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Intergovernmental Fiscal Relations in Developing Countries

Roy Bahl and Johannes Linn

The financing and management problems of many of the largest cities in developing countries have begun to attract the serious attention of economists. Several factors explain why these issues have been so long ignored: the traditional concerns of development economists have been macro growth models and the agricultural sector; the urban fiscal problem was small in relation to the financial problems of the central government; aid donors dealt with central governments; the fiscal data of local governments were scanty; and troublesome local government issues seemed better left to administrative specialists. Things have changed, primarily because the fiscal problems of cities have become national concerns and because donors have recognized that the success of capital projects in urban areas is closely tied to the ability of local governments to meet recurrent cost obligations.

This chapter addresses an increasingly important aspect of urbanization in developing countries—the problems and practices of urban government finances. It identifies and analyzes the most important pressures on local budgets, suggests major options for reforms, and sets out constraints on improvements. An important limitation to this effort is the inadequacy of comparable data, as reflected by the paucity of empirical support for these arguments.¹

Urban Government Finance as a National Problem

That the financial health of cities is an important national issue for developing countries is borne out by at least five considerations. First, economic growth at the national level is often led by urbanization and the in-

creased productivity associated with it. It follows that if cities are unable to finance services, maintain their infrastructure, or accommodate population growth, national economic growth will be slowed. Second, there is increasing concern about the problems of the urban poor and the need to provide them with improved living conditions. Water, sewerage, primary education, and refuse collection are locally provided services to which the urban poor often do not have adequate access. Important related problems concern issues of how to allocate more resources to the provision of such services, how to distribute a fair share to the urban poor, and whether and how to charge recipients for their use of these services.

Third, the resource mobilization issue has assumed growing importance. In most developing countries the share of GNP that is mobilized for total public sector activities is thought to be too low, and local governments may contribute measurably to increasing it. Urbanization generates increases in taxable capacity that can sometimes be more easily reached by local than by central governments. Increases in property values can be captured by property taxes and growing business activities by business taxes. Some expansions in formal employment can be more easily tapped by local than by central income taxes, and automobile-related charges might be effectively levied by local governments. With respect to the provision of certain services, such as water supply, sewerage, and transport, there is a substantial opportunity for local governments to recapture costs through user charges. It would seem reasonable to assume that increasing the mobilization of local government resources could have a significant effect on national tax effort.

Fourth, external lenders have begun to recognize the

importance of strengthening local government finances. Capital projects have annual operating and maintenance costs, and in some cases the supporting services must be provided. For example, a sites and services housing project must have a water and sewer system, adequate refuse collection, street lighting, road maintenance, and access to primary education services. In many cases the provision of these services lies with the local government, and therefore the success of the entire project depends on the ability of local government to meet the necessary recurrent costs.

Finally, questions have been raised about the optimal distribution of city size. Some have argued that cities have become too large, that the resulting fiscal and management problems are insurmountable, and that centralization of population and economic activity is somehow bad for economic development. Others have countered by noting that productivity advantages are associated with city growth and that effective urban management is possible with the correct institutional framework. Nevertheless, a decentralization movement is under way in many developing countries to increase the fiscal autonomy of local governments and to bring government decisionmaking closer to the people.

The Urban Fiscal Gap

Urban governments in developing and developed countries alike complain that their resources are inadequate for providing sufficient urban services. The gap between perceived service needs and financial resources (the "fiscal gap") has been interpreted in several ways. The most common explanation begins with the observation that urban populations in developing countries have expanded rapidly in recent years and are likely to continue expanding in the foreseeable future (World Bank 1979). Urbanization has led to rapid increases in expenditure requirements, but revenues have not increased commensurately because local governments are often restricted to income-inelastic revenue sources.

