinforce rivalries among government agencies outlined above, for example with one donor supporting an agency promoting decentralization and another donor supporting a different agency promoting a reform – be it financial, management, civil service, or sector specific – that undermines the autonomy of local governments, and in the context of this paper, weakens incentives for local revenue generation. In some cases, donors even help develop different revenue administration systems for different local governments in the same country. In aid-dependent countries, such donor behavior can contribute to the development of internally inconsistent local government policies and systems. [45]

In short, challenging relationships among national agencies, across elements of public sector reforms and among donor programmes result from institutional weaknesses, capacity limitations and poor coordination, but they are often rooted in the types of country political economy considerations noted above – the incentives of various (often unevenly empowered) actors to pursue different and perhaps incompatible objectives. This includes donors, who face specific incentives that shape their individual behavior, their interactions with each other, and how they work with country counterparts.

THE CRUCIAL ROLE OF SUBNATIONAL POLITICAL ECONOMY DYNAMICS

Even if national policies, systems and procedures are consistent with key fiscal decentralization principles and even under national political and bureaucratic conditions that are conducive to local government empowerment, decentralization (both in general and local-revenue specific) can face daunting local political challenges. A well-conceived framework that meets normative principles is ultimately necessary for the development of a viable system that balances an appropriate upward accountability and mechanisms to promote robust downward accountability, but it is not the only relevant factor.

Mainstream theories of fiscal and political decentralization (explicitly and implicitly) assume that local officials face incentives, through elections and other means, and have the capacity to respond to their constituents, who are also assumed to have the knowledge, capacity and motivation to hold their

[44] Donor support to decentralization is discussed in Smoke (2001), Romeo (2003), Fritzen (2007), Development Partner Working Group on Decentralization (2011), and Smoke & Winters (2011).

[45] Examples are given in Blair (2000), Fjeldstad (2006), Connerley, Eaton & Smoke (2010), Eaton, Kaiser & Smoke (2011) and Development Partner Working Group on Decentralization (2011).

elected local governments accountable. It is well known that some of these core assumptions are unevenly met in developing countries. [46] Some constraints are specific to local revenue, but the general nature of local political dynamics also affects how well local governments will raise and use resources.

Unfortunately, the relevant issues are complex and difficult to assess fully and definitively. Available empirical evidence is relatively limited, contradictory, and often challenging to interpret in policy-relevant terms. It is nonetheless important to review key features of political decentralization that can influence local revenue behavior, including the role of electoral, non-electoral and other accountability mechanisms in promoting local fiscal performance. It is also important to keep in mind that the behavior of other actors that shape the local institutional landscape can also have an impact.

The role and limitations of local elections

Fair and competitive elections are framed as a foundation of decentralized governance, and they can raise the credibility of local governments and increase civic engagement, including citizen readiness to contribute to the public purse. [47] The number of countries holding local elections is on the rise, which seems to be a positive sign.

At the same time, a number of caveats are in order. First, several factors can limit the quality and meaning of elections: councils may be only partly elected, elections may be based on closed party lists that limit voter choice, or one political party may dominate. Some of these can result from national rules and the national and intergovernmental dynamics discussed above, while others result from local decisions. While it is not possible to detail the nature and quality of local electoral systems here, it is important to note that they do affect local accountability relationships.

Second, cultural traditions, ethnic identification, and political party loyalties, among others, can heavily influence how elections work and the results they yield. This in turn can lead to the significant politicization of local government behavior, including revenue generation, such that patronage, clientelism, corruption and non-democratic behavior play too dominant a role and undermine downward accountability.

Third, electoral accountability is not necessarily favorable to local revenue collection. Recent work on Mexico found that changes in one state's electoral rules for local governments that were intended to improve accountability did lead to broader service provision (some through clientelistic practices), but it also, except in larger urban areas, reduced revenue collection. [48] Other work in Italy discovered that less competent (qualified or experienced) mayors were more easily re-elected if they favored less visible taxes (personal income tax surcharges) rather than more visible ones (property taxes). [49] The former type of taxes, however, decreases transparency and compromises the local revenue–expenditure linkage. And some work in France showed decreases in local tax rates as party majorities increase in departmental assemblies.[50] Of course, lower taxes may be what the voters wanted, but this begs the question of how local services are funded and whether citizens feel sufficient responsibility for contributing towards the costs of providing them.

Fourth, even if elections in principle establish good downward accountability, other types of accountability relationships can offset this. This includes not only inappropriate upward accountability – the types of undue or capricious instances of higher-level interference discussed above – but also horizontal accountability, between elected local officials and staff who administer revenue and service delivery. There is a common problem, whether de jure or de facto, with a lack of clarity in

[46] Examples of relevant literature (positive and negative) include: Tendler (1997), Manor (1998), Schneider (1999), Blair (2000), Olowu (2003), Wunsch & Olowu (2003), Taliercio (2004), Ribot & Larson (2005), Bardhan & Mookerjee (2006), Shah (2006), Cheema & Rondinelli (2007), Connerley, Altunbas & Thornton (2010), Eaton & Smoke (2010), Martinez-Vazquez & Vaillancourt (2011), Faguet 2014.

[47] A useful review of the literature and perspectives on local elections is found in Bland (2010).

[48] Gomez-Alvarez (2012) reviews this experience in the state of Nayarit.

[49] See Bordignon & Piazza (2010)

[50] See Dubois, Leprince & Paty (2007)

the division of responsibilities between elected and appointed local officials. Elected councilors should be setting broad expenditure and revenue policies for functions under their control and overseeing managerial and technical staff that advise them and execute these functions. Often, however, especially in newly decentralizing countries, staff transferred from central to local governments maintain strong upward accountability relationships. This can weaken the ability of local councils to be responsive to their constituents, which in turn can leave citizens dissatisfied and unwilling to pay local revenues. Of course, councilors could interfere too much in technical functions if they have too much control over staff, for example intervening in revenue collection responsibilities for political reasons.

In short, the effects of local elections on decentralization and local revenue behavior are not entirely straightforward. Much depends on the various contextual factors discussed above and the specific rules and processes governing electoral and fiscal systems, which result from both central and subnational constitutions and laws and the traditions and politics underlying them. Local elections are important, but no presumption should be made that adopting best practice fiscal decentralization reforms will result in the normative benefits attributed to them if local political processes do not provide an adequate environment for this to occur.

Non-electoral accountability mechanisms

Even where the local accountability challenges noted above are not very consequential and local political competition is robust, local elections are widely seen to be a rudimentary means for improving downward accountability, especially in developing environments. There has been an increasing trend in recent years to develop (or to adapt in the context of local democratization) other accountability mechanisms, such as: participatory planning and budgeting, recalls, town meetings, referenda, general or service-specific oversight boards, or user committees and social auditing of local resource use. Such mechanisms can foster better public knowledge of how revenues are defined and levied and how proceeds are used. More robust elections supplemented with appropriate and sufficiently inclusive participation mechanisms should be expected to increase civic engagement and help to deliver better local services. This in turn can enhance citizen trust in local governments, develop local social capital and improve the acceptance and use of local revenue generation powers. [51]

Although non-electoral mechanisms can be important, three caveats bear emphasis. First, citizen engagement processes can be rather mechanical. Participatory budgeting, for example, emerged organically in a specific political context in one city in Brazil. Although not for lack of trying, it can prove difficult to transplant to other environments, which requires more than producing a step-by-step manual that meets normative guidelines, and mandating its use. If participation is perfunctory or non-inclusive and the results of the process constitute optional advice to local governments rather than influential inputs, the mechanism is not likely to achieve its intended goals.

Second, non-electoral accountability mechanisms can be just as vulnerable to political forces as local elections are. If such processes are captured by political parties, business leaders or powerful but narrowly representative civic groups or NGOs, they will not transcend local politics as usual. Even genuine attempts to improve inclusivity, such as mandating minimum representation of neglected groups (such as women or ethnic minorities) in formal processes, need not be immediately meaningful in broadening citizen voice or affecting the ways local public resources are raised and spent.

Third, effective adoption of accountability mechanisms requires that citizens want to use them and actually do so. Mechanisms for providing inputs or comments on local plans and budgets may be available, but a sufficiently broad range of people must be aware of this. Furthermore, citizens may not know how to use these mechanisms, and they may not feel empowered to do so or free to express their views. In terms of local revenue-specific

[51] Issues related to the role of participatory governance are discussed in various ways in de Mello (2002), Blair (2006), Commins (2006), Platteau (2006), Manor (2007), Wampler (2007), Boulding & Wampler (2010), Brinkerhoff & Azfar (2010).

arrangements, mechanisms to appeal property tax assessments or local business license fees, for example, will not be effective if people are unaware of them or face barriers in using them, such as the lack of appropriate knowledge, poor access to advice, or even outright intimidation from local governments.

The wider local accountability landscape

As if the untidy context of local institutions and local political dynamics were not a sufficient challenge, developing countries often experience a much wider array of accountability relationships that affect local government behavior and performance. Local governments are in fact rarely the only actors involved in local service delivery and revenue generation. They may exist alongside deconcentrated levels of administration, and both may have agencies dealing with the same services in the same territorial areas. If their respective roles are not well defined and honored, and if the deconcentrated entities have superior funding that they use for services that are local functions by law, local governments can face a serious accountability challenge.

In a number of countries, central governments have created constituency development funds, which award to members of parliament discretionary funds to deliver services in their constituencies, in practice often including services that are local government functions. Community-driven development programmes, which provide funds for service delivery from a national agency (often with donor funding) primarily to nongovernmental local entities, may compete with nascent local governments. In some countries, nongovernmental service providers also play a major role (independently from subnational governments) in delivery of basic services.

In metropolitan areas, multiple types of governance mechanisms are used to manage a range of functions across wider areas, ranging from unified metropolitan administration (such as in Cape Town) to various mechanisms intended to coordinate public functions across proximate jurisdictions (such as in the Manila Metropolitan Development Authority). The latter types of mechanisms may be mandatory (imposed by the central government) or voluntary (formed at the discretion of local governments), and they may be general-purpose or limited to one or more specific functions. In either case, political dynamics and embedded incentives affect how they are structured and condition how they operate and perform. Such inter-jurisdictional institutions have great significance for local governance, to how services are provided, and how revenues are raised and shared. (The Slack paper in this volume provides more detail on metropolitan governance).

The main point here is that if there are multiple lines of accountability and funding channels for service delivery with insufficient clarity on responsibilities and many actors potentially involved in providing the same services, citizens are likely to be perplexed about exactly what to expect from elected local governments. If this is the case and they are not sure exactly what services their local government provides to them, it seems highly likely that they would be reluctant to pay local revenues.

Subnational politics, accountability and revenue generation

Ultimately, the extent to which local governments use their allowable revenue powers and the way in which they use it depend on the sources and distribution of local political power. This can be vested in some combination of economic elites, ethnic or religious groups, certain political parties, labour unions, and civil society groups or coalitions, among others. The mix of power shapes incentives faced by local politicians. Local governments may, for example, tax businesses more or less heavily than households, or various activities and sectors differentially, thus potentially creating behavioral distortions and visible inequities. Therefore, under some political conditions, the strong revenue autonomy so valued in fiscal decentralization theory may in practice allow elite capture, exploitation of certain local entities or individuals and/or capricious or politicized revenue enforcement.

Political power is, of course, not the only factor that matters. The nature of local revenue sources and the clarity and quality of accountability mechanisms can also be important. Some revenue sources are simply unpopular, difficult to administer and/or perceived as unjustified or unfair. And if the responsibilities of local governments are unclear and there is competition for service delivery space from other actors as illustrated above, citizens may not feel fairly treated (in terms of benefits received for revenues expended and relative to other local residents), and, therefore, they will be less inclined to comply with demands for them to make local revenue payments.

A number of prominent local revenue sources are particularly complex for local politicians to deal with. The property tax, for example, is often recommended as one of the potentially most suitable and productive (if administratively demanding) local government taxes. Yet it is very noticeable to those who pay it directly, and it can be onerous because it is often made in a few large payments, as opposed, for example, to a consumption tax that is spread out over many small transactions. The concentration of land ownership and division between the rich elite and poor or disadvantaged (in terms of status, physical location and living conditions) in developing countries also politicizes and confounds effective implementation of this tax. Influential businesses and citizens may have sufficient political power to limit their property tax burden. In addition, obvious inconsistencies and inequities in tax administration and ambiguity regarding how tax proceeds are used can create opposition to compliance and substantially undercut the credibility of local governments in the eyes of their constituents.

Building on this latter point, citizen compliance is obviously critical for effective local revenue generation. Available evidence, while admittedly limited, suggests that compliance can improve or decline under decentralization. The effect seems to depend on economic conditions, citizen attitudes to local governments, and variations in local political dynamics, including their willingness and ability to enforce the tax code.

On the positive side, the city of Porto Alegre (Brazil), which is internationally recognized for pioneering participatory budgeting, substantially improved tax compliance through local participatory mechanisms. [52] Revenue yields increased substantially during a period of national fiscal reform that included major increases in intergovernmental transfers, which might have been expected to dampen local revenue efforts. Brazil, of course, is a middle-income country with stronger political, administrative and civil society institutions than many developing countries, and the above-noted caution about transplanting reforms should be kept in mind. Yet the experience there with successful initiatives can at least provide some inspiration for other countries seeking reform.

On a more negative note, tax compliance in Senegal generally decreased after collection was devolved to local government councils. This result is reportedly due to widespread perceptions of inadequate service provision and the generally weak level of trust in local government institutions. [53] The strongest compliance occurred for reasons other than the conventional social contract (contributions to help finance local services received) – among foreigners and others who recently moved into the community. These individuals strategically used tax payments to validate their claim to be legal residents.

Local government tax compliance in other countries for which information is available shows more mixed performance but raises important points about citizen willingness to pay. In Tanzania, tax compliance was found to improve when individuals could afford to pay and perceived a threat of sanction. The factors that weakened compliance were perceptions of punitive/unfair enforcement and dissatisfaction with local services. [54] Successful enforcement is associated with local government capacity and whether revenue collection could be insulated from interference by local councilors. Evidence from South Africa and Uganda also suggests that perceptions of poor local service delivery and/or unfair tax treatment undermine tax compliance, but indicates that citizens would be willing to pay local taxes if the local government did more for them. [55]

52 Schneider & Baquero (2006) review the literature and examine the Porto Alegre experience.

53 The nature of the system and details of the research are explained in Juul (2006).

54 Fjeldstad & Semboja (2001) and Fjeldstad (2001) elaborate on the research and the results.

55 See Fjeldstad (2004 & 2005) and Kjaer (2004 & 2005).

One other limited but tantalizing piece of evidence underscores why more focus on own revenues seems worthwhile. A study of local budgets in some East African countries found that as the share of local budgets financed from local revenues increased, the share of expenditures on service delivery also rose.[56]

In contrast, greater dependence on intergovernmental transfers and development aid was associated with a higher budget share for administrative costs and employee benefits. More work is obviously needed, but this finding tentatively seems to support the notion that when citizens contribute more to local governments, local officials are more responsive to their needs.

There is not enough empirical evidence to draw definitive conclusions, but there are some clear indications both that citizens are willing to pay local government revenues if they perceive that they are being treated fairly and receiving some benefit from local government expenditure, and that local government efforts to enforce tax compliance do not go unnoticed by their constituents and can be productive if they are reasonably structured and seen as impartially administered. More generally, the evidence reinforces the potential political and fiscal value of better informing and engaging citizens regarding the generation and use of local government revenues.

