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Metropolitan City Finances in the Asia and Pacific Region: Issues, Problems and Reform Options

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2. Metropolitan City Finances in the Asia and Pacific Region: Issues, Problems and Reform Options

Roy Bahl

1. Introduction

With unprecedented urbanization and the ambitious 2030 Agenda for Sustainable Development, countries will need to engage in fundamental restructuring of governance and finance to address this challenge and realize the objectives of sustainable and inclusive development. It will be challenging to meet the Sustainable Development Goals. In particular, Goal 11 "Sustainable cities and communities", Goal 1 "No poverty", Goal 6 "Clean water and sanitation" and Goal 9 "Industry, innovation and infrastructure" require that Governments ensure access to affordable housing and basic services, upgrade slums and provide safe, affordable, accessible and sustainable sanitation, protection from fire hazards and transport systems, with special attention to the needs of those in vulnerable situations. Even to move in the direction of such goals, Asian and Pacific countries must find ways to provide public services more efficiently, to govern metropolitan areas[15] with a better eye toward ensuring equity in the

[15] The term 'metropolitan area' refers to the built-up space covered by large cities, including their suburban areas. This is similar to the United Nations (2008, p, 13) definition of 'urban agglomeration', which includes the population "contained within the contours of a contiguous territory inhabited at urban density levels without regard to administrative boundaries."

provision of services, and to mobilize more resources through taxes and charges for services.

The focus here is on the last of these areas, revenue mobilization by local Governments in metropolitan areas. It is meant to help policymakers in the Asia-Pacific region in two ways: by providing a policy framework for an overall city financing strategy, and by identifying some of the specific options for increasing metropolitan local government revenues.

Given the sheer scale of Asia-Pacific urbanization in recent decades and forecasts for the coming decades and the enormous investment gaps in urban infrastructure, public services, housing and environmental sustainability, a comprehensive reform of the system of financing large cities would be necessary to resolve the revenue shortfall challenge in the region. The economic base of metropolitan cities is large and growing, and moving taxation powers closer to the local governments may help to mobilize revenue. A reform programme consistent with these objectives can be designed and implemented, but as with any new programme, there will be many capacity, legal and political hurdles to overcome.

Most importantly, this reform will require an asymmetric approach to public expenditure and revenue assignments under which metropolitan local governments will have greater autonomy than local governments in the rest of the country. The reform will need to be comprehensive. It will call out changes in both the governance structure of metropolitan areas and the assignment of expenditure responsibilities. Services that provide area-wide benefits will need to be provided directly by regional local governments, with taxing and charging powers, or at least the delivery of these services must be coordinated effectively. A lower tier of local government might also be responsible for local services. However, the senior local government in the region will be the metropolitan authority, which also will be responsible for equalization of public service levels within the metropolitan area.

Intergovernmental transfers to metropolitan local governments will be limited to those that are required to cover the cost of benefits that spillover beyond the boundary of the metropolitan areas. Otherwise, metropolitan area local governments will be responsible for covering the costs of the services they provide. This can improve the efficiency of local public service provision, and it can free up significant revenue for allocation to other purposes.

Metropolitan local governments would be given the power to levy certain new taxes and charges, and they should be required to use these powers to finance their budgets. The metropolitan area-wide local government could levy more efficient taxes on motor vehicles, business sales and property, and user charges, and could impose a piggyback levy on certain central (or state/provincial) taxes. The underlying local governments could focus on property taxes, benefit taxes and licenses.

While these general principles would provide useful guidance for policy decisions, it is worth highlighting upfront that there would be no simple “one size fit all” solution. The choices of strategy, policy and implementation will depend on the local context of governance structure, institutions, preferences of the citizenry and socioeconomic considerations.

A second limitation is that some important topics are not covered in this discussion. These include notably, land policy, housing finance, public-private partnerships, local public administration, and regimes for debt finance. A separate paper could be written on each of those topics, and including any of them in this discussion diverges too far from the central concern of this chapter. Also, this chapter limits the discussion to low- and middle-income countries in the region, even though the experiences in the more industrialized countries can be very constructive.

Finally, there is the question of which metropolitan areas in the Asia-Pacific region are good candidates for the reform options discussed. No specific list of cities is proposed here, but the focus is on large urban agglomerations and on countries where subnational governments play a more significant role in the fiscal structure.

This chapter begins with a discussion of why revenue mobilization by big city governments has become an important question, and how the development of a proper framework for metropolitan finance might be approached. It then presents a critical review of the governance and finance practices in metropolitan areas in the Asia-Pacific region, followed by a discussion of the reform options that might be part of a way forward.

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2. Urbanization and the fiscal challenge of financing large cities

The urban population of the Asia-Pacific region more than doubled between 1950 and 1975, doubled again between 1975 and 2000 and is projected to almost double once more between 2000 and 2025. In absolute terms, the current quarter century (2000-2025) is projected to add an estimated 1.1 billion people to the region’s urban areas (ESCAP, 2015). Of the 28 megacities (cities with more than 10 million people) worldwide, 17 are in the region, and 60 per cent of the increase in the world's urban population between 2000 and 2030 is taking place in the region as well. Mobilizing adequate resources to meet infrastructure needs and providing basic public services and housing for the expanding urban population will be no small task for central and local governments in the region.[16]

The benefits of urbanization to economic development are well known (World Bank, 2009; Yusuf, 2013; Glaeser and Joshi-Ghani, 2015; Ahluwalia, Kanbur and Mohanty, 2014; ESCAP, 2015). Agglomeration effects allow firms to capture economies of scale, more exchange of ideas increases labour productivity and innovation, access to a larger and more specialized labour market helps relax supply constraints and increases productivity, and a more advanced infrastructure and education system leads to productivity increases. The Asia-Pacific region has done particularly well in capturing the benefits of urbanization. In a ranking of Global cities according to their competitiveness, 13 of the top 50 are in the Asia and the Pacific (A.T. Kearney, 2010).[17] As shown in table 2.1, it is not uncommon for individual metropolitan areas to account for a disproportionate share of national gross domestic product (GDP) in the Asia-Pacific.

Table 2.1

National population and GDP shares of metropolitan areas in the Asia-Pacific region

Metropolitan area	Population (millions)	Percentage of national population	Percentage of national GDP
Bangkok	10.1	12.6	29.1
Jakarta	10.2	11	16
Manila	11.5	10	37.2
Beijing	21.1	2	3.43
Mumbai	20.7	2	6.16
Istanbul	14.3	19	27
Karachi	15	8	14
Colombo	5.6	27	40
Yangon	4.35	8	23
Dhaka	17	11	35
Hanoi	7.7	9	12.6
Kathmandu	5	18	33

Source: drawn from various sources.

16 Most of this increase is in China and India, but significant urbanization is also taking place elsewhere in the region.

17 The rankings are based on five factors: business activity, human capital, information exchange, cultural experience, and political engagement.

Providing public services in cities with populations of 5 million to 20 million in low- and middle-income countries poses great challenges, which are exacerbated by inadequate infrastructure, insufficient housing stock and large concentrations of poor families. Continued in-migration together with a large backlog of unmet needs suggests that incremental changes to the national system of fiscal decentralization or taxation will not resolve the public financing problems of large urban areas.

It almost certainly costs more to meet the demand for public services in large metropolitan areas because of higher factor costs (labour, land), transportation costs, water supply provision and because of cost duplication in metropolitan areas where many municipalities provide the same services.[18] Metropolitan areas also require special public services to accommodate their large populations and more dense living conditions. This might include a larger and more complicated road network, and mass transit to reduce congestion. More dense living conditions and urban poverty may require heavier outlays on sanitation, security, firefighting,[19] and the like. The metropolitan population, with better education and higher income, generates greater demand for high quality of public infrastructure and services, including better education, healthcare and better amenities, such as recreation, a cleaner environment and open space.

Keeping up with infrastructure investment needs is perhaps the major financial challenge facing metropolitan cities. Ingram, Liu and Brandt (2013) estimate, with an income driven model, that developing countries will require an annual amount of about 2.8 per cent of GDP for new infrastructure investment in urban areas, and an additional 2 per cent of GDP for maintenance. If these projections are only approximately correct, they are well beyond the reach of most developing countries where total central and local taxes average about 16-17 per cent of GDP and have not increased greatly in the past four decades (Bahl, 2014; see also Yoshino and Morgan, 2017). Individual country studies also paint a bleak picture of the prospects for covering the infrastructure gap. Estimates for India are that new investment in urban infrastructure will rise only to about 1.14 per cent of GDP over the next 30 years (Ahluwalia, Kanbur and Mohanty, 2014).

Slum improvement is another major challenge confronting Asian countries. It focuses on three activities: investment in infrastructure and public service amenities, improvement of shelter, and security of land tenure. The two latter activities are multi-government tasks, necessarily led by central Governments. The improvement of local public services may fall in large part to the metropolitan local governments, depending on

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18 To some extent, these higher costs will be relieved by capturing economies of scale and density.

19 Special equipment to deal with tall buildings for instance.

expenditure assignment, but in general is almost always well beyond the limits of their present access to finance. For example, over half of the population of Mumbai lives in slums with little access to clean water or sanitation. Most do not have access to health and education. Rao (2009) and Bandyopadhyay and Rao (2009) cite statistics that underline the magnitude of the problem: just 78 per cent of people living in slums use tap water; only 37 per cent use communal toilet facilities and 24 per cent walked 0.2-0.5 km to latrine facilities; there is little by way of solid waste disposal; and only 84 per cent of slums had approach roads suitable for motor vehicles.

While there is a general perception that large cities in Asia and the Pacific are incurring chronic deficits because of high investment needs for urban development, overborrowing and inadequate revenues, it is not an easy task to accurately evaluate the fiscal health of a city and estimate the actual financing gap.[20] In addition to the problem of data shortage, defining fiscal health itself is especially difficult. The accounting definition of fiscal condition focuses on budget balance. On the surface, this seems straightforward: Does the city government raise enough revenue from its regular sources to cover the amount it spends? But this straightforward definition can give a misleading picture. There may in fact be a budget deficit that is covered by irregular transfers from higher-level government (bailouts), deferred payment to creditors or to public pension funds, or short term borrowing from banks. All of this might be effectively hidden in the accounts and so it is difficult to get meaningful results from accounting statements of financial condition.

More importantly, a balanced budget does not give information about the quality of public services delivered, or about whether present levels of tax burdens are sustainable. A straightforward comparison of total expenditures and total revenues of Asian cities may show large financial surpluses, as for example, in Manila and Jakarta. But in fact, neither city spends their full budgeted amounts for various reasons, including that intergovernmental transfers are received too late in the fiscal year to be fully spent, the local governments do not have the capacity to spend the full amounts of revenue available, capital projects are delayed, and so on. It is risky to draw conclusions about fiscal health from these surpluses.