A better understanding of the nature of the problem and the alternative reform possibilities requires some understanding of the components and determinants of the fiscal gap. A useful starting point may be to cast the problem in terms of a set of identities that define the expenditure requirements and revenue constraints of urban authorities. Expenditure needs or requirements for the i th public service in a particular city may be defined as:

$$(10-1) \quad \hat{E}_i = \frac{\hat{E}_i}{\hat{Q}_i} \frac{\hat{Q}_i}{P} P = \hat{e}_i \hat{q}_i P$$

where \hat{E}_i is the required expenditure for service i , \hat{Q}_i

is the quantity of service i required, P is population, \hat{e}_i is \hat{E}_i/\hat{Q}_i , the unit cost of the required service, and \hat{q}_i is \hat{Q}_i/P , quantity of service i required for each inhabitant.

The actual level of expenditures for public service, E_i , may be defined as

$$(10-2) \quad E_i = \frac{E_i}{Q_i} \frac{Q_i}{P} P = e_i q_i P$$

where Q_i is the quantity of service i actually provided.

Local government revenues, R , may be defined as

$$(10-3) \quad R = T + C + G$$

where T is taxes, C is user charges and other current revenues, and G is externally raised revenues.

The fiscal gap, \hat{D} , in a city may then be defined as

$$(10-4) \quad \hat{D} = \sum_i \hat{E}_i - R = \sum_i (\hat{e}_i \hat{q}_i P) - R.$$

By contrast, the actual budgetary deficit, D , is

$$(10-5) \quad D = \sum_i E_i - R = \sum_i (e_i q_i P) - R.$$

This formulation clarifies the distinction between the fiscal gap, which reflects the shortage of revenue available to provide required services, and the budget deficit, which reflects the actual shortfall of revenues. Budget deficits do not always occur, but fiscal gaps are commonplace. Equations 10-1 through 10-5 are also useful in organizing the discussion of urban fiscal problems by focusing separately on the expenditure and revenue sides of the local government budget.

Expenditure Pressures

The expenditure side of the local budget is subject to two sets of pressures: demand or needs which raise Q_i , and cost factors which raise e_i . Much has been written about how these factors affect expenditures in developed countries (Bahl, Johnson, and Wasylenko 1980), but less attention has been paid to expenditure determinants in developing countries. One might ask whether the decisionmaking model used to explain urban fiscal outcomes in advanced countries fits the developing-country experience.

The advanced-country model of expenditure determination holds that the fiscal choices of politicians are influenced by the preferences of the median voter, the relative prices of public goods and services, the income level of the community, and the availability of external resources. The developing-country case often differs because voters have less chance to express their preferences; local councils are as often appointed as elected, and the chief administrator of the city may be a central government employee with substantial autonomy. In addition, local government financial autonomy is quite

restricted. For instance, it is common for the central government to place tight controls on local government tax rate changes and borrowing practices and to impose constraining mandates for service levels. Although local fiscal choices in developing countries are more constrained, however, they are by no means nonexistent. Many local councils and mayors are elected; the composition of centrally appointed local councils often reflects local political considerations; and appointed city managers do attempt to take local preferences into account. Even in the most centrally planned and centrally controlled developing countries, the public protests high bus fares or water rates, sometimes effectively resists tax rate increases, and often demands increased public services.

All of this implies that a more constrained version of the traditional maximization model would be relevant for developing countries. To this end it seems necessary to explain the determinants of urban government spending levels in terms of demand-related or need-related factors, cost factors, and the capacity to finance.

Demand or Need Factors

The demand for local public goods is determined by relative prices, incomes, needs, and taste factors. Tastes, or preferences, affect the rate at which consumers are willing to substitute private for public goods. For example, changing preferences may reflect the demand for better educational services by families whose income has risen above subsistence levels, changing societal values such as substitution of welfare and housing services for the extended family structure, the demand for more redistributive actions to prevent unrest,² and willingness to pay more taxes in return for governmental action to offset negative externalities that result from the growing underprovision of urban public services.

Needs. An important consequence of urbanization is that public service requirements change and decision-makers may have to interfere with or override individual preferences in providing them. The continuing increase in the numbers of the urban poor calls for increased social and economic services and perhaps for a different package of public services—for example, serviced sites rather than permanent housing, small health clinics rather than hospital additions, more standposts rather than water main extensions, and the like.