Voters gather at the polling booths during the municipal elections, in Cape Town, South Africa. @Shutterstock

IMPLEMENTING POLITICALLY-GROUNDED AND PRAGMATIC LOCAL REVENUE REFORMS

The preceding material highlights the challenges of trying to make fiscal decentralization – both in general and for revenue generation – work successfully. Central to these challenges is the often unbalanced focus on designing systems that meet normative goals and the comparatively modest attention given to embedded political and institutional constraints that affect how they are implemented. An effective system requires good design, and, as noted above, political economy factors shape that design. But it also requires a pragmatic strategy to implement the system in a way that is sensitive to political economy realities and other constraints, such as weak capacity. In recent years there has been more interest in implementing and sequencing reform. [57] Most of this work is not specific to local revenue, but it has considerable relevance to it.

Equally important, local revenue reform strategies need to be placed in the larger context outlined above. Improving local revenue powers, if their functional responsibilities are unclear and channels of accountability are questionable, may do more harm than good. Similarly, local government steps to improve tax administration and enforcement in the absence of tangible citizen willingness to pay may be pointless.

To consider a concrete example, every local government would like to be able to tax a high value base, such as property or local economic activity. Even if such a tax is devolved (or an existing tax is enhanced) and reforms are well designed, the tax may not be productive without sufficient care as to how it is implemented in technical and political terms. The central government must be willing to devolve or correct weaknesses with the tax and develop workable procedures for operating it. Subnational governments need to face incentives – from the central government and from their constituents – to adopt the new or reformed taxes and develop the capacity to use them fairly and effectively. Citizens and businesses must learn to pay new taxes, which they will resist doing unless they broadly perceive that subnational governments are being responsive and treating them fairly.

The role of international development agencies as partners of government bureaucracies in supporting fiscal decentralization and other public sector reforms should not be underestimated, especially in aid-dependent countries. – Paul Smoke

These are very politically and institutionally significant changes that will not come about rapidly or without effort in many developing countries. If too much happens too quickly without steps to influence attitudes and incentives and build capacity, the reform will be unlikely to succeed, perhaps giving political ammunition to national actors who favor centralization. For example if reform increases tax burdens without providing benefits, compliance and trust in local governments are likely to suffer. If the reform is too slow and produces limited revenues or visible improvements in local services, local governments and their constituents will become frustrated and lose interest.

The central government perspective

The political economy factors outlined above tend to push central governments to take one of two approaches to reform. [58] The fiscal framework approach involves developing comprehensive intergovernmental rules and systems based on normative principles applied to a given country. The core assumption is that if proper incentives are embedded in the framework, actors at all levels will adopt its provisions and develop any needed capacity. This approach follows traditional technical advice and is also consistent with pressure to move quickly felt by countries in crisis. In some cases there may be an unstated assumption that many local governments lack capacity to use the system, so that the political goals of declaring reform

[56] See Hoffman & Gibson (2006).

[57] Implementation is treated to varying degrees in Smoke & Lewis (1996), Litvack, Ahmad & Bird (1998), Falleti (2005), Smoke (2006, 2007, 2010, 2014), Bahl & Martinez-Vazquez (2006), Ebel & Weist (2006), Shah & Thompson (2004), Bahl & Bird (2008), and Martinez-Vazquez & Vaillancort (2011).

[58] See, for example Bahl & Smoke (2003) and Smoke (2007 & 2010).

can be met without major implementation, limiting perceived threats to the power of national actors. This pure framework approach is rarely ideal for developing countries since conditions required for it to work are not in place.

A diametrically opposed approach is one in which major reform is mandated, but subject to a heavily managed process for implementing the reforms gradually over time (as per decisions of the centre, based on clear rules or not). This managed approach involves a more active and sustained role for central government in overseeing reform, and it also allows formal adoption of reform without allowing it to rapidly rock the status quo. Because the approach is likely to treat capable local governments too conservatively, it will hinder their ability and incentives to raise local revenues and provide public services. And unless there are explicit provisions to build the capacity of weaker local governments, they may never meet the conditions required for empowerment.

If reform is genuinely desired, there is potential value to a more consciously strategic approach in between these two extremes. This would frame devolution as an intergovernmental process and recognize key political and institutional constraints. It might involve, for example, consultative mechanisms among actors at all levels to define reform processes and steps; asymmetric treatment to recognize the diverse characteristics and capacities of local governments; partially negotiated trajectories such that local governments take responsibility for adopting certain reforms over a specific time frame instead of being told what to do; and performance-based processes that create incentives for pursuing reform. As steps succeed, more advanced reforms can be undertaken.

This type of implementation strategy also faces hazards. Assessments and negotiations could become politicized, and reforms might stall. But these are general concerns with reform, and well-crafted processes and accountability mechanisms could alleviate risks. The specific situation will also differ among countries. Some countries already have a local revenue system that needs reform, while others are transferring existing revenues to local governments or creating new sources for them. Such differences in the nature of the system – along with the political and institutional factors outlined above – should ideally be used to shape the strategy for a given country.

The local government perspective

Local governments should and do approach implementation from a different perspective than the centre. Even the most capable local governments must be strategic in adopting revenue reforms that require major increases in what residents pay and non-trivial behavioral changes. In order not to shock the system (by overwhelming local government capacity and citizen tolerance), modest and less politically contentious steps could be undertaken before complicated or controversial ones, and the social contract can be invoked by trying to link revenue increases to specific and visible service enhancements. [59]

For example, if a local government intends to move from low, ad hoc property valuation to standardized full market valuation, assessment ratios could be phased in, and tied to announced improvements in service delivery. Similarly, new or increased user charges for particular services could advance incrementally towards full cost recovery in order to avoid potential undesirable distortions in service use, severe equity effects, or administrative and political opposition. New systems and procedures could also be tested through well-publicized pilot initiatives, allowing for visibility, debate and well-justified modifications before mainstreaming the revenue reform in question.

Another element of a local government strategy would be the use of institutional innovations to improve public knowledge and citizen engagement. Adopting or tailoring citizen engagement and oversight mechanisms can facilitate acceptance of revenue reforms, and public education and information (media and technology based) may improve citizen understanding and compliance. Targeted consultation with beneficiary groups

[59] Some discussion of these approaches and examples are provided in Kelly (2003), Fjeldstad (2006), and Smoke (2008 & 2011).

can facilitate acceptance of revenue reforms. Examples include negotiations with a business association to increase property taxes in return for better roads in industrial areas; discussions on raising market fees with market vendor associations in return for longer hours and improved sanitation; or public hearings on raising water fees to finance more reliable water service. Not every revenue increase can or should be negotiated, but such interactions with affected parties can create a basis for enhancing revenue and citizen trust by linking increases in taxes and fees to specific service improvements.

Other mechanisms can also help. User committees for specific services have been used to connect citizens to subnational service delivery and to lay the foundation for associated revenue generation, although such bodies can also be used to bypass weak governments and constrain their ability to assume their legal functions. [60] There are also opportunities to work with community-based groups on service delivery and revenue generation for certain services, such as trash collection in urban areas and maintenance of minor irrigation canals in rural areas. These can help to improve revenue generation and provide service improvements that benefit local governments, the partner community groups and local residents more generally. In short, small, well-conceived measures can start to change how local governments function as well as how their constituents perceive them.

The overarching point is not that any of these approaches or examples are universally applicable, but strategies for local revenue enhancement that embrace their spirit are likely to have some relevance in a broad range of contexts, and other approaches could also be devised. All of these examples clearly have technical dimensions, but they are also sensitive to political realities. Equally important, such approaches can be used to some extent independently by local governments, even where national constraints preclude extensive central government policy reforms to strengthen local revenue generation.

CONCLUDING COMMENTS: A POLITICAL ECONOMY LENS ON LOCAL REVENUE REFORM

Although the situation has improved in some countries during the long wave of public sector decentralization that emerged in the 1980s, local governments in developing countries – whether in the larger or smaller urban areas, respectively covered by the Slack and Fox chapters in this volume – often do not have adequate autonomous fiscal powers to meet basic responsibilities, much less to be influential drivers of development in their jurisdictions and beyond. Revenue powers tend to be particularly constrained. Even if more robust empowerment frameworks have been adopted, they may not be implemented according to the provisions of enabling constitutions and laws. In general, revenue yields commonly disappoint expectations. The situation is often somewhat better in large urban areas, but there is almost invariably considerable room for improvement.

This paper has focused broadly on the political economy factors underlying the unsatisfactory state of local revenue generation, and considered general paths to improved performance that take these factors into account. Yet it is critical to underscore the fact that local revenue generation does not exist in a vacuum; it is related to other aspects of the local public sector – fiscal and administrative – also subject to political economy dynamics. Moreover, local governments are the analytical focal point and are embedded in consequential political economy forces specific to them, but some factors that facilitate or inhibit their ability to generate revenue are rooted in the higher level governments and citizens from whom they derive their power and credibility. What matters for realizing improved revenue generation is how the intergovernmental fiscal structures, local governance mechanisms, and political connectivity to local taxpayers work together.

[60] See the discussion and examples in Manor (2004).

This means that solving a limited revenue problem or focusing only on associated local level challenges may not result in improved performance. For example, a reform effort that narrowly targets improved revenue collection mechanisms may not solve key issues, such as dependence on a nonresponsive higher level agency for an important function (such as land titles or property assessment); national level political protection of government or parastatal agencies that constitute a large share of the local tax base; selective interference by local politicians in revenue collection; or reluctance of citizens to pay local taxes because they do not feel they are receiving adequate services or simply mistrust local governments. Thus, a more holistic and flexible mindset and approach are necessary to diagnose local revenue problems and consider options for remedying them.

Given the considerable diversity of developing countries and the local governments within many of them, as well as the paucity of good evidence, it is difficult to conclude a paper on this topic with satisfactory policy generalizations. At the same time a number of broadly relevant points can be raised.

First, the foundational step required for reform is to document the nature and extent of the local revenue deficiency to be addressed in a well-grounded way. Is the revenue source under consideration considered appropriate for local governments? Is it administered in conformance with relevant laws and regulations? Is there a sense of potential yield compared to actual yield? Are there socioeconomic factors – weak economic base, high informal employment, or extensive poverty – that limit local revenue productivity? Are there administrative considerations (such as inadequate staffing or operating resources, lack of necessary equipment, data constraints, and capacity limitations), that hinder effective management and collection of the revenue?

Second, what are the relevant political economy dimensions of the revenue problem(s) identified, those that contribute to its existence or affect prospects for its resolution? Is there any interference or inaction on the part of the central government, such as limits on the revenue source that unduly constrain its yield, or failure of a central agency to approve base or rate modifications? Are there other governmental or quasi-governmental authorities – including intermediate tiers of government, metropolitan planning commissions, and service delivery boards – that influence or interfere in local revenue administration? At the local level, are certain local actors (especially potentially high value groups or individuals) protected from taxation? Are local politicians artificially restricting use of the revenue or manipulating its collection for political gain?

Third, are there other aspects of the local fiscal system that require attention before the revenue problem can be addressed or in conjunction with it? Are services financed by the revenue being provided at sufficient levels of coverage, quality and reliability? Is there any imbalance in local revenue coverage, such that some taxpayers feel taken advantage of and others are getting a free ride? Are incentives for local government collection of own revenues weakened by generous intergovernmental transfers that fail to account for local revenue generation effort in how they are allocated?

Fourth, are there identifiable ways in which local accountability relationships contribute to weak performance of the local revenue system? Are citizens clear about what local governments do and how the taxes and fees they pay are used? Are citizens satisfied or dissatisfied with local governments in general or with specific services in particular, potentially affecting their willingness to pay local taxes and charges? Are

. . . a more holistic and flexible mindset and approach are necessary to diagnose local revenue problems and consider options for remedying them. – Paul Smoke

there adequate channels for people to communicate with local governments? Do people have access to the information they need to evaluate local government performance? Can citizens register complaints about service delivery and revenue liabilities to their local government and get them addressed?

Fifth, if a local government can concretely identify the nature and source of weak revenue performance, what kinds of options for dealing with the problems might be considered? What steps can be taken locally by local governments, and which need to involve requests and negotiations with other levels of government or other types of actors? Are the local options general in coverage or do they need to deal with particular agencies or groups of constituents? Is there a way to link revenue reforms more clearly to concrete improvements in service delivery? Are there opportunities to partner with other actors (governments at the same or a different level, business associations, community groups) in demonstrating the need for revenue enhancement or engaging in the revenue administration process itself? Various examples of such approaches were provided above, but many more could be feasible in almost any context.

Sixth, what is the probability that certain potentially desirable courses of action will be successful? It is often relatively easy to identify problems and measures that would improve revenue collection, but sometimes the political economy obstacles to undertaking them are formidable. Thus, it is important to understand which actors will support and which will oppose changes in local revenue systems, and what can be done to bring reluctant actors on board. It is also essential to be strategic in selecting the necessary steps to increase the probability of successful initiatives. Even small, politically feasible initial steps that begin to improve revenue generation can transform the attitudes of various involved actors and lay a foundation for more consequential reform.

The relevance of many of these issues and questions, of course, may vary greatly across countries, local governments within countries, and even with respect to individual local revenues. The points raised are also selective; there may be many others that need to be considered to understand the nature of problems and opportunities and what types of concrete actions can be taken to deal with problems and capitalize on opportunities. Specific recommendations for reform will depend not only on the facts of the system, but how its elements fit together and any relevant constraints that are identified.

A few additional points are worth noting in closing. First, not all efforts to improve local revenue reform need to originate with higher-level or local governments. Civil society actors can productively put pressure on officials to change their behavior if they want more from their local governments and are willing to contribute so as to realize the desired improvements. This can be accomplished through more robust use of electoral and participatory mechanisms, collective action taken by business associations, adoption of civil society driven citizen report cards, and other measures. Such actions can improve local governance connections and enhance the overall climate for local revenue generation.

Second, there has been insufficient focus on understanding how some local governments have been able to mobilize revenue more successfully than others, even when facing similar constraints. There is some best practice literature, but much of it focuses on the role of particular strong agencies or individuals who aggressively pushed reform. Rarely is there much detailed analysis of the specific actions these leading actors took, how they were able to take steps that their peers have found difficult or impossible, and whether the successful practices are appropriate for use in other local governments that may face similar local revenue weaknesses but different contextual conditions.

Third, capacity building needs must be incorporated appropriately into efforts to improve local revenue generation. Even if political economy conditions are right, local governments might not have the right human resources and skills to make local revenue reforms work. Local government capacity building has been dominantly supply driven, classroom style training of short duration. For local revenue reforms to work, capacity building ideally needs to be tied to the specific tasks at hand, with sufficient on the ground follow-up to institutionalize needed skills and desired behaviors.

Although universal recommendations are elusive beyond a high level of generality, there is enough known about local revenue generation to be able to move forward with reforms in most environments. One fact is clear: there is a great need for incorporating political economy analysis into the reform process. At the same time, there is a great deal that we do not know, and much more can be done to understand relevant national and subnational political and bureaucratic dynamics and to consider their implications for pragmatic, strategic and productive local revenue reform.

