FINANCING URBAN LOCAL GOVERNMENTS
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Urban Public Finance in Developing Countries by Roy W. Bahl and Johannes P. Linn (World Bank, 1992, pp.552+xiii)

Management of urban growth is now in the forefront of the policy concerns of developing countries. There was a time when attitudes toward urbanisation were ambivalent as national policies focussed on rural development to stem the rural-urban migration that accompanies industrialisation. In recent years there has been a growing realisation that, after all, urbanisation is not quite an evil to be warded off at any cost; rather, urban conglomerates can contribute to growth in several ways, such as by facilitating the formation of skills, helping to reap the economies of scale in infrastructural investments and generating large pools of taxable capacity that can be tapped to finance the investments and provide the basic civic facilities. It is also recognised that there are links between macroeconomic policies and the urban economy. In any case, urban explosion as a fall-out of growth is a reality that has to be recognised. Facts are too stark to be ignored. Between 1950 and 1990 urban population of developing countries grew four-fold, from under 300 million to 1.3 billion, and is projected to reach 2 billion by 2000 A.D.. As many as 17 out of 21 megacities of the world which are going to have 10 million people each will be in the developing countries. Management of urban growth, particularly, financing and delivery of essential services in the cities, has thus emerged as one of the top priorities of public policy in most developing countries. With national government budgets under severe pressure, a key policy question is, "How can the cities pay their way?".

Policymakers across the developing world have responded to the challenge of urban growth in various ways, each country evolving instruments and institutions best suited to its circumstance with varying degrees of success and there is already a considerable body of literature depicting individual country experience. There has however been little attempt to evaluate the results achieved in an analytical framework or draw lessons which can be generalised. Bahl and Linn have earned the gratitude of policymakers and urban economists around the world by filling this gap and providing a compendium that can be drawn upon for guidance in the financing of urban local governments for years to come. There has no doubt been a resurgence of research interest in urban management issues, of late, reflecting the recognition of their urgency, of which two notable ones are the World Bank's policy paper Urban Policy and Economic Development : An Agenda for the 1990s and the USAID publication Urban Economies and National Development by Peterson, Kingsley and Telgarsky. But none compares in breadth and depth with this truly encylopaedic volume.

The output of a massive research project financed by the World Bank, the publication presents both theory and facts bearing on issues in urban finance with three-fold objectives, viz., improving the state of knowledge, helping to identify and examine the critical issues and developing appropriate criteria for public policy. The focus is on the fiscal problems of cities, for it is the growth of large cities that gives rise to special problems and, in the coming years, is going to demand a good share of the attention of planners and policymakers in all developing countries. While the work is not without its shortcomings, it must be acknowledged that the authors have succeeded in achieving these objectives in good measure.

Sifting through massive data and literature on urban finances and issues, the authors have sought to appraise the performance of city governments across developing countries, comparing theory with practice in order to generalize about the way they respond to the challenges of urbanisation, problems they encounter, practices that have succeeded, and those that have failed. In the process they modify and adapt several of the standard analytical tools to developing country settings to take account of their institutional characteristics, distributional concerns and their administrative limitations. The contents, rich in both theory and facts, are presented in four parts : Part I sets out the analytical framework, Part II deals with taxes levied by local governments, their potential and problems, Part III discusses the principles and possibilities of user charges, and Part IV goes into issues in intergovernmental fiscal relations. The main conclusions and lessons for policy are recounted in an epilogue.

II

To put the issues in perspective, in Part I of the study the authors first assess the role of local governments in providing public services in terms of their functions, share in total public spending and the functional distribution of their expenditures in selected cities from developing countries. Based on self-explanatory tables they also analyze how the urban governments finance their expenditures and their trends over the last two decades. Although generalization is difficult because of wide variation across countries and cities and also differences in their reference periods, a few facts stand out.