On the bright side, metropolitan city areas have a greater taxable capacity than the rest of the country, and this tax base has been growing. If metropolitan area local governments effectively tap the revenue potential in big cities, they can significantly narrow the revealed and hidden city financing gaps in the Asia-Pacific region. Most big cities in the region have

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20 In many countries, particularly in South Asia, there are no reliable data on metropolitan revenues.

yet to secure access to broad tax bases (table 2.2) and have remained highly dependent on transfers from the central (or state/provincial) government. In fact, the major local government revenue source in Mumbai – the tax on the entry of goods into a local area for consumption, use or sale (Octroi) – was recently abolished in favour of a new national tax on goods and services, and the major revenue entitlement of local governments in China has been folded into the central value added tax.

Table 2.2

Revenue bases of local governments in selected metropolitan areas of Asia-Pacific countries

City/ metropolitan area	Power to Levy a broad based, local non-property tax	Major revenue source	Comments
Mumbai	No, see comments	Transfers	Until 2017, Octroi was the principal revenue source. Octroi, a terminal tax, was known for its distortive effects on trade.
Beijing	No (see comment)	Transfers	Chinese cities have access to the national government tax base through shared tax transfers but cannot impose taxes or change rate or legal base.
Jakarta	No	Transfers	Does not participate fully in general revenue sharing, but can receive other transfers.
Manila	No	Local sources, including a turnover tax on certain local businesses	Poorest local governments in the metro are more dependent on transfers
Istanbul	No	Transfers	Very little local government taxing power
Ho Chi Minh City	No (see comment)	Transfers	Viet Nam cities have access to the national government tax base through shared tax transfers and conditional grants
Bangkok (BMA)	No	Transfers	Local governments have access only to minor taxes
Karachi	No	Transfers	Major local government revenue source is property tax
Kolkata	No	Transfers/own source	Approximately equal shares of financing from own source and transfers.

Increasing the rate of revenue mobilization by metropolitan cities is not an easy fix. Resolving the financing gap requires settling on the right degree of fiscal decentralization within the metropolitan area, finding a way to coordinate the work of many different government agencies, upgrading the quality of the local government staff, and developing a viable plan for resource mobilization. Things are much more complicated than simply finding the money.

Still, the growing tax base in metropolitan cities is underused and the timing for metropolitan fiscal reform in the Asia-Pacific region may be good. The heavy investment needed to maintain a competitive infrastructure and an adequate quality of public services will also lead to an automatic increase in the potential property and consumption tax bases that can be captured by the right kind of revenue mobilization system. If the commercial and industrial sectors remain competitive, and if the middle class emerges, and if the quality of services improves, there may be an increased willingness to pay for local services.

3. Directions for reform in Asia and the Pacific: towards a metropolitan fiscal strategy

How can countries effectively capture the revenue opportunities generated by urbanization and meet the urban financing demand? Developing countries in the Asia-Pacific region have conducted useful policy experiments and taken important fiscal reform initiatives to achieve this objective. Some have arranged new government structures and have made sweeping changes in expenditure assignments (Indonesia); some have encouraged increased revenue mobilization by urban local governments (the Philippines); some have relaxed debt finance restrictions; some have created new, targeted grant programmes for large cities (India); some have resorted to the sales of land to support spending needs (China); and some have begun to rely on capturing part of the land value increases that have come with urbanization.

Despite the progress made, these reforms were carried out in an ad hoc or piecemeal way and the revenue they have generated falls far short of what is needed to sustain the region's fast urban expansion in the coming years. Of the country reform programmes in intergovernmental fiscal relations reviewed in table 2.3, none has put in place significant new taxing powers for metropolitan local governments.[21] Developing countries in the Asia-Pacific region need a well-conceived overarching metropolitan fiscal strategy aligned with a national urban development strategy. It is a difficult challenge to accomplish within the existing economic and political constraints, and most have not even attempted this.

How might the policy advocacy for increased revenue mobilization by metropolitan local governments be stimulated? One possibility is for government to form a metropolitan fiscal strategy that can accommodate the delivery of appropriate local government services in the entire labour market area. This approach respects jurisdiction boundaries (if applicable), while enabling local governments to implement effective coordination

[21] All, however, are empowered to levy some form of tax on real property.

Table 2.3

Major intergovernmental fiscal reforms in recent years: selected metropolitan areas

Metropolitan area	Reform	Implications for local non-property tax revenue
Manila	Reform of local government code in 1991 devolved tax and expenditure responsibilities and powers	The only broad-based taxing power devolved to cities is the local business tax.
Jakarta	"Big Bang" decentralization of expenditure responsibilities in 2001	No provision for strengthened local revenue raising powers
Beijing	Various reforms to intergovernmental fiscal system including elimination of the "local business tax"	Share of value added tax (VAT) earmarked for local governments has increased, land revenue rationalized, no independent revenue raising powers.
Mumbai	Constitutional Amendment of 1974 defining the powers of local government; State Finance Commission initiatives recommending strengthened local revenue bases.	State governments have resisted movement to implement the constitutional amendment. No strengthening of local revenue powers. Octroi, the major local government own revenue source, has been abolished.
Ho Chi Minh City, Hanoi	2002-2004 budget law, increasing the autonomy of local governments	No significant increase in local government revenue raising powers
Bangkok	2001 amendment to decentralize responsibility for expenditures, and to guarantee adequate revenues.	No initiative to increase local government revenue raising powers.

mechanisms to provide services. The metropolitan fiscal strategy could include local financing to cover at least the local benefit services provided in the metropolitan area. Two general features are essential for such a strategy to succeed. First, it must accommodate the special needs of metropolitan local governments in delivering public infrastructure and services and create necessary policy space for metropolitan local governments to leverage their stronger capacities in revenue mobilization. Second, the strategy must fully recognize the interactions between revenue assignment, expenditure assignment and the structure of metropolitan governance.

Such a metropolitan fiscal strategy could be implemented as part of a broader fiscal decentralization reform. In theory, there are several advantages of empowering local governments to raise revenues. First, the standard of accountability of government officials is much higher when they must finance some public services with taxes on residents. The result of this accountability may be a better quality of public services, a package of services that fits local preferences, and a greater willingness to pay.

Another potential gain from local government autonomy is an increase in the overall rate of revenue mobilization, reflecting both the presumably greater willingness to pay for services that are more in tune with local preferences and in some instances, perhaps, by the potential comparative advantage of subnational governments in collecting certain taxes. Although the amounts involved may not be large, the potential revenue gain from decentralized taxation may nonetheless be significant for developing countries where the average ratio of tax to GDP is low (Bahl and Bird, 2008).

However, in many countries in the Asia-Pacific region, higher-level governments may be dug in against relinquishing fiscal powers to local governments. Higher-level government officials often prefer to shape local government priorities according to central (or state) government objectives. There is also fear that giving the large local governments access to a broad-based tax will crowd out some central/state government taxes and diminish the size of the revenue sharing pool.

On the other hand, this firmly entrenched system of revenue centralization in Asia and the Pacific may be overtaken by urbanization and by the sheer magnitude of metropolitan fiscal problems. Many countries in the region are characterized as making a low tax effort, and have found it difficult to overcome the obstacles to increased levels of taxation. Nevertheless, the demands for new urban services and additional infrastructure spending may become too much of a problem to ignore. At some point, the easier way to go may be to create a special fiscal regime for the large cities and to let them manage their own fiscal affairs.

A start toward special fiscal arrangements for metropolitan finance has been made in China where four large cities have provincial status,[22] in the Republic of Korea where the metropolitan cities have provincial status, and in Indonesia and Thailand where Jakarta and Bangkok have been given provincial status, although these cities still do not have significant revenue autonomy.

There are many ways to enhance the revenue raising autonomy of metropolitan local governments. These might include the power to levy new taxes, the power to set tax rates and user charge rates, the power to control exemptions and preferential treatments, and the authority to impose a sur-rate on a national tax base. Incentives to use these powers could be embodied in a special regime that limits the flow of intergovernmental transfers to metropolitan local governments. This would

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[22] They are Beijing, Shanghai, Tianjin and Chongqing.

likely result in a higher "tax price" for residents and businesses in the metropolitan areas.[23]

In many countries, a special fiscal regime that provides metropolitan areas with more fiscal autonomy is a difficult political sell. In India for instance, states are responsible for controlling metropolitan area local governments but have used that power to delay implementation of the 1974 constitutional amendment that provided a clear schedule of rights and duties of third tier local governments (McKinsey Global Institute, 2010; Rao and Bird, 2014). In unitary countries where local governments are usually governed by a central law, their position in the intergovernmental fiscal system is even less secure than in federal countries. While metropolitan local governments in unitary countries often have significant expenditure powers, as for example in the case of expenditure assignments in Indonesia (Smoke, 2013) and in China (Bahl, Goh and Qiao, 2014), neither of these two countries devolves any significant amount of revenue power.

4. Metropolitan fiscal strategy and the question of governance structure of metropolitan areas

The reform options for an efficient system of local government revenue mobilization in metropolitan areas will depend on the structure of government in the metropolitan area and the assignment of expenditure responsibilities. These are crucial considerations in designing the structure of an enhanced revenue system for metropolitan local governments in the region. Since governance and expenditure assignment regimes will differ from city to city, so too will the best options for revenue mobilization.

The link between revenue mobilization and metropolitan government structure is especially confining. In a metropolitan area where there are numerous municipalities, there will be more factor mobility across jurisdiction boundaries, tax burdens will be exported and wide fiscal disparities may result. This will limit the possibility of developing efficient broad-based taxes in jurisdictionally fragmented metropolitan areas. By contrast, if the local government boundaries cover the entire metropolitan area, broad based taxes may be levied with less economic distortion because there is less possibility for one municipality to export the tax burden to another.

The link between efficient local revenue systems and expenditure assignment is an equally important consideration. To a large extent, the assignment of revenues to the local governments in an efficient system is

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23 This means that residents and businesses in metropolitan areas pay a higher level of taxes for public services received than residents and businesses in other local government areas.

driven by the functions for which local governments are responsible. For example, some functions are best financed by user charges, some by general taxes, some by intergovernmental transfers, and so on. The model is summarized in box 2.1. In a jurisdictionally fragmented system where there are significant differences in the taxable capacity of local governments, disparities in public service levels will emerge.