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3

INNOVATIVE GOVERNANCE APPROACHES IN METROPOLITAN AREAS OF DEVELOPING COUNTRIES

THEMATIC PAPERS

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INTRODUCTION

The urban population, which is now about 50 per cent of the world's population, is estimated to rise to 67 per cent in 2050 (United Nations, 2012). The number of mega-cities (those with more than 10 million people) is also on the rise. Whereas in 1970, there were only two mega-cities (New York and Tokyo), in 2011 there were 23 mega-cities, and their number is projected to increase to 37 by 2025. Most of these mega-cities will be in less developed regions. By 2025, the number of large cities (those with a population between 5 and 10 million) will reach 59 and the majority of these cities will also be in developing countries.

Although rapid urbanization has created economic opportunities for many cities, it has also resulted in serious challenges for municipal governments: increased air and water pollution, transportation gridlock, deteriorating infrastructure, increased violence and crime, rising poverty and urban slums, and widening income disparities. Local governments face pressure from residents to expand and maintain hard services such as water, sewers, transit, and roads, as well as soft services such as social services, education, and health. Demands are also coming from businesses to improve transportation and information technology infrastructure to help them compete internationally. Businesses are also looking for services that will attract the knowledge workers – services that enhance the quality of life in the city such as parks, recreation, and cultural facilities.

Improving the level of service delivery is always a question of resources, but it is also a question of governance. The quantity and quality of local public services and the efficiency with which they are delivered in a metropolitan area depend, to a considerable extent, on how its governance institutions (especially its formal governmental structures but also civil society), business associations, and non-profit organizations – function. [61] Governance determines how efficiently costs are shared throughout the metropolitan area, how service delivery is coordinated across local government boundaries, how effectively local residents and businesses can access governments and influence their decisions, how accountable local governments are to their citizens, and how responsive they are to their demands.

[61] In one of the few empirical studies of governance and urban performance, Kaufmann et al. construct a worldwide database of cities containing some key determinants of city performance. They find that good governance (and globalization) at both the country and city level matter for city level performance in terms of access to services and quality of delivery of infrastructure services (Kaufmann, Leautier, & Mastruzzi, 2004).

This paper identifies a range of governance mechanisms to support the efficient and equitable provision of public services in metropolitan areas in developing countries. The first part sets out a number of standard criteria for evaluating different governance models. Using these criteria, the second part describes and evaluates various models in both developed and developing countries, with a particular emphasis on innovative approaches in metropolitan areas in developing countries. The third part offers some final observations on metropolitan governance in developing countries. It concludes that, even though we can point to some innovative governance mechanisms around the world, there is no one model that stands out above the rest and can be applied everywhere. The national and local context is critical to understanding where different models and mechanisms will be successful. Nevertheless, most countries would benefit from some form of regional structure for their metropolitan areas that addresses regional issues and, at the same time, responds to local concerns.

It is worth noting at the outset how little information there is on the governance (and finance) of individual metropolitan areas in developed or less developed countries. The choice of case studies in this paper reflects the information available on individual metropolitan areas and is in no way meant to be a comprehensive look at innovative mechanisms around the world. Since arguably, the governance of metropolitan areas affects the lives of people more directly than much of what other levels of governments do, there is a need for much more serious data collection and analysis of local governance and finance issues.

HOW DO WE EVALUATE GOVERNANCE MODELS?

Several criteria to evaluate governance structures in a metropolitan area have been set out in the literature. [62] Some of these criteria suggest that a fragmented system of small local governments would work best; others point to large consolidated metropolitan governments. The choice of governance structure thus comes down to determining which criteria are most important in each metropolitan area.

Economic efficiency

The starting point for the design of a governance structure is economic efficiency. The decentralization theorem suggests that the efficient provision of services requires decision-making to be carried out by the level of government closest to the individual citizen, so that resources will be allocated with the greatest efficiency (Oates, 1972). [63] When there are local differences in tastes and costs, there are clear efficiency gains from delivering services in as decentralized a fashion as possible. This criterion thus calls for smaller, fragmented, general-purpose local governments. [64]

The decentralization theorem assumes there are no economies of scale or externalities in a metropolitan area; but these conditions rarely occur in a metropolitan area. It also considers only economic criteria for designing government structure and not other criteria such as access and accountability or equity across the metropolitan area. These other considerations are described below.

Although rapid urbanization has created economic opportunities for many cities, it has also resulted in serious challenges for municipal governments… – Enid Slack

[62] See, for example, Slack (2007) and Bahl (2010).

[63] Some studies refer to this principle as the "subsidiarity principle" which was included in the Treaty of the European Union in 1992 in the context of the division of powers and responsibilities between European governmental bodies and their member countries. This principle has been applied to the role and structure of government at all levels.

[64] It has also been suggested that smaller government units may stimulate competition between local jurisdictions for mobile residents and tax bases that will induce them to offer the best possible mix of taxes and services (Klink, 2008).

Economies of scale

Economies of scale occur where the per-unit cost of producing a particular service falls as the quantity of the service provided increases. Although this criterion points to the need for larger government units that can capture economies of scale, there are some problems with its application. First, the literature is mixed on the extent to which economies of scale will actually be achieved in large metropolitan areas.[65] Studies suggest that economies of scale depend on the type of service, and for some services economies of scale are achieved at relatively small population sizes.[66] Because each urban service will likely realize the lowest per-unit cost at a different scale of production, it is difficult to draw boundaries for general-purpose local governments based on this criterion.

Second, there is some evidence that larger units of government will result in higher costs for some services because there may be problems delivering services to remote areas within the region or because governments can be become so large that there are diseconomies of scale in the provision of some services. Third, the jurisdiction that provides the service does not necessarily have to be the one that consumes it. Economies of scale can be achieved by the jurisdiction producing the service (which may be different than the jurisdiction consuming the service) or by contracting out the service to the private sector. In this context, the design of government structure may be less important. Fourth, particularly in the context of less developed countries, the impact of a weak infrastructure may negate the advantages of economies of scale. For example, economies of scale may be achieved by having one large school instead of several smaller schools scattered throughout the metropolitan area but, if the transportation system is inadequate, students may not be able to get to that school. Even though there may be economies of scale in centralizing some functions, it may still be necessary to decentralize the services so that people have access to them.

Externalities

The provision of some services results in externalities (spillovers) whereby the benefits (or costs) of a specific service in one local government jurisdiction spill over to residents of another jurisdiction. For example, a road in one municipality can provide benefits to residents of neighbouring municipalities who also drive on it. In this case of an external benefit, the local government of the municipality in which the road is located has no incentive to provide services to residents of other jurisdictions (because they do not generally pay for them) and is thus unlikely to take account of the external benefits when deciding how much to invest in the road. The result is an under-supply of the service that generates an external benefit.

One way to remove the resulting inefficiency from an externality is to design government jurisdictions large enough so that all of the benefits from a particular public service are enjoyed within the boundaries of that jurisdiction. Such boundary readjustments would internalize the externalities (ensuring that those who benefit from the service also pay for it). As with economies of scale, however, not only will the optimal sized jurisdiction be different for different services, the appropriate size to achieve economies of scale may differ from the size that is appropriate to internalize externalities.[67]

Equity

Equity refers to the ability to share costs and benefits of services fairly across the metropolitan area. When there are many local government jurisdictions in a metropolitan area, there are likely to be some rich communities and some poor communities. In these circumstances, the rich communities will have a more adequate tax base with which to provide services and may not have very great demands for some services (such as education or social services). The poor communities, on the other hand, may require more services but have only a small tax base on which to

[65] See Fox & Gurley (2006) and Byrnes & Dollery (2002) for a review of studies on economies of scale.

[66] See Moisio & Oulasvirta (2010) for estimates for health care and education in Finnish municipalities and Found (2012) for estimates for fire and police services in Ontario, Canada.

[67] Another way to address externalities is through intergovernmental transfers. The transfers would have to be conditional to ensure the funds are spent on the service that generates the externality. They would also have to be matching (that is, requiring a certain portion of the contribution to come from the local government and the rest from the donor government) to reflect the extent of the externality. For more information on intergovernmental transfers, see Slack (2009).

levy taxes. The more municipalities within a metropolitan area, the greater this problem will be.

One way to address this equity problem would be to consolidate the rich and poor areas, in effect taxing the rich municipalities and using some of the proceeds to subsidize the poor municipalities. An alternative approach is to shift the redistributive function to a senior level of government or for the senior level of government to provide transfers to municipalities based on need and fiscal capacity.

Access and accountability

Access and accountability—both of which depend to a considerable degree upon the extent to which citizens have access to local government through public meetings, hearings, elections, and direct contacts with officials—are easier to achieve when local government units are smaller and more fragmented (Smoke, 2013). Smaller government units can provide citizens with greater access to local decisions because the ability of the public to monitor the behaviour of decision makers falls as the size of the government increases (Boyne, 1992). The larger the local government jurisdiction, the more likely it is that special-interest groups will dominate citizen participation (Bish, 2001). In countries where democratic traditions are not well established, access to policy decisions is particularly important because there is no opportunity to vote out the government.

Summary: Trade-offs

In economic (and fiscal) terms, the choice of an appropriate governance structure for a metropolitan area depends upon how one weighs these conflicting considerations: efficiency, access and accountability point to smaller local government units, while economies of scale, externalities, and equity suggest larger governments.

Metropolitan areas everywhere face the challenge of how to balance regional interests and local interests. As the world becomes more urbanized and metropolitan economies evolve, there is a need for a regional vision and for many services (such as transportation and land use planning, or economic development) to be delivered on a regional basis. At the same time, some services are very local (such as parks and recreation) and benefit from more local provision and local responsiveness. As will be highlighted below, different countries have used different governance models to balance regional and local interests reflecting the different weights attached to each of the criteria set out above.

> *… the governance of metropolitan areas affects the lives of people more directly than much of what other levels of governments do, there is a need for much more serious data collection and analysis of local governance and finance issues.* – Enid Slack

FIVE MODELS OF METROPOLITAN GOVERNANCE

Models of metropolitan governance can be categorized in a number of different ways. In this paper, the categories are: one-tier fragmented model, one-tier consolidated model, two-tier model, city-states, and voluntary cooperation (including special purpose districts). [68] Although these categories are useful to understand the different types of government structures, it should be noted that it is possible that one city can appear in more than one category – for example, a city that is characterized as a fragmented one-tier government may have special purpose districts and thus also be classified under the voluntary cooperation model.

One-tier fragmented government model

In a one-tier fragmented government model (also referred to in the literature as the Public Choice model or Jurisdictional Fragmentation[69]), a metropolitan area has a large number of autonomous local government units each having some degree of independence in making decisions within their own jurisdiction about what services to deliver and how to pay for them.[70] The advantage of this model is that local governments are more accessible, accountable, and responsive to local citizens than larger government units.

However, opportunities to address spillovers of services across municipal boundaries, achieve economies of scale in production, or coordinate service delivery across the metropolitan area are limited. Fragmentation creates a policy environment in which metropolitan-wide consensus is difficult to achieve in areas such as economic development, environmental quality, social and spatial disparities, equitable funding of services, and quality of public services throughout the region (OECD, 2006). From an equity perspective, fragmentation can lead to large fiscal disparities among local government units with the metropolitan area because each local government will have different expenditure needs and differing abilities to raise revenues.

Examples of one-tier fragmented government structures

There is a proliferation of fragmented one-tier models in both developed and developing countries. Perhaps the best example is the United States where most metropolitan areas are characterized by fragmentation. A typical example is Los Angeles, a metropolis with almost 13 million people, which is divided into more than 200 cities and five county governments with no metropolitan government (Vogel, 2013). With the exception of a few regional agencies, there is no regional collaboration on services or infrastructure. Fragmentation of local governments in the US reflects a strong tradition of home rule and local autonomy,[71] acceptance of competition among local governments, and a higher tolerance for fiscal disparities than might be found in other countries (Bahl R. , 2010).

Metropolitan areas in Switzerland are also characterized by a high degree of institutional fragmentation of local governments. Geneva, with a population of about a half a million people, has as many as 74 municipalities, not including the municipalities in the region that are located across the border in France. In both Zurich and Geneva, the amalgamation of communes is highly unpopular and there has been no effort to create regional institutions (Kubler & Rochat, 2013). As with metropolitan areas in the US, fragmented local governments in Switzerland reflect a long tradition of local autonomy.

The São Paulo Metropolitan Region with a population of 20 million comprises 39 municipalities (including the City of São Paulo with 11.2 million people). Fragmentation in São Paolo can be understood in the context of the military regime, which favoured regional structures and the subsequent introduction of a new constitution in 1988, which did the opposite. The new

[68] For other ways to categorize governance models, see, for example, Bahl (2010), Klink (2008), and Lefecre (2008).

[69] Heinelt and Kubler refer to the fragmented one-tier model as the Public Choice model (Heinelt & Kubler, 2005); Bahl and Linn refer to it as Jurisdictional Fragmentation (Bahl & Linn, 2013).

[70] Fragmentation can refer to local governments and special purpose bodies at the local level (horizontal fragmentation) as well as to local governments and upper level governments (vertical fragmentation) (Bahl & Linn, 2013).

[71] Home rule refers to voters' control at the local level over expenditures and revenues.

constitution delegated responsibility for designing metropolitan structures to state legislatures and recognized municipalities as members of the federation with similar status to states. The result is that municipalities in Brazil are not subordinated to the states or any structures created by the states (such as metropolitan areas). The states have created metropolitan authorities but there are no tools to implement or fund these policies. Moreover, anything the metropolitan authority does needs the approval of all of the constituent municipalities, which is generally difficult to obtain.

Mexico City is governed by the Federal District [72] with 16 municipal sub-units, the States of Mexico and Hidalgo with 59 municipalities, and additionally the federal government. The Metropolitan Region of Buenos Aires includes the Autonomous City of Buenos Aires (similar to a province with a directly elected mayor) and an additional 32 surrounding municipalities. It does not have a metropolitan government.

Metropolitan Manila has been described as a city of villages with autonomous local units resisting higher-level controls of their activities (Laquian, 2002). The Philippines has a history of preference for local autonomy that has made cooperation at the metropolitan level in Manila extremely difficult. Moreover, the affiliation of metropolitan structures in the mind of the public with the Marcos regime has further limited the ability to introduce such a structure. As will be discussed below, however, there is a regional administrative body that tries to coordinate planning and service delivery on a metro-wide basis but it cannot impinge on local autonomy.

Greater Mumbai, with a population of 12.5 million, is situated within the Mumbai Metropolitan Region (MMR) with a population of 22 million. The MMR includes seven municipal corporations, 13 municipal councils, a part of two districts, and over 900 villages. There are many parastatals (public companies) but the overall management of MMR rests with four main ones that were established by the state government of Maharashtra to perform specific functions: the Mumbai Metropolitan Region Development Authority (MMRDA) which is a planning agency for the metropolitan region; the Maharashtra Housing and Area Development Authority; the Slum Rehabilitation Authority; and the Maharashtra State Road Development Corporation (Mathur, 2013). There are also seven parastatals established by the national government and operating in Mumbai including the Airport Authority of India (Pethe, 2013).

Governance in Mumbai is complex and confusing with overlap and fragmentation between the Municipal Corporation of Greater Mumbai and the parastatal agencies (Mathur, 2013). It has been referred to as the governance conundrum, where governance is multi-level (central, state, local) and multi-organizational (parastatals) and involves sharing of fiscal and functional powers among all of these actors (Pethe, 2013).

One-tier consolidated government model

A one-tier consolidated government model, also referred to as the metropolitan reform tradition (Heinelt & Kubler, 2005) or the metropolitan model (Bahl & Linn, 2013), is a single local government with a geographic boundary that covers the entire metropolitan area. It is responsible for providing the full range of local services. Large single-tier governments have generally been formed by amalgamation (the merger of two or more lower-tier municipalities within an existing region) or by annexation (appropriation of a portion of a municipality by an adjacent municipality).