On an average, about 15 per cent of total government spending and one-third of all urban area spending is accounted for by sub-national governments in developing countries. Together with the fact that their responsibilities often include major development functions such as public works, mass transit and primary education, cross country survey shows that local governments do play an important part in the development of large cities. Despite handicaps, - population growth, inflation, and resource constraint, - real per capita expenditure of local governments and autonomous agencies increased during the 1960s and the first half of the 1970s. In the 1980s however many cities saw real expenditure levels decline, signifying fiscal problems and a deterioration of civic services. There was also a trend towards central financing of urban services. Nevertheless, available evidence points to a continuing significant role of local governments in resource mobilization and their potential.

In general, city governments meet about 70 per cent of their expenditure out of locally raised revenues (in some cities the proportion is incredibly high, e.g., 100 per cent in Karachi). There has however been a decline in the share of local revenues in the 1980s reflecting greater dependence on external sources usually controlled by higher level governments. Significantly, data from a few cities clearly suggest that the ability of local governments to enhance their services is determined to a great extent by the availability of their own source revenue. While some might feel sceptical about the precise statistics, given the limitations of local finance data, these assessments would seem to accord with the general perception about the primacy of own revenue in conditioning the service level of civic bodies.

Averages based on available data show that about 50 per cent of the local revenues is derived from taxes; the rest comes from self-financing services, but again the pattern is far from uniform across countries or cities. A variety of taxes are drawn upon by local governments, the property tax being the most common and often the dominant tax source. Although local tax revenue usually forms a relatively small proportion of total government revenues, theory as well as experience of several countries suggest that improvement in their design and implementation can enhance the fiscal capacity of local governments significantly while minimising adverse equity or efficiency effects. The volume provides a balanced appraisal of the potential of various revenue sources - tax and non-tax - that urban local governments can draw upon to meet their ever increasing expenditure responsibilities, focussing on practices that have paid dividends. Discussion of local government taxes and charges for urban services takes up the best part of the publication spanning two out of its four parts. The practices in regard to both are appraised in a theoretical framework but in a language that should be intelligible to interested laymen and trained policymakers alike.

III

Part II, made up of five chapters explores at considerable length how urban governments can generate a larger share of their total revenue through taxation than at present. Though constrained by limitations of their fiscal powers, urban governments in search of revenue levy taxes of diverse kinds, many of them, of no more than nuisance value. These are classified under five categories. Of these, the first, comprising three, viz., the property tax, the vehicle license taxes and the entertainment taxes yield most of the revenue. Barring the tax on buildings, these are regarded as equitable and uncontroversial from the efficiency angle. Quite appropriately, appraisal of alternative systems and analysis of the incidence and allocative effects of urban property taxation occupy three of the five chapters of Part II. The relative merits and drawbacks of alternative bases adopted for property taxation are discussed at length. Suggestions based on experience and theoretical merits are put forward at the end that should be helpful in reforming and reinforcing the property tax systems of developing countries. The main conclusions emerging from the review of alternative systems are worth reproducing for their relevance in the strategy of reform.

First, property tax structure and administration go together and must be viewed as such while undertaking reform. Next, administration of property tax has four critical aspects, viz., property identification, record keeping, assessment, and collection. Attention must be paid to all of them if the taxation of property is to show better results. These, the authors argue, underline the need to view property tax as a system and not merely as a set of independent activities. While the striking success of collection-led strategy in improving the property tax yield in Indonesia would seem to belie the validity of this prognostication, there is no doubt a lot of merit in approaching property tax administration as a system with four interrelated dimensions, calling for concerted attention.

Another conclusion underscores the valuable role of monitoring and quantification in identifying the weaknesses in the operation of property taxes. How helpful monitoring can be in this regard is brought home by the experience of Bogota. The ratio of effective to statutory rate of property tax in that city was no more than 0.5. Quantitative analysis found this to be attributable to a 32 per cent shortfall in collection below legal dues, exemption of 13 per cent of all assessed property values, and underassessment by 15 per cent. It was also discovered that the low income elasticity of property tax revenues stemmed mainly from the low elasticity of market values. While permanent improvement in buoyancy cannot come about merely through administrative changes, the systems approach can obviously help to locate weaknesses which undermine the revenue productivity of a given structure with a degree of precision not possible otherwise. An obvious prerequisite for application of quantitative techniques in diagnosing the ills of an administrative system, however, is a well-designed data base, a requirement few municipal governments in this country fulfil. Organising a reliable data base for local finance should be among the first priorities in any scheme of property tax reform in all developing countries.