Box 2.1

Matching expenditure assignments with local revenue instruments

An efficient local government revenue system will reflect the services that it is assigned to deliver.

- For publicly provided goods and services, where the benefits accrue to individuals within a jurisdiction and where the exclusion principle can be applied in pricing, user charges are the most efficient financing instrument. This includes most public utilities.
- Other local government services, such as general local administration, traffic control, road maintenance, street lighting, security, primary schools, local clinics and parks and recreation are local public goods whose primary benefits accrue to the local population. They are most appropriately financed by taxes and licenses.
- For services in which substantial spillovers to neighbouring jurisdictions commonly occur – such as health, higher education, and certain types of infrastructure expenditures – provincial or national intergovernmental transfers should contribute to financing.
- Borrowing is an appropriate arrangement for financing capital outlays that have a long service life, such as public utilities or mass transit.

Source: Bahl and Linn, 1983.

Three basic approaches to metropolitan governance are ***jurisdictional fragmentation***, which emphasizes home rule; ***functional fragmentation***, which emphasizes technical efficiency; and ***metropolitan government***, which emphasizes coordination and internalizing externalities (Bahl and Linn 1992). In practice, the advantages and disadvantages of these three forms of metropolitan governance play out in a compromise that attempts to capture the benefits of a favoured approach while minimizing some of its costs. The result, almost always, is a mixed model of metropolitan governance.[24] The pros and cons of the different arrangements are summarized in table 2.4. There is no one pattern of metropolitan governance that is generally followed in Asia.

24 This classification is useful because it allows a focus on the kinds of governance trade-offs that can be made, and it lends itself well to a focus on less developed countries. But it does oversimplify, as would any taxonomy. For less simplified, but very useful classifications, see OECD (2006) and Shah (2013).

Table 2.4
Alternative metropolitan government structures, with examples from Asia and the Pacific

Government structure	Emphasis	Advantages	Disadvantages	Examples
Jurisdictional fragmentation	Home rule	Voters have more control over services delivered and tax levels	Does not deal effectively with spillover effects; coordination is difficult; and large fiscal disparities can result	Manila, Kolkata, Karachi
Functional fragmentation	Technical efficiency	Professional management; can capture economies of scale; may have access to a dedicated revenue stream	Less directly accountable to local voters; coordination with other services can be difficult	Mumbai
Metropolitan government	Coordination of service delivery, technical efficiency	External costs can be internalized; economies of scale can be captured; broad based taxes are more feasible; fiscal disparities can be eliminated	Government decisions are more distant from local voters; intergovernmental conflicts with lower tier neighbourhood governments; diseconomies of scale	Jakarta, Beijing, Bangkok

Jurisdictional fragmentation

Under a jurisdictional fragmentation approach, many general-purpose local governments (municipalities) operate in the same metropolitan area with some degree of independence in choosing their package of public services and their tax, user charge, and debt financing arrangements. In many cases, there also is an overlying metropolitan government of some sort, or a region-wide special district, or a mechanism for cooperative agreements, but the emphasis in service delivery usually is on the role of the underlying cities and municipalities.

The advantage of the jurisdictional fragmentation model is that it keeps government functions close to the people. Because the population of the fiscal decision-making unit is smaller, the local government bureaucracy is less intense and local politicians are more accountable to a constituency to whom they are known. Residents are more likely to get the package of services that they want under a fragmented government arrangement. This also means that local governments in the metropolitan area can compete for residents and businesses with the package of public services and taxes that they offer.

The advantages of this home rule model will come at some cost: a failure to capture economies of scale, and operating within a set of boundaries that are too small to internalize important external effects or to allow coordinated service delivery. Jurisdictional fragmentation also can lead to large fiscal disparities among local governments in the metropolitan area, since constituent local governments almost surely will have different expenditure needs and different financing and service delivery capacity. The unit cost of service delivery may be higher because of so much duplication of administrative services, and because of the failure to capture economies of scale. Finally, the jurisdictional fragmentation model leads to some confusion about accountability. Metropolitan residents may live in municipality A, work in municipality B, and shop in municipality C, and may be uncertain about who to hold responsible for the quality of public services provided.

The jurisdictional fragmentation model is the choice for governing metropolitan areas in many low-income and middle-income countries, including some in the Asia-Pacific region. The sixteen cities and one municipality in metropolitan Manila are responsible for those services whose benefits are thought to be contained within local boundaries (World Bank, 2017; Manasan, 2009, p. 338; Diokno, 2009). Each is entitled to levy a property tax and a local sales tax, and they are self-governed. The Metropolitan Manila Development Authority (MMDA) was established to coordinate urban policy and service delivery, but has neither the political authority nor the resources needed to fulfil its statutory mandate. The result has been a long-standing situation of political gridlock that prevents any effective action to implement coordinated metropolitan-wide solutions to such critical issues as traffic management, flood control and pollution (World Bank, 2017).

The local government units in metropolitan Manila (cities and municipalities) are governed by elected councils, while the chair of the MMDA is appointed by the President, and its membership is prescribed by law to include mayors of the constituent local governments. The MMDA has no revenue raising authority. These institutional arrangements have significantly compromised the coordination objectives of the MMDA (Smoke, 2013).

The Kolkata metropolitan area is governed by three municipal corporations (including Kolkata), thirty-eight municipalities, and twenty-four rural local governments. The municipal governments are dominant in terms of service provision and revenue raising (Sridhar and Bandyopadhyay, 2007). The Kolkata Municipal Corporation covers 20 per cent of the land area of the metropolitan area but accounts for 37 per cent of the population. The Kolkata Metropolitan Development Authority (KMDA) has the responsibility for planning and carrying out major infrastructure development in the metropolitan area. The KMDA is a state agency, though some elected local representatives are on its board. It is financed by grants from the federal and state governments. The Kolkata metropolitan council is like that in Manila, but seems to have more buy-in from the municipal governments and the state government. The appointed Chief Minister of the State chairs the committee, and there is provision for coordination between state government ministries and the metropolitan government. It is required that all municipal development plans coordinate with the metropolitan development plan.

The Karachi Metropolitan Corporation is underlaid by six municipal district corporations. Each level has service delivery responsibility but expenditure assignments are unclear and there is no effective provision for coordination. The autonomy of local governments is limited by provincial controls including the approval of local budgets and the appointment of chief local officers. In addition, provincial government agencies deliver services within the metropolitan area, and carry out regional planning, which further complicates the coordination of service delivery. Most local government services are financed by intergovernmental transfers from the provincial government.

Functional fragmentation

Under the functional fragmentation approach, the delivery of a single function (or a related grouping of functions) is placed under the control of either a public company or a special district government. In fact, some degree of functional fragmentation exists in almost all metropolitan areas, including those with many municipal governments, but the arrangements vary widely, as does the degree of emphasis placed on the use of public companies and special districts. Public companies can exist side by side with either a fragmented local government arrangement or an area-wide metropolitan government.

A main advantage of functional fragmentation is that an autonomous agency or a public company is likely to be more technically efficient than a local or higher-level government because it is specialized, it may be able to attract and retain higher-quality management and staff, and it serves a large enough population to capture economies of scale. Because it is usually the only entity in the urban area responsible for the function, the problems of coordination for that function are considerably less than under a jurisdictionally fragmented model. Finally, a public company or a special district government may have access to a dedicated revenue stream (such as an earmarked tax, a share of the budget of a higher-level government, a compulsory transfer from the city government, or user charges), and if well run, it has greater potential for debt finance than do many general-purpose local governments.

The major drawback to this approach is that public companies and even special districts are less directly accountable to local voters than elected municipal councils are. This depends on how the board and the management of the autonomous agency are determined, and here the practice varies widely.

Special districts play an important role in financing services in the metropolitan areas of low- and middle-income Asian countries. An autonomous agency of the Mumbai municipal corporation is responsible for electricity and bus services and has shown good management successes. India also makes use of parastatals, which are public companies operated by various departments of the state (or federal) government. The 21 parastatals operating within Mumbai account for a large share of total infrastructure spending in the metropolitan area. Some of these parastatals route their funds through various metropolitan agencies, and in such cases coordination problems in service delivery are made more manageable (Pethe, 2013). A similar situation characterizes the Karachi metropolitan area where provincial agencies are responsible for several services including water and sewer and solid waste management, and for master planning.

Metropolitan government

Under the metropolitan government model, most general services and infrastructure services are provided by an area-wide local government.[25] In practice, area-wide governments often share fiscal powers with lower tiers of government or publicly owned companies. This gives local governments some sense of home rule, even though most power is vested in the overlying metropolitan area government.

There are several versions of area-wide governance. One is the large city that includes most of the urban population in its boundaries (such as Beijing and Jakarta). Another is the large city that dominates public services provided in the metropolitan region but does not include all municipalities that are within the labour market area (such as Mumbai). Yet another version of area-wide governance is an appointed agency usually charged with planning and coordination responsibilities, often for capital facilities. In some cases, these metropolitan authorities have responsibility to deliver region-level services, as in the case of Manila.

The significant advantages of the metropolitan government approach are the internalizing of spillover effects, the built-in coordination in the delivery of functions, the better opportunity for capturing economies of

[25] For discussions of metropolitan-area governance, see Bahl and Linn (1992), Bird and Slack (2004), Jouve and Lefèvre (2002), OECD (2006), Slack (2007) and Bahl (2013).

scale, and the possibility for accessing a broad tax base in an efficient way. This gives a potential for better resource allocation compared with dividing responsibility for local services among several municipalities and special-purpose governments. The metropolitan government form also offers greater potential for equalization because the quality of local services is not tied to the wealth of each local jurisdiction, as it is with jurisdictional fragmentation. To some, the area-wide approach of governance has so much upside that it is a hard recommendation for governance in big cities (McKinsey Global Institute, 2010).

On the other hand, the metropolitan form of governance diminishes the power of local voters to influence their budget. In effect, the election of the local council is replaced by election of local representatives to the more distant metropolitan council. A second drawback is that metropolitan governance often brings intergovernmental conflict. If lower-tier local governments exist under a metropolitan arrangement, they may resist the leadership (and especially the dominance) of the metropolitan government.

The boundaries of the metropolitan government may not be large enough to fully capture the benefits of area-wide governance. This problem might be resolved by annexations or consolidations or by appointing a commission to redraw jurisdictional boundaries, as was done in South Africa (Ahmad, 2003). Often these changes are politically difficult to accomplish, and outgrown boundaries stay in place. A particularly challenging problem with boundaries is the case of Beijing, where the integrated urban area can be seen as including parts of adjacent Hubei Province and Tianjin Municipality, which could lead to the creation of a super metro area with a population of more than 50 million.