The advantage of the consolidated model is that it can provide better service coordination, clearer accountability, more streamlined decision making, and greater efficiency than a series of small, fragmented government units (Bahl & Linn, 1992). It has also been suggested that large metropolitan governments

[72] A federal district is a governing structure for capital cities in some federal countries. It is either the creation of the national government or the constitutionally established seat of government (as in Mexico City). A federal district lies outside of the territory (and the jurisdiction) of any state or province. The local government of the federal district performs many of the same functions as other cities in the country as well as state or provincial functions. Other federal districts are Abuja, Addis Ababa, Canberra, Delhi, and Washington, DC. For more details on the governance and finance of capital cities, see (Slack & Chattopadhyay, 2009).

have the ability to be more competitive in the global economy (Meloche & Vaillancourt, 2013). The larger taxable capacity of a consolidated one-tier government increases its ability to raise revenues, charge user fees, and borrow; thereby allowing it to be financially more self-sufficient than smaller government units. Metropolitan governments can be given access to more broad-based taxes because labour is less likely to cross metropolitan boundaries than local boundaries and they may have an inherent advantage in tax administration because of their size (Bahl R. , 2010). There is a wider tax base for sharing the costs of services that benefit tax payers across the region so that the quality of service is not tied to the wealth of each local jurisdiction. Large one-tier governments can also take advantage of economies of scale in service provision and internalize externalities.

On the negative side, amalgamation reduces competition among municipalities, weakening incentives for them to deliver services efficiently. [73] Reduced competition may also lead to higher tax rates.[74] On the other hand, if some localities could not previously afford to provide an adequate level of service at a reasonable tax rate because they did not have adequate resources, amalgamation may allow them to provide a level of service comparable to richer localities in the region.

A directly elected, consolidated one-tier government has the advantage that voters can elect decision makers who can be held accountable for their decisions. Yet, a large-scale one-tier government may reduce access and accountability because the jurisdiction becomes too large and bureaucratic and citizens do not feel that they can easily access their government. To overcome this problem, some metropolitan governments have established community committees to address local issues; or satellite offices have been set up across the municipality where people can pay tax bills, apply for building permits, or perform other municipal functions. Such devices may – or may not – increase accessibility, but will also to some extent reduce the potential cost savings that might otherwise result from a larger government unit.

Innovative governance mechanisms have been tried in one-tier systems to encourage citizen access and participation in an otherwise inaccessible system. Increasingly, local budgets and financial accounts are freely accessible on the internet. The Open Government movement around the world is motivated by a desire to create more transparent and participatory forms of government, enabled by transformative technological innovation. Online access to government information and data allows citizens to work with government on policies and services and to hold them to account for their decisions. In some instances residents are actively encouraged to participate to some extent in developing the expenditure plans for their areas. Participatory budgeting is the practice of including citizens in decisions on how the budget is formulated.[75] It was introduced, in part, as a way to address severe inequalities in services (especially water and sanitation) and quality of life. The extent to which online access to information and participatory budgeting can actually substitute for smaller local governments is an open question.

A major challenge with a one-tier consolidated structure is determining the appropriate geographic boundary for the metropolitan government. Looking around the world, we find that geographic boundaries of metropolitan governments rarely coincide with the boundaries of the economic region. Even where the geographic boundary does cover the economic region at the time of the consolidation, it will not continue to do so as economic boundaries expand over time; economically dynamic regions, by their nature, eventually outgrow their local political boundaries. Yet government boundaries are difficult to alter and boundary expansions are rarely attempted by state

[73] The consolidation of the upper-tier government and six lower-tier municipalities in Toronto in 1998, for example, was designed to save costs; but the evidence suggests that it is unlikely that cost savings were actually achieved (Slack & Bird, 2013). The Toronto amalgamation did result, however, in some redistribution within the metropolitan area, increasing equity among residents in service levels and tax burden.

[74] Charlot, Paty & Piguet, for example, estimated a model of tax-setting for the local business tax in French urban municipalities from 1993 to 2003 and concluded that a reduction in the number of municipalities limits tax competition and increases local business tax rates (Charlot, Paty, & Piguet, 2012).

[75] Porto Alegre, Brazil introduced the practice in 1989 and it is now used by 180 municipalities in Brazil and many other countries in Latin America and elsewhere.

or national governments simply because they are politically unpopular, involve substantial adjustments, and are difficult to get right (Clark & Clark, 2014). Even a consolidated city thus has to coordinate services such as transportation and planning with neighbouring municipalities.

Examples of a one-tier consolidated model

Consolidation of municipalities through amalgamation, merger, or annexation to one tier is not very common around the world. Nevertheless, there have been some noteworthy examples of amalgamation. The City of Cape Town, for example, was established as a one-tier municipality in 2000 by amalgamating the two-tier structure that was created following apartheid. The main aim behind the amalgamation was to reduce the gross inequities in services between the rich and poor local authorities by creating "one city one tax base" (Steytler, 2013). There was also recognition of the need for regional coordination of services. The boundaries of Cape Town, drawn by the Municipal Demarcation Board, have resulted in a metropolitan city that is truly bounded, in the sense that the entire metropolitan area falls within the political boundaries with little or no spillovers in service delivery (Steytler, 2013).

To improve local responsiveness in a one-tier consolidated structure, Cape Town established 23 sub-councils, which exercise only those powers delegated by the municipal council. Sub-councils can spend some small ward allocations (there are 105 wards) and award business licenses. They are not elected but they do allow the metropolitan city to devolve some decision making to a level closer to the people without giving up any power (Bahl R. , 2013). The metropolitan government has also adopted a system of ward forums with 20 members from community organizations. However, the effectiveness of these forums and ward committees is questionable (Steytler, 2013). [76]

The history of municipal amalgamation in Toronto spans more than 50 years beginning in 1954 with a system of one-tier municipalities, the subsequent creation of a two-tier metropolitan government (a metropolitan tier and 13 lower-tier municipalities) in 1954, and the most recent amalgamation in 1998 which saw the merger of the metropolitan and lower tiers to create a single-tier City of Toronto. It has been argued that the amalgamation created a city that, at the same time, is too big and too small. It is too big to be responsive to local residents and too small to address the regional issues that plague the region. Moreover, the evidence shows that the amalgamation, which was intended to achieve cost savings, did not do so (Slack & Bird, 2012). However, it has ensured a more equitable sharing of costs among municipalities within the metropolitan area.

Shanghai is a one-tier city, which is divided into administrative units: urban districts and street offices. Since 1990, the urban districts of Shanghai have gained new administrative powers such as planning, public works maintenance, approval of local foreign trade deals, and commercial administration.[77] Although technically a one-tier consolidated city, devolution to the urban district level has had more of an impact on land use than devolution to the municipal government because districts are responsible for development funds and land use decisions and have been actively involved in construction projects (Zhang, 2007). District governments can collect revenue from district-owned enterprises and share tax revenues with the municipal government. At the same time, district governments, because they are smaller than the municipal government, can make decisions that reflect local interests. Street offices, which act as a representative or agency of the district government, manage the delivery of 14 different services in the community (Wu, 2002).[78] Further, residents' committees are management bodies and not government institutions, but they are elected by residents to undertake many tasks assigned by the government such as maintenance of public order and basic welfare provision. More recently, Shanghai has also seen the emergence of business owners' associations and property owners' associations (Zhang, 2007).

[76] The Municipal Demarcation Board is an independent authority responsible for determining the categories of municipalities, their outer boundaries, and the boundaries of wards in South Africa. Members of the board are appointed by the president on the recommendations of an independent panel presided over by a justice of the Constitutional Court (Steytler, 2013).

[77] Urban districts vary in size with the largest being the Pudong district with 1.65 million people.

[78] These services include local justice, community security, traffic control, fire protection, sanitation, streetscaping, open space maintenance, environmental protection, family planning, employment and labour force administration, day care services, disaster protection, collective-owned businesses, community services and farmers' markets.

Abidjan is a one-tier consolidated city that was established in 2001 by the national government after disbanding what was considered to be a reasonably successful two-tier system that had been in place since the late 1970s (Stren, 2007). The newly created district of Abidjan comprises the original ten communes (that were the second tier in the two-tier system) and three additional large prefectures on the outskirts of the city. The amalgamated city increased significantly in size to include some rural areas.

Two-tier government model

The two-tier government model consists of an upper-tier governing body (usually a region, district, or metropolitan area) encompassing a fairly large geographic area and two or more lower-tier or area municipalities (such as cities, towns, or villages). In principle, the upper tier is responsible for services that provide region-wide benefits, generate externalities, entail some redistribution, and display economies of scale. Services that provide local benefits are the responsibility of the lower tier.

Redistribution is achieved at the upper-tier level through a combination of tax and spending policies. Taxes are generally levied at uniform rates across the region, with the contribution of each lower-tier municipality to the upper-tier municipality depending upon the size of its tax base. The upper-tier government makes expenditures on services that benefit the entire city-region and are not necessarily distributed among the lower-tier municipalities in the same way as revenues are collected. A uniform tax at the upper-tier level combined with region-wide expenditures serves to redistribute resources from municipalities with larger tax bases to those with smaller tax bases. Nevertheless, there may still be differentiation in service levels and tax rates with respect to services provided by lower-tier municipalities.

Two-tier structures have potentially important advantages over the one-tier model in terms of accountability, efficiency, and local responsiveness. Critics of the two-tier model, however, commonly argue that costs will be higher because of waste and duplication in the provision of services. There is, however, little evidence to support this argument. The provision of many public services can easily be divided among the tiers. In health and education, for example, more specialized (and costly) services can be provided regionally, with primary services being provided locally. With respect to infrastructure (such as roads and water), major capital projects can be planned, financed, and managed at the regional level, while local connections are dealt with at the local level. Dividing responsibilities in such ways can also make service provision more accountable and responsive to local preferences.

However, two-tier structures are definitely less transparent and more confusing to tax payers, who can seldom determine precisely who is responsible for which services. Moreover, the existence of two levels of municipal council has been said to lead to considerable "wrangling, inefficient decision-making, and delays in implementing policies" (Kitchen, 2002), although the extent to which this is a problem depends largely upon the precise governance structure, not to mention the commitment and goodwill of the individuals involved.

Examples of a two-tier government model

Two-tier governance in London is generally regarded as a successful model. Greater London, with a population of 7.4 million, comprises 32 boroughs and the Corporation of London. The Greater London Authority (GLA) with a directly elected Mayor came into being in 2002. The GLA is responsible for region-wide services. Transport for London is responsible for roads, buses, trains, subways, traffic lights, and regulation of taxis. The London Development Agency coordinates economic development. The Metropolitan Police Authority and the London Fire and Emergency Planning Authority are also included under the GLA umbrella. The boroughs retain primary planning responsibility as the local planning authority and are responsible for housing, education, social, and health services.

Barcelona is a more recent example of the formation of a two-tier structure. Legislation passed by the regional Parliament in 2010 significantly modified the governance of Barcelona through the creation of an upper-tier metropolitan government with 36 lower-tier jurisdictions. The Metropolitan Council comprises all of the mayors of the municipalities as well as 90 councillors, the Governing Committee, and the President. The President is elected by the Council from among the mayors.

This new metropolitan body, which came into existence in 2011, replaced three previous metropolitan bodies: the Metropolitan Entity of Hydraulic Services and Waste Management (EMSHTR) which covered 33 municipalities; the Metropolitan Transport Entity (EMT) which covered 18 municipalities; and the Association of Municipalities of the Metropolitan Area of Barcelona (MMAMB) which was a voluntary body made of 31 municipalities. Not only was the metropolitan area greater than that covered by these metropolitan bodies but it replaced three different entities in the same metropolitan area (each made up of a different number of municipalities). The new structure reduces the substantial (and unproductive) complexity of the previous system (Bosch, Espasa, & Sole-Vilanova, 2013). The example of Barcelona shows that it is possible to move from a series of special-purpose districts dealing with specific services (discussed further below) to a more broadly based two-tier government structure.

Tokyo, a city of over 13 million people, has a metropolitan government that encompasses a number of lower tiers: 23 special wards, 26 cities, five towns, and eight villages. The Tokyo Metropolitan Government (TMG) has administrative responsibility for services such as water supply, sewerage, and fire protection to ensure uniform and efficient region-wide coverage. The Metropolitan-Ward Council is a consultative body for communication and coordination between the metropolitan government and the wards. The wards are responsible for services such as welfare, education, and housing. Cities, towns, and villages also provide services such as waste disposal and incineration, public hospitals, and profit-making projects, often establishing their own shared-delivery cooperatives and regional associations.

Seoul, with a population of over 10 million, is a special city within South Korea. The Seoul Metropolitan Government, headed by a directly elected mayor, plans and manages for the whole functional metropolitan area (Clark & Clark, 2014). The city is divided into administrative tiers that are further sub-divided into 25 gu units (districts) which are subdivided into 522 dong (neighbourhoods). The dongs provide services to the residents within their administrative areas. The mayors of the gu are also elected. The Metropolitan Government of Seoul has made a conscious effort to engage citizens in local decision-making through online initiatives and participatory budgeting (Snyder et al.). It uses open government policies and social media to encourage citizen participation. Twitter feeds allow citizens to communicate directly with the mayor and city staff.

City-states

City-states are cities that are, at the same time, a state or province (or nation). The advantage of being a city-state is that area-wide governance can internalize externalities, there is significant local autonomy in budgetary decisions, the regional boundaries can allow for region-wide taxation, broad-based taxes, and enhanced borrowing powers (Bahl & Linn, 2013). The provincial-city administration is similar to a province but with a smaller geographic boundary and no local level governments to contend with.

Nevertheless, city-states have their problems. Because they tend to be smaller than state governments, the expansion of the urban population over time beyond its boundaries and into other states can result in inter-jurisdictional conflict. This problem can be particularly acute for capital cities that are city-states where a large proportion of government employees (as well as private-sector companies, lobby groups or universities) work in the capital city but live outside of its boundaries and use city services for which they do not pay (Slack & Chattopadhyay, 2013). Problems are also created when city-states are created and leave behind the hinterland. How does the state government manage to pay for services without the resources of its largest city? Moreover, there are often tensions between the mayor (or governor) of the city-state government and the central government because the city-state is politically strong and the mayor may be considered to be a rival by the central government (Bahl & Linn, 2013). This conflict may result in discrimination against the city-state by the central government with respect to funding and other powers.

Examples of city-states

There are a few examples of city-states around the world. In Germany, for example, Berlin, Bremen, and Hamburg are all city-states with spending and taxing powers of both a city and a state government. As noted earlier, there is no guarantee that city-states have the right geographic boundaries. Berlin, for example, tried to expand its boundaries to include the suburban municipalities in the neighbouring state (Land) of Brandenburg but was not successful (Zimmermann, 2009).

Singapore is a city-state nation with a dominant single political party. Recognized for its orderliness, cleanliness, and traffic efficiency, other cities look to Singapore to replicate the policies that have led to its success. It is not clear that its governance model can be applied in other contexts, however, because of its unique circumstances. In particular, the absence of political opposition since the 1970s has made it easier for politicians and bureaucrats to implement policies without facing public resistance (Huat, 2011). Another major difference is that for many of the policies that Singapore has introduced (for example, with respect to employment and immigration), it has acted as a national government rather than as a municipality (or even state government) and one that has been insulated from the usual conflicts of an intergovernmental system. In other words, Singapore's success does not necessarily result from its achievements as a city but rather as a nation (Huat, 2011). There are examples, however, of specific local policies that other cities have tried to emulate, such as a version of its electronic road pricing system which has been introduced in London and proposed, but defeated, in New York City.