While acknowledging that property tax systems do not lend themselves to evaluation in terms of definitive judgements, the authors offer ten generalizations that may be helpful in the formulation of tax reform in developing countries. Some of these might appear self-evident but are often ignored in practice, such as that the tax structure should be kept as simple as possible, with emphasis on improving the administration. However, there are a few which emerge from theory and might not be that obvious, e.g., that a flat rate property tax on all real estate is not likely to be regressive in either the short or the long run or that elimination of concession for owner-occupied properties can enhance the progressivity of the tax. Two other similar generalizations focus on the deleterious effect of a property transfer tax on the operation of urban land markets and the futility of land value increment taxation. Observers of property tax scene in developing countries would, of course, readily agree that in raising the buoyancy of property tax revenue there is no substitute for attention to administration.

One might wonder, however, whether the authors' scepticism about the transfer of tax and land value increment tax is that well founded. Taiwan's success in implementing the land value increment tax with a top rate of 60 per cent (and a similar attempt in Korea to use a 50 per cent tax on the increase in the annual value of land) point to the potential of betterment taxes on urban land as a revenue raiser and also as an instrument to contain speculations in urban land and impart a measure of equity in the tax incidence. In a subsequent chapter, the authors themselves acknowledge the potential of development charges in financing infrastructure investment in growing cities, although they have reservations about the merits of the betterment levy as such.

Although the analysis and prescriptions for property tax reform are in general incontestable, one may feel that they tend to be a little simplistic, even platitudinous at times, and fail to take into account the realities facing reformers in developing countries. The problems encountered in property tax reform in India and their links with the other components of the legal framework like the rent control laws come readily to mind. While there is a passing reference to the stagnation in property tax base arising from rent control in India the problem of valuation arising from the acute imperfections of urban real estate market - the high proportion of 'black' money in real property deals - do not seem to have received the attention it deserves. These problems are surely not peculiar to India, although it can be regarded as a serious road block to improving property tax revenue buoyancy. It would be helpful if more attention was paid to the suitability of the presumptive approach in property valuation and the experience with area-based taxation in relation to real property than the authors thought appropriate. However, the general lessons drawn have their usefulness everywhere and ought to be heeded by policymakers contemplating reform of their property tax system. The chapters on incidence of property taxation and its allocative effects provide a lucid exposition of the theory, both conventional and current, backed up with empirical analysis based on data from selected cities.

Of the other taxes which can rightly be assigned to urban governments, taxes on motor vehicles come out as the most promising, though often underutilized. The case for the taxation of the ownership and use of automobiles is built on three strong arguments: capturing a rapidly growing tax base, recovering the costs of public expenditure entailed by automobile use and containing their social cost (pollution). The bases available for automotive taxation are also examined in some detail - the fuel taxes, taxes on sale and transfer of motor vehicles, the unrestricted annual licence taxes and congestion taxes (restricted licences, parking fees, tolls, etc.). A combination of these instruments appears to be the best way of taxing automobiles. Alternatives that offer good revenue potential without causing much efficiency loss are the unrestricted license taxes and fuel taxes at differential rates according to the degree of congestion. Restricted license taxes such as practised fruitfully in Singapore are also worth attention.