There are numerous examples of metropolitan governance in low-income and middle-income countries in the Asia-Pacific region. Four of China's large cities have provincial status and are empowered to manage the fiscal affairs of their underlying district governments. These four Chinese cities have no taxing powers but are responsible for the provision of most public services (box 2.2). The five largest cities in Viet Nam have provincial status and some discretionary expenditure, but local budgets are approved by the next higher level of government and subnational governments have very limited taxing powers. Istanbul is a special case because the metropolitan area includes both a provincial administration with an appointed leadership, and a metropolitan municipality with an elected leadership. The metropolitan municipality performs most of the major urban functions and the provincial administration performs some area-wide functions and oversees coordination. Beneath the metropolitan municipality are 73 local-level municipalities that perform mostly neighbourhood functions. The result in Istanbul is a centralized system with most fiscal decision-making at either the metropolitan municipality or the provincial administration level (OECD, 2008a).

Bangkok is a single tier provincial city whose governance extends to the entire metropolitan area. It overlays 18 districts, each of which has a directly elected local council. Local government budget decisions are limited by central mandates and controls, and Bangkok has relatively little revenue raising power.

Box 2.2

China's system of subnational government revenues

In most countries of the world, the dividing line between a local tax and an intergovernmental transfer is whether the local government has some discretionary power to determine revenue by setting the tax rate or tax base (Bird, 1999). In China, revenues to local governments come from three different sources.

Shared taxes are returned to local provincial governments in some proportion to where they are collected. The rate and base is set by the central government, and may be changed only by the central government. Most of these taxes are collected by the central tax bureau, though the business tax (recently phased out) was collected by the local tax bureau. The tradition in China is to refer to these are 'local taxes', but the international terminology refers to them as 'intergovernmental transfers'.

Conditional and unconditional grants are made to provincial governments and are referred to in China and internationally as 'intergovernmental transfers'.

Non-tax revenues and user charges give subnational governments some discretion in determining the amount of revenue raised, and the amount of cost recovery.

5. Financing metropolitan development: revenue options and reforms

The call to strengthen the financial condition of metropolitan local governments has been given for a long time (Bahl and Linn, 1992). Few have taken up the call, however, primarily because of some combination of resistance by higher-level governments and weak administrative capacity at the local level.

Property and land taxes

Reform recommendations for urban government finance in low-income and middle-income countries almost always centre on an upgrading of the property tax. Large cities have a comparative advantage in levying a successful property tax (McCluskey and Franzsen, 2013). The tax base is stronger because property values are high and continuing to rise, and because the tax administration system has improved, and metropolitan areas have demonstrated an ability to absorb new technologies. External donors continue to invest significant resources in strengthening the capacity of local governments to levy the tax. Moreover, the property tax has some features of a benefit levy and there could be more willingness to pay because public services tend to be better in metropolitan areas.

Yet, property tax revenues account (on average) for less than 1 per cent of GDP and less than 4 per cent of all tax revenues in developing countries. Even in the large metropolitan areas where property values have risen dramatically, land and property taxes sometimes do not carry a commensurate load in financing urban government services.

There does not appear to be a groundswell of popular support to emphasize property tax financing of local government services. Taxpayers and their elected officials seem to be of one mind about not liking this tax, and their reasons are understandable. The amount of tax paid is known to the property owner (as compared to the value added tax (VAT) for example), giving the owner a more realistic feel for the burden and for the public services that might be provided in return. Taxpayers often feel that they pay more in taxes and charges than they get back in services, and elected government officials do not want to raise expectations about public service levels. Both groups probably are happier when actual tax liabilities are less transparent (as in the case of sales taxes). The bad reputation of the property tax also comes from the notional definition of the taxed base and the judgmental nature of the assessment – "how much would your house sell for if you sold it" or "what is the normal rent that might be paid for the flat that you occupy". Finally, the property tax is levied against unrealized increases in the (housing) wealth of a taxpayer who may perceive no increase in his or her capacity to pay. These are some of the reasons why local governments in Asia often do not fully use their taxing powers.

Some Latin American countries have all but given up on the property tax, and moved on to subnational government sales taxes (box 2.3). Is it time for Asian countries to do the same? Is it better to live with the harmful economic distortions that come with a local sales tax to capture its revenue potential? Or should countries in the Asia-Pacific region continue to work on the property tax in hopes of finding the breakthrough reform that will make it efficient, revenue productive, and more acceptable to taxpayers?

The recommendation here is to stick with the property tax, but to pair it with at least one other broad-based, revenue productive local tax. The property tax has too many desirable features to be abandoned. It can approximate a benefit levy for some local services, is not regressive in its distribution of burdens, has less harmful distortive effects than consumption taxes, has significant revenue potential, and cost-effective administration is within reach. Moreover, it is available to local governments and the laws for its implementation are usually in place. Certainly, it cannot carry the entire financing load for metropolitan local governments, or even a majority of the financing, but it can make a much more significant revenue contribution than it does now.

Box 2.3

Subnational government sales taxes in Latin America

The metropolitan city of Buenos Aires has province status and derives over half of its tax revenues from a turnover tax levied on total sales revenues. The turnover tax levied in the metropolitan city of Bogota (Colombia) accounts for about 40 per cent of local tax revenues. The tax rate and tax base are set by local councils (within allowable limits) and administration is by the municipality. Other taxes on gross sales are limited to certain sectors. The service activity tax (ISS) in Brazil is a municipal government tax on local services, almost all of which is collected by the largest municipalities (Rezende and Garson, 2006). It is an important source of revenues for the third-tier subnational local governments and raises about twice as much revenue as the local property tax.

The best comparable data on the revenue yield of the property tax in developing and transition countries (IMF, various years) suggests an average yield equivalent to only about 0.6 per cent of GDP (Bahl and Martinez-Vazquez, 2008). At the same time property tax revenue often plays an important role in the budgets of some local governments (table 2.5). In the 36 largest cities in India, the property tax accounts for 28 per cent of own source revenue (Mathur, Thakur, and Rajadhyasksha, 2009). De Cesare (2012) reports a survey of 64 municipalities in Latin America that shows the property tax to account for an average of 24 per cent of local government tax revenue. This gives a different perspective on the issue, namely that the property tax in developing countries is an important part of the strategy for local government finance even if it is not an important part of the strategy for overall government revenue mobilization. Moreover, the revenue dependence on the property tax is even greater in many of the large cities.

Property tax structure in Asian metropolitan areas

Property tax practices vary greatly across metropolitan areas in Asia and the Pacific. Some countries tax rental values (India), some tax capital values (the Philippines), some are very liberal with exemptions (Pakistan), some focus their tax on land use (China), and some impose a very low rate (Indonesia). Even where countries tax the same base, they may assess it differently. For example, Manila and Jakarta both tax the capital value of

Table 2.5

Property tax revenue performance in selected metropolitan cities

City/metro	Per cent of total city revenue (2010)	Per cent of local tax revenue (2010)
Belo Horizonte (Brazil)	No data	31.2
Cape Town (South Africa)	20.5	41.1
Rio de Janeiro (Brazil)	17.5	25.0
Hong Kong, China	3.78	5.10
Kuala Lumpur	44.9	93.0
Makati City (Manila)	34.0	41.0
Manila City	28.0	54.0
Quezon City	21.0	33.0
Delhi	30.1 (2007)	18.1 (2007)
Kolkata	46.0 (2007)	27.4 (2007)

Source: McCluskey and Franzsen (2013); Mathur, Thakur, and Rajadhyasksha (2009).

property, but Manila uses comparative sales to tax land and depreciated replacement cost to tax buildings while Jakarta uses formula tables for both land and buildings.

This means that there is not likely to be a single reform solution that will fit all the cases. Moreover, because there are so many key components to the tax (for example, identification and valuation of properties, collections, tax rates and exemptions), reforms must necessarily focus on details. This is not to say that there are not common problems that plague city governments in most urban areas and that keep the property tax from reaching its potential. In fact, most metropolitan areas fail to administer the tax efficiently. They do not assess property as the law requires, they do not include all properties in the tax base, and they do not collect full property tax liability. The following cases of big city practices in Asia gives some indication of the way these problems hold back property tax revenue mobilization.

The property tax in the Mumbai municipal corporation is equivalent to about 1.4 per cent of local GDP, which is relatively high (the average for all urban governments in India is about one-fifth of this level). It accounts for about 22 per cent of all own local source revenues, and has a buoyancy of a little less than unity.[26] Yet Pethe (2013) notes that this is a disappointing outcome, because of the rapid increase in property values in Mumbai and the erratic revenue flow in recent years. The collection rate of the tax is only

26 The revenue-income buoyancy of a tax is the average percentage increase in revenues for a 1 per cent increase in GDP. The buoyancy coefficient does not make adjustments for the revenue impacts of discretionary rate and base changes.

45 per cent, leaving much room for improvement. Surprisingly, the average collection rate for all large Indian cities is only 37 per cent (Mathur, Thakur and Rajadhyasksha, 2009).

The metropolitan cities in China do not levy an annual, value-based property tax. The State Council has proposed that such a tax should be implemented "when the time is right". It is difficult to formulate such a tax because all land is owned by the Government, and because the infrastructure for property tax administration (assessment, tax rolls, collection mechanisms) must be put in place (Bahl, Goh and Qiao, 2014). China does impose taxes on real property, but these are mostly an ad hoc group of levies on land use and transfers rather than a property tax system with clearly defined objectives. Together, these taxes account for about 1.6 per cent of GDP, which is well above the average for low-income and middle-income countries (but below the average of industrial countries) (Man, 2011). The government continues to report that a property tax will soon be introduced.[27]

Jakarta and Manila are interesting cases in the development of the property tax. The tax was devolved to local governments in Indonesia between 2011 and 2014, and early results suggest that the 30 largest urban governments, including Jakarta, account for about 70 per cent of revenue. In the Philippines, the local governments in metropolitan Manila account for 45 per cent of total national tax collections (as compared to 20 per cent of national population), but the property tax share of local revenues has been declining due to a failure to update the tax rolls and a rapid increase in intergovernmental transfers (McCluskey and Franzsen, 2013).