The growth in the need for public services is most often associated with increasing population. Some would argue that expenditures must increase at least in proportion to population to maintain even a constant per capita level of service (equation 10-1). For example, water system expansions may involve increasing mar-

ginal costs because of the greater depth required for tubewells or the greater distance to a catchment area. Urban population growth rates in developing countries tend to lie considerably above national population growth rates (table 10-1). Moreover, in some developing countries the rates of growth of the largest cities tend to be even higher than the growth of the total urban population.

Income Effects. The positive and strong relation between urbanization and per capita income in developing countries has been well established in two respects: the

Table 10-1. Urbanization in Selected Developing Countries, 1960–80

Country	Urban population as percent of total population		Percent of urban population in largest city	
	1960	1980	1960	1980
Low income ^a	15	17	11	13
India	18	22	7	6
Sri Lanka	18	27	28	16
Pakistan	22	28	20	21
Tanzania	5	12	34	50
Zaire	16	34	14	28
Indonesia	15	20	20	23
Sudan	10	25	30	31
Middle income ^b	37	50	28	29
Kenya	7	14	40	57
Ghana	23	36	25	35
Egypt	38	45	38	39
Zambia	23	38	n.a.	35
Thailand	13	14	65	69
Philippines	30	36	27	30
Nigeria	13	20	13	17
Peru	46	67	38	39
Colombia	48	70	17	26
Côte d'Ivoire	19	38	27	34
Tunisia	36	52	40	30
Jamaica	34	50	77	66
Malaysia	25	29	19	27
Korea, Rep. of	28	55	35	41
Algeria	30	44	27	12
Mexico	51	67	28	32
Chile	68	80	38	44
Brazil	46	65	14	16
Iran	34	50	26	28
Argentina	74	82	46	45
Venezuela	67	83	26	26

n.a. Not available.

Note: Countries are listed in ascending order of per capita GNP.

a. Weighted average for all low-income countries given in World Bank (1981).

b. Weighted average for all middle-income countries given in World Bank (1981).

Source: World Bank (1981).

more urbanized developing countries tend to have higher per capita incomes (Beier and others 1975; Renaud 1981; Smith 1974), and per capita income in the largest cities tends to be the highest in the country (Linn 1982). There is less objective evidence on the relation between the increase in urban population and the increase in per capita income in urban areas.

Increasing per capita income tends to increase the per capita demand for services (q); the magnitude of the increase is dependent on the income elasticity of demand for locally provided services. Positive income elasticities for urban services have been observed for water supply, electricity, telephone service, and solid waste disposal services (Linn 1982). These higher levels of consumption of utilities may be largely attributable to increased ownership of appliances that use water, electricity, or both (washing machines, radios, televisions, and the like), while the increased need for solid waste disposal may be associated with generally higher consumption levels and reduced recycling in the home.

The demand for motor vehicles is highly income-elastic, which implies that the demand for urban highway infrastructure is positively related to per capita income.³ The demand for schooling is strongly correlated with household income, since the lower the income the more likely it is that children will be forced to drop out of school to seek employment (Beier and others 1975), and the less able are households to bear out-of-pocket expenditures for education (Meerman 1979). Similarly, the demand for health care increases with incomes, with better education, and with rising familiarity with modern health care techniques.

Per capita income increases also result in a demand for a higher quality of urban services. Higher quality may mean individual rather than communal water supply and sanitary facilities,⁴ reduced risk of electric outages, more rapid communication and transport, and better health care, education, and fire and police protection.