In addition to taxes on property and automobiles, local governments levy a variety of taxes to obtain revenue, though not many of them are very productive. They are often antiquated, difficult to administer and bad from equity and efficiency angles. Yet they remain alive out of inertia and lack of any attempt at a comprehensive local tax reform. Some of them however have proved to be prolific revenue generators and tended to persist despite widespread condemnation. Taxes on industry and trade like the octroi and the sumptuary taxes continue to be relied upon heavily by local governments because of the facility they offer of raising amounts of revenue without resistance. A classic example in the Indian context is octroi. Possible alternatives which can beget substantial revenue without serious ill effects include local income taxes and general sales taxes. Reform to move away from harmful taxes on trade and commerce towards better alternatives however cannot make headway unless a viable alternative is offered. The study serves to focus attention on several of these alternatives. Policy makers in India confronted with the task of finding ways of recompensing the municipal governments while pleading for the abolition of octroi and "Path Kar" would do well to take a look at this part of the volume.

Charging for user services also constitutes a potent source of urban revenue that can help improve the efficiency of resource use and investment decisions while securing the revenue needed to meet the costs of providing them in way acceptable to the people. Three substantial chapters comprising Part III of the work are devoted to a consideration of the principles and practices of pricing urban services focussing on public utilities (water supply, sewerage, electricity and telephones), social waste disposal, public transport, road construction and housing. Reference is also made to education, health, public markets, cemeteries and abattoirs, though only incidentally.

The major issues involved in the pricing of urban services are first gone into in a general context and examined from the angles of efficiency, fiscal constraints, equity and growth and also political and administrative feasibility. The relevance and implications of the basic welfare maximising rule of pricing - the marginal cost pricing rule, both short and long run - are expounded lucidly along with a critical review of the underlying assumptions affecting its applicability in the real world and adjustments and refinement that may be needed in implementation. The conclusion that setting user charges equal to marginal cost can increase the efficiency of resource use in urban development remains valid for rich and poor countries alike. It is recognised that problems arise in its application in developing countries from externalities, distortions in input and output prices, imperfect consumer information, administrative and transaction costs, lumpiness of capital and so on. These are examined almost itemwise and solutions offered to achieve efficiency.

Strict adherence to the marginal cost pricing rule may cause deficits in the local government budgets, where there are large economies of scale or there is rapid technological change. The relative merits of alternative ways of taking care of the problem - general fund financing, multipart tariffs, uniform tariff - are discussed, bringing out the pitfalls and the trade-offs involved. Complexities that arise when distributional concerns are introduced are considered next and the theoretical constructs to meet them are summarized in a table. While they provide no universally applicable rule, the models serve to illumine the complexities of the task and thereby help as guide to policy.

There are analytical and practical issues that need to be addressed before the models can be used. The problems arise from factors like trade off among efficiency, revenue and distributional considerations, and the difficulties of estimating price elasticity of demand for public services and the incidence of public service benefits and charges and so on. The role of value judgements and the need for assessing the political and institutional setting in undertaking any reform of public service pricing are acknowledged.

How general principles can guide policy in practice is demonstrated in the next two chapters with reference to urban water supply and a few other urban services like electricity, telephones, solid waste collection, bus service and housing. The responsibility for electricity supply commonly rests on higher level governments or agencies, although there are instances where urban agencies are entrusted with the task of distribution (an example on hand is BEST of Bombay). Similarly, local telephone network and service are sometimes given to local agencies to run. Hence the relevance of guiding principles for pricing in respect of these services. However, issues as intricate as electricity or transport service pricing need much more extensive discussion than perhaps could be accorded in an omnibus chapter on "Charging for Other Urban Services". The authors evidently have tried to be comprehensive in their coverage but in the process compromised depth in places. The prescriptions for pricing some of the services comprised under this head might indeed raise eyebrows in poor countries, such as the proposition that public agencies should steer clear of direct involvement in the construction of urban shelter, and would do better to provide essential service inputs to the housing market. Anyone familiar with state of slums in cities like Bombay or Delhi (or perhaps the plight of street children in Latin American countries) would wonder whether the market can really take care of their less fortunate inhabitants.

There is however a section in this chapter which, though brief, merits special attention of authorities grappling with the problem of finding resources for improving the infrastructure of growing cities. This is on "Development Charges". While the authors are somewhat dismissive about the efficacy of instruments like the betterment levy in recouping public costs of urban infrastructure development, they highlight the success of development charges of two particular types used by local governments for urban development in some countries for quite some time. These are: the land readjustment systems of East Asia, and the valorization schemes of Latin America.