The success with the property tax as a local government revenue source is due largely to how well local governments assess and collect the tax. While there is a great deal of variation in this, and accurate data are hard to come by, the results are generally not very good. Mathur, Thakur and Rajadhyasksha (2009) surveyed five large Indian cities and found the ratio of assessed to market value to vary in a range of 9-30 per cent. A study of Pakistan's Punjab province, where Lahore is the largest city, suggests that property is undervalued at 45-80 per cent (Bahl, Cyan and Wallace, 2015). There are success stories, including Quezon City in metropolitan Manila, where property tax collection increased threefold between 2005 and 2008 by computerizing tax rolls to make payments easier and eliminate corrupt middlemen (UN-Habitat, 2010). Bangalore, India revamped its assessment system to a simplified area basis with great success (Rao, 2008).

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27 At the close of the 19th National Congress of the Communist Party in October 2017, the Minister of Finance issued a strong statement about the government's intention to implement a property tax.

Other cities in the region have been innovative in their practices, and this has shown up in improved revenue flows. Delhi, Chennai and Kuala Lumpur have used a self-declaration approach to identify properties for the tax roll and this has resulted in a significant increase in the coverage of the tax. University level courses in valuation have been introduced in Manila and Kuala Lumpur, and this has helped in establishing a permanent valuation staff in both cities.

The determinants of revenue performance

Property tax revenues amount to such a small percentage of GDP in low-income and middle-income countries in Asia and the Pacific in part because fiscal decentralization (the empowerment of local governments to make fiscal decisions) has not been a leading development strategy. Subnational governments account for about 28 per cent of total government expenditures in industrial countries but only 18 per cent in developing countries. Since the property tax is primarily a local government tax, it is used more sparingly in low income countries. In an econometric analysis of the variations in the property tax share of GDP across 70 developed and developing countries, Bahl and Martinez-Vazquez (2008) found that higher levels of decentralization increased the reliance on property taxation.

Other barriers to increased revenue mobilization are important. The administration of the tax is costly. The absence of a full and up-to-date survey of all land (urban and rural), records of title that enable a completion of the tax roll and a determination of tax liability, reliable data on the sales price of properties, and good valuation expertise are expensive problems to fix. At current yields of the property tax, it is difficult to justify such outlays, even in metropolitan cities. The result is that most developing countries improve their administrations with marginal upgrades rather than with comprehensive reforms. Revenue increases, it follows, are also marginal.

The weak revenue performance in Asian countries is also due to the social engineering of the property tax, and to the political rent-seeking that dramatically narrows the base. Government-owned property is exempt in most places, owner-occupiers pay less property tax than other owners, low income families (and sometimes all families) benefit from a threshold exemption, and the non-profit sector tends to be favoured with a tax preference. The revenue consequences can be substantial. A study of Punjab province in Pakistan estimates that bringing owner-occupied property fully into the tax base would triple the level of property tax revenues (Bahl, Cyan and Wallace 2015).

Sometimes local government property tax revenues are low because policy and administration are in the hands of central (or state/provincial) governments that are not very interested in the amount of revenue raised for local governments. The story is an old one. Politicians at the central government level do not have adequate incentives to increase property taxes that benefit urban local government budgets. For example, in Indonesia the property tax and property transfer tax were shared responsibilities between the central and subnational governments until 2009 when they were devolved. Before that time, when policy and administration were centralized, revenue growth was almost flat. The implementation of the devolution includes both policy and administration and is focused on empowering local governments to adapt their property tax structures and property tax administration systems to the local environment. While the early results are somewhat promising in terms of revenue mobilization, local governments have been slow to move their property tax towards its full potential. The property tax takes time to implement, and it is still too early to make a full evaluation (Kelly, 2014; Haldenwang et al., 2015).

The weak performance of the property tax may indicate other sources of subnational government tax revenues are available and that they are preferred to the property tax. In Argentina, sales taxes (primarily the turnover tax) account for about two-thirds of subnational government tax revenue while the property tax accounts for only about 12 per cent. In Brazil, the local sales tax raises two times more revenue than does the property tax. Colombia's larger cities raise more from the gross receipts sales tax) than from the property tax. In Mumbai the property tax is 24 per cent of local government revenue but the octroi (a form of sales tax on the entry of goods) was 44 per cent before it was abolished in 2017. and the revenue elasticity of the octroi was significantly larger (Pethe, 2013). In China, central and subnational governments (until recently) raised significant revenues from a gross receipts tax that was earmarked fully for subnational governments, but a broad-based annual property tax is yet to be authorized

The property tax also is crowded out by intergovernmental transfers in all metropolitan cities. More grants (or more direct expenditures by the metropolitan government in the metropolitan area) can dissuade local voters and politicians from increasing statutory tax rates, assessment rates or collection rates of the property tax.

Finally, the revenue take from the property tax has been slowed by the actions of higher-level governments and by the legal framework that has been put in place. Rent control legislation has all but wrecked the property tax in some Indian cities, rate limits imposed by higher-level governments can lead to lower revenues (Manila and Kuala Lumpur), and legislation to exempt government-owned property has eroded the tax base (Hong Kong, China).[28]

The special problem of revaluation

Periodic revaluation and the introduction of a new property tax roll is perhaps the greatest barrier to maintaining the rate of revenue mobilization of the property tax. The base is determined by an appraisal process that must be redone periodically (every three or five years). So, instead of the relatively smooth increases (or decreases) in the income or VAT base, large one-time increases are likely to accompany revaluation. Moreover, preparing the new values is a costly and time-consuming affair and putting the new roll in place is contentious and often becomes a media event.

In some urban areas, including Hong Kong, China and Jakarta, revaluations are carried out annually, but typically tax rolls are redone on a 3-5 year cycle. Not surprisingly, metropolitan local governments implement new valuation rolls with a delay out of fear of voter reactions to large increases in property tax bills. Sometimes, politicians try and minimize their exposure to such situations by giving a simultaneous reduction in the statutory rate, or capping the increase in taxable assessed values. Some metropolitan local governments have indexed their assessments between revaluation periods, but this raises equity problems when property values grow at different rates in different sectors and in different neighbourhoods. Some cities in metropolitan Manila have made arbitrary adjustments by revaluing land but holding constant the value of buildings. The failure to revalue can impose a significant revenue cost. Had Punjab Province, Pakistan brought in its newly completed valuation roll in 2006, property tax revenues would have doubled (Bahl, Cyan and Wallace, 2011).

Taxes on property transfers

Nearly all Asian countries tax transfers of ownership, specifically, a tax is imposed on the sales price of properties that is paid at the time of exchange. This may be levied as a stamp duty on the transfer document and/or as a separate property transfer tax, or even as a capital gains tax.

There are several reasons why real estate transfer taxes have found their way into tax systems in developing countries, and why their staying power is so great. (Bahl, 2004; Alm, Annez and Modi, 2004). First, it is an easy tax handle because most buyers/sellers desire a legal record of ownership and therefore will voluntarily comply. Second is the revenue

[28] In India, the Constitution does not give separate taxing powers to local governments. The State governments assign the taxing powers and all discretionary changes in the base and rates have to be approved by the State governments.

motivation and what might appear to be a very low cost of collection. In more than a few countries, the property transfer tax generates as much revenue as the annual property tax. Third, the distribution of the tax burden tends to be progressive. Fourth, the number of people paying real estate transfer taxes in any given year is much smaller than the population paying general taxes, hence lessening voter opposition. Fifth, a property transfer tax might reach that part of the taxable capacity (property wealth) that is not captured by most income tax and VAT. Finally, some governments have used the property transfer tax to try and cool down an overheated investment market in real property.

The disadvantages of the property transfer tax (and for a capital gains tax on real estate) are that it imposes a cost on property transactions thereby reducing the volume of formal transactions and slowing the development of the real estate market, and the administrative costs can be very high. In low-income and middle-income countries, the tax base often is determined by taxpayer declaration of the sales price. Because of the low probability of being detected as underreporting, and because the property transfer tax often is levied at a high nominal rate, property owners have a significant incentive to understate taxable value. This leads to a revenue loss, but it also leads to a weakening of the data base that is necessary for objective assessment of the annual property tax.

Three alternative paths to reform could enhance revenues and improve land market efficiency. The first is to abolish the property transfer tax and make up the revenue loss with increased levels of other taxes. The second reform direction retains the property transfer tax at significantly lower rates (where they are high), and aggressively monitors declared values for transactions. This might be done by requiring certified appraisals at the expense of buyers/sellers, upgrading and expanding the valuation staff at the local government level, and imposing significant penalties for under declaration. The third reform path is to replace the property transfer tax with a tax on capital gains from sales of real property. While there are some administrative obstacles to implementation, the problems are no more difficult to resolve than the problems that prevent the present sales tax on transfers from working. There has been some experience with capital gains taxes on property transfers, for example in Taiwan Province of China (Tsui, 2008).

Value capture[29]

Urbanization and the projected rapid growth of large cities in Asia will bring significant increases in the demand for residential housing and in the

29 Land value capture instruments are most developed in Latin America where practitioners and policy analysts have developed several workable approaches. For a good review of the practice, see Smolka (2013).

demand for land to be used for non-residential purposes. Real estate values also will be driven up as the constraints on urban development are relaxed (through zoning changes that allow development on the urban fringe) and by infrastructure investments that enhance the quality of public services. Projections of new infrastructure investments equivalent to 2.5 per cent of GDP per year gives some idea of the magnitudes involved (Ingram, Liu and Brandt, 2013). The potential revenue increase is significant.

These value increases are reflected to some extent in the annual property tax base and annual property tax revenues, but not very much because of revaluation lags and because of the low effective rates of the property tax in most Asian countries. Large urban governments in some countries, particularly those in Latin America, have now turned to using various other fiscal instruments to capture a portion of these land value increments to support the financing of public investments and public services. This process is generally referred to as "value capture".

There is a strong case for the public sector to confiscate a part of the increment in land values that is a result of government actions. First, this approach is equitable in that it reclaims some of the benefits of government sector actions for the public. If an investment of $10 million in a new road will increase property values in effected areas by $20 million, why not at least recover the cost of the project from the beneficiaries? Since these land value increments are 'unearned' (the property owners did nothing to generate them), it seems a fair and even efficient approach to cost recovery.

A second important advantage is the generation of revenues to support the public budget. Several inventive schemes have been developed to use expected land value increases to fund the cost of public investments such as road improvements, large scale capital projects and general urban development (Smolka, 2013). Under the right circumstances, this can give the best of both worlds: the developer can move ahead with the project and the Government can avoid raising taxes to cover the cost of the infrastructure investment (box 2.4).

In the Asia-Pacific region, property values are growing with urbanization, and prospective public investments are large, so clearly there is potential for value capture. Nevertheless, Asian countries have a mixed record on using the property tax to generate revenues from changes in land use. For example, Bangkok and Karachi do not tax vacant or unused land, Jakarta taxes it at the same rate as developed land, though Bangalore, Kuala Lumpur and Manila tax it at a higher rate.

