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# GOVERNING AND FINANCING METROPOLITAN AREAS IN THE DEVELOPING WORLD

# 1

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The economic activity that drives growth in developing countries is heavily concentrated in urban areas.<sup>1</sup> Catchphrases such as “metropolitan areas are the engines that pull the national economy” turn out to be fairly accurate.<sup>2</sup> But the same comparative advantages of metropolitan areas that draw investment also draw migrants who need jobs and housing, lead to demands for better infrastructure and social services, and result in increased congestion, environmental harm, and social problems. The challenges to metropolitan public finances are to capture a share of the economic growth that is adequate to finance the new and growing expenditure needs and to organize governance so that services can be delivered in a cost-effective way, giving the local population an adequate voice in fiscal decision making. At the same time, care must be taken to avoid overregulation and overtaxation, which will hamper the now quite mobile economic engine of private investment and entrepreneurial initiative.

This book identifies the current issues of importance in metropolitan governance and finance in developing countries, describes the practice, explores the gap between practice and what theory suggests should be done, and lays out the reform paths that might be considered. Part of the solution will rest in rethinking expenditure assignments and instruments of finance. But this will need to be done in a context of how government is structured, the characteristics of the local economy, the infrastructure gap, the concentration of poverty and slums, environmental

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<sup>1</sup>This chapter uses, for simplicity’s sake, the traditional terminology distinguishing between developing countries and industrial countries, following the World Bank in its World Development Indicators (World Bank 2012): the former are referred to as *low and middle income countries*, and the latter, as *high income countries*. Although the line between low- and middle-income countries is becoming increasingly blurred, the grouping remains broadly relevant.

<sup>2</sup>All broad generalizations are bound to have exceptions. For example, economies that rely heavily on primary exports such as natural resources may be driven primarily by commodity prices.

concerns, and the external financing options. The “right” approach also will depend on the flexibility of political leaders to relinquish some control in order to find a better solution to the metropolitan finance problem.

This chapter reviews the main lessons that have been learned about each of these issues, by drawing on the existing literature and on the research reported in the 14 chapters that follow.

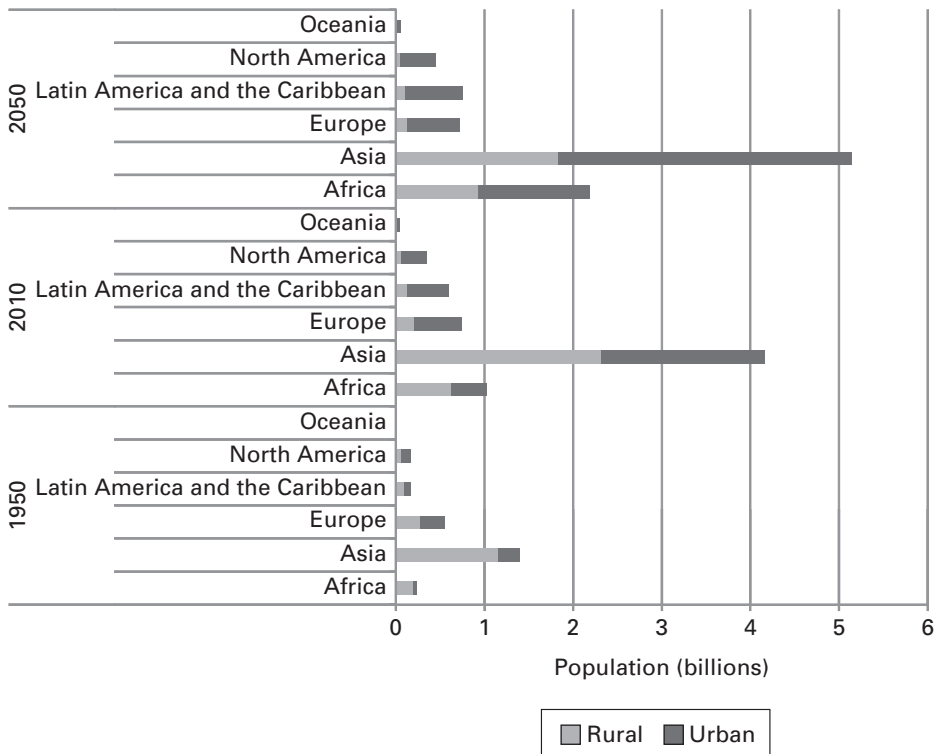
## URBANIZATION TRENDS AND ECONOMIC GROWTH

The rate of urbanization in developing countries is projected to reach the 50 percent mark in the 2010s (United Nations 2008). According to current estimates, the world population will likely grow from approximately 7 billion in 2012 to more than 9 billion by 2050 (U.S. Census Bureau 2012), and virtually all of the population increment will be absorbed by urban areas in developing countries (figure 1.1).

The number of megacities (populations > 10 million) is projected to increase from 19 in 2007 to 27 in 2025, when about 10 percent of the world’s urban population will reside in these cities. Of the projected 27 megacities, 21 will be in less developed countries. By 2025, 48 cities will have populations from 5 to 10 million, and three-fourths of these will be in developing countries (United Nations 2008).

**FIGURE 1.1**

Rural and urban population by major regions, 1950, 2010, and 2050



SOURCE: United Nations (2012).

It is not uncommon for individual metropolitan areas to account for more than one-fourth of national gross domestic product (GDP) in Organisation for Economic Co-operation and Development (OECD) member countries (OECD 2006).<sup>3</sup> The same is also true in developing countries, for example, 27 percent in Istanbul and 52 percent in Buenos Aires (Braun and Webb forthcoming; OECD 2008a). The benefits and costs of this degree of economic primacy are not limited to the largest cities. The positive trickle-down effects will include growth in firms that supply metropolitan-area industries and generation of tax revenues that are redistributed to local governments in the rest of the country. But there also are negatives, such as the brain drain from other regions to metropolitan areas, as the most talented workers move to cities to seek better opportunities, and the political friction that metropolitan-area dominance sometimes causes (see Smoke, chapter 3; Sud and Yilmaz, chapter 5).

The size of metropolitan areas can be an economic blessing or a curse, depending on how they are managed. But there is no question that big challenges lie ahead.

- Not only will an increasing number of cities be megasized (10 million and greater), but also they will be clustered in multimetro regions/corridors. Regional planning will be imperative.
- Rising mobility with greatly expanded car ownership will result in declining urban densities and will create challenges for infrastructure, environment, and agricultural land use. Effective land use regulation can help address this challenge.
- With globalization, metro economies are highly integrated in the global economy and will need to be more competitive. In particular, the growth of the largely unregulated and mobile service sector in these metro economies requires “smart growth” strategies by cities. The development of information technology services will be a key factor.
- The delivery of adequate services in metropolitan areas should be viewed as part of the smart growth strategy and will be especially challenged by the large populations living in slums.
- Metropolitan areas will need to be at the forefront of the response to climate change and green growth opportunities (see Wetzel, chapter 12).

In chapter 2, Yusuf summarizes key factors that can drive strong and sustainable metropolitan income and employment growth: (1) an economic base that is competitive in domestic and global markets; (2) strong information technology and transportation linkages; (3) a concentration of human capital skills; and (4) quality governance that supports metropolitan growth and captures the opportunities upon which urban growth thrives. Glaeser and Gottlieb (2009) also link metropolitan growth to the transfer of information.

<sup>3</sup> This chapter uses the term *metropolitan area* to refer to the built-up space covered by large cities, including their suburban areas. This is similar to the definition used by the United Nations (2008, 13) 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.”

The poster children of smart-growth metro areas among the developing countries are Shanghai and Bangalore (Bengaluru).<sup>4</sup> But in many developing countries, the metropolitan areas have not developed a globally competitive economic base. African cities such as Kinshasa and Dar es Salaam have experienced significant population growth but mostly because of conflict and worsening conditions in rural areas. In chapter 2, Yusuf cites Karachi, São Paulo, Cairo, Manila, and Johannesburg as examples of cities that are growing but not generating exports or importing new technologies.

## GOVERNING METROPOLITAN AREAS

Typically, the responsibility for governance and service delivery in a metropolitan area is vertically fragmented among central, provincial/state, and local governments. They are horizontally fragmented among municipalities, areawide general-purpose local governments, special-purpose districts, and public enterprises. Rarely is there enough coordination among these governments (Rojas 2008).