Expectations and Demonstration Effects. Changing expectations regarding appropriate service levels and quality also increase the demand for urban services. This is especially true for water- and electricity-using appliances, motor vehicles, and educational achievement and therefore for the derived demand for such related urban services as public utilities, road construction, and education. The demand for public services may also be heavily influenced by a demonstration effect from more developed countries. As a result, developing-country governments have frequently raised standards rapidly to attempt to attain the levels of quality and technology found elsewhere. Examples are the often unchecked growth of private automobile ownership, high use of and

high quality standards for water supply, water-borne sewerage technologies to replace such traditional disposal techniques as night-soil collection, and construction of incinerators or composting plants for solid waste disposal to replace conventional recycling techniques. All these can result in significant increases in expenditure requirements (Linn 1982).

Migration and Poverty. Increased local government expenditures also result from the locational decisions of poor migrants, who typically swell the populations of cities in developing countries. Often these migrants squat on or purchase at cheap prices land that is difficult to service owing to topography (mountainsides, swamps, flood areas, and so on). As these settlements become relatively well established, the need to service them increasingly becomes a political and humanitarian necessity for urban governments, and the result is substantial expenditure requirements.

Cost Factors

Local government expenditures may also rise because the cost of providing a given quantity of public services rises—that is, because of an increase in e_i . Increasing factor costs, particularly for labor, are a prime reason for increases in local government expenditures. Conversely, local government unit costs may fall as population increases if there are economies of scale in the provision of urban public services.

Unit Cost of Inputs. Probably the principal factor responsible for unit cost increases is inflation. To the extent that developing countries are plagued with higher levels of price inflation than are industrial countries, local government costs in developing countries will increase more rapidly than those in industrial countries. General inflation can lead to increasing per capita expenditures but does not explain an increasing share of local government expenditure in income. There are, however, factors that tend to raise urban public service input costs more rapidly than the general inflation rate.

First, the provision of public utility services frequently requires investment outlays on a large scale. Urban governments therefore have to rely on foreign credits from international agencies, from the international capital market, or from suppliers. As is well-known, the supply curve for funds is upward sloping, and large cities are likely to run into increasing costs of capital unless the central government is the primary borrower and passes on the loan funds at subsidized rates to urban governments. The extent and terms of borrowing by urban governments are almost always controlled by the central government, and thus the cost of capital as it is

passed on to local authorities is effectively a policy instrument of the central government. The rising cost of capital is reflected ultimately in the public sector as a financial cost, whether at the national or at the local level, and thus the large capital-intensive infrastructure works required by rapid urbanization may well involve higher-than-average interest rates.

Second, the average cost of public employees may also be affected by urbanization, although the direction of this effect is not completely clear. If workers become more productive as city size increases, and if private sector wages respond to productivity increases, there is some possibility for a wage rollout to the public sector. This suggests increasing public sector wages during the urbanization process. Yet the extent to which the competitive wage thesis holds depends on the rate of immigration and, other things being equal, a greater rate of immigration will dampen the wage rollout effect. The local public sector, as part of the general services sector, is labor-intensive and does not require a skilled work force. Newly arrived migrants swell the numbers of unskilled workers available and hold down the wage rate in the services sector.

It may also be argued that wage rates increase more rapidly than does the general price level, owing to institutional factors that determine the wages and salaries of local government employees. Labor unions for local civil servants exist in some countries and can be extremely vocal in pressing for higher wages.⁵ In other cases local government salaries and wages are determined by the central government. Since it frequently does not bear the brunt of local government salary readjustments, the central government may be quite willing to raise local civil service salaries more rapidly than the general price level.⁶

Third, land prices are also likely to rise more rapidly than the general price level in cities as a result of rapid urban population growth, increased density, and the resulting scarcity of serviced urban land. Rising land prices tend to have particularly strong impacts on the unit costs of services that are relatively land-intensive, such as the transport sector—which requires substantial amounts of urban land for streets and sidewalks—parks and recreation, schools, and solid waste disposal.

Finally, the unit cost of energy has risen more rapidly than the general price level and may well continue to do so. This can burden larger local governments that tend to rely more heavily on the use of motor vehicles for provision of services and on the use of electricity—for instance for street lighting and for the pumping and treatment of potable water and of sewage.