Land Sales and Leases

Another area where urban development and land value increments come together is in the sale or leasing of public land. The issue is of greatest

Box 2.4

Value capture

The practice of value capture is widely varied in terms of the fiscal instruments used, especially in Latin America where the approach is most advanced. These include betterment levies (special assessments on beneficiaries to recover the cost of a project), exactions (payment by developers to compensate government for a change in land use that will enhance values or incur costs), land adjustment (recovery from land owners of costs of expansion of urban settlements into the urban fringe), and certificates of additional construction bonds (development rights sold by auction to private firms).

The basic idea in these approaches is pretty much the same. The local government has a marketable product to sell, usually some combination of improved public services, land, development rights, building permits, increased floor area ratios, or zoning changes. The beneficiary (a developer or a property owner) pays for one or more of these products with a portion of the expected increase in land values. The fiscal arrangement through which the beneficiaries purchase the product is often determined by the nature of the project itself, whether it is a road improvement, a large scale urban redevelopment project, an increase in building heights, or the extension of public services to the urban fringe. Sometimes the government determines the value of the development rights, and in some case the values are determined in the market by auction. Special assessments are levied on beneficiaries to recover project costs and are distributed according to a formula determined by the government.

Source: Smolka (2013).

Note: The floor area ratio is the ratio of floor area to the net surface of the undeveloped land (where net surface is defined to exclude rights of way and environmental set asides).

importance where land is owned by the Government and land use rights are leased. Perhaps the most prominent example in recent times is the leasing of lands by Chinese local governments. On the one hand, this policy opened the door for financing a large amount of infrastructure that was necessary for the absorption of nearly half-billion migrants to cities. By 2013, it accounted for about one-third of subnational government revenues (inclusive of intergovernmental transfers), and 7 per cent of GDP. On the negative side, it also involved dispossessing farmers from urban fringe land with little compensation, a significant amount of the money leaked out to private sector activities, and the collateral of land fuelled over-borrowing and a debt crisis (Bahl, Goh and Qiao, 2014; World Bank and Development Research Center of the State Council, 2014). Moreover, the sustainability of the programme depends on the supply of land available and on fluctuations in the price of land. Though revenue dependence on land leases is down from its peak years, regulations on compensation levels and the practice of claiming land has been significantly strengthened.

Directions for property and land tax reform

There is no "one size fits all" for property tax reform, yet there are some basic principles to guide a revamping of property taxation that might fit most Asian cities. While it will not be a simple matter to make the property tax more productive, the following basic rules could significantly enhance the chances that a country will implement successful property tax reform.

1. Determine the primary role the property tax will play in national urban policy. It could be revenue mobilization, a tax on property wealth, a stimulus for more intensive use of land, an integral part of a fiscal decentralization strategy, or some combination of these. This will require a thorough analysis of the existing property tax and a plan for better aligning it with the reform objectives.
2. Find a champion. Not many politicians will want to play this part. Those who are strong advocates of fiscal decentralization will be more sympathetic to strengthening the property tax as a source of local government revenue. If the reforms are limited to metropolitan areas, and lower the dependence of big cities on intergovernmental transfers, there may be broader support for the reform proposals.
3. Do an audit of the legal underpinnings of the property tax – the constitution, the property tax laws, and the implementing regulations – to make sure that the definition and coverage of the tax base, and the tax rate structure, are clear.
4. Provide incentives to stimulate property tax revenue mobilization in metropolitan areas. The most powerful ways to do this are by giving metropolitan local governments discretion to increase property tax revenues and by reducing the availability of intergovernmental transfers.
5. Set an optimal division of property tax administration between higher and lower levels of government, based on comparative advantage in handling the maintenance and upgrading of the cadastre, property transfers and valuation. The weaker the local government capacity is, the stronger is the case to centralize such responsibilities, perhaps to a metropolitan tax administration.
6. Ensure the infrastructure for property tax administration is sufficient. Metropolitan governments should develop a system that generates and records accurate information on property transactions. Such information is essential to developing the value map that underlies a good assessment practice, and to using computerized mass appraisal. Replacing the property transfer tax with a capital gains tax on real property could

remove an impediment to accurate self-reporting of transaction amounts. However, until the basic data infrastructure is in place, it may be necessary to use more presumptive assessment schemes, such as area-based systems.

7. Ensure that metropolitan local governments are responsible for setting nominal rate structures and for exemption policy and review. A broad-based property tax may enhance equity. Low income housing could be exempt or assigned a lower burden, but the practice of exempting owner-occupied property, government property, and providing special exemptions should be rethought. At a minimum, all exemptions should be reviewed periodically, the tax expenditure implied should be recalculated and reported annually, and a sunset period should be set to review and reconsider every exemption.
8. Raise collection rates to increased revenues. Experience has shown that ease of compliance with the property tax can help improve collection efficiency. However, tougher enforcement and more realistic penalties are likely to be more effective in raising property tax efforts than are attempts to create a more 'friendly' property tax.
9. Most countries should concentrate their reform and revenue mobilization efforts on the big cities. The larger tax base is there, as is the better administrative machinery and the greater local public financing needs. Local governments of less densely populated and more rural areas are important, but the type of tax imposed is likely to be more rudimentary and these governments will in any case remain more dependent on central (or state/provincial) transfers.
10. Finally, change the focus of reform to the creation of a comprehensive system for taxing all land and real property. The base for the annual property tax, the transfer tax and value capture overlap – all tax property values — and could be administered by a single agency. However, each of the three taxes could be levied according to a different rate and base schedule. The result could increase the revenue yield from property taxes enough to justify significant increases in administrative expenditures.[30]

[30] For a discussion of this possibility in the case of Pakistan, see Bahl, Cyan and Wallace (2011).

Consumption and production taxes

In those countries where fiscal decentralization is an objective, where the law permits, and where local government structure is compatible, it is possible for cities to adopt a broad-based consumption or production tax. This could lead to several favourable outcomes: increase the tax price of services provided in metropolitan areas; increase the overall level of resource mobilization; and reduce the claim of intergovernmental transfers on local governments.

But there are dangers in this strategy. Subnational government consumption taxes usually are levied as gross receipts (turnover) taxes, imposed at the point of sale, which can lead to distortions in resource allocation. Cascaded taxation can give advantage to vertically integrated companies, and enable the exporting of tax burdens. The "headquarters problem" arises when national firms pay tax for all branches at the headquarters location. This raises an interesting question. Do the efficiency gains from financing additional public services from autonomous local government taxes offset these efficiency costs of a gross receipts tax?

The experience with broad-based taxes on commerce in the Asia-Pacific region is much more limited than in Latin America. Until recently the Mumbai Municipal Corporation raised about half of its own source revenues from the octroi, an entry tax on goods entering the city. Collection was at octroi stations, was based on a complicated rate schedule, and had long been criticized for imposing heavy compliance and administrative costs, distorting the allocation of resources, and opening the door for significant corruption. Octroi was abolished in Pakistan more than a decade ago, and for all of India except Maharashtra State, but until 2017 it continued in Mumbai because it was thought that the revenue required to replace it "would be of unimaginable magnitude" (Pethe, 2013, p. 253). However, when the harmonised goods and service tax (GST) at the central and State levels was introduced in India, the octroi was abolished and replaced with a compensating grant from the State government. The details of this replacement are still being worked out, but appear to include a guaranteed rate of increase in the annual grant award.

In metropolitan Manila, a business tax on total sales is imposed by cities and municipalities at the point where the sales take place. This puts the 17 cities and municipalities in competition with one another for tax base, is distortive and leads to significant fiscal disparities across local governments. For example, in 2008, the average level of business tax revenues was equivalent to nearly 40 per cent of total local government expenditures in the metropolitan area. The per capita business tax revenue among local governments in metropolitan Manila ranged from $169 to $5 (Nasehi and Rangwala, 2011).

Another version of the assignment of general consumption taxes is the revenue sharing practiced in Asia, particularly in transition countries. For example, Viet Nam and China assign a share of the VAT to regional governments, with sharing on a derivation basis.[31] However, the subnational governments have no authority to change the rate or base of the tax. In effect, these are intergovernmental transfers because the local governments can take no formal action to affect the revenue yield.[32]

The Bangkok metropolitan government also is partly financed by a share of the VAT collected within its boundaries. Some metropolitan local governments in Asia, for example in Istanbul, Delhi and Jakarta, levy selective sales taxes on electricity bills.

Taxes on motor vehicles and motor vehicle use

There is a strong case for using the taxation of motor vehicles in the revenue structure of subnational governments (Bahl and Linn, 1992; Bird, 2010). The number of motor vehicles has been growing faster than population and roadway infrastructure in most large Asian cities. This trend is expected to continue as the middle-class population continues to grow. Between 2010 and 2030, the number of passenger vehicles in China, for instance, is projected to increase from 58 to 450 million and from 15 to 135 million in India (ESCAP, 2015).

There is much to be said about using motor vehicle taxes to finance a greater share of metropolitan local government expenditure. The ownership of motor vehicles is not concentrated in the lower income brackets. Driving generates negative externalities — congestion, air pollution and greenhouse gas emissions — which will grow worse as the number of private vehicles increases. Motor vehicles are easily taxed, as is their use.

The roadway construction and maintenance costs, traffic management costs, and the external pollution and congestion costs are likely to differ from place to place. In part, these costs will reflect choices that people make about where they live and work, and how they get around. They also reflect choices that businesses make about where they

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31 A "derivation" basis means that the amount of revenue returned to the local government is in proportion to the amount collected.

32 The Chinese have abolished their local business tax, which was levied on gross receipts for a wide range of service activities. This levy was revenue productive (about 30 per cent of all subnational government tax revenues). The rate and base were determined by the central Government, but all of the revenues were retained by the provincial governments on a derivation basis. This tax is now folded into the central VAT, of which 50 per cent is being shared with provincial governments on a derivation basis (Bahl, Goh and Qiao, 2014).

will locate, and choices that governments make about the kind of public transport network that they are willing to provide. An efficient tax on the motor vehicle sector will bend some of these choices. The challenge will be to find a family of taxes on motor vehicle ownership and use that will raise significant revenue, improve resource allocation, and be administratively feasible. Almost certainly the rate for an efficient tax on motor vehicles will vary from one large city to the next.

Motor fuel taxes

From a revenue perspective, the tax on the vehicle sector with the most revenue potential is a fuel tax. The base of the tax (fuel consumption) can be income elastic because of the growth in the number of motor vehicles, but also will respond to changes in the price of petrol if levied on an ad valorem basis. While it is true that fuel taxes are related both to road usage and to such external effects of vehicles as accidents, pollution, and congestion, the relationships are usually too complex to capture in any precise way with a single tax (Newbery 2005).