### *Theory*

There is a strong case for metropolitan-wide governance, and the case grows stronger as metropolitan areas grow. But “thinking metropolitan” is much easier than restructuring government or coordinating service delivery for the entire urban area. The metropolitan area is an economic concept, with boundaries that change as the economy changes. In practice, it is mostly used for planning purposes. These plans usually are not fully implemented, and even if they are, they tend to be limited in their coverage of the area and the functions considered. Local governments, in contrast, are elected (or appointed) entities and are defined by political boundaries that fragment the metropolitan area (see Bahl, chapter 4). The idea of metropolitan governance across political boundaries has not been easy to sell.<sup>5</sup>

The decentralization choice that so perplexes central governments in developing countries can also be applied to the question of governance within metropolitan areas (see chapter 4). The fiscal decentralization theorem gives a norm that all services should be delivered at the lowest level of government, consistent with efficiency considerations (Oates 1972). So, if there were no economies of scale in service provision and no externalities, and if only economic efficiency was considered, the best governance for the metropolitan area would be a large number of small municipalities with relatively homogeneous populations. But there are scale economies, externalities, and political factors to consider, and preferences for strong local autonomy vary across regions. So, how metropolitan governance is finally structured

<sup>4</sup> Hong Kong and Singapore also demonstrate that it is possible to turn troubled cities into thriving metropolises in a few decades. While these two cities are atypical in that they are city-states, they also faced many of the same challenges and grasped many of the opportunities that the large metropolitan areas in the rest of the developing world are facing today.

<sup>5</sup> For a discussion of the difficult political economy issues involved in moving toward metropolitan governance in Toronto, see Slack (2000). For a discussion in the developing country context, see OECD (2008b).

depends on the relative strength of the demand for home rule versus the demand for more efficiency in service delivery.<sup>6</sup>

### *The Practice*

The practice of metropolitan governance varies considerably. Any taxonomy of the various models used is likely to oversimplify things, but this section classifies governance systems according to the horizontal (intrametropolitan) and vertical (federal-provincial-local division) arrangements for service delivery and taxation.<sup>7</sup>

#### HORIZONTAL ARRANGEMENTS

The structure of governance within metropolitan areas is usually a mixture of the three basic strategies: jurisdictional fragmentation (autonomous municipalities within a metropolitan area), functional fragmentation (single-purpose public enterprises), and metropolitan-wide government (Bahl and Linn 1992). The way in which countries mix these strategies depends on politics and how they value local autonomy, on the one hand, and technical efficiency, on the other. At one extreme are São Paulo, which includes 39 autonomous municipalities, and the Mexico City metropolitan area, where services are delivered by two states, a federal district, and more than 50 local level governments. Johannesburg and Cape Town, at the other end of the spectrum, are metropolitan governments that deliver their assigned services on an areawide basis with little autonomy at the submetropolitan level. Lying between are all sorts of arrangements. Manila's 17 cities and municipalities are overlaid by a metropolitan government with some areawide responsibilities, and metropolitan Mumbai relies on central- and state-owned parastatals (public companies) for metrowide service delivery.

The great variation in practice that exists among developing countries suggests that almost any arrangement can work, if "work" means that local services do not collapse. The questions are whether a stronger set of services could have been delivered under a different government structure, and whether economic development would have progressed as a result. Unfortunately, there is no good evidence to prove the better results from one system than from another, and of course, "better" also depends on what local voters want from their government. This is mostly because so many other factors are important.

There is much for developing countries to learn from the experience with metropolitan governance in industrial countries about how they have handled the tensions from demands for local control versus areawide government and how they have financed this growth.<sup>8</sup> This experience can help identify the governance choices that are feasible when constraints on revenue mobilization and service delivery capacity are relaxed. It supports a hypothesis that time and economic growth will lead metropolitan governance practices in developing countries toward workable

<sup>6</sup> Here *home rule* means the extent to which governance of a local jurisdiction is in the hands of the local population.

<sup>7</sup> While the taxonomy originally developed in Bahl and Linn (1992) is followed here, an alternative is suggested by Shah in chapter 9.

<sup>8</sup> The experience with fiscal decentralization in industrial countries is reviewed in Bahl (2011) and Slack (2007).

decentralized structures. But in the short run, the choices in developing countries are much more limited because of rapid population growth and scarce resources, and movement away from fiscal centralization is proving to be difficult. It will be a long time before governance in a metropolitan area such as Mumbai or Mexico City settles into a structure like those adopted by Toronto or Copenhagen.

#### VERTICAL ARRANGEMENTS

The defining feature of public finance and governance in most developing countries is centralization. In chapter 5, Sud and Yilmaz point out that only a handful of developing countries specifically recognize local governments in the constitution. Central governments raise most of the tax money, spend the largest share of the public budget, and make the rules about how subnational governments operate (e.g., expenditure assignment, taxing powers, and the borrowing framework). The road to better metropolitan governance and fiscal outcomes in metropolitan areas begins with the national government (and with the state government in some large federal countries). Virtually all enabling legislation for metropolitan-area governance requires a central or state government initiative.

To a large extent, the success of metropolitan-area public finances depends on how vertical intergovernmental relations are structured (see chapter 3). In particular, three issues are of great importance. The first is whether metropolitan cities will be treated the same as other local governments in the country or be given a differential fiscal treatment. In some countries, local governments in metropolitan areas are not treated differently (see Bird and Slack, chapter 6). In others, there is differential treatment (see chapter 3), usually taking one of the following forms: (1) provincial city status (see box 1.1); (2) special expenditure assignment and taxing arrangements for cities of different sizes; (3) special arrangements under the intergovernmental transfer system (Bahl 2011); or (4) special status for national capital cities.

The second issue is the direct delivery of services within metropolitan areas by higher-level governments: the so-called vertical programs of the central (or state) government. The policy question is whether and how service delivery by local governments and higher-level governments will be coordinated within the urban area.

Third, there is the issue of the degree to which the actions of metropolitan local governments will be tightly regulated by higher-level government ministries. A ministry of local government or a ministry of interior often provides general control to ensure compliance with laws and regulations, but regulations that are too stringent can undermine local authority and create obstacles to good performance (see chapter 3). Arguably, more problematic are the controls imposed by sector ministries (e.g., in infrastructure, education, and health), which can significantly limit local government expenditure discretion, as has been the case in Colombia and Peru (see Bird forthcoming; Martinez-Vazquez forthcoming; see also chapter 3).

#### REFORM OPTIONS

On balance, stronger metrowide governance approaches, supported by local coordination and accountability mechanisms, are appropriate and ultimately unavoidable. Continuing rapid urbanization has overtaken present metropolitan gover-

**BOX 1.1**

## Provincial-level cities

Historically, city-states have been among the most successful jurisdictions in producing rapid economic growth and effective urban growth. Medieval Venice and the cities of the Hanseatic League in Northern Europe are early examples. Hong Kong and Singapore are the contemporary counterparts. Interesting questions are whether there are lessons to be learned for metropolitan governance and finance from the experience of the city-states, and whether there is a way to pattern metropolitan governance at least partially after that model. In larger countries, this could take the form of provincial cities, where the metropolitan-area local government has both provincial and local status. For example, in China, the four largest cities are treated as provinces and have the powers of both provincial government and local government.

There are some clear advantages to this approach. It allows for areawide governance that can internalize potential external effects but also allows for significant autonomy in making budgetary decisions. It becomes much like a state in a federation but usually with more manageable boundaries and without the understructure of local governments to deal with. A further advantage is that its boundaries can be large enough to allow regional taxation, and perhaps to adopt a broad-based tax. Finally, its borrowing powers can be enhanced because it can oversee and regulate larger public enterprises and because its revenue base can support debt better than if it were a city government within a metropolitan area or subject to provincial oversight.