Land readjustment systems have been in use in several countries at different times, such as Germany, Japan, the city of Perth in Australia and Taiwan and most extensively in recent times, in Korea. Introduced by Japan, this system has been used in Korea for practically all large residential urban developments and had helped the development of almost seven times as much urban land as the private market, especially as the urban fringes. In essence, the scheme envisages assembling of parcels of "raw" land on urban fringes by a public agency without monetary compensation to the owners to be returned to them proportionately after servicing and subdivision for urban use, with a fraction retained for infrastructure like roads, open spaces and so on and some, to be sold for raising funds for development. Contrasting with the readjustment programmes, the valorization schemes of Latin America, have served to finance infrastructure improvements in already subdivided or built up urban areas, by allocating the costs of improvement across beneficiaries.

While problems have been encountered in the implementation of these systems and the distributional impact (especially of the readjustment schemes) has tended to be adverse to small land owners, there is clearly a lesson to be drawn from the Korean experience, viz., that perhaps these offer a more effective and viable development mechanism than taxes or levies whose nexus to the benefits is not readily perceived. It may be of interest to Indian readers to know that mechanisms like land readjustment to finance urban infrastructure development are not unknown in this country. These were introduced in Gujarat and Maharashtra years ago but fell into virtual disuse for various reasons and are currently being revived in Maharashtra. Striking success has been achieved by public agencies in raising funds for urban infrastructure development through instruments of this kind (e.g., the surplus generated by the Bombay Metropolitan Regional Development Authority by acquiring, developing and then selling land on the fringes of the megacity and lent for development activities like investment in urban transport). Unfortunately, there is hardly any systematic attempt to appraise these schemes critically or disseminate the results of their operation among other States. The need for exploiting the potential of instruments like these to help urban development is acquiring urgency in the context of the acute crunch that faces the public sector everywhere.

V

The last part of the work is devoted to issues in intergovernmental fiscal relations. The first of the three chapters comprised in this part deals with the "Structure of Urban Governance". In theory, the case for decentralisation in governmental organisation is almost overwhelming - it enhances the efficiency in the development of the size of the public sector and the composition of services preferred by the people, contributes to nation building by encouraging people to identify with governmental activity and helps resource mobilisation. The current structure of local governments in developing countries also reflects the commitment of national governments to decentralisation. Yet in practice, as noted at the outset, local governments account for less than one-sixth of total government spending in developing countries as compared to about one-third in industrial countries and even the measure of one-sixth is probably on the high side since, quite frequently, local governments exist in form but have little autonomy in reality.

What should be the optimum structure of government in a given situation however does not admit of a straightforward answer. The authors conclude their survey of theory and practice in this regard with the answer "it depends". However, the survey provides an idea of the kind of structures that have emerged in developing countries and their relative strengths and weaknesses - fragmented jurisdiction (many municipalities operating within a single urban area), metropolitan governmental set-up in conjunction with one or two autonomous agencies (to supply water, power or transport, for example) and functional fragmentation with independent agencies delivering specified services. It might be salutary to know in the present context in India with the enactment of laws to give constitutional status to city governments ("Nagarpalikas") that the experience with local governments in the metropolitan areas of developing countries demonstrate the merit of a structure built on "accommodation", emphasising at once, the role of local control and participation, central coordination and control and also technical efficiency. Blending the best of all three is what ultimately makes for optimal delivery of public services - a lesson that needs some reiteration in this country right now.