The size of these external costs, and the likelihood that they will vary significantly within a country, supports the case for a locally imposed tax on motor fuels. The cost of road investment and maintenance, and the external costs of automobile ownership and use, is much higher in some urban areas than in others, and is likely to be highest in the larger urban areas.

Motor fuel taxes could be levied by either a metropolitan area government or by a transportation special district that covers the entire metropolitan area. It could be imposed as a piggyback on the central government tax on motor fuels with the metropolitan area government having some discretion in rate setting. Collection at the pump is the best option for tax administration, but the technology and the skills of the provincial/local administration may not be ready in some low-income countries, and fuel carrying can become a problem. An alternative is to impose differential provincial fuel taxes at the refinery or wholesale level, with the refiner or wholesaler acting as a collection agent for the states/provinces, and remitting taxes in accordance with the destination of fuel shipments.

In many low- and middle-income countries, motor fuel is already heavily taxed and the higher-level governments are unwilling to provide any revenue space to local governments. But this is not always the case. Provincial and local level motor fuel taxes in developing countries are imposed by subnational governments in only a few low-income and middle-income countries. Istanbul's "environmental sanitation tax" is imposed as a sales tax on gasoline. A differentially higher rate for motor fuels under the state government VAT in Brazil is one example of a destination-based tax on motor fuels. Under Colombia's gross receipts tax, motor fuels are charged a rate of 1.38 per cent. A share of the central tax on motor fuels and motor vehicle transfers is a major source of own revenues for Jakarta.

Motor Vehicle Registration and Licenses

A charge for motor vehicle registration and licensing has the potential to yield a significant amount of revenue, but it rarely does. There are two general approaches to levying this tax. One is an annual personal property tax, based on the depreciated value of the motor vehicle. Under this approach, the objective usually has more to do with taxing wealth than with approximating a green tax, and takes the form of imposing higher rates on higher-valued vehicles. Taxing according to the value of the car is difficult to justify from an environmental point of view because price is unlikely to be correlated with carbon dioxide emissions or fuel consumption. The other approach is an annual tax based on such features as the age and engine size of the vehicle (older and larger cars generally contribute more to pollution), the registered location of the vehicle (cars in cities add more to pollution and congestion), driver records (20 per cent of drivers are responsible for 80 per cent of accidents), and axle weight (heavier vehicles do exponentially more damage to roads and require roads that are costlier to build) (Bird and Slack, 2013). If technology permits, even more refined pricing schemes could be applied, at least in the most heavily congested urban areas or at border crossings.

Almost all Asian cities levy some form of registration tax on motor vehicles, but it rarely yields significant revenue. The problems with administering this tax vary from country to country (and from state to state in some federal countries). While there is, in principle, no good reason for under collection, enforcement is sometimes lax. This is said to be due to a feeling that high registration and operating costs are unjust in metropolitan areas that do not have adequate public transport systems. Even without sound arguments, increased automobile taxes of any kind are contentious, and politicians tread lightly.

An interesting dimension of the use of motor vehicle registration is the possibility of using this as an instrument for rationing road use. Singapore's pioneering programme with a restricted license based on congestion levels and peak hour commuting patterns has been a widely celebrated policy. Another less targeted approach uses licenses to limit the number of motor vehicles on the road. In China, for example, Beijing and Shanghai have set a cap on vehicle registrations and established a quota for newly registered license plates.

User charges

User charges should be moved closer to full cost recovery levels in large cities to improve the efficiency of service delivery for the public functions, lower local tax rates and reduce the claim of cities on intergovernmental transfers.

The principle behind user charges is simple enough. Let users pay for a service according to how much benefit they receive from it, usually measured by how much of it they use. The binding requirement is that the service must be amenable to pricing. Many services that are typically provided by the Government fall into this category, including water and sewerage, electricity, mass transit, road use and much more.

When services cannot be priced, but exclusion in consumption is possible, an alternative cost recovery measure is some form of benefit charge or tax. This might include financing for garbage collection and solid waste disposal, entry into parks, parking and advertisement fees, a general charge for business services collected through a license, real property registration fees, and special assessments to cover the cost of new public investments.

The revenue potential in all of this is considerable, as is seen by the results in industrial countries where the pricing of public services is widely used. In the United States, user charges and fees account for about 35 per cent of all own source revenues of local governments (Fox and Slack, 2010).

Most observers of metropolitan city finances decry the inadequate recovery of costs with user charges. While there are not adequate data to make firm comparisons, several case studies of cities have made the point. Redistribution is the one most often cited reason why cost recovery is not the norm. Most metropolitan governments are hesitant to zone low income families out of the market for necessities or merit goods. Critics argue that there are better ways to protect poor families than subsidized prices of government provided services. There is also a perception among some populations that government services are an entitlement that should not be paid for with cost recovery prices. But this argument ignores the fact that the services will be paid for with general taxes that are not necessarily levied on those who benefit from the services provided. Finally, there is the question of what is meant by full cost recovery, and whether it should somehow include the benefits enjoyed by non-users.

Intergovernmental transfers

Researchers and policymakers usually argue that metropolitan local governments should be more revenue self-sufficient, but rarely is a target level set for self-sufficiency. At least in theory, one might argue that the target should be set as metropolitan areas need to raise at least enough revenue from their own sources to cover those local government expenditures that provide benefits to the local population and that are not mandated by higher-level governments.[33] In other words, only the spillover benefits to non-payers should be supported by intergovernmental transfers. With adequate devolution of revenue raising powers, this rule might work reasonably well for a metropolitan area-wide government structure (Bangkok or Shanghai) but not for a fragmented metropolitan local government structure (Manila, Kolkata or Jakarta) because some local governments lack adequate taxable capacity to raise adequate revenues. In those cases, the greater self-sufficiency mandate will probably lead to increased fiscal disparities within the metropolitan area.

The current practice

Though hard evidence is not available for all cities in the Asia-Pacific region, it is almost certainly the case that local governments in metropolitan areas fund more of their budgets from own sources than do other local governments. Shah (2013) developed a sample of 17 metropolitan areas and calculates an average dependence on intergovernmental transfers of 42 per cent of total revenues. It is hard to find a pattern in these data because the range is from less than 10 per cent in Pune, India to 36 per cent of total revenues in Delhi (Bandyyopadhyay and Rao, 2009) to over 70 per cent in Istanbul. On average, it is likely that Asian city governments are more dependent on transfers than are those in, for example, Latin America (table 2).

The treatment of metropolitan area local governments in the intergovernmental transfer system varies quite a lot. Many countries do not have a special regime for large urban areas, meaning they treat metropolitan local governments the same way as they treat other local governments (Shah, 2013). In other cases the formula used to distribute transfers may include elements to increase or reduce the amounts flowing to richer areas. If the distribution formula does not account for fiscal capacity (the Philippines), or includes an effective equalization feature

[33] Technically, all who benefit from local services should pay the local tax, including non-residents who migrate in to work or shop. For most metropolitan area-wide local governments, the number of non-residents is much the same as the local resident population. But in a jurisdictionally fragmented metropolitan area, the daytime population is often quite different from the resident population.

(Indonesia or Viet Nam), the richer provinces and metropolitan areas will be less favoured.

In some countries, there are special arrangements for metropolitan areas and additional resources may be provided to accommodate their special needs through grant programmes or by giving large cities both provincial and city status. Those arrangements may include some metropolitan areas while excluding others. For example, the Jakarta metropolitan area is excluded from the “needs” portion of Indonesia’s general revenue sharing programmes on grounds that it already has a fiscal surplus. However, Jakarta receives a share of national personal income tax revenues and is eligible to receive ad hoc conditional grants.

Countries that share central government revenues on a derivation basis, meaning they return the shared tax revenues according to where it is collected, will favour the wealthier provinces and metropolitan local governments. Four of the highest income Chinese metropolitan local governments have provincial status and receive significantly larger per capita amounts of shared taxes.[34] Metropolitan Bangkok receives a significant per cent of revenues from centrally-determined surcharges on VAT and excises that are shared on an origin basis (Shah, 2012; Varanyuwatana and Laovakul, 2010).

If the objective is to target specific projects with conditional grants, ad hoc distribution methods are often used and the metropolitan local governments are often excluded. Countries that try to match an index of expenditure needs to an index of taxable capacity, and distribute against the needs gap, will usually discriminate against the larger and wealthier metropolitan local governments. Ad hoc capital grants can be dangerous for metropolitan areas if the continued funding is not guaranteed. Cases in point are the halting of construction of transportation projects in both Jakarta and Bangkok (Shah, 2013).

India has a separate programme for urban local governments. The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) began in 2005 to finance public infrastructure on a sustainable basis (box 2.5). The grants were earmarked for infrastructure and required certain reforms to improve urban governance. A thoughtful critique of JNNURM noted that the programme was hampered by slow release of funds, cost over-runs, inadequate capacity to absorb grants at the local level, problems in monitoring the progress with urban management reforms and enforcing the conditionality, and the inability of state and local governments to back JNNURM with their own financial resources (Ahluwalia, Kanbur and

34 The simple correlation between per capita revenue sharing transfers to provinces and per capita GDP is -0.91 (Bahl, Goh and Qiao, 2014, pp. 30).

Box 2.5

The Jawaharlal Nehru Urban Renewal Mission (JNNURM)

The JNNURM was launched in 2005, under the leadership of the Ministry of Housing and Urban Development, as the largest ever nationwide scheme for urban infrastructure development and service delivery in India. It was designed to improve both infrastructure and urban governance, and included a special component of providing basic services to the urban poor. The JNNURM required the urban local bodies to prepare a city development plan and to agree to certain mandatory reforms in urban governance as a grant condition. The mandatory reforms included using double entry accounting and management information systems, using geographic information systems for e-governance and property tax reform, and recovering operations and maintenance expenditures through user charges. The nodal agency for the reform programme was appointed by the state government, and the programme was financed by a federal grant with matches from the state and urban local bodies.

The JNNURM mission was closed in 2014 by the new government and replaced with the Atal Mission for Rejuvenation and Urban Transformation (AMRUT). In addition, the new government started a programme called "Smart Cities". Under the "smart cities mission", the government has chosen to grant Rs. 1 billion to 100 cities in five years beginning 2015 (20 cities each in five years) for upgrading their infrastructure and the cities are chosen based on competition among the cities on the quality of proposals made.