Shanghai is a city-state that has provincial and local powers and responsibilities and it reports directly to the national government. Because the municipality is under the direct control of the national government, the local governing authority has considerable power. The Mayor is appointed by the central government and exercises authority delegated to him but is also permitted to make some autonomous decisions.

Ulaanbaatar is the capital city of Mongolia and, with a population over 1 million, it is the largest city in the country, by far. Ulaanbaatar has the status of a city and aimag (province). The capital city is divided into nine düüregs (districts) and the districts are divided into 144 khoroos. The Capital City Governor is also the Mayor of Ulaanbaatar. The Governor, who is nominated by city council but appointed by the prime minister, serves a dual function –implementing central government policies and implementing the decisions of the local assembly. This dual subordination of the governor/mayor to the national government and the local council brings into question the autonomy and independence of Ulaanbaatar and also creates tension between its role as the national capital and its role as a city (Slack, 2013).

Voluntary cooperation and special-purpose districts

Voluntary cooperation has been described as "minimal government restructuring" in which there is an "area-wide body based on voluntary cooperation between existing units of local government in the agglomeration with no permanent, independent institutional status" (Sharpe, 1995). These structures are popular at least in part because they are easy to create politically and can easily be disbanded. Cooperation takes different forms in different countries, but generally implies some degree of administrative integration as well as some political linkage because member local governments have some form of representation on the boards. Moreover, as a rule, such cooperative organizations can levy taxes or collect contributions from the municipalities or levy user fees to pay for services. Although the voluntary model does not include an elected, area-wide government, it is an alternative method of recognizing the inter-relationship of localities within a region through some form of area-wide arrangement.

Through voluntary cooperation, municipalities can provide services across a region without resorting to amalgamation. Municipalities retain their autonomy with respect to expenditure and tax decisions, but at the same time have the ability to reap economies of scale in service delivery and address externalities associated with service provision.[79] Problems of accountability may arise, however, when services are provided by another jurisdiction. Citizens are often unable to get information about services from their locally elected officials because they do not have direct access to these functions; there is a "democratic deficit" (Dafflon, 2012).

When policy-makers in the various local governments have the same objectives, the voluntary model can work well. It does not work as well when different governments have divergent objectives (Bird & Slack, 2008). Some degree of redistribution may or may not be accepted by the municipalities involved. Cooperation usually involves bargaining, and some municipalities in a region may not have much with which to bargain. The problems faced by many metropolitan areas – global competition, fiscal disparities, and sprawl, to name some – are so great, that any real solution likely requires a governance structure that has a permanent institutional status.

Special-purpose districts

Single-purpose special districts may provide specific municipal services for several municipalities or manage regional services with significant externalities or economies of scale. One advantage of special-purpose districts is that each service spillover can be addressed on an individual basis. Since the spillover boundaries are seldom the same for each service, as noted earlier, differently sized special districts could be established, such as a region-wide transit district or a hospital district. Other advantages may include the delivery of services by professionals whose decision making is somewhat removed from political influence, making management easier and possibly more professional (Bahl R. , 2013); and the ability to use dedicated revenues from user fees or earmarked taxes to finance capital expenditures.[80]

Special-purpose bodies also have disadvantages, however. In particular, voters have less control over these bodies than they do with a municipally elected council. [81] Another problem is that, since each body has responsibility for a single service, it is not required to make trade-offs between, for example, expenditures on transit and expenditures on water and sewers. When there are many independent special-purpose bodies, it is difficult to coordinate interrelated activities. The proliferation of decision-making bodies has "created a diffuseness of government organizations that is difficult for citizens to understand" (Kitchen, 1993). Such bodies weaken general-purpose local governments both through competition for resources and by reducing political accountability (Bird, 1995).

If officials are appointed to special districts rather than being elected, taxing powers would not be appropriate because they would not improve accountability. Special-purpose bodies with an appointed board should charge directly for services with some regulation of monopoly powers (Bahl R. , 2010). When not funded entirely by user charges, there is no direct link between the expenditure decisions made by the special-purpose agencies and the local councils responsible for collecting the taxes to fund them. The absence of what Breton (1996) calls the "Wicksellian connection" between expenditures and revenues results in reduced accountability (Bird & Slack, 2013b).

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[79] In terms of achieving economies of scale, Bel found that inter-municipal cooperation in 186 municipalities in Spain for solid waste services resulted in lower costs in 2000. For municipalities with fewer than 20,000 residents, the average cost was 20 per cent lower where there was cooperation. For municipalities with fewer than 10,000 residents, the costs were 22 per cent lower (Bel, 2011). The average cost differences were not significant in cities with a population over 20,000 residents, however, since they already operate at an optimal scale.

[80] It has also been argued that the salary schedule may be outside of the normal civil service and thus higher salaries can be offered to attract greater talent (Bahl R. , 2010).

[81] Of course, the extent of this problem depends on how the board of the special purpose body is selected – is there municipal representation on the board? Is the board an appointed independent board? Is it an arm of the state or national government? (Bahl R. , 2013)

Without accountability, there is no incentive to be efficient: a higher level of technical efficiency through more professional management is not the same thing as economic efficiency. Services may be better delivered, but they are not necessarily delivered to the right people in the right quantities and qualities. Moreover, such special-purpose jurisdictions are more likely to be captured by special-interest groups – including public employees – whose decisions tend to increase costs and alter service provision in ways that do not necessarily reflect the interests of those the jurisdiction is supposed to serve. [82]

Examples of voluntary cooperation and special districts

In Finland, the smallest municipalities have formed partnerships and cooperative arrangements with other municipalities and the private sector with the purpose of finding economies of scale and improving service delivery (Moisio A. , 2011). The most common form of cooperation is the joint authority in which membership is voluntary, except for hospital services and regional councils, to which each municipality is required by law to belong. Authorities are run by boards that are indirectly elected by member municipalities.

Special districts that deliver select services in a particular geographic area proliferate throughout the United States. Services range from fire protection, water, libraries, sewers, transportation, and urban renewal (Vogel, 2013). The boundaries of a special district may be within a city or cross municipal boundaries, so they can be very local or more regional in scope. In some cases, regional special-purpose bodies are required in order to receive federal aid. For example, federal transfers for transportation in the United States require that local governments be part of a Metropolitan Planning Organization (MPO). This national government incentive has been successful in creating MPOs across the country.

Brazil provides some good examples of inter-municipal cooperation. In 2005, the national government passed legislation to promote the creation of municipal consortia. The legislation grants legal status to consortia, which enables them to secure loans and offer guarantees on their own. Municipal consortia are also entitled to exercise supervisory, regulatory, and planning roles. The state government may also take part in municipal consortia. In Belo Horizonte, for example, state-level incentives, in the form of transfers, were behind a successful inter-municipal health initiative (Arretche, 2013).

Although São Paulo is an example of a one-tier fragmented government system with no institution of metropolitan governance for the region, sub-groups of municipalities have formed to find solutions to specific regional issues. For example, the Greater ABC Chamber was formed in 1997 to bring together the mayor, private sector groups, and civil society in seven municipalities to address two issues: the decline of the auto industry and the need for watershed protection (Wetzel, 2013). Unlike the top–down health initiative by the state government in Belo Horizonte, the Greater ABC Region is an example of a bottom–up approach to metropolitan governance for at least a small part of the São Paulo region. The shared nature of the problems helped to forge a new regional identity and led community leaders and politicians to tackle the problem of economic decline through a number of initiatives.

The ABC cooperative scheme does not represent a formal structure of governance nor does it include all services or even the entire metropolitan region, but some authors have noted that it has been successful because it takes a flexible and pragmatic approach to problem solving. It has operated on the basis of pilot projects that have incrementally built up trust among the main actors (Klink, 2008). Other structures have been created in the past to support coordination, but

[82] Berry finds that "concurrent taxation" with territorially overlapping local special-purpose fiscal jurisdictions taxing the same base raises both tax and spending levels with no noticeable increase in service levels or quality. For example, he found that special-district libraries spent more but provided fewer books compared to municipally-operated libraries (Berry, 2009).

with limited funding and decision-making authority, they have mainly served in only an advisory capacity (Wetzel, 2013). The ABC consortium has worked because it was able to bring together different stakeholders to solve specific issues. Indeed, the Greater ABC is considered to be a "showcase of successful cooperation" (Arretche, 2013).

In metropolitan Bogotà, a public company has implemented a comprehensive transportation plan for the metro area that includes the regulation of private bus operators. Transit is fully funded from user fees and from a surcharge on the gasoline tax (Bahl R. , 2013). In Buenos Aires, several regional arrangements exist for services such as: waste disposal and environmental policies, public works and sanitation, and watershed management (Klink, 2008). In India, parastatals (public companies) are responsible for delivering a range of services; In Mumbai, for example, there are 21 parastatals, which account for the bulk of infrastructure spending (Bahl R. , 2013).

Metropolitan Manila, as noted earlier, is an example of a very fragmented system. However, some regional coordination for planning and service delivery is undertaken by the Metropolitan Manila Development Authority (MMDA), which was created by the Philippine national government for the 16 municipalities in the Manila metropolitan region (Smoke, 2013). The MMDA is responsible for services which have a metropolitan-wide impact or that require a level of expenditures that is beyond the capacity of the individual local government units. Its responsibilities include development and investment planning, land use planning, urban renewal, housing, solid waste disposal and management, transportation and traffic management, flood control and sewage management, pollution control, and public safety. It derives resources from the central government, as well as a 5 per cent contribution from the local government units, fees, and fine revenues.

The MMDA is not a corporate unit of government but rather a special development and administration unit under the direct supervision of the president of the country. It performs planning, monitoring, and coordinating functions but can only perform these functions if they do not diminish the autonomy of local governments on local matters (Laquian, 2002). It has been argued that the MMDA is not very effective, however, because it is a national corporation rather than a local institution with limited powers and budget (Montgomery, Stren, Cohen, & Reed, 2003). For example, the MMDA is supposedly in charge of transport and traffic management, but the central government controls the financing, construction and maintenance of roads and bridges (Laquian, 2002). Furthermore, there are no incentives for city mayors to take on a metropolitan focus (Smoke, 2013).

... to improve service delivery, most countries would be well advised to move towards developing more effective systems of governance for the whole metropolitan area than now exist. – Enid Slack

CONCLUSIONS

This review of governance models around the world does not point to one model that works best and that can be applied everywhere. There are, however, some examples of initiatives that have worked well in specific contexts in developed and less developed countries – the geographic boundary of the City of Cape Town that reflects the economic region; the two-tier government structures in cities such as London and Barcelona; the ABC Chamber in São Paulo which brings together various stakeholders to tackle economic problems on a voluntary basis; national government financial incentives in the United States that have resulted in the formation of regional planning bodies; and open government initiatives in Seoul and participatory budgeting in Porto Alegre, both of which encourage citizen participation and greater accountability. There is no guarantee, however, that any of these innovative mechanisms will work in a different context.

The types of governance structures and initiatives that have emerged in the various metropolitan areas reflect the local and national context; differences in constitutional provisions, whether the country is federal or unitary, division of responsibilities, assignment of revenue sources, history and politics of the country, and a host of other factors. For example, a metropolitan area in a country with a long history of local autonomy (such as the United States, Switzerland, or the Philippines), is unlikely to create metropolitan governments by amalgamating smaller, local governments, but it may form a regional body voluntarily. A successful model in a metropolitan area in a country with an authoritarian regime cannot easily be applied to a metropolitan area in a country with democratic traditions. As is often the case with institutional design, while the questions to be dealt with seem universal, the answers are invariably context-specific, and policy choices are rarely straightforward (Stren & Cameron, 2005).

Nevertheless, to improve service delivery, most countries would be well advised to move towards developing more effective systems of governance for the whole metropolitan area than now exist. A strong regional structure that encompasses the entire economic region is essential to ensuring that services are delivered in a coordinated fashion across municipal boundaries, and to be able to improve service delivery by reaping the benefits of economies of scale and internalizing externalities. Lefèvre (2008) emphasizes five characteristics of an effective regional structure: political legitimacy through direct election; geographic boundaries that match the functional territory of the metropolitan region; independent financial resources; relevant powers and responsibilities; and adequate staffing. All of these characteristics point to a consolidated one-tier or a two-tier government structure.

Yet, voluntary cooperation and special-purpose districts that have very few of these characteristics are popular around the world, while amalgamation tends to be unpopular. As Dafflon (2012) notes, amalgamation is usually justified for economic reasons – administrative economies, economies of scale, improved efficiency, internalization of spillovers, and more robust tax bases; but opponents justify their position on the basis of democratic arguments: voice and free democratic choice at the grassroots level. The choice of voluntary cooperation and special-purpose districts over a regional government structure to address inter-municipal service delivery issues tilts the balance towards local autonomy and responsiveness and away from a regional vision.

Voluntary cooperation may be effective in providing some services but it is unlikely to provide an adequate regional foundation for metropolitan areas. Where special districts are created to deliver specific services, the regional vision is further diluted, but also, since the boards of special districts are generally appointed or indirectly elected from members of the local councils, accountability to local citizens is compromised. A shift from inter-municipal cooperative governance structures to a regional government structure with direct election would improve political legitimacy, but almost inevitably at the expense of local responsiveness. At the very least, some form of community or neighbourhood councils is needed to balance regional and local interests. Recent innovations in open government (and open data) and participatory budgeting can also improve citizen engagement.

The real choice for effective governance in a metropolitan region comes down to the choice between a one-tier structure and a two-tier structure. A one-tier structure is simpler to understand and more transparent than a two-tier structure and it may be better at achieving political and fiscal accountability. Two-tier structures are inherently more complex and may result in undesirable duplication, overlap, and general confusion among citizens as to who is responsible for what and who pays for what. On the other hand, a two-tier structure may achieve greater efficiency than can be attained in a more centralized one-tier structure. Desirable economies of scale and scope can be realized at the upper-tier level, while the continued existence and vitality of the lower tier permits more responsiveness to local variations in preferences and maintains the linkage between local financing and spending decisions. Any desired degree of regional redistribution can be achieved within either a one-tier or a two-tier structure, although obviously most easily in a one-tier structure in which tax rates are uniform across the city-region and all taxes are available for redistribution.

Finally, the services that local governments in metropolitan areas provide and how they pay for them are inextricably linked to governance (Bird & Slack, 2013a). Although this paper has not addressed municipal finance issues directly, viable solutions to the problems of metropolitan areas can be attained only when those who live there have to make the critical decisions about service delivery, pay for the services, and live with the consequences (Bird & Slack, 2007). The fragmentation of the governmental structure of metropolitan areas means that it is often both technically and politically difficult to make appropriate decisions on expenditures when benefits and costs spill over municipal boundaries. How to share costs fairly within the metropolitan area is also always and everywhere a controversial issue. What is needed to improve service delivery is thus: first, to design some form of effective metropolitan governance, and second, to set out an appropriate fiscal structure.