There also are disadvantages. For one, the metropolitan area may have already spread across jurisdiction boundaries so that the city-province status is assigned to the core city. In this case, the areawide governance advantage is lost. This is the case of Buenos Aires. Another disadvantage is the hinterland problem; for example, if Mumbai were made a state in India (an appealing prospect), it would leave the present state of Maharashtra without its most important revenue generator. A third disadvantage is that city-states are ad hoc arrangements, created as special cases by the central government. How does one draw the line for deciding if there will be more of them, and how will the provincial city be made to fit within the existing local government code or budget law? Finally, a city-state may be politically strong, with a governor or mayor who might be considered a rival by the central government and the legislature. This can lead to some degree of discrimination against the metropolitan area in terms of its treatment within the metropolitan area.

nance structures in terms of the ability to coordinate services, provide infrastructure, and make use of regional financing tools. There is no single magic bullet for reform that is right for all countries, because the taste for fiscal decentralization within metropolitan areas varies from location to location. However, the reform process must begin with the central government (or state government) taking a metropolitan (vs. a submetropolitan local-government) view of reform choices. One likely result of this reform direction is that some measure of home rule below the metropolitan level will be lost.

If the potential loss in home rule from areawide governance is thought to be too great, and history suggests this to be the case in many metropolitan areas, a second-best solution is to institute coordination mechanisms. Vertical coordination, if the case of Mumbai is any indication, is a very difficult matter (see chapter 10). In practice, the experience with this approach has been one of mixed success, especially when coordination and consultation are voluntary rather than mandatory. A good case in point is the São Paulo metropolitan area, where the autonomy of the 39 municipalities is guaranteed by the constitution, leaving each with veto power over coordination programs for service delivery (see chapter 12). In response, São Paulo

and other Brazilian metro areas have begun to experiment with metropolitan councils and other such coordination mechanisms that bring all the stakeholders together to find solutions.

## PUBLIC EXPENDITURE CHALLENGES

The pressure on expenditure budgets to support metropolitan services is not likely to lessen in the coming decades, though the severity of the problem will vary from city to city. The demand for services will remain high, costs are rising, backlogs are severe, management is problematic, and the special problems of slums are overwhelming.

### *Expenditure Demands*

The factors that will pressure increases in public expenditures in urban areas include (1) population growth; (2) growing per capita incomes; (3) business demands to upgrade the infrastructure and to upgrade the public amenities necessary to attract and retain a strong labor force; (4) the negative externalities that accompany urbanization, such as pollution (solid waste collection) and congestion (transportation); and (5) the special needs of a heavy concentration of poor and badly housed families, often in sprawling slums, that call for major public investments by metropolitan governments. The magnitude of the slum problem is staggering. One estimate is that about \$60 billion per year will need to be spent on slum improvement and prevention for the next 15 years (see Freire, chapter 14).

Supply-side factors also drive up unit costs of service provision disproportionately in the urban areas. Some of these are due to diseconomies of size. Examples are the costs of handling refuse collection and solid waste disposal, managing traffic congestion, dealing with pollution, and supplying such resources as potable water. Metropolitan labor and land costs also are higher than in smaller cities and rural areas.

A tension in urban budget decisions arises from the pressure to invest in new physical and social infrastructure versus the pressure to maintain and improve existing assets. Metropolitan economic growth is often associated with heavy investment in transportation: mass transit and freeways to reduce congestion, as well as seaports and airports (see chapter 2). Infrastructure to support new residential developments is in step with strengthening the amenity attractions of cities, while infrastructure to support industrial parks is in keeping with the goals of capturing agglomeration economies. Modern hospitals and an emphasis on education curriculum that supports the new economy are also aligned with the strategy. Innovations in governance, such as e-governance, are signs of progress with which most political leaders would like to be associated. And in all of this, there is the political appeal of being associated with modernity and all the visibility this produces.

The competing strategy is to concentrate more on fixing what already exists, and what in many cases is woefully inadequate. For example, basic water and sewer systems may need major repair and upgrading, roads and streets are often in disrepair, and solid waste disposal may be surviving on a temporary solution. The deliv-

ery of social services is often outdated, for example, overcrowded school classes, improperly staffed or supplied health clinics, and unenforced environmental regulations. As necessary as they are, expenditures to address the backlog can, at the margin, be viewed as crowding out expenditures that attract new investment (Glaeser 2011).

### *Managing Service Delivery*

The poor record of service delivery by local governments in developing countries has long been used as the justification for keeping public expenditure management centralized (see Bahl and Linn 1992). In various countries, the problem is linked to a combination of weak staffing, inadequate management systems, inability to capture economies of scale, expenditure mandates imposed by higher-level governments, and an inadequate revenue base. In chapter 5, Sud and Yilmaz argue that the institutional weaknesses of local governments that stand in the way of the provision of good services are an even bigger problem than the shortage of resources. A major reason for lack of capacity at the local level is the inadequacy of the civil service system, which often accords local government officials a lower status, including lower salaries and fewer chances for advancement, and generally a system that does not encourage professionalism.

The view that local governments have little capacity to deliver services (or collect revenues) is, however, too broad a generalization. A review by the World Bank (2009) of 190 of its municipal development projects, covering about 3,000 municipalities, reports significant improvements in urban public management. And the quality of public services delivered in metropolitan cities is far better than that provided in the rest of the country (see chapter 6). The coverage of basic water and sewer services is higher, health clinics are more accessible, and the scope of services provided is broader. This has been explicitly recognized in countries such as Colombia, where the large cities have been given more expenditure responsibility and autonomy.

An important route to further strengthening public management in metropolitan areas is to give local governments more discretion in making decisions about service delivery and about managing their budgets. The kinds of central controls that might be relaxed are the appointment of chief local officers; decisions about hiring, firing, and promoting employees; employee compensation; budget allocations; and the selection and design of capital projects (see chapters 3, 5, and 6).

Another key element of improved urban management is increased accountability of the service providers to their ultimate clients: voters and businesses in the cities. How exactly such accountability is established, through political oversight by elected officials and local councils, community and business advisory councils, citizens report cards, contractual obligations, and so forth, will vary with the political and administrative system and culture. But without such accountability, public and private providers will have few incentives to improve the management and delivery of metropolitan services.

### *Reform Directions*

Those who believe that the problem of efficiency in service delivery is mostly poor management have an oversimplified viewpoint. The following are five areas where structural and management changes could benefit service delivery in urban areas.

1. Clear up the often murky division of responsibilities across central, state, and metropolitan local governments. The action needed here is to review and revise the local government code or budget law and to make explicit provision for the metropolitan level of government.
2. Improve the capacity of local employees to deliver services. Achieving this goal involves undoing a multitude of policy sins, including freeing up local governments to make budgetary decisions (including personnel decisions), upgrading the status of local government employees in the civil service system, and improving management techniques.
3. Increase resources available so that more efficient infrastructure can be put in place and properly maintained.
4. Better capture economies of scale in service delivery by addressing external effects stemming from local government budget decisions in metropolitan areas. This might involve more effective coordination of service delivery among local governments or, preferably, internalizing the externalities by creating areawide governance and service delivery.
5. Increase accountability of local officials for the quality of service delivery by instituting various accountability mechanisms and by moving away from the practice of higher-level governments appointing local officials.

## TAXES AND CHARGES

The low level of revenues raised by subnational governments in developing countries is often cited as a failing of the intergovernmental fiscal system (see chapters 4, 6, 8, and 13). However, implementing a strategy to increase local revenue mobilization will be difficult. Subnational governments often have only limited taxing power, and they often underuse the taxing power that they do have. Central (state) governments are loathe to give up their control over the tax base for fear that their own revenue mobilization efforts will be harmed by the competition, and elected local government leaders are not always eager to have the accountability that comes with increased taxing powers. There also is a pure political dimension: increased local taxing power may enhance the success and hence visibility of local politicians, who may be present or future political rivals. Add to this the limited assignment of expenditure responsibilities given to subnational governments in many developing countries. The result is that subnational government taxes in developing countries account for 2.3 percent of GDP, compared with 6.4 percent in industrialized countries (see table 1.1).

### *Theory*

In chapter 8, Martinez-Vazquez points out that no unified theory of revenue assignment will identify the best division of taxes between local and higher levels of

TABLE 1.1

Fiscal decentralization: International comparisons for the 2000s

Region	Subnational government expenditures		Subnational government taxes	
	Percentage of total government expenditures	Percentage of GDP	Percentage of total taxes	Percentage of GDP
Developing countries	18.8 (n = 16)	5.1 (n = 20)	11.4 (n = 16)	2.3 (n = 20)
Industrial countries	27.8 (n = 26)	13.9 (n = 26)	22.7 (n = 24)	6.4 (n = 25)

Data reported are unweighted averages for the 2000s for years in which data are reported. Numbers in parentheses are numbers of countries included.