"Flows and Effects of Intergovernmental Transfers" constitutes the subject matter of the other chapter in this part. Given the limitations of the tax and borrowing powers of local governments arising from considerations of efficiency and central control over macromanagement of the economy, arrangements for the flow of funds from higher level governments through shared taxes, grants and loans are a universal adjunct of decentralised governance. How to institutionalise these flows to take care of the expenditure needs of lower level governments without treading on their autonomy constitutes the essence of what is known as fiscal federalism. The task is not simple, as the experience in India and several other federations amply show. While a formal arrangement for transfers can assure adequacy of resources to local governments, automated flow of funds tends to breed fiscal irresponsibility. Nevertheless, intergovernmental transfers form a major source of local government finance in most developing countries and their share in local government revenue seems to be increasing (in Calcutta, for instance, 55 per cent in 1982 as against 19 per cent in 1975). How to structure them to achieve the desired results while preserving the incentives for economy and raising revenues on their own remains a challenge for fiscal planners everywhere. The volume under review provides a digest of the various forms in which the intergovernmental flows can be structured and their merits and drawbacks.

Grants and tax sharing can be arranged in several ways, and the determination of their quantum and distribution among the lower level governments (e.g., voting by the national legislation annually) can be either ad hoc or formula based. A variety of arrangements is possible, each with its merits and drawbacks. Forms of tax sharing and grants with local and state governments in selected developing countries are summarised in two neatly arranged tables. Principles for evaluating the alternatives in terms of their allocative and equalizing effects as also implications for revenue adequacy, efficient functioning and autonomy of local governments are also put forward with an illuminating, though brief, discussion of their relevance in designing an optimal structure of intergovernmental flows, drawing again from theoretical literature and experience.

The sobering conclusion is that no single policy instrument like grants can achieve all the objectives. Attempts to serve several objectives simultaneously, like equalization of fiscal capacity across jurisdictions and stimulating local government tax effort while minimising administration cost and promoting local autonomy may end up by achieving little in any direction as the effect of one may be neutralised by that of the other. As in most other areas of public policy, one has to set priorities and attach weights to each objective in that light.

The last chapter consists of an Epilogue setting out the main conclusions, not just by way of a summary, but as an overview of the issues and lessons. While in parts, it might look a little too bland, policy makers, hardpressed for time, might profit from a reading of this chapter alone. It might whet their appetite for a look at the preceding parts of the volume.

All in all, the publication is a most welcome and valuable contribution to the literature on local government finance. It presents in a single volume a comprehensive and at the same time in-depth survey of the major issues and problems in financing the expenditures of urban governments, drawing on both state-of-the-art theory and experience. For a long time to come it will remain a reference compendium for researchers and planners engaged in finding the means of managing urban growth in developing economies. Of course, drawbacks do come to notice when one takes a close look. For instance, doubts arise on the quality of the data as one stumbles on statements such as this: "all local governments in metropolitan Bombay spent the equivalent of $ 55 per capita in 1982, which was 43 per cent of estimated total (Central, State and local) government spending in the Bombay metropolitan area" (page 13). Anyone familiar with the structure of government in India and the relative shares of the Centre, States and local authorities in the total expenditure of government would find such a figure a little astonishing. Another shortcoming is that much of the data relied upon in generalizing about the expenditure and revenue structure of local governments relate to 1970s and early 1980s. Rarely do they relate to any year beyond 1985. One does not know whether the trends noticed till the mid-eighties persisted through the latter half of the decade or there was any change of course.

Also, in their anxiety to present a respectable coverage in terms of issues and geographical spread of their survey the authors seem to have missed out some of intractable problems in finding resources for urban governance. The prescription for greater reliance on property tax, for instance, is unexceptionable. Unfortunately, the fact remains that it is an unpopular tax. Despite prodding, few local governments in the world seem to have mustered the will to use it with any perseverance or seriousness of intent. In the circumstances, the real alternatives have to be looked for elsewhere. How to find alternatives which would respect considerations of economic efficiency and avoid extra-territorial taxation is a task that does not seem to have been squarely addressed.

It may not however be fair to demand answers to all country or city specific problems from a framework meant for general application. Perhaps, a volume like this cannot afford to get enmeshed in tackling uncommon issues. Nevertheless, given the constraints of keeping the coverage manageable and the aim of addressing a wide audience, the authors have done an admirable job.

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