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STRUCTURING SERVICE DELIVERY IN SMALL URBAN AREAS

THEMATIC PAPERS

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INTRODUCTION

Access to a range of services, including water, sewer, education, fire protection, transportation, and others, is key to a high quality of life and a productive economic environment. These services are often delivered poorly in developing countries and access to them varies widely since they are normally localized in both consumption and delivery. Inadequate delivery is particularly a problem at the periphery of large cities and in small urban areas, which lowers consumer satisfaction and weakens production. Lost output not only has implications for the local area but in aggregate can also harm the broader macro economy. Poor service delivery can also lead people and businesses to relocate to areas where services are more plentiful, thereby congesting services and activity in the core of metro areas.

This paper examines service delivery problems in peri-urban areas and smaller urban places. These groupings, however, contain an enormously diverse set of places, so the discussion of issues, problems and possible solutions will not fit all areas, and needs to be cast broadly. Some of the places may be densely populated while others have modest population concentrations. In some the service delivery conditions can be difficult because of culture and crime. Demand for services may be low in some areas, either because the residents have low income, or movement to these areas was because of low demands. Different demographic groups and parts of a country may have varying demands for public services because of reasons such as diverse incomes, ability to substitute alternatives, and conditions. Thus, service levels can efficiently vary across cities. For example, high quality electric services may be more important in business districts than in neighbourhoods.

Inadequate access to services can arise because of problems on either the delivery side or the financing side and the limitations discussed here may not always be unique to peri-urban and smaller urban areas. For example, various actors with different goals and motivations make decisions on the levels and distribution of public services. The participants in these decisions are not altruistic and will often act in their own self-interest. As a result, the political process is unlikely to yield an efficient set of service delivery decisions, because of principal–agent problems, information asymmetries, and so forth. Indeed, they may seek to thwart efficient service delivery to maintain rents that exist in the status quo. In other cases, political decisions may be made that result in uneven services across cities or demographic groups, while acceptable service levels are available in other parts of the city. On the other hand, service delivery could potentially

[83] The author is grateful to Julia Ross for very helpful research assistance. The paper draws heavily on Fox & Gurley (2006) in some places.

be impeded by high service provision costs, at least relative to the core of larger cities. Simply, the fear is that the governments are too small to allow low cost service delivery. The overall culture and organizational environment for service delivery may be poor, particularly at the periphery. Further, revenues may be unavailable to finance services because of weak local tax systems. Identifying the causes for inadequate services is necessary if the problems are to be fixed and better services provided.

Care must be taken in presuming that low (or different) service levels in one city relative to some others or relative to external standards is necessarily evidence that services are inadequate or that there are underlying delivery problems. Demand for services may vary across a country (or counties) and these demand-determined differences may well signal efficient rather than inefficient resource allocation. External standards are developed without consideration of the opportunity cost of resources within a particular city or country, though effective demand considers these opportunity costs. Poor resource mobilization, for example, may mean that the opportunity cost of resources in the public sector is very high and can alter choices for public services. Further, externally driven demand for services, such as can occur when international organizations offer low cost or free infrastructure, likely results in need for more operations and maintenance expenditures and inefficient resource use unless the infrastructure is consistent with local demands. Well intentioned donor finance can result in too high service levels in some places relative to the decisions that local users would make as they evaluate the various tradeoffs in resource uses. Domestic demand evaluates the use of resources for private consumption with each of the alternative uses in the public sector. Even when cities operate effectively and revenues are mobilized appropriately, cities should not be expected to sustain service delivery capacity provided by donor inputs that are inconsistent with local demands. Of course, international organizations may have a role in educating local populations and leaders on the importance of expanding service levels, if local demands are based on poor information.

The remainder of this paper is divided into eight sections after this introduction. The first section provides a brief discussion of city government size variation around the world. The second section briefly examines problems with local resource mobilization and the inability to produce appropriate levels of services because of a poor revenue structure. Section three addresses determinants of an efficient government size. Section four evaluates economies of size for local government services. Section five considers other factors that help determines efficient city size. Section six focuses on consolidation. Section seven identifies a series of alternative means of achieving efficient service delivery. Finally, section eight discusses some problems associated with these alternative mechanisms.

CITY SIZE AROUND THE WORLD

Countries differ dramatically in the size of their local governments, suggesting no single model is the ideal approach for service delivery. Table 1 illustrates average municipal size for OECD countries and Table 2 for selected African countries. The OECD averages are surely reduced by the large number of small municipalities, but the data illustrate that the norm is modest size municipalities; and in many cases ones that will be unable to take advantage of significant size-economies if they produce services in house. Evidently, issues of sufficient city size to take advantage of production economies are not unique to cities in developing countries. Indeed, notice in Table 2 that African municipalities are dramatically larger on average than in OECD countries. History and culture play a large role in the size of governments and certainly explain part of the large differences. Yet many other factors go into economic decisions on the right size of cities, as discussed in the next several sections.

Table 1
Average population and geographic size of OECD municipal governments

Country	Average number of inhabitants per municipality	Average municipal area (Sq. km)
Australia	40 085	13 614
Austria	3 590	36
Belgium	18 855	52
Chile	50 440	2 192
Czech Republic	1 680	13
Denmark	56 180	440
Estonia	5 905	200
Finland	16 915	1 057
France	1 735	17
Germany	7 170	32
Greece	34 885	406
Hungary	3 140	29
Ireland	38 960	612
Italy	7 305	37
Japan	74 170	220
Korea	220 285	440
Mexico	44 780	798
Netherlands	41 125	102
Norway	11 725	900
Poland	15 545	126
Portugal	34 050	299
Slovak Republic	1 850	17
Slovenia	9 665	96
Spain	5 690	62
Sweden	32 935	155
Switzerland	3 305	17
United Kingdom	155 775	601
United States	8 815	274

Source: OECD (2013), Subnational governments in OECD countries: Key data (brochure),
OECD, Paris, available at http://www.oecd.org/regional/regional-policy/Subnational-government-key-data-2013.pdf (accessed 12/16/2014)

Table 2
Average population and geographic size of selected local governments

Country	Average population	Average size of local governments (Sq. km)
Algeria	38 813 722	2 381 741
Angola	19 088 106	1 246 700
Côte d'Ivoire	22 848 945	322 463
Ghana	25 758 108	238 533
Kenya	45 010 056	580 367
Mali	16 455 903	1 240 192
Nigeria	177 155 754	923 768
Rwanda	12 337 138	26 338
Somalia	10 428 043	637 657
South Africa	48 375 645	1 219 090
Uganda	35 918 915	241 038

Source: Adapted from CIA World Fact Book, available from https://www.cia.gov/library/publications/the-world-factbook/wfbExt/region_afr.html (accessed 12/16/2014)

REVENUES

The case for decentralization of government lies mostly on the service-delivery side and not the revenue side of government. Thus, local governments often find financing of service delivery difficult, as they are constrained to less productive revenue instruments, leading to a more likely inconsistency between service delivery demands and resources at the local level. Service delivery will be significantly impeded, even if demand for the services exists, unless systems are in place to allow sufficient mobilization of local resources. User fees are an exception that can provide an effective local revenue source and are usually the best option for financing local services. An important advantage is that user fees simultaneously allow determination of the appropriate level of services and provide a financing source for service delivery. If fees are set properly, users obtain the service as long as they are willing to pay the marginal cost of production and the service is unavailable to those who are unwilling to pay the marginal cost. The level of services will be efficient because it is only obtained by those willing to pay the marginal cost.

Of course, user fees can only be imposed when the services can be priced, such as with water, sewerage, intra-city transit and electricity. User fees are poor instruments where pricing will inefficiently crowd out consumers, such as with basic education, or where collection may be costly or inefficient. Objections to user fees are also sometimes espoused because they are regressive and low-income households may have little access to the services; still, other means of addressing access for low-income households should generally be found while relying on user fees to raise revenues.

Taxes must be imposed in cases where user fees are not available. As a general rule the national government has a strong comparative advantage in collection of revenues relative to subnational governments. The advantage arises in part because the capacity to collect the major taxes, including the personal income tax, corporate income tax, value added tax, and customs, is generally enhanced by jurisdiction over a wider geographic area.[84] Further, many countries assign local governments a narrow set of revenue instruments, including such choices as amusement taxes, vehicle taxes, various charges and user fees, and stamp duties. Local governments are also frequently assigned the property tax, which can be a good local tax source, though it generates modest revenues in most countries (except for those coming from a British tradition).

Where differences in revenue-generating options exist across cities in a country, larger cities are given greater flexibility than smaller places, creating an additional imbalance. The revenue-generating problem is exaggerated at the periphery of large urban areas and in smaller cities because economic activity, the location of businesses, and the site of corporate headquarters is concentrated in larger cities. The outcome is greater tax revenues in big cities and an enhanced ability to find tax handles (large businesses and visible activity) from which to collect taxes. Also, the collection systems are often more developed in larger cities, though they may be bureaucratic and inefficient as well. Thus, the difficulty of collecting revenues is exaggerated in smaller towns and outside big cities. Limitations on the access to local resources raise their opportunity cost in the public sector and emphasize the importance of spending them well and on local priorities. These limitations can also cause local governments to seek inefficient means of generating resources, such as trying to earn profits in areas better performed by the private sector.

Intergovernmental transfers from the national government can fill the gaps arising from the vertical distribution of revenues, and can also fill the horizontal gaps caused by differing capacities across local governments to collect revenues. No effort is made to discuss the broad set of issues surrounding intergovernmental transfers, but they are often insufficient to ensure financing of adequate service levels.

Service delivery is impeded when local governments are unable to mobilize the necessary resources to finance appropriate levels, even when demand is present. The outcome is almost surely uneven service delivery across cities because of differential capacities to collect revenues. Smaller urban areas and the periphery of cities are most likely to be disadvantaged and would need to exert much greater efforts to generate the same amount of revenue as those with relatively greater tax bases. Additionally, higher tax rates in smaller cities may exacerbate the problem by causing mobile residents and businesses to move to lower tax jurisdictions.

Better access to resources is the only solution to service-delivery problems arising because of poor revenue collection systems. This requires a combination of access to better tax instruments, an improved vertical and horizontal transfer system, and a willingness of governments to exercise the revenue authority that they have. Still, it is important to realize the service delivery issues and alternatives discussed below will not improve service delivery that is impeded because of inadequate resources.

Access to a range of services, including water, sewer, education, fire protection, transportation, and others, is key to a high quality of life and a productive economic environment. – William F. Fox

[84] For example, businesses and higher income taxpayers often can easily shift tax bases (activity or assets) to another city to avoid taxes, but probably cannot evade or avoid national taxes in the same way. Of course, some of these same taxpayers may be able to shift tax base out of the country to evade taxes.

STRUCTURING GOVERNMENT FOR SERVICE DELIVERY

A series of factors should enter the decision on the best size for local governments and the differing priorities placed on these will lead countries to adopt differing sizes even when making new decisions on government size. But the appropriate size may change rapidly; in fact more rapidly than the political challenges of altering jurisdictional size can be overcome, so maintaining governments that are right-sized may not be possible on a political basis. Therefore, technical solutions to efficient service delivery may be necessary, so technology and demand shifts are among the factors that could alter the efficient government size.

It is important to recognize that efficient size should not be determined solely by the size that appears to achieve minimum production costs; a number of other criteria should be factored into the decision. Six factors are discussed here, but as they may point in somewhat different directions, decisions on size of government are as much art as science. The list should include:

(a) Economies of size. Local governments should be large enough to benefit from economies associated with larger service provision. A sampling of the research on the extent of economies is provided below, and the results suggest that cities do not need to be large to reap economies associated with many services.

(b) Differences in the demand for services. Cities should be the size that allows the outcome of the political process to yield the services that users demand; but choices will reflect self-interest and the tastes and costs of decision-makers. It has been argued that cities should be small enough that service users, including businesses and consumers, have a range of choices across governments in the tax–expenditure package they choose. Users can vote with their feet to select the desired package.

(c) Acceptability of cross subsidies. Cross subsidies between areas of cities or between various demographic groups are more likely in larger and more heterogeneous places. These cross subsidies may be more acceptable in some cities or some countries than in others. Smaller governments with more homogeneous populations are better able to avoid cross subsidies.

(d) Tax competition. Many small local governments may increase the potential for tax competition. Competition is beneficial if it encourages efficient local government size and service delivery, but is inefficient if it pushes tax rates too low to finance services that are demanded.

(e) Corruption. Local government size should be selected to limit the opportunities and incentives for corruption.

(f) Political accountability. Local governments should be selected so that they encourage accountability of local officials. Appropriate political accountability will limit corruption, but these issues are separable since political leaders could avoid corruption and still not be accountable for efficient decision making.

Many nuances exist in applying these factors; several of them are discussed in more detail below.

Poor service delivery can also lead people and businesses to relocate to areas where services are more plentiful, thereby congesting services and activity in the core of metro areas. – William F. Fox

An aerial view of Mexico City. @Shutterstock

ECONOMIES OF SCALE

An important concern is that peri-urban areas or smaller cities may suffer from higher service delivery costs because they lack the scale to produce services at low per person costs. Economies of size refer to the degree to which per capita costs for service delivery fall as the size of a city becomes larger. Generalizing the extent of economies of size is difficult because many other things typically change as city size is expanded. In the simplest case, larger size simply means a greater population. But even then, a greater population for a given city geography means increased population density which can raise the need for services (such as happens with congestion) or make service delivery less expensive, such as when the cost of a given distance of water and sewer lines can be spread across more households. In other cases, larger size can entail delivering services across a different geographic area (such as with annexation or consolidation of governments) and with differing service delivery conditions (such as when services are delivered along the periphery of a large urban area). The result is that the potential for economies of size is likely to be very context specific and to differ across services. As a result, experiences from one city and academic research should be extrapolated with caution. Nonetheless, some of the general findings of research on capital-intensive services and on labour-intensive services is described below.

Capital intensive services

Services can be usefully separated into capital-intensive and labour-intensive, to discern the probability that economies of size will result from delivery in larger units. [85] Size economies are more likely for capital-intensive services, such as water, sewer, and intra-city transportation, than for labour-intensive services, such as schools and fire protection. Economies of size can result from several sources. One is indivisibilities that arise in production, such as when there is a lower bound on the size of plant regardless of the population to be served. Economies of scale, where the additional output rises faster than a proportionate increase in inputs, is a second potential source of size economies. Effectively, this refers to lumpiness in small-scale production. Economies of scale result from characteristics such as a more efficient organization, cost savings from larger scale purchasing, or a production function that is non-linear. Economies of density may exist where services can be delivered more cheaply as more consumers are located in the same geographic area. Some services may have a public goods nature, which means little diminution of the service as it is consumed by more people. Parks below capacity or an additional car to an uncongested road are examples of this.

Even with capital-intensive services, the case for size economies is more complicated than might be anticipated. Take delivered water as an example, which includes several distinct activities that may differ in their extent of economies. Collection and treatment of water is generally expected to yield lower unit costs as the amount of treated water rises, because of economies of scale; yet these economies may be fully absorbed in modest-sized producers with no additional economies as producers become large. But this only tells part of the story. The water must then be distributed and the additional cost of piping, water towers and so forth over greater distances can offset economies from water production.[86] Cost savings from distribution of water are more likely to be linked with greater density than with greater scale. Not surprisingly, research concludes that the potential gains from delivering water services to larger areas and more people are very case-specific. For example, Garcia & Thomas (2001) find that costs are lowered when water systems in France were consolidated. Kim & Lee (1998) conclude that cost would be lower from consolidating water districts in the Seoul area, but the savings would be much less likely in a low density, less developed place.