SOURCE: Calculations based on data from the International Monetary Fund (various years) and estimates drawn from the case studies by Roy Bahl.

government. However, he argues that the principles of benefit taxation and optimal taxation can provide useful guidance.<sup>9</sup> The benefit approach to subnational government taxation emphasizes vertical balance in the system; that is, metropolitan-area governments should have enough taxing power to cover the portion of assigned expenditure responsibilities that confers local benefits. In practice, few, if any, metropolitan areas in developing countries achieve this level of vertical balance, and by this rule, almost all are overly dependent on transfers. When the cost of raising funds is introduced as a consideration, the theoretical vertical imbalance is smaller.

### Practice

No reliable, comparable data allow a comprehensive international comparison of how metropolitan-area public services are financed (see box 1.2). In chapter 8, Martinez-Vazquez uses country case studies to survey the practice. He points out two systemic weaknesses related to the failure of local governments to use their taxing potential: the limited assignment of revenue-raising powers to subnational governments, and the bad design of the local tax instruments that are assigned. These weaknesses may be attributed to political economy constraints; the frequent incompatibility of metropolitan government structure with regionwide taxation; the fact that the usual candidates, user charges and property taxes, cannot be levied at high enough rates to cover the expenditures of large urban governments; and the failure of central governments to design intergovernmental transfers to provide incentives for increased local government revenue mobilization.

<sup>9</sup> In chapter 8, Martinez-Vazquez notes that from optimal taxation, the optimal solution to the revenue assignment problem is characterized by an identical marginal cost of public funds for all government units. The marginal cost of public funds captures the economic losses to society associated with raising additional revenues to finance government spending, including the excess burdens of taxes, political costs, and administrative and compliance costs.

**BOX 1.2**

## Data limitations

Very few comparable data are available to describe or track the fiscal performance of metropolitan-area local governments. Neither of the two major sources of fiscal information, the International Monetary Fund and the OECD series, report data for individual local governments or attempt to aggregate the finances of these local governments to a metropolitan-area standard. To the extent that data for individual local governments are available at all, it is for individual countries. And even here, many countries do not bother to report this information on a comparable basis.<sup>1</sup>

If the chapters in this book identify a constraint to understanding the fiscal performance of metropolitan-area fiscal systems, it is the absence of comparative information. And, given the expected explosion of urban population that will continue until mid-century, it is crucial to know more about public finances. It is not possible to benchmark important indicators such as tax effort, infrastructure spending, or fiscal disparities or how the metropolitan areas fit within the transfer equalization system. Such data would also be invaluable for evaluating fiscal decentralization strategies, assessing borrowing capacities, and researching the determinants of successful practice.

Why has such a data set not emerged? One answer is that there has not been much interest in local finances in general and in metropolitan-area finances in particular. Another is that it would be a costly exercise and would require country cooperation. But it could be done, probably best by an international agency. The International Monetary Fund would be a good choice because of its interest in revenue mobilization and because much of the national tax base lies in metropolitan areas. The World Bank would be a good choice because of its extensive urban operations and its interest in the financial solvency of subnational governments. The job itself could start with a sample of perhaps the 50 largest governments and would entail defining the database, working out the method of aggregation to a metropolitan-area basis, and assembling the data on a comparable basis. The resulting annual compendium could be of enormous value.

<sup>1</sup> South Africa and Indonesia do report local government finance data on a comparable basis for individual local governments.

## PROPERTY TAXATION

The property tax has most of the characteristics of a good local tax, including the potential to match tax burdens approximately with expenditure benefits, to make relatively little interference with market decisions, and to avoid imposing heavy burdens on poor families.<sup>10</sup> It is a particularly good fit for metropolitan areas, even where government structure is fragmented. The assignment of expenditure responsibilities to local governments may be limited to property-related services such as police and fire protection, parks, refuse collection, local roads, and primary schools. Since these functions have relatively limited spillover effects, the case for financing by a property tax (and user charges) is a strong one (Bahl and Linn 1992).

In practice, the property tax is a relatively minor source of revenue in most developing countries (Bahl and Martinez-Vazquez 2008). Data are not readily available to compare property tax collections in individual metropolitan areas of developing countries, but a survey of 30 large metropolitan areas carried out by McCluskey and Franzsen in chapter 7 provides some basis for inference about recent revenue performance. Two conclusions stand out in this survey. First, most property tax revenue is collected in metropolitan areas. For example, metropolitan Manila local

<sup>10</sup> In chapter 6, Bird and Slack caution that the burden of nonresidential property taxes might be exported and therefore might not offer the efficiency advantages that residential property taxes offer.

governments account for 20 percent of the Philippine population but for nearly half of all property tax collections. Second, recent revenue performance varies widely, with some large cities showing growth and others experiencing real per capita declines. It is difficult to generalize about why some cities do better than others.

One explanation for the weak revenue performance of the property tax is its unpopularity with voters and local political leaders. Property taxes are visible; they are levied on a subjective, judgmental basis; and they tax unrealized increases in wealth. The result is that most local governments are unwilling to impose the tax at a meaningful effective rate. Exemptions and preferential treatments narrow the tax base, sometimes dramatically; collection rates are low in many metropolitan areas; and aggressive enforcement measures have little support.

Another explanation for the weak revenue performance of the property tax is that intergovernmental transfers have grown along with the economies in many countries (see Shah, chapter 9). This has allowed metropolitan local governments to avoid raising property tax rates or issuing new valuation rolls. Another possible explanation for slow growth in property tax revenues is that successful nonproperty tax revenues such as the sales tax on services in Brazilian cities have crowded out the use of property taxes. Finally, for many large metropolitan areas, especially those with significant slums, property tax collections are limited by the absence of legal title to property.

Administration is a major constraint to property tax revenue mobilization, though significant improvements have been made in many metropolitan areas in recent years. The use of technology and the improved quality of staff have led to a more comprehensive coverage of parcels and to better recordkeeping (see chapter 7). But some metro cities are still tied to the paper-based systems, and the property tax rolls are incomplete. Furthermore, property valuation presents major administrative problems. While it has become easier to identify properties and keep track of improvements with computerization and such tools as satellite photography and geocoding of data, reliable information on market values are rarely available. Hence, properties are assessed infrequently and at a rate that is well below market value. Finally, legal constraints such as rent control in Mumbai have held back revenue mobilization (see chapter 10).

Governments in developing countries have not been standing still on property tax policy, and many different approaches to defining the tax base have been tried. In chapter 7, McCluskey and Franzsen note a trend suggesting that governments are moving toward capital value systems where the tax is levied on both land and improvements and away from rental systems and site value systems. In recent years, there has been increased interest in area-based systems where the tax is levied on the physical characteristics of properties rather than on its assessed value.

The property value base might be reached with several other forms of taxation. Such taxes include property transfer taxes, capital gains taxes on land, various kinds of special assessments, and the sale of government land. In principle, these revenue instruments can increase the total return from the property value base. However, the size of the revenue yield on these taxes varies significantly from place to place, as does the quality of the administration (see box 1.3).

**BOX 1.3****Property transfer taxes**

The property transfer tax is levied at the time of a sale of real property, usually against a legal base of the total market value of the property as stated in the sales contract. However, the taxed base in developing countries is almost always lower than the actual sales proceeds because of under-reporting in the value of sales contracts (see chapter 7). Moreover, the property transfer tax is sometimes a state or central government tax, and the revenues do not flow to local governments in the metropolitan area where the transaction takes place.

Some analysts have argued that the transfer tax is an inefficient and badly administered sales tax whose elimination is overdue. Another view is that with appropriate reforms it has good potential as a revenue instrument and could be used to strengthen the annual property tax (Bahl and Wallace 2010). If there were a joint administration with the property tax, local governments would be in a position to upgrade the property and transfer tax administration and valuation simultaneously, based on a roll of market values for all properties that sold in the metropolitan area in a given period of time.

An alternative to the property transfer tax, and arguably a superior tax instrument, is a capital gains tax on real property. By taxing property value increases, governments could recoup some of the gains associated with public investment in the metropolitan area. The drawback to capital gains taxes on land is the administrative difficulty, particularly with setting a base value and with making adjustments for inflation and investments in new improvements.