Mohanty, 2014, pp. 49-55). While the programme improved infrastructure chiefly in water supply and drainage, the main gain may have been to raise the ambition of Indian cities.

How to reform the grant system

A goal for metropolitan areas should be that they finance most local public services with revenues raised from beneficiaries through local taxes and user charges. To this end, metropolitan local governments should be empowered to levy new taxes including surcharges on central or provincial level taxes. Intergovernmental transfers to metropolitan local governments should be limited to those that compensate for benefit spillovers, and those levied to reduce income distribution concerns such as slum upgrading.

In many metropolitan areas, there is a heavy dependence on intergovernmental transfers to finance local public services, and so the transition to a more locally financed system will take time. Replacing grant financing with local taxes and charges will be painful to much of the local population and will need to be implemented gradually. The development of a new tax code and a new administrative structure also will take time. Higher-level government leaders, and many local political leaders will need to be convinced that such changes are in the best interests of the country, and this will further slow the transition.

There also is a question of how this separate regime for intergovernmental transfers will be structured in metropolitan areas with a fragmented local government structure. Tax decentralization in such cases (Metropolitan Manila or Metropolitan Kolkata) accentuates fiscal disparities, thus the new grant regime will need to include an intra-metropolitan equalization feature.

For those countries in the region where the traditional centralized approach to urban finance is continued, intergovernmental transfers will remain a mainstay of the urban public finance system. In this case, the central Governments should be certain that it has structured the transfer system to accomplish the objectives it has set for it. So long as metropolitan local governments can rely heavily on grants from higher-level governments, significant increases in revenue mobilization at the local government level will not likely happen.

6. Recommendations on the way forward

The public finances in the metropolitan areas of the Asia-Pacific region were long ago ready for reform. The agglomeration benefits that came with urbanization have shown up in a rapid growth in GDP in metropolitan areas that increased the capacity to tax in urban areas. But at the same time the backlog in public services and infrastructure continued to grow. Because central (and state/provincial) governments faced other significant claims on their resources, the devolution of revenue raising powers has not taken hold in low- and middle-income countries in the region. New and very different approaches to fiscal reform are called for, and in the fiscally centralized Asia and Pacific region, the reform medicine will be hard to take.

The place to start is with an economic development strategy, that is a national urban policy for urban areas. Barriers that stand in the way of capturing agglomeration effects should be eliminated, and the migration to cities should not be discouraged. This strategy calls for incentives such as lowering the regulatory costs of interregional and international trade, and increasing investment in transportation networks, and improving the quality of services offered to residents and businesses in the large cities in the region. So far, countries have said relatively little about how to develop local government finance networks that make large city finances more manageable and generate revenues to support adequate services and infrastructure investment.

What is the way forward? How can Asian countries develop fiscal strategies to support their urban economic development strategies? Three central elements of such a strategy might be suggested.

1. Recognize that metropolitan areas are different from one another and that one approach to increased revenue mobilization in urban areas of the Asia-Pacific region will not fit them all. Populations in different metropolitan areas do not necessarily adopt the same objectives for their budgets, and central/provincial governments that are responsible for controlling metropolitan areas are driven by many more motives than economic development. In the end, the revenue raising strategy adopted by China will be different from that adopted in India will different again from that adopted in the Philippines, and so on.
2. Where local government autonomy is deemed an important part of the urban area development strategy, metropolitan area local governments should be able to cover most of their budget expenditures with locally raised revenues, in effect charging a tax price that covers the marginal cost of providing local benefit services.[35] This will require that they be given significant, additional revenue raising powers.
3. Higher-level governments might consider establishing a blue-ribbon commission to study the feasibility of a special regime for metropolitan area finances. The scope of this inquiry would include metropolitan government structure, the assignment of expenditure responsibilities, and the assignment of revenue raising powers including taxation, user charges and borrowing, and provisions for accountability.

A specific option that warrants consideration is to develop a metropolitan fiscal strategy that provides for a special governance and financing regime for metropolitan areas. [36]

Most countries engage in urban planning but relatively few integrate their urban plans with a fiscal plan. Urban plans often focus on land use and public facility needs without giving careful attention to the fiscal question of how to pay for and maintain public services.

Most countries do not have a metropolitan fiscal strategy, so large cities are often viewed as just another unit in the local government fiscal system. They sometimes have the same revenue raising power as other local governments, and their entitlements to intergovernmental transfers are often calculated in the same way.

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35 'Local benefit services' are local government-financed services where the benefits of the service are enjoyed by local taxpayers. Locally financed services that benefit non-payers should be financed with intergovernmental transfers.

36 For a good discussion of this issue and the constraints to implementation, in the context of the Philippines, see World Bank, 2017.

But the continued growth of urban populations and urban economies and the challenges of global competition are pushing systems to change. Many countries are recognizing that urban economic growth will not be sustainable without a metropolitan strategy that resolves the underlying governance and financing problems. In many urban areas, the efficient provision of services and their financing has outgrown the jurisdictional boundaries of cities. Many take the view that the mix of service provision and financing should include regional taxes, delivery of some services on a regional basis, and a revenue model focused on more self-sufficiency (Bahl, Linn, and Wetzel, 2013, p. 27).

In short, metropolitan areas need to become more than a convenient way to think about planning for the labour market area, and area-wide governments need to be responsible for much more than planning and land use regulation. They need to become local government units with elected leadership, broader service delivery responsibility and more autonomy in their spending and revenue raising decisions. Metropolitan local governments should have more autonomy in their spending and revenue raising decisions. The case for higher-level intervention in the financing of metropolitan local governments is much weaker than that for other local governments in the country.

Area-wide metropolitan local governments offer the best future for governance and finance. When the jurisdiction boundary is large enough, spillover benefits and costs can be internalized and economies of scale can be captured. Metropolitan area-wide governments can rely on broader tax bases because their coverage of the economic region is greater. Broader based consumption, motor fuel and property taxes bring fewer distortions because there is less mobility across jurisdictional boundaries. The broader tax base and the larger jurisdiction coverage will also increase the debt repayment power of the metropolitan government. Jurisdictional fragmentation, which emphasizes home rule, does not offer these advantages, and it tends to be characterized by large intra-metropolitan fiscal disparities. Where countries choose to stay with the home rule emphasis that characterizes jurisdictional fragmentation, financing will be more through intergovernmental transfers and horizontal systems of revenue sharing to eliminate unwanted fiscal disparities among municipalities.

The best approach to getting a metropolitan fiscal strategy in place will vary from country to country, but in most cases the policy reform would concentrate on three components. The first is to create “special” metropolitan city governments within the present regime but with broader taxing and spending powers and more autonomy than other local governments. These powers might include the ability to enact certain new taxes and the freedom to set new tax rates and user charges, and to control exemptions and preferential treatments. Metropolitan local governments can gain this autonomy in exchange for much of their claim on the present system of intergovernmental transfers. This would be new policy ground for most of the Asia-Pacific region.

The second component of the strategy would be to encourage metropolitan governments to move to areawide boundaries for service delivery and revenue raising. This might be done in several ways. Convert existing central or state government metropolitan development agencies into elected local governments with significant autonomy to deliver services and raise revenues. Create metropolitan taxing districts. Relax annexation laws, and provide incentives to expand metropolitan boundaries where necessary. To preserve some measure of home rule, an underlying tier of local self-government might be created. The city-barangay model in The Philippines is an example of how this might work.

Third, the cost dimension of the urbanization problem may be addressed by raising tax prices in metropolitan areas to a level commensurate with the cost of providing services. “If you want to live and do business in the big city, you have to pay the price.” This strategy will also influence migration and investment decisions in urban areas. But implementing this part of the strategy will require the devolution of taxing powers to metropolitan local governments.

China is a special case. The Government is committed to a centralized regime for revenue mobilization. For the time being, local autonomy will be limited to the expenditure and non-tax parts of the budget. Nevertheless, metropolitan area boundaries are more or less in place, as is a system of broad-based intergovernmental transfers to finance services, and a supplementary system of land revenues contributes to financing the costs of urbanization. Furthermore, the Government of China is on record as recognizing the increasing costs of urbanization and the need to improve the revenue base of urban local governments (World Bank and Development Research Center of the State Council, 2014, p. xxvi). Another emerging problem in China is how to service populations and businesses when their activities spill across provincial boundaries.

The policy matrix for metropolitan fiscal reform would include the following:

1. Metropolitan area-wide local governments should be created and should have taxing powers commensurate with the expenditure responsibility assigned to them and with their demands for local public services. Where metropolitan areas continue with a pattern of jurisdictional fragmentation, they will be financed by higher property taxes and user charges, and will receive

increasing amounts of fiscal transfers from the higher-level governments.

2. A special expenditure assignment regime should be enacted for metropolitan local governments. The regime should make provision for cooperative arrangements and contracting, and for appropriate horizontal arrangements for revenue sharing. All local government employees should be hired, fired and compensated by the local governments. Local governments in metropolitan areas should have the autonomy to plan and implement their budgets.
3. Metropolitan local governments could be allowed to impose a higher marginal rate on property and land taxes. Some thought should be given to a metropolitan area-wide property tax administration district, funded on a contract basis with the local governments. Provision should be made for the imposition of value capture mechanisms. Remove any restrictions on tax rates or the valuation of taxable property.
4. Local governments in metropolitan areas could impose higher taxes on motor vehicle registrations, and could be allowed to impose a sur-tax on motor fuels, or to share in such a sur-tax.
5. Local governments in metropolitan areas should be given the power to impose a broad-based tax for general purposes. This might include a sales tax or a business tax, or it might be levied as a surcharge on a national consumption tax with a local option rate.
6. Local governments in metropolitan areas should be given the power to impose higher rates of special taxes and licenses to reflect the benefits from public services in large cities. These might include business licenses, development charges, and surcharges on the national income and sales taxes.
7. User charges should be increased to recover at least operating and maintenance costs for public utilities and transportation services provided in the metropolitan area. This includes general business licenses which might be imposed at a higher rate in large urban areas to reflect the level of public services provided.
8. In countries that decided on revenue devolution, local governments in metropolitan areas would no longer participate in the general intergovernmental transfer scheme, or in special schemes, but would be eligible for conditional transfers to correct for spillovers with national or regional implications. Intra-metropolitan fiscal disparities could be dealt with by horizontal equalization schemes.

9. Again, China is different, but the same principle could apply. Residents and businesses could pay the higher cost of better services provided in metropolitan areas. This could be done in many ways, such as the enactment of an annual property tax, full cost recovery from user charges, higher licensing costs, and more aggressive mobilization of revenues from the motor vehicle sector.

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