Similar logic applies to many other capital-intensive services, such as electricity, solid waste, sewer treatment and intra-city transit. Bel (2011) concludes that intra-city buses are produced at constant returns so that costs do not fall with size. Bel also finds that solid waste offers economies of scale for smaller cities

[85] Hirsch (1968) used a similar concept of vertically-integrated and horizontally-integrated services.

[86] Water collection, treatment and distribution can be thought of as differing services with different potentials for size economies. Further, the question also arises as to whether economies of scope exist in producing these together.

but these benefits are fully achieved at populations of 50,000 or less, so that neither economies of scale nor economies of density can be expected in larger places.

Labour intensive services

Lesser size economies are generally expected from labour-intensive services such as schools and fire protection. Many of these services are provided through a series of production facilities (such as schools or fire stations) that must be located near the consumers, thereby offering limited potential for economies. Further, education is provided by teachers who usually have a limited number of students, so few economies are available once there are sufficient numbers of students to allow each teacher to have the desired number of students in the classroom. Some cost savings can result as the central administration and other partially fixed costs are spread over more students. At the same time, additional levels of management and bureaucracy can be added as school districts grow in size and coordination becomes more difficult, which at some point offset any potential economies from larger school buildings. Per student costs can be seen as U-shaped as the number of students in a district rises, with costs that could decline until school districts reach approximately 6,000 students (Duncombe and Yinger 2001).

Further, the findings on scale in labour-intensive services must be balanced with the need for the consumer to go to the service, or the service to be taken to the consumer, which is the case for many labour intensive services, such as education and fire protection. In other words, there are transportation costs, which for schools are often borne separately by households and are not reflected in the school district's costs. These costs, which rise with distance, can offset economies within the school; and the same can be true for fire stations. These transport costs often benefit from density economies, or rise with lower density.

Finally, the quality of services can diminish when the production units become larger or are located further from consumers. School quality is often associated with parental involvement in the school, which can be linked with schools operating on a neighbourhood basis. The quality of fire and police protection grows with rapid response, which requires nearby location; similar relationships could exist for other services.

Conclusion on size economies

Overall, research on size economies suggests that any available economies for many services are achieved in modest sized cities, perhaps 50,000 people or less, hence many small urban areas are not at a cost disadvantage in providing services. Still, the results offer evidence that small rural places and low-density communities are most likely to suffer from high-cost service delivery because of indivisibilites in production and high distribution costs. Fragmentation of government into many smaller units may be a bigger concern for larger metropolitan areas because some services, such as child welfare, public transit, airports, and so forth (which may not be delivered in smaller urban areas), benefit strongly from coordination across the metropolitan area. Also, smaller urban areas may have lesser ability to employ the technical, financial and managerial expertise that are required to operate sophisticated service delivery and to deliver a wide range of services.

The case for decentralization of government lies mostly on the service-delivery side and not the revenue side of government.– William F. Fox

OTHER FACTORS IN DETERMINATION OF CITY SIZE

The above mentioned factors influencing desired city size evidenced that a number of other considerations should enter the decision besides size economies, and these often suggest smaller cities is good policy. Analysts often argue that services should be provided according to the principal of subsidiarity, which means that services should be provided by the closest government possible to people. The notion of closest government could imply a small government. Small governments also mean that service users have greater opportunities to select the package of services and taxes that best reflect their demands within a given labour market. A market for local public services that causes local governments to operate more efficiently with both improved service quality and lower costs can be a result of consumers and businesses voting with their feet and moving to the jurisdictions that provide the services that are demanded at the best tax price (Tiebout, 1956). Evidence generally supports higher quality services when more competition is present. Low cost delivery of the services people demand most is the expected outcome. But, this framework abstracts from size economies.

On the other hand, competition between jurisdictions becomes harmful if tax rates are pushed inefficiently low. The likelihood that some municipalities choose to operate like tax havens and lead to excessively low rates could grow with large numbers of smaller jurisdictions. Kanbur & Keen (1993) demonstrate that relatively smaller governments have the incentive to undercut relatively larger governments.

Large jurisdictions with similar services provided to all residents and businesses are a way to ensure service access to a broad set of users, which in itself can be a goal. On the other hand, broad access to services will result in cross subsidies among taxpayers, which are common within every government. Specifically, cross subsidies tend to go from those with large tax bases to those with small bases, or at least from those who pay more in taxes than they receive in services – to others for which the reverse is true. The cross subsidies will become larger as the population becomes more heterogeneous in the sense of greater diversity in incomes and in demand for public services. Interestingly, research suggests that populations are more heterogeneous than might be expected, even within smaller cities in a metropolitan area. The likelihood for subsidies will also rise as similar services are offered to everyone within the jurisdiction. The willingness to accept cross subsidies can affect the desirability of large versus small jurisdictions, with larger jurisdictions possible in places where subsidies are more acceptable.

A general expectation exists that smaller governments are more accountable to their constituents than larger ones because political leaders are more accessible when located nearby. This may not always be true, but can be an additional argument for smaller governments. Some research suggests that satisfaction with service delivery is higher in smaller places. On the other hand, people may want to be more involved in larger governments because there is more in which to be interested.

The linkage between corruption and government size can also be important to judgments on the best city size. Results are mixed on this issue, but Fiorino et al. (2011) concluded that corruption is lower with more fragmented government, but only when linked to greater expenditure and revenue decentralization. Trust in government seems to be inversely related to size, independent of the degree of corruption.

It should be noted that demands for public services may grow with city size and density. Congestion, negative externalities and other factors may lead people and businesses in larger cities to demand more services. For example, intra-city transportation, police and fire protection, solid waste collection and disposal and sewer systems grow in importance as city size and density expand. The additional costs of delivering these services can offset any size economies that result from producing at larger scale and density, so that costs do not fall even as the same level of service per person becomes cheaper. In this context, however, city size refers to the overall scope of the metropolitan area and not the size of the individual local government. Significant local government fragmentation may leave large metropolitan area without full benefits of size economies but with greater demand for services to offset costs associated with density and size of population.

CONSOLIDATION

Local government consolidation is proposed or adopted with many expectations in mind and the success of consolidation depends on getting the right incentives in place to achieve the different objectives. Consolidation of areas or governments into larger government units is an option to achieve the size necessary to deliver services efficiently across an area. The expectation might be to expand the overall capacity for delivering services, independently from the costs. More efficient service delivery decisions might be expected as scarce talent for skilled managers is spread across more people or as planning is undertaken more efficiently. Steiner (2001) found that poorly performing municipalities in Switzerland were more likely to consolidate. Confusion over service responsibilities may be reduced or equity in access to services increased across the area. On the other hand, service inefficiency could grow because everyone in the larger government is offered the same services, though service demands differ. Many consolidated governments offer some service differentiation to lessen this problem, and the public choice literature suggests that citizens will be more favorable to consolidation if they still have some choices. Additionally, private sector alternatives can be used to expand access to services when local governments fail to provide services demanded by those with higher service tastes. Private schools, generators to improve consistency of electricity, and fences for security are examples of such alternatives.

Consolidation can also permit geographic externalities to be internalized within the city (though significant size may be necessary in some cases to fully internalize externalities). Environmental planning and transit systems are examples where larger size may help internalize the benefits and costs, though Toronto's experience suggests that it is difficult to find a size that internalizes all of the externalities. Further, tax and public service spillovers also occur, as for example, people live and receive public services in one jurisdiction but work and pay taxes in another jurisdiction.

Large cities may be expected to enhance economic development because they are better able to manage economic growth and firms generally prefer to work with a smaller number of different governments in an area (though there is no evidence of more firm locations in areas with fewer governments). Also, a consolidated government can have greater political influence with the national government because it represents more people and economic activity.

Consolidation with the centre city or other places is an obvious option at the periphery of big cities or for smaller cities in a large metropolitan area. Many consolidations have occurred around the world including Toronto, Canada; Nashville, Tennessee; and Lexington, Kentucky in the United States; as well as several places in Switzerland (Dafflon, 2011). Merging local governments has been proposed or implemented in a number of developing countries as well, including Sudan, Jordan, Zimbabwe, and Rwanda (see Fox & Gurley, 2005). More efficient or lower cost service delivery is often given as the argument for consolidation.

As noted above, the size economies associated with most services are limited so there is little likelihood that costs can be reduced by consolidation unless a group of very small jurisdictions are combined. The potential cost savings from consolidation are further compromised by the transition costs that will arise when existing service delivery organizations are combined. Simply, consolidations are not green field development of public service delivery but the combination of governments with a mix of operating cultures and varying expectations from workers, constituents and the national government. Capital and systems that are already in place cannot be easily relocated. Substantial costs may result when systems are combined and must be made to work together. Labour is a significant cost for local government and workers need to be eliminated if savings are to result, though this is often a difficult political challenge even if the workers are redundant. Considerable time may be necessary to allow staff numbers to decline, particularly if done by attrition, so any cost savings may be long in coming if they occur at all.

Consolidation can be very difficult to achieve politically because of the many agreements that must be reached and the fact that all the players have something to lose. Consolidated governments, like previous governments, are not altruistic. The various actors may work to defeat the benefits of consolidation, or at least to limit them. Citizens are concerned about issues such as the dominance of the existing centre city in the new consolidated government. Government workers are worried about reduction in jobs, change in the working environment and other job-related factors. Politicians fear losing their position, so they are more likely to be in favor of consolidation when it involves few governments. The advantages of consolidation diminish as concessions are made to various groups to reach agreement. Consolidation also moves political leaders further from constituents and inhabitants (or disconnects them), which can reduce satisfaction with government and make it more difficult to communicate with leaders.

ALTERNATIVE SERVICE DELIVERY MECHANISMS

Large governments may not be necessary to take advantage of size economies (to the extent they exist) or to obtain the technical, managerial, and financial expertise to deliver services efficiently. A set of alternative service delivery options can help smaller cities or consumers in the urban fringe obtain high quality and low cost service delivery. Four broad options are briefly discussed here: (a) single purpose governments, (b) privatization, (c) contracting out to other municipalities, and (d) municipal cooperation. Three of the four are alternative public sector approaches and the other is private-sector oriented. All four can be options for smaller urban areas and experience in the United States indicates that these alternatives are used more heavily among mid-sized cities.

Research provides some generalizations on how alternative service delivery systems are used in various countries. Provision of local public services by traditional governments is most common for the largest and smallest places in the United States, with the alternatives more frequently used by mid-level governments (Warner, 2011). Nonetheless, it is important to remember that provision by traditional government structures is still the predominant approach among all city sizes. Municipal cooperation is more prevalent among smaller municipalities, at least in the United States. Smaller cities find private sector providers less available, and the overall market for the services less developed because of the modest demand that they represent. Small municipalities are more likely to contract with larger municipalities or to provide the services in-house. Larger cities also use privatization less but are more prone to mix public service provision and private delivery for the same service. One possible explanation is that their access to professional managers allows them to handle complex production more effectively. Additionally, large cities do not need to use external providers to obtain any size economies. Further, service provision is often more complex in large cities and fewer private sector firms have the skill necessary to deliver the services.

Differences in approach to service provision also exist across geographies, with public service provision more common among rural and core metropolitan cities and less common in the suburbs. Rural communities find private market providers less available and can face higher service production costs because of diseconomies of density. For-profit contracting is associated with higher income and suburban municipalities while places with high poverty are more likely to engage in municipal cooperation for service delivery.

Warner (2011) lists four strategies that governments can use to actively create markets as a means of making these alternative strategies more viable: (a) government cooperation to gain scale, (b) government splitting the market because scale is attained at a lower size, (c) splitting services into various sub-components which can be contracted out or delivered in house, and (d) privatization whether to private for-profit firms or to public companies. Warner observes that these strategies are used less by smaller rural places in the United States and are more often selected by mid-sized or larger metropolitan areas.

Alternative government structures

As noted above, the alternative delivery mechanisms can be divided into different public sector approaches and private delivery. Nonetheless, there is a grey area as to how different structures fit in this categorization, particularly where the approach mixes private and public sector delivery. The categorization is further complicated as de Mello & Lago-Peñas (2011) note that Brazilian and Spanish local government cooperation occurs with both higher levels of government and private sector firms, so that a wide range of cooperation takes place.

Government cooperation or contracting out: Government cooperation or contracting with other governments is frequently used to attain scale. Cooperation, which is often (but not exclusively) used in large metropolitan areas, allows municipalities to band together to deliver services that require much broader scope. Cooperation may allow many of the benefits of consolidation without some of the efficiency losses that can be associated with the public choice reactions of the various participants to consolidation. De Mello and Lago-Peñas find that municipalities are more likely to cooperate in delivery of services where the potential exists for cost savings (though in some cases their results suggest greater cooperation when costs could rise). These include social services that need metropolitan-wide perspective, such as child welfare, job training and drug programmes, and infrastructure services such as airports and transit. Smaller urban areas away from large cities can have the potential for cooperation when they are in reasonable proximity to others.

Many examples exist of this type of cooperation. De Mello and Lago-Penas observe that 41 per cent of Brazilian municipalities with populations over 5,000 are members of consortia for health care and 27 per cent of Spanish municipalities are members for social services, such as support for old age and disability. They note that small rural Spanish municipalities cooperate in delivery of solid waste collection. However, only small regional firms offer private sector delivery of the services in rural places so the benefits of lower cost service delivery still may not be as available as in large cities where national firms compete. Multi-government municipal cooperation in the Netherlands allows public sector organizations to compete with private sector firms to help push costs down. In Italy, utility companies have developed to deliver multiple types of services across a number of cities with the hope of achieving both economies of size and scope.

Cooperation requires voluntary agreement across municipalities, though not to the extent of consolidation. Nonetheless, cities will only cooperate where it is in their best interest to do so. Both cooperation and contracting out in the public sector require other nearby governments with a willingness to deliver services for additional governments. Reasonable capacity to negotiate with other municipalities is a key to cooperation (and contracting out), since these arrangements can entail significant political costs to develop. This means that lower capacity and lower income municipalities may be less able to take all steps necessary to participate in an association. Cooperation is also unlikely to solve problems of different service levels across municipalities because the willingness to engage in cross subsidies is much lower with voluntary cooperation.

Shifting service responsibilities to intermediate governments is an alternative to voluntary agreements that eliminates horizontal negotiations between governments, though negotiation would be necessary to facilitate the change in vertical assignment of service responsibility. This approach recognizes that broad expenditure assignment determines which level of government is responsible for delivering which services, and setting the assignments higher in the vertical system can overcome some of the problems that could arise from insufficient service delivery scale. By virtue of the larger geographic size, mid-level governments often provide the scale necessary to deliver services. The intermediate government could provide the service for all inhabitants or fill the gap in areas where the service is not otherwise being delivered by cities.

Single purpose governments: Single (or limited) purpose government service delivery units are relatively common in the United States. These governments can be structured at the appropriate size to allow the capacity to deliver services efficiently, though the efficient size could change over time and altering the borders of the governments is often relatively difficult. More than 33,000 non-education districts and nearly 13,000 education districts operated in the United States in 2012. [87] The largest number of non-education districts provides water supply, housing and community development, drainage and flood control, soil and water conservation, sewerage, and libraries. Education districts have declined in importance, mostly through consolidation as the number of districts has fallen from over 108,000 in 1942. Other single purpose governments have grown, with the number rising from 28,000 thirty years ago. [88]

Limited-purpose governments can be structured to the most efficient size for the specific service (at least in the beginning) and can concentrate on doing a small set of things well. On the other hand, they fail to achieve any economies of scope that can arise from cross-service delivery. Further, they raise significant accountability and transparency issues for consumers who may be unclear on who is responsible for which services, and can require users to contact multiple service deliverers when complaints need to be registered.