**USER CHARGES AND BENEFIT CHARGES**

Researchers of local government finance have long discussed the significant potential for user charges and benefit charges, including charges for water and sanitation, electricity, solid waste disposal, urban transport infrastructure, and mass transit services (see Bahl and Linn 1992; see also chapter 6). The charges can be directly related to the use of a service (e.g., the consumption of water), or they can be levied on the value or physical attributes of the property that is serviced to capture some of the benefits that result from public investments in metropolitan areas. The so-called betterment levies, special assessments, or development charges may be structured to cover the cost of construction of new infrastructure or to capture a part of the land value increase resulting from new infrastructure. Various forms of betterment levies are used in the financing of general infrastructure and even slum upgrading projects (Bahl and Linn 1992; see chapters 13 and 14).

There is ample evidence that user and benefit charges can be structured to support cost recovery, especially in the case of transportation and public utilities. User charges have formed the backbone of financing for public enterprises that deliver urban services on an areawide basis. But some analysts argue that metropolitan local governments have not used such charges to the extent they could have (see chapters 8 and 13), and when they have made use of public service pricing regimes, they often have done it badly (see chapters 6 and 10).

The primary reason for the poor experience with user charges is the politics of raising the price of services that are often considered as necessities and hence the concern that user charges are highly regressive. More likely, the resistance is from those who use the services most heavily, who usually are not poor, and who basically object to the removal of a subsidy that they have enjoyed (Bahl and Linn 1992; see chapter 6). Moreover, users resist paying higher charges when services are of

low quality or only intermittently provided, which is often the case in cities in low-income countries.

#### NONPROPERTY TAXES

It is not likely that even well-administered property tax and user charge systems will generate enough revenue to meet the financing needs of metropolitan local governments; therefore, other broad-based taxes will be necessary if revenue self-sufficiency is to be enhanced (Bahl and Linn 1992; see chapter 6). One might also argue that, structured correctly, such alternative taxes could approximately pass the benefits test; that is, a local sales tax or a local income tax could be viewed as a benefit levy on those living, shopping, or working in the city.<sup>11</sup>

Though several types of nonproperty taxes can meet the revenue test and can satisfy efficiency norms to a reasonable extent, these options are not widely used in developing countries.<sup>12</sup> This said, it should be noted that some metropolitan-area local governments in developing countries have adopted broad-based taxes (see chapter 8). Where metropolitan local governments have provincial status, sales and payroll taxes have been easier to assign. The local business tax accounts for one-third of city and provincial revenues in China (see Wong, chapter 11), and the gross receipts tax accounts for 70 percent of revenues in the capital district of Buenos Aires. Various forms of local sales tax have also done well in Bogotá and São Paulo, where they account for about one-third of revenues.

In practice, however, these taxes are often badly designed. For example, Buenos Aires and Bogotá make use of distortionary gross receipts taxes, and the state governments and the national capital district in the Mexico City metropolitan area impose a tax on payrolls by place of work, with no recognition of commuting patterns.<sup>13</sup> Metropolitan Mumbai still relies heavily on revenues from the *octroi*, a kind of import duty on goods entering the city, which distorts trade flows and is poorly administered (see chapter 11).

Motor vehicles are an attractive target for financing metropolitan services (Bahl and Linn 1992) but are generally underutilized. Motor vehicle taxes can take the form of licenses to operate; a tax on the estimated value of the vehicle; a sales tax on motor fuel, tolls, or parking; and restricted permit charges. Aside from the potential to raise substantial amounts of revenues, higher motor vehicle taxes might lead to beneficial economic and environmental benefits. One of the formidable obstacles to more use of motor vehicle taxes to finance metropolitan-area services is the fragmented nature of local governance. Vehicle owners in a system such as Manila, with 17 local governments, could simply shop for the lowest rate, and enforcement by the losing local governments would not be cost-effective. The same would be the case

<sup>11</sup> In chapter 8, Martínez-Vázquez makes the good argument that taxes on public utility use, such as telephone service and electricity, can fit the benefit principle well because consumption of these services tends to be a good proxy for the use of local public services by households and businesses.

<sup>12</sup> By contrast, subnational governments in industrial countries make relatively heavy use of broad-based taxes (see chapter 8).

<sup>13</sup> Technically, the industry and commerce tax in Bogotá is better described as a business tax, though its base is primarily gross receipts.

for motor fuel taxes. For governments that have a regionwide jurisdiction boundary, or for regional taxing districts, this problem would largely disappear.<sup>14</sup>

### *Reform Options*

Allowing local governments to set the tax rates and user charge rates so that the cost of local services is more nearly covered is an efficient strategy and reduces the claims of large cities on the national budget. Certainly there are instruments of non-property taxation that can lead to a significant revenue increase. One is to finance a greater share of expenditures assigned to metropolitan governments with regionwide taxes on sales, income, or motor vehicles. If the metropolitan government structure is fragmented, the direct levy of a broad-based tax may not be feasible. In this case, the options are to use intergovernmental transfers more heavily or to make use of a regional taxing district and then allocate the revenues by formula among the eligible local governments in the metropolitan area. Such horizontal sharing arrangements are used in industrial countries and a few developing countries.

There is an especially strong case for metropolitan-area taxation of automobile ownership and use, including motor fuel taxation. The technical difficulty to be overcome is how to assess the tax on a destination basis, either by fuel taxation at the pump or by requiring recordkeeping by distributors.

Metropolitan local governments need to look especially hard at the policies for making more and better use of user and benefit charges. Here there are many good options, ranging from a recapture of land value benefits resulting from public infrastructure investment, to removal of subsidy elements in the present system of user charges (see chapters 13 and 14), to user charges levied at cost recovery levels.

The property tax has not played the dominant role in big city finances that many had hoped. But reformers have not given up, and sizable investments continue to be made in making the tax more productive and fair. Investment is concentrated mostly on administration, particularly on the identification of taxable properties and on valuation. To some extent, such improvements will naturally evolve in metropolitan areas because of economies of scale in administration and because of their ability to attract and retain higher-quality staff and to make more extensive use of private valuers. The ability to absorb modern technology has also led to an upgrade in property tax administration (see chapter 7).

Valuation remains key to a more productive and fair property tax. Some countries have begun to experiment with computerized mass appraisal, but the jury is still out on whether this is an appropriate technology for developing countries. Otherwise, better sales value data, as might be obtained through a better administered property transfer tax, and three-year revaluation cycles are the most obvious steps to be taken.

In many countries, changes in the property tax structure are a prerequisite to improving property tax revenue performance. Reforms in broadening the tax base by eliminating exemptions and preferential treatments can lead to a significant

<sup>14</sup> In the United States, some local governments raise substantial amounts of tax revenue from taxes on automobiles registered in their jurisdictions.

increase in revenue productivity and can improve horizontal equity. The potential returns from such actions are great but require taking on some powerful special interests. This political resistance is often the deal breaker in property tax reform.

Many urban areas could benefit from a comprehensive review of their property tax system. Among the important questions that can be answered in such a review are how to divide administrative responsibilities when government structure is fragmented, how best to capture economies of scale in assessment and collections, how to set up an areawide system for monitoring outcomes, how to coordinate the administration of the various property related taxes, and how to involve higher-level governments in the administration of the property tax.

## INTERGOVERNMENTAL TRANSFERS

The amounts spent for public services provided in most metropolitan areas are much larger than own-source revenues of local governments, which means that much of the job of financing local services is left to the intergovernmental transfer system and to vertical programs. Some policy analysts see this as an inevitable outcome in developing countries and stress the need to sharpen the structure of transfers so that they can better match the goals that have been set for them (see chapter 9).

### *Theory*

Grants can be justified to fill the gap between expenditure assignments and revenue-raising powers, to compensate for external benefits of metropolitan government spending beyond the city boundaries, and to equalize revenues across jurisdictions. These objectives tell us that grants will play a significant role in metropolitan finances in developing countries (see chapter 9).

However, there is a good case for an asymmetrical transfer system in terms of how metropolitan local governments are treated compared with all other local governments. Their stronger economic base and hence higher local revenue mobilization capacity suggest that they will require fewer transfers than other jurisdictions and will not participate in equalization grants. However, rapid and sustained metropolitan growth also generates needs and expectations for rapid expansion and improvements in physical and social infrastructure services; hence, revenue needs are greater (see chapter 6). Another asymmetry stems from different choices made about governance in metropolitan areas. For example, a fragmented local government structure will require more financing from transfers (or through vertical programs), all else being equal, than an areawide structure, because externalities and disparities must be accommodated and because the possibilities for regional taxation are more limited (see chapters 4 and 9). In cases where metro areas combine state/provincial and local government responsibility, as is often the case for capital cities, they will be entitled to a larger transfer share.

