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Roundtable on Fiscal Issues

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Recommended Citation

Bahl, Roy W. and Marlene Fernandes "Roundtable on Fiscal Issues." The urban age - urban finance issue 3(3) (English). The global city magazine Washington, D.C. : World Bank Group.
<http://documents.worldbank.org/curated/en/570061468053708270/The-urban-age-urban-finance-issue-3-3>

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Public Discourse

THE ▽ URBAN ▲ AGE

Volume three

17448

Number three

September 1995

U R B A N F I N A N C E I S S U E



In the "Roundtable," we present several questions to prominent people on the topic being discussed in each issue. The purpose is to create a forum for interchange and debate among people with opposing points of view. Our hope is that readers will find it a starting point for generating their own discussions, both within their cities and in response to *The Urban Age*.



Marlene Fernandes is an architect and urban planner. She is currently technical assistant to the executive director of the Brazilian Institute of Municipal Administration (IBAM), and is coordinator of the Mega Cities Project in Rio de Janeiro. Ms. Fernandes is also the coordinator of the Habitat II regional seminar on urban financial strategies for Latin America and the Caribbean.



*Roy Bahl is professor of economics and director of the Policy Research Center at Georgia State University. His book with Johannes Linn, *Urban Public Finance in Developing Countries*, is one of the few comprehensive analyses of this subject. Recently, Professor Bahl has been working on fiscal decentralization in Russia and China.*

UA: *Urban finance involves the provision of important goods and services; improvements in the provision and funding of these activities require what kind of changes in the political incentive structure?*

FERNANDES: The improvement in the provision and funding for housing, infrastructure, and urban services requires government incentives that reduce risks, increase competitiveness and enable markets, formal and informal, to work. Some of these incentives are: keeping a stable regulatory framework, such as tariff structures to sustain long term capital investment recovery; providing subsidies to supply those who cannot afford to pay full service costs; and using bidding or contracting-out procedures that reward the suppliers' competitiveness, productivity, and efficiency.

BAHL: Local government officials must be accountable to those who consume urban services if the efficiency of delivering these services is to improve. This requires that local councils be popularly elected and that local chief officers be appointed by these councils. It is also important that budgets be formulated by local councils so that citizen preference for various government services can be reflected.

UA: *What kind of intergovernmental revenue arrangements should accompany fiscal decentralization?*

FERNANDES: It is necessary to adopt a fiscal structure that would reduce the need for intergovernmental transfers, giving each level of government the autonomy to collect and allocate the fiscal resources necessary to exercise their specific functions.

BAHL: Three characteristics of the intergovernmental fiscal system must hold if true decentralization is to be achieved. First, there must be some assignment of revenues and rate-setting power to the local government; the sharing of central government taxes on a derivation basis is not decentralization. Second, grants must be distributed in a transparent way so that local governments can plan their fiscal affairs with a reasonable degree of certainty. Third, there must be correspondence between the expenditure responsibility and the fiscal resources that are assigned to local governments.

Ideally, intergovernmental transfers should be used only as a compensatory mechanism between regions, municipalities, or cities with different economic capacities. Part of the transfers could be used to stimulate local governments to improve their fiscal capacity and increase their revenues.

UA: *What risks do intergovernmental financing arrangements create for national macroeconomic management?*

FERNANDES: Subnational governments may force upwards interest rates in the financial markets. They may also increase living costs, affecting inflation through their pricing policies that could increase public deficit and external debt - risks usually associated with national governments.

BAHL: If the intergovernmental system assigns significant taxing and spending powers to local governments, the ability of the central government to use fiscal measures in its macroeconomic stabilization program will be limited. As fiscal decentralization shifts the determination of investment priorities to local governments, higher income local governments will have a greater taxing capacity. On the other hand, decentralization should lead to a greater willingness to pay for services and therefore to an increase in the rate of revenue mobilization.

UA: *How does one encourage cities to become creditworthy while giving them a reasonable but binding constraint to encourage efficient use of revenue sources and service provision?*

FERNANDES: There are three ways to do this. First, by adopting criteria to distribute fiscal resources that would reward efficiency and effectiveness of service provision. Second, by reinforcing local social controls to improve accountability, efficiency, and transparency in the use of resources. Third, by adopting enabling strategies such as capacity-building and institutional development, to improve planning, budgeting and management activities.

BAHL: Local governments will never have an incentive to be creditworthy unless they have some autonomy in determining their budgets, real access to credit financing and a hard budget constraint that limits their liability to run up deficits. A key to encouraging strong and responsive local government is to allow the imposition of a wide range of user charges, limited only by the acceptance of these by local voters. There is no inherent inconsistency between fiscal responsibility and budget constraints; legal limits on borrowing and tax rates can still leave room for discretionary fiscal actions and for budget planning to meet local demands.