Roundtable on Fiscal Issues

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Good Municipal Financing Practices in Latin America

by Monica Ramirez Londono

BOGOTA. Traditionally, local economic development in Latin America has been viewed as a consequence of national economic trends and policies introduced by central governments. Successful local economic development was considered to be simply the result of chance that a particular region or place ended up benefiting from a government investment, public infrastructure improvements, or better facilities.

However, as increased urbanization has taken hold on the continent, with more than 70 percent of the population now living in towns and cities, it is recognized that national economic development is increasingly urban-driven; it is also recognized that local authorities play a crucial role in removing inefficiencies in production that hinder the productivity of businesses, private enterprises, and family enterprises, which together account for nearly 80 percent of the gross national product (GNP) in developing countries.

Promoting local economic development

The importance of local government in local economic development is also underlined in the context of Latin America’s recent economic crises and the macroeconomic or structural adjustment policies that were introduced in the region. Local governments were practically the only level of government during the 1980s where economic development and social policies were combined. Besides, local governments have certain clear advantages over national governments in promoting some kinds of local economic development. They have a better understanding of the dynamics of a local economy and are also better placed to mobilize community organizations.

Municipal governments in the region have tried to promote local economic development in various ways. Traditional approaches include establishing industrial parks, or places where enterprises can start up with the necessary infrastructure. Some of the most important new initiatives, however, are deregulating land markets, making investments in urban infrastructure, and making services run more efficiently. All three help stimulate economic productivity and private enterprise.

An interesting case is Tabio, a small town in Colombia, situated on the outskirts of Bogota. In the early days of Colombia’s decentralization program, Tabio’s mayor managed to get his local community to make a commitment to reduce the town’s poverty and develop the town. He did this by motivating young people and helping create a sense of local pride and identity in the town.

For instance, an inventory of the municipalities’ botanical resources made the local community aware of the threats to the natural environment, and motivated them to work for the conservation of these resources. The community also became involved in local projects to pave streets and spruce up public places. These endeavors helped raise Tabio’s tourist appeal it had once had, and brought economic activity and dynamism back to the town.

In another initiative, ILULA-CELCADEL in the Andean region has...
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 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 Bahls 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:** 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.

**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, 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.

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