### *The Practice*

The extent to which metropolitan local governments depend on transfers varies greatly across cities. On the one end of the spectrum, central cities like Buenos Aires

have been assigned significant taxing powers and finance nearly 70 percent of their budget from own-source revenues. The same is true for the metropolitan areas in South Africa. But most large urban areas appear to depend much more on intergovernmental transfers (see chapter 9). More self-financing might be a favorite recommendation of policy analysts, but it has been less embraced by elected politicians. Indeed, control of transfers and direct spending in metropolitan areas is a tool often used by central authorities to encourage the “good behavior” and/or policy alignment of key metropolitan areas.

The reasons behind this are not hard to understand. Metropolitan areas in many developing countries raise much of the national revenue.<sup>15</sup> By keeping metropolitan-area local governments more dependent on transfers (vs. local taxes), the competition for the metropolitan tax base can be minimized. If the central government can give itself a near monopoly in taxing urban economic activity, by denying subnational government’s access to the more productive tax bases, it will be in a position to use the tax/transfer system to draw funds away from the metropolitan area to use for equalization grants and for its own direct expenditures. Moreover, elected subnational government officials are not anxious for more power to impose politically unpopular taxes and often would rather lobby the national parliament for discretionary grants. With the increased urban population in most countries, and increased representation in national and state congresses, their chances at success with discretionary grants have increased. Finally, in chapter 8 Martinez-Vazquez notes that the structure of broad-based taxes that most subnational governments levy is highly distortionary.

Many countries do not provide for a differential structure of transfers for metropolitan vs. nonmetropolitan local governments (see chapter 9). The large urban governments may get less on a per capita basis, for example, in South Africa, but all local governments are covered under the same transfer formula. Some countries use an asymmetric treatment but usually owing to special governance structure arrangements such as provincial-level cities or national capital districts (see box 1.1). Asymmetric treatments are more likely to favor metropolitan areas by recognizing their special needs, while uniform-formula systems are more likely to discriminate against them with provisions for equalization. The other route to a differential treatment is conditional grants, usually for capital projects, which are given on an ad hoc basis and may be earmarked for urban infrastructure, as has been the case in India.

### *Reform Options*

It is not uncommon for developing countries to restructure their intergovernmental transfer systems. But reforms rarely focus on developing a metropolitan strategy. If they did, the strategy for restructuring transfer regimes for big cities might include two reform components.

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<sup>15</sup> For example, metropolitan Bogotá accounts for about 20 percent of Colombia’s population but for nearly one-half of total value added tax collections (Klink 2008).

The first would focus on weaning the metropolitan local governments from transfers while ensuring that they have sufficient authority to tax and impose user charges. A hard budget constraint with no “back door” for financing deficits would be part of this strategy. The financing of infrastructure investment would be shifted from transfers toward debt finance, where the borrowing is supported by locally raised revenues. Transfers will never disappear entirely as a financing source, because there will always be externalities to reckon with, but in many metros, grants can be reduced dramatically.

A second, complementary component of the strategy would be to redesign the transfer system to be asymmetric, with metro local governments treated under a different regime than other local governments. The vertical-share entitlement of metropolitan-area governments would be lower because of their greater taxable capacity. The resulting revenue loss to metropolitan local governments would be compensated by increased taxing powers. With a separate regime, it will be possible for the central government to accommodate differences in metropolitan government structure (more reliance on grants where local government is more fragmented), provide incentives for regional taxes and greater tax effort, and address intrametropolitan fiscal disparities. The latter could be accomplished with the transfer formula for central (state) grants, with horizontal transfers from rich to poorer local governments within the metropolitan area and with earmarked grants, such as for slum improvement programs.

## INFRASTRUCTURE PROVISION AND FINANCING

The success of metropolitan areas in attracting the investment necessary to sustain economic growth, offering the amenities to attract and retain high-quality human capital, and providing minimum acceptable levels of public services to the population will depend to a large extent on the quality of the metropolitan-area public infrastructure. Better infrastructure can attract investment that leads to new revenue streams and can draw private investors, foreign capital, and donor support, thereby increasing the pool of available resources. But the provision of infrastructure in large urban areas is beset with an enormous backlog and with new demands generated by rapid population and income growth.

### *Expenditure Needs*

No comparative data set will allow an international comparison of infrastructure expenditure needs in developing countries. In chapter 15, Kharas and Linn project annual global urban public infrastructure investment requirements amounting to \$120 billion, based on estimates for Asian cities by the Asian Development Bank. Another recent model based on country data estimates annual expenditure needs to be about 3 percent of GDP for new infrastructure plus another 2 percent for maintenance (see Ingram, Liu, and Brandt, chapter 13). By comparison, subnational government taxes in developing countries average only 2.4 percent of GDP (see table 1.1).

Case studies of metropolitan areas provide evidence on the magnitude of unmet infrastructure needs. For example, in chapter 12 Wetzel reports that the city of São

Paulo has maintained capital spending levels at 8–10 percent of current expenditures, which is well below investment needs. Mumbai metropolitan local governments could cover only one-tenth of infrastructure needs, even if borrowing were at full capacity (see chapter 10).

### *Quality of Services*

The responsibility for providing infrastructure services within the metro areas is often shared among several local governments, and there usually are coordination problems among them. This is the case in both Mexico City and São Paulo. An alternative is for the service to be the responsibility of a metropolitan public enterprise (or several public enterprises) or of a higher-level government, but in this case, local control over planning and service delivery will be diminished, as in the case of Mumbai (see chapter 10).

Other arrangements have the potential to produce a more satisfying result. One possibility is a metropolitan local government with areawide responsibility for a range of infrastructure services. Under this arrangement, some degree of home rule for the underlying municipalities and even neighborhoods can be preserved; service delivery can be coordinated, and planning can be more efficient. This is the case in Johannesburg, Cape Town, and Toronto.

An arrangement that might work effectively is one where the general-purpose metropolitan government plans and authorizes the infrastructure investments but the management and financing are accomplished through a special district: a single-purpose local government such as a school district or an urban development district. This approach has been taken in some metropolitan areas in China (see chapter 11).

Irrespective of the governmental responsibility for planning and management, infrastructure service provision is often weakened by inappropriate public policies. These include poor incentive frameworks such as soft budget constraints, subsidies, poor maintenance, and bureaucratic inefficiencies (see chapter 13).

### *Financing*

Infrastructure needs on the order of 5 percent of GDP are well beyond the financial reach of most metropolitan areas in developing countries. However, there is space to increase significantly the resource base for infrastructure finance. The focus might be in four areas: (1) increased revenue mobilization from own-source revenues; (2) debt financing; (3) transfers; and (4) funding from public-private partnerships (PPPs).

### *Own-Source Revenue*

Buenos Aires, São Paulo, and Bogotá are examples of metropolitan areas that have done quite well with additional revenue mobilization. But in most developing countries, local governments are less successful. Own-source revenues of all subnational governments in developing countries are equivalent to less than 3 percent of GDP.

The overall contribution to infrastructure finance has been well below what is needed. In fact, however, there are plenty of viable revenue options, including improved property taxation, selective use of nonproperty taxes, and user and benefit charges (see chapters 6–8).

Chinese metropolitan governments have been particularly innovative and have engaged heavily in land sales (long-term leases) as a method of mobilizing resources for infrastructure finances. For all local governments in China, land leases now account for about 30 percent of revenues (see chapter 11). Land sales have great advantages: revenue potential and low political cost. But even in a unique setting like China, there are drawbacks, including sensitivity of land revenues to the real estate cycle; riskiness of land value collateral for loans; the temptation of “easy money” leading to overspending in local government budgets; underestimating opportunity costs of converting land to urban use; and the exhaustible nature of government-owned land as a resource (see chapter 11).