Private sector alternatives

Privatization through for-profit firms is relatively more common in the United States, and the use of public companies is more common in Europe. Local governments can unbundle services into their wide array of both inputs and outputs when making decisions on contracting out to either other public providers or the private sector. Many such examples exist. The private sector can be responsible for road repaving and other maintenance, or for construction, or for both. Prisons can be contracted out, but other police services operated by the public sector. Different types of transit are often provided by different actors and they can be coordinated as appropriate to limit congestion and gaps in service provision.

Privatization requires development of a market for services that allows potential competitors to develop service-delivery expertise. The hope is that the market competition will result in lower prices and enhanced quality. Warner (2011) observes that the data do not suggest cost savings from privatization, though the education literature provides some evidence that competition improves outcomes. In some cases, such as water production, the natural monopoly character means the service is either delivered by a public or a private monopoly, neither of which has a strong incentive to be efficient so it may be unreasonable to expect significant improvements. But privatization has not led to lower costs or higher consumer satisfaction in other services either, such as solid waste. Additionally, the public sector often must manage the private sector producers to ensure they meet public sector objectives and deliver services at a low cost. The choice between privatization and public sector provision depends at least in part on whether government is better able to produce services or to manage private sector production of the services. Smaller local governments, in particular, may lack the skills to manage firms effectively.

Municipalities can benchmark the cost and quality of services by allowing some areas to be served by private sector firms and others by the public sector. Barcelona uses this mixed market approach for both solid waste and transit (Warner, 2011). The mixed approach also maintains the potential for the municipality to deliver the service if good private sector providers are unavailable and allows competition between the public and private sector that limits the ability of either to form a monopoly.

Markets are less likely to exist for smaller and more remote local governments than for larger governments. Important reasons are that small governments may not have the size to interest

[87] U.S. Bureau of the Census, 2012 US Census of Governments, Organization Component Estimates (http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk).

[88] Ibid.

private firms and are less likely to have the capacity to organize and cooperate to achieve the scale necessary to attract the private sector. Further, lack of a developed market for services, as may occur in smaller cities, limits local government's ability to benchmark service quality and costs in this manner.

Problems with alternative service delivery mechanisms

Based on experience in Switzerland, Dafflon (2011) identified a series of issues that arise with certain alternative delivery systems. The first is the complex set of principal–agent problems that are inevitable because of the varying relationships. Local public officials have a principal–agent relationship with the voters and they must subsequently establish one or more additional principal–agent relationships with various external service providers. The issue is additionally complex when governments are cooperating to deliver a service because the principal–agent relationships are not unique. These relationships may hamper users' ability to obtain the services they demand but may also raise service delivery costs and the potential for rents to develop.

Second, information asymmetries exist between the service delivery agent (such as a private sector firm) and the principal managing the city (and further between the voters and the manager). The asymmetries exist even prior to startup of the service delivery mechanism, and they can become worse as the agent gathers more information during the operational phase. A moral hazard exists because the agent has the incentive to use the asymmetric information to maximize its own welfare and not that of the residents and voters. Benchmarking through mixed public and private service delivery is one way to lessen the asymmetries. The problems are complicated further when several governments are responsible for providing the many services that users demand. Information costs rise and users are unable to easily discern who is responsible for meeting their demands. Accountability and transparency are generally harder to assure with these alternatives since delivery is less directly under control of the municipality and users may not know who to hold responsible when problems arise.

Public service delivery in peri-urban and small urban areas can be limited by problems on both the resource mobilization side and on the institutional side.– William F. Fox

CONCLUSIONS

Public service delivery in peri-urban and small urban areas can be limited by problems on both the resource mobilization side and on the institutional side. Adequate services cannot be delivered unless sufficient resources are available. Local governments in many countries are granted limited own source revenue options, so inadequate resources are a concern. User fees are the best means of financing for those services where a price can be imposed, because they offer both a means of determining the amount of services to be delivered and provide financing for the services. Local tax revenues are necessary when user fees cannot be efficiently levied. Access to broader based tax sources that grow with the economy is essential to a well-functioning system. Intergovernmental transfers are also a very important source of local government financing in essentially every country, but transfers are often an unreliable source as national governments can vary their transfers across the business cycle. The opportunity cost of resources in the public sector is very high in places where they are difficult to obtain, and this high premium emphasizes the importance of providing those services for which a high demand exists.

The paper focuses on one aspect of the service delivery issue, choosing the correct institutional arrangement for services. Many other difficulties arise, not the least of which is the political economy problem of accurately translating service demands into service provision. Appropriate size for a city is one aspect of ensuring low cost, high quality services. The size of service delivery units should depend on a number of factors, including potential for size economies, limiting corruption, achieving political accountability, homogeneity of service demands and acceptability of cross subsidies, and likelihood of tax competition. Size economies are generally limited for local public services, particularly, when all costs including service production and distribution are taken into account. Therefore, many peri-urban and smaller urban areas should not be significantly disadvantaged by insufficient scale for most services; so they should not be technically limited by the ability to produce services at low unit costs. Several of the other factors also suggest that relatively smaller cities often have the opportunity to be more efficient than larger ones, though smaller places may find it difficult to obtain the managerial and technical talent to provide some high quality services.

To realize the potential to deliver services well in many smaller cities, alternative means can be found to offset limitations that arise because of staff skills, scale or some other factors. Both alternative public sector approaches and privatization can enhance service delivery in some cases. Among these approaches are contracting with other governments, cooperating with other governments, single purpose governments, consolidation, and shifting service responsibilities to intermediate level governments. Consolidation is politically costly to achieve and is unlikely to reduce costs in many cases. A number of experiences with consolidation can be found around the world, but it is discussed much more often than it is achieved. Cooperating or contracting out is less politically costly, but still requires a skilled set of people to negotiate agreements. Privatization has the potential to lower costs and improve service quality, though research seldom finds that costs are lowered. Furthermore, competitors are often limited in more rural places and smaller cities, so its greatest potential is in larger cities and higher income places. Furthermore, the benefits depend on the extent to which governments can manage private firms' delivery of the services, compared with their ability to deliver the services directly. Governments may need to actively develop a market for their services in cases where demand may seem inadequate for the private sector to seek out the market.

Alternative service delivery mechanisms are often characterized by difficult principal–agent problems, where both constituents and local policy makers find it difficult to align priorities of the various groups, and particularly to ensure that priorities of the service consumers are properly reflected in service delivery. These problems are exacerbated by information asymmetries that tend to grow over time as service providers are able to understand costs and production conditions beyond the cities and consumers. These and other problems plague these alternative systems with weak accountability and transparency.

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KEY MESSAGES

ON MOBILIZING FINANCIAL RESOURCES FOR PUBLIC SERVICE DELIVERY AND URBAN DEVELOPMENT

- In order to fulfil their mandate in a fiscally responsible manner, local governments in developing countries must have available significant sources of own tax revenues and also non-tax revenues in the form of user charges and fees. Adequacy of own revenues is the key to an improved ability to deliver needed goods and services and to better accountability of local officials to their constituents. Own revenues – unlike tax sharing and other transfers – uniquely bring an element of horizontal accountability of public officials to their constituents on the revenue side of the budget.

- Given that effective fiscal decentralization requires meaningful revenue autonomy, we need to ask what form of autonomy is preferable and then how much revenue autonomy is needed. The most desirable form of autonomy at the subnational level is to allow elected authorities to set the tax rates for a closed list of taxes set in national level legislation. The desirable degree of revenue autonomy should allow the wealthiest subnational governments – those with the largest tax bases – to finance most of their expenditure responsibilities with own revenues.

- No design of a decentralized system of finance ever reaches a perfect balance between expenditure assignments and revenue assignments at the subnational level. Transfers need to be used to address vertical and horizontal imbalances, including tax sharing, unconditional equalization grants, and conditional grants. In addition, disciplined access to credit is an appropriate source for financing subnational government capital investment responsibilities. Because borrowing can lead to overspending, there is a need for controls, most commonly through explicit government rules.

- Subnational governments cannot always count on the availability of capital grants and borrowing to finance their infrastructure needs. Increasingly, subnational governments have introduced innovative approaches to financing infrastructure. The most common of these innovative avenues are several methods for capturing the increment in land value resulting from public investments. However, although welcome as a complementary tool, these alternative revenue sources cannot be seen as a long-term solution to the shortage problems for operating budgets, which need to rely heavily on the existing conventional revenue tools.

- User charges and fees, property taxes, betterment levies, vehicle and transportation taxes, local business taxes, excise and sales taxes are good subnational level taxes.

- Value added taxes, local border taxes, and corporate income tax (profit tax) are not good subnational level taxes.

- Desirable properties of local-level taxes include: buoyancy, with revenues roughly changing in proportion to the economic base; horizontal equitability, providing equal treatment to taxpayers in similar circumstances; relative efficiency, causing low distortions in economic activity; incurring relatively low administrative costs; and being politically acceptable.

ON URBAN GOVERNMENT REVENUES: POLITICAL ECONOMY CHALLENGES AND OPPORTUNITIES

- Although there is a well-developed set of public finance principles for choosing and designing local government revenues, and it is often used as the anchor for developing intergovernmental and local fiscal reform, urban revenue performance in developing countries is commonly mediocre or worse. This state of affairs persists both because the mainstream principles do not adequately consider key factors that influence local revenue generation and because the principles are not always appropriately implemented.

- Underlying this situation is a set of diverse, complex political economy considerations that rarely get the attention they deserve. These range from the behaviors of national politicians and bureaucrats who shape the rules of the intergovernmental fiscal game and how they are implemented, to local political economy dynamics among elected councilors, local government staff and citizens. These actions and interactions play out in a broader context that also influences the options for effective local revenue reform and decentralization in general. Insufficient understanding and inattention to these dynamics can result in serious flaws in revenue reform design and implementation.

- Some remedial actions to improve local revenue generation can be taken by urban governments on their own, but others require national-level action or support, or at least recognition of what is feasible locally given constraints imposed by higher levels. Even where local action can be productive, urban officials must be mindful of essential linkages among the elements of the local governance system. Pursuing a state-of-the-art but revenue-specific reform without attention to other relevant factors, such as expenditure policies, fiscal transfers, or accountability mechanisms, is unlikely to result in improved local revenue performance.

- Given the complex array of actors and interdependencies involved in urban revenue generation and the common need for considerable policy and system modifications in many developing countries, it is important to be strategic in pursuing urban government revenue reform. Sudden dramatic changes are likely to overwhelm local capacity and may even provoke pushback from those parties most affected by the reforms. Particularly critical at the local level is to invoke the social contract - to ensure that those citizens who will pay more to their local government under revenue reforms feel that they are getting some benefit from doing so, and are being treated fairly in the process.

ON INNOVATIVE GOVERNANCE APPROACHES FOR METROPOLITAN AREAS IN DEVELOPING COUNTRIES

- Improving the level of service delivery in metropolitan areas in developing countries is always a question of resources; but it is also a question of governance. Governance determines how efficiently costs are shared throughout the metropolitan area, how service delivery is coordinated across local government boundaries, how effectively local residents and businesses can access governments and influence their decisions, how accountable local governments are to their citizens and how responsive they are to their demands.

- A review of governance models around the world does not point to one model that works best. The types of governance structures and initiatives that have emerged in various metropolitan areas reflect the local and national context; differences in constitutional provisions, division of responsibilities, assignment of revenue sources, history and politics of the country, and various other factors.

- The criteria used to evaluate governance structure in a metropolitan area are: (a) Economic efficiency, (b) economies of scale, (c) externalities, (d) equity, and (e) access and accountability.

- There are some examples of initiatives that have worked well in specific contexts – one-tier consolidated structures where the geographic boundary reflects the economic region (such as in Cape Town); two-tier government structures (as in Barcelona); voluntary cooperation among municipalities within the metropolitan area (as in Sao Paulo); national government financial incentives to create regional bodies (such as in the United States); open initiatives (as in Seoul) and participatory budgeting (used in Brazilian municipalities) which encourage citizen participation and greater accountability.

- Metropolitan areas everywhere face the challenge of how to balance regional and local interests. As the world becomes more urbanized and metropolitan economies evolve, there is a need for a regional vision and for many services to be delivered on a regional basis (including transportation, land-use planning and economic development). Most countries would thus be well advised to move towards developing more effective systems of governance for the whole metropolitan area if they want to improve service delivery. A strong regional structure that encompasses the entire economic region is essential to ensure that services are delivered in a coordinated manner across municipal boundaries; and to be able to improve service delivery by reaping the benefits of economies of scale and internalizing externalities. At the same time, some services are very local and would benefit from more local provision (for example in the cases of local streets, parks and recreation).

- The social participation in metropolitan governance is very important, even at the regional level, because it holds both the government and public responsible; it encourages both parties to accept outcomes of the choices they make; and it encourages governments to prioritize their actions.

ON STRUCTURING SERVICE DELIVERY IN PERI-URBAN AND SMALL URBAN AREAS

- Consumption and delivery of services are localized and therefore access to them can vary across different parts of a city.

- Problems on both the delivery and financing sides are the main sources of inadequate accesses to urban services in these areas. Contributing factors are (a) decision makers with different goals and motivations regarding the levels and distribution of public services, (b) higher service provision costs relative to the core of larger cities, (c) governments are too small to allow low cost service delivery in small towns, (d) political decisions that result in uneven services across cities or demographic groups while acceptable service levels are available in other parts of the city, (e) inadequate revenues due to weak local tax systems, and (f) low effective demand for urban services.

- User fees are the best option for financing local services. They allow determination of the appropriate level of services and provide a financing source for service delivery. User fees are good for charging for water, sewerage, intra-city transit and electricity. User fees are poor instruments where pricing inefficiently crowds out consumers as in the case of basic education, or where collection may be costly or inefficient. However, user fees can be regressive. Taxes must be imposed in cases where user fees are not available.

- Many factors determine the most appropriate size for local governments. The appropriate size may change more rapidly than the political dimensions of altering jurisdictional size. Thus, maintaining governments with the right size may not be possible.

- Economies of size in delivering public services are fact-specific and can differ across services.

- Mobilization of adequate financial resources from local sources is the key to providing efficient and effective public services in peri-urban areas of large cities and in small urban centres. Small towns have low revenue bases and they need to make an extra effort to generate the same amount of revenue.

- Options to ensure efficient and effective delivery of services to peri-urban areas of large cities and in small towns in developing countries include (a) transfers from the national government, (b) cross subsidies, (c) single-purpose governments, (d) privatization, (e) contracting out to other municipalities, and (f) municipal cooperation.

Cities are assets, solutions and drivers of economic and social development. Cities possess huge untapped economic potential that can and should be leveraged to create wealth and economic opportunities for all. This requires good urban planning that supports urban compactness, integration, and connectivity. However, even the best urban plans risk ending up unused if they are not accompanied by financial and regulatory strategies for implementation. Strategic public investments must go hand in hand with strategic funding mechanisms and supporting governance systems.

The Challenge of local government financing in developing countries documents both the challenges and solutions related to the ability of local governments to mobilize revenues from local resources. The report also identifies successful governance mechanisms for efficient and equitable provision of public services in metropolitan areas of developing countries, and shares experiences and methods to making public service

HS Number: HS/031/15E
ISBN Number: (Volume) 978-92-1-132653-6

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