#### INTERGOVERNMENTAL TRANSFERS

In countries that decentralize revenue raising to a lesser extent, capital transfers may be used directly to fund infrastructure projects. These are usually ad hoc grants that are earmarked for specific capital purposes, as is done, for example, in São Paulo (see chapter 12). Direct transfers earmarked for infrastructure are also used in India (see chapter 10). South Africa makes use of a more formal municipal infrastructure grant, designed primarily to improve services in poor neighborhoods, and about 24 percent of the allocations go to metropolitan-area local governments (van Ryneveld 2007). Another approach is to dedicate a share of intergovernmental transfers to debt repayment, as has been done in Mexico.

#### BORROWING

Borrowing is arguably the most efficient way to pay for public assets that have a long life. By matching payment for the infrastructure with the time pattern of benefits received, governments can capture the returns from infrastructure investments while deferring the payment. Larger urban governments often are in a good position to make use of debt markets to fund long-lived public assets. Their economic bases are stronger and more diversified; there is an unmet demand and some willingness to pay for better services, and metropolitan areas (sometimes) have access to a strong base of own-source financing. In functionally fragmented systems, enterprises operating on a metropolitan-area basis can support debt with properly structured user charges.

But there can be problems with borrowing by metropolitan-area governments, as some researchers of metropolitan finances have argued (Prud'homme 1995; Tanzi 1996). The revenue stream of local government revenues may not be large enough to sustain repayment, but borrowing may go forward anyway in anticipation of some form of bailout. This has led to overborrowing and to some form of bailout in such metropolitan cities as Buenos Aires, São Paulo, and Johannesburg, and more recently in China (see chapter 11). Many countries attempt to control for overborrowing with various forms of fiscal responsibility legislation (Liu and Webb 2011), though these

programs have met with varying degrees of success. Another problem is that the capacity of subnational governments to manage, plan, and deliver local services may be limited, and this may compromise both the quality of the services provided and the repayment plan (see chapter 10).

Intergovernmental arrangement may be a further complicating factor in metropolitan areas with fragmented government structures. In these cases, the best possibilities for debt finance will involve enterprises that operate on a regionwide basis but are independent of the underlying municipal governments.

The practice of borrowing by metropolitan local governments in developing countries and the success with debt finance vary widely among large urban governments. South African metropolitan governments borrow from a government-owned bank and through a privately owned intermediary but without a repayment guarantee from the central government (van Ryneveld 2007). At the other extreme are Chinese local governments, which could not borrow but created a backdoor route with special-purpose urban investment companies that borrowed on behalf of the municipal government and were supported by assets pledged by the municipal government (see chapter 11).

Governments might consider the following guidelines in forming policies to strengthen the use of debt finance for improved metropolitan infrastructure services.

- Provide local governments with more autonomy on both the revenue and expenditure sides of the budgets. If infrastructure is to be maintained, and if the debt obligations are to be met, local governments need to be able to control their level of budgetary resources. Even a well-structured borrowing framework cannot substitute for repayment capacity of the local government.
- Limit debt finance to capital projects with a long life.
- Impose a hard budget constraint on borrowers, with no possibility of a “costless” bailout by higher-level governments if the underlying problem is that the local government was imprudent in incurring the debt obligations. Put a central-government-mandated borrowing framework in place with clear rules about who can borrow, how much, for what purpose, from whom, with what instruments, and with what restrictions. Compliance with the framework should be carefully monitored.

#### PUBLIC-PRIVATE PARTNERSHIP

During the 1990s and early 2000s, the hope was that private involvement would increase the efficiency of service provision and provide badly needed resources to support urban infrastructure investment. In fact, PPP has added relatively little to urban capital financing in developing countries in the 1990s and 2000s (Annez 2007; Alm 2010). Less than 10 percent of investment has been in the high-priority water/sewer sector, and an even smaller share has been in the form of full or partial privatization (Menard forthcoming). To the extent that PPP has been used, it has focused more on the energy, telecommunications, and transport sectors.

Annez, Huet, and Peterson (2008); Annez (2007); and Ingram, Liu, and Brandt in chapter 13 all argue that the inherent riskiness of urban investments is the main constraint to increasing the flow of private capital. There is a weak record of full cost recovery and often an unwillingness of local governments to stand behind the kinds of tariff levels and regulatory arrangements needed to attract private investors, especially for longer-term contracts. In chapter 10, Pethe describes the failure to use PPP arrangements in Mumbai as being due to a “trust deficit” between the public and private sectors. There also is weak institutional capacity for dealing with PPP.

For the public sector, there is the risk that services provided may not be what the public wants. There is also the risk that the private partner will fail and the public sector will have to take on the obligation in full. How successful such arrangements are from the perspective of either partner depends very much on the details of exactly how the contractual arrangements are structured and how the risks are shared.<sup>16</sup> Given the weak institutional capacity of subnational governments in many developing countries, it seems unlikely that they will have a strong hand in negotiating such contracts. The Indian High Powered Commission on Urban Infrastructure (High Powered Expert Committee 2011, 101) puts it well: “Weak governments cannot rely on private agents to overcome their weaknesses nor can they expect to make the best possible bargains for the public they represent.”

## FINANCING SLUM IMPROVEMENT

Slums are a pervasive feature of most cities in developing countries. Poor people, both city born and immigrants, live in overcrowded and unhealthy conditions, with little access to clean water and sanitation; no tenure security; limited access to jobs, education, and health services; and restrictions on their ability to engage in basic entrepreneurship, except in informal activities that fall below the radar of municipal authorities.

According to estimates of the United Nations, about 1 billion slum dwellers lived in the cities of developing countries in the mid-2000s, a number that is projected to double by 2030. The largest concentrations of slums are then expected to be in Africa and South Asia (see chapter 14). The total amount in investment required to meet the backlog in services and the demands of the growing urban poor population is huge: one estimate puts the total cost at \$900 billion over 15 years. This would require a sixfold increase over what is currently being spent.

Five key elements are needed to address the problem: (1) basic services, including water, sanitation, transport, education, and health; (2) improved shelter (housing); (3) security of tenure; (4) an absence of obstacles for the poor to engage in formal-sector employment and entrepreneurial activity; and (5) improved security to deal with the pervasive threat of crime and violence, especially in Latin America.

<sup>16</sup> For detailed exploration of the appropriate way to structure PPP arrangements when this approach seems appropriate, see Engel, Fischer, and Galetovic (2010). For a skeptical view of the range of opportunities to exploit such possibilities, see Menard (forthcoming).

The good news is that, among these problems, only basic services, shelter, and crime control place significant demands on the national and metropolitan authorities' fiscal resources. Creating security of tenure and a supportive business environment, in contrast, mainly requires political readiness to take on established interests that benefit from the status quo and resist the regularization of tenure and a supportive approach to low-income entrepreneurial activity. Indeed, by providing tenure security and by drawing the poor into the formal economy, the metropolitan authorities will be able to turn some slum dwellers into urban citizens who can share in financing the costs that metro governments incur on their behalf. Protection from crime and violence requires not only better policing, which does cost money, but also more jobs, reduced corruption, and more community engagement.

In terms of financing instruments, it helps to distinguish between service and shelter provision (Bahl and Linn 1992; see chapter 14). Metropolitan infrastructure services for slum areas, such as water, sanitation, solid waste collection, and transport, usually involve a combination of public and private provision, and their operating costs can in principle be funded by user charges; however, the capital costs need to be covered from cross-subsidies (with better-off users funding the poorer ones), from general municipal revenues, or from higher-level government grants. Education and health services usually also involve a combination of public and private providers, but if metro governments wish to upgrade these services for slum dwellers in the interest of a better-educated and healthier work force, they will have to find the resources in their municipal budgets or partner with national or state level ministries.

The situation differs for shelter construction. Slum dwellers generally create for themselves a minimum amount of shelter, without any public financial support, by investing their own limited resources and labor in incremental improvements over time. The question, then, is how public and private engagement can support and enhance this process of shelter construction. Traditional mortgage finance mechanisms are usually out of reach of slum dwellers. However, credit is potentially important, and one avenue is the development of microcredit schemes. These are often initiated by nongovernmental, not-for-profit organization without direct government funding, but they need a supportive regulatory framework and can be helped by limited public grant funding, especially to overcome start-up hurdles. Other mechanisms involve grants that allow slum dwellers to purchase building materials or help them improve specific components of their houses (e.g., pouring a cement floor, such as the *piso firme* program in Mexico that was supported by a large private company). Public housing programs that involve the large-scale construction of multistory housing for slum dwellers are generally financially unaffordable in low-income countries, and even in middle-income countries they are difficult to finance and manage, the successful experience of Hong Kong and Singapore notwithstanding (see chapter 14).<sup>17</sup>

<sup>17</sup> In chapter 14, Freire reports that in some developing countries public housing subsidies are sizable, up to 4 percent of GDP; however, they are usually not effectively targeted at poor families living in slums; rather, they tend to benefit the better off. One option for governments therefore is to reduce such housing subsidies and put the

Addressing the challenge of slum improvement in the large cities of developing countries is complicated by the geographic fragmentation of metropolitan jurisdictions and by murky intergovernmental fiscal relations. Metropolitan fragmentation means that poor and rich municipalities coexist in metro cities, making it very difficult to plan and implement comprehensive slum improvement programs and to cross-subsidize from better-off to poorer neighborhoods, even though all would benefit if the prevalence and severity of slums were reduced. The problem is compounded where responsibility for metropolitan slum improvement is divided or unclear among national, state, and metro agencies, as is generally the case, and where revenue authority at metropolitan and municipal levels is constrained. Establishing a metrowide authority to address slum improvement and giving it clear planning, implementation, and financing mechanisms, as was the case in Hong Kong and Singapore, would go a long way toward overcoming the challenges that slums pose to modern metro management and financing.

## THE ROLE OF INTERNATIONAL AID

As in other areas of development, international development assistance can and does provide support in filling domestic resource gaps for urban investments.

### *Current Practice*

Many donors are involved in providing such aid, with the World Bank by far the largest, followed by Japan and then the regional development banks (see chapter 15). But aid flows to urban areas have been stagnant in recent decades and undersized relative to urban investment needs, despite frequent calls by urban experts in and out of aid agencies for greater support. Aid in urban areas has often been confined to single sectors, such as roads or sanitation, without addressing broader, cross-cutting issues of management that might strengthen the sustainability of those interventions that do exist. Africa's urban investment needs, in particular, have seen neglect by donors. Donor agencies have prepared urban strategy documents; these have called for greater engagement in supporting urban development, but implementation of the strategies generally has fallen short of the stated goals.

This underinvestment in urban aid occurred even though evaluations show that such investments on average tend to have greater development impact than does aid to other sectors. To make matters worse, engagement of donors at country and city levels has generally lacked a long-term strategic perspective and hence has been one-off, fragmented, and uncoordinated rather than systematically sequencing and scaling up successful interventions.

A key constraint to the sustainability and scaling up of donor-supported programs has been the lack of development of local financing capacity for maintaining

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money to better targeted use in supporting urban infrastructure development and schemes that directly help slum dwellers improve their shelter conditions.

and building on the aid-financed initiative, once donor support ceases. This, in turn, can be traced back to either a lack of focus by donors on the fiscal capacity of urban governments or, where donors did focus on this important dimension, a lack of impact in actually enhancing local revenue-raising capacity. In addition, donors generally do not focus on the question of how to rationalize intergovernmental transfers, which provides a critical part of local government resources. And while there have been some examples where donors systematically tried to help strengthen the borrowing capacity and institutional and policy framework for city governments, in general such interventions showed little impact. Finally, donors have not paid adequate attention to the special financing needs and capacities of metropolitan areas compared with other urban areas (see chapter 10). This is in part because donors are obliged to work with national-level government entities and metropolitan areas are often not a formal level of government, in contrast to state or city levels.

### *Reform Directions*

Aid donors need to go beyond broad statements of strategy and focus more systematically on the financing needs and the need to build the institutional capacity of urban governments. Experience shows that donors could effectively channel at least some of their resources through municipal development funds (also known as urban investment funds), which are national-level agencies that provide funding and technical support to urban governments for meeting their investment needs. But such funds, and the financial and technical support that donors provide, have to be carefully tailored to country conditions, for example, credits in middle-income countries and grants in low-income countries (Annez, Huet, and Peterson 2008; see chapter 15).

Donors could also form better partnerships with one another and pool their resources for comprehensive and longer-term engagement in support of urban and metropolitan investments, institution building, and policy reform. To do so effectively, they would need to better support the preparation of in-depth analytical reviews of metropolitan socioeconomic conditions and investment needs, assess the institutional capacities and stakeholder interests, and help develop and implement longer-term metropolitan development strategies. In doing so, special attention should be paid to the urban finance dimension, that is, supporting the development of (1) local financial revenue mobilization and management capacity; (2) effective intergovernmental transfer schemes; and (3) effective metropolitan debt management frameworks.

## THE WAY FORWARD

Building and sustaining metropolitan economic competitiveness and providing adequate services will be as essential as it is difficult, given the existing backlogs and the expected high rate of urbanization. The relative prosperity in urban areas has also drawn poor migrants, and large slums have grown up, with attendant social problems. The urban poor have little taxpaying power and many needs. A com-

peting claim on resources is the infrastructure and social services needed to support the economic growth sectors. Both face significant financing gaps.

There are different scenarios for where all of this might lead. No doubt, different countries will make different choices. The following three considerations might usefully inform these choices: the metropolitan strategy; the relation of finance, function, and governance; and political economy.

### *Developing a Metropolitan Strategy*

In most developing countries, metropolitan finance and governance seem to have been on the back burner, with higher-level governments more often reacting to problems brought by urbanization than addressing the more fundamental issues. The reasons for this are not difficult to understand. The quality of services is already much better in metropolitan areas, and metropolitan local governments tend to finance a greater share of their budgets from their own resources than do other local governments. Metropolitan local governments also typically serve a more educated electorate than do those in the rest of the country, and the accountability process probably works better. Why spend central reform efforts and political capital on something that seems to be working? Moreover, mayors and governors might be future political rivals, and strong ones at that, so it is understandable that the sitting central government might not want to address metropolitan governance and finances.

But the continued growth of urban populations and urban economies and the challenges of global competition will change all of that, at least for some metropolitan areas. Many countries will come to recognize the need for a metropolitan strategy. They will amend their approach to fiscal decentralization by developing a separate model for spending, taxing, and borrowing in the large metropolitan areas. The efficient provision of public services, and their financing, has outgrown the jurisdictional boundaries of the central cities; hence, a new approach needs to be designed to cover these metropolitan-wide governance and finance challenges. The new mix of service provision and financing should include regional taxes, delivery of at least some services on a regional basis, and a revenue model for metropolitan areas that focuses more on self-sufficiency.

### *Finance Follows Function Follows Governance*

Many metropolitan areas comprise numerous local governments. The boundaries of these jurisdictions do not change often or easily. To a large extent, the assignment of expenditure responsibilities to local governments conforms to these boundaries, as does the financing. Most of the fragmented local government structures in metropolitan areas are highly dependent on intergovernmental transfers or on vertical program spending by higher-level governments.

Metropolitan-wide government, on the other hand, allows externalities for many public services to be internalized and a broader range of services to be assigned to the metro-level agencies. Financing of a metropolitan city government will include property tax and user charges, but other taxes, often those reserved for state-level

authorities, should be considered in the mix, while intergovernmental transfers will become less dominant in the revenue structure.

The lesson here is that discussions of innovative financing of metropolitan-area local services must begin with a recognition of the limits placed by the existing governance structure and an assessment of how it might be changed to accommodate service delivery on an areawide basis, and hence regional taxation. Efforts to build metropolitan councils and to draw on new e-technologies for accountability and transparency may also help to support more effective management of metro areas, when it may be politically difficult to alter formal governance structures.

### *Political Economy*

Good economics and good public management objectives may point toward metropolitan strategies that are not in step with the political realities in the cities concerned. In the end, political solutions usually win out. Most developing countries have a long history of fiscal centralization, and the centralists are particularly resistant to giving subnational governments more power to tax the broad bases of income and consumption. Borrowing by subnational governments is another fear, and rigid local borrowing frameworks are now the rule in many countries. On the question of expenditure assignment to metropolitan local governments, centralists will resist giving up control over matters such as employee compensation policy and will hesitate to relax some mandates for local spending.

But for many cities of the developing world, circumstances may now be more in favor of a metropolitan strategy. With the increase in urban population, the metropolitan-area constituency is growing in political power and may be in a better position to sway politicians. Moreover, the opportunities and the challenges of metropolitan cities are likely to become great enough to force themselves onto the policy agenda of governments around the world.

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