Confirmation of the hypothesis that input prices tend to increase with the population size of cities is found in frequent observations of price levels that are higher in

larger cities than in rural areas, although these differences are rarely measured accurately. Thomas (1978) found that in Peru the average cost of living in Lima exceeded that in rural areas by a substantial margin. This may be largely explained by differentially higher input prices in Lima, compared with the rest of the country. A similar conclusion for Brazil is presented by Thomas (1982).

Technological Progress and Economies of Scale. Technological progress should reduce input requirements per unit of public output and thereby reduce unit cost (e_i). It is generally recognized, however, that technological progress in most public services is slow (Baumol 1967) and that some technological advances may lead developing countries to adopt modern technologies which are inefficient and excessively costly. Examples are composting facilities for solid waste disposal, waterborne sewerage systems and treatment plants, limited-access rapid speed highways, subways, and possibly even premature computerization.

Technological economies of scale may also imply declining unit cost during urbanization. A detailed study of engineering costs for certain urban services in India appears to support this hypothesis (Stanford Research Institute 1968). Similarly, a study of water supply costs for small and intermediate-size cities in Colombia has shown declining unit costs (Insfopal 1975), which are probably largely attributable to economies of scale. These economies of scale, however, are likely to be limited to public utilities, and it is not even clear whether governments in rapidly growing urban areas are always in a position to benefit from them. Moreover, economies of scale may be offset by diseconomies of agglomeration, particularly in larger, denser urban areas. Diseconomies result from congestion, which tends to increase with city size and is especially problematic in transport. Diseconomies may also result from limits in the carrying capacity of the natural environment (examples are air and water pollution) and from the increasing scarcity of natural resources, especially water and energy. Other examples are the increased need for disease control and fire and police protection which are associated with the large scale and high density of urban living. In all cases some inputs (space, natural resources, and so on) grow scarce as urbanization proceeds, and larger amounts of other inputs (labor, capital, and intermediate inputs, in particular) have to be applied to maintain service levels and provide clean water and air, good health care, and a safe environment.

Public Service Employment. Cost increases for urban services may result if local government is viewed as an employer of last resort. Overstaffing of local gov-

ernment offices is typical, and as a result the financial costs of urban services are inflated. Whether this is desirable as a matter of policy depends on the tradeoff between the gains from additional employment, often at low economic costs (because of widespread unemployment or underemployment of skilled and semiskilled labor), and the financial impact of such a policy.

Revenue Constraints and Opportunities

Urbanization most often puts pressure on local government budgets by driving up expenditures; at the same time revenues may rise by less than a commensurate amount. Following equation 10-4, total revenues available to finance the growing expenditure requirements of cities may be separated into tax revenues (T), other current revenues, including user charges (C), and external funding (G).

Taxes

Total tax revenues of an urban government are determined by a set of factors which may be summarized in the definitional identity

$$(10-6) \quad T = \sum_j \left(\frac{T_j}{L_j} \frac{L_j}{B_j} \frac{B_j}{Y} \frac{Y}{P} \right) = \sum_j r_j t_j b_j y P$$

where

- T = total tax revenue
- T_j = tax revenue of tax j
- L_j = legal tax liability of tax j for given tax statutes
- B_j = base of tax j
- Y = total personal income
- r_j = collection rate
- t_j = legal tax rate
- b_j = base to income ratio
- y = per capita income
- P = population

Considering the rapid growth in population and income and the relatively high per capita income levels associated with urban growth, the process of urbanization should and does provide a relatively strong taxable capacity for urban governments. Not only do increased population, income, and motorization represent a strong economic base (in relation to the rest of the country), but larger cities also have the potential for more efficient collection. Urban local governments have a better professional expertise than other local governments, and urbanization brings growing formal employment, more cars, and increased property values—all readily identifiable tax handles. Finally, the statutory tax

rate ceiling is usually higher for larger cities. Thus, urbanization may give a substantial boost to local government tax revenues through increases in the values of Y , P , r_j , and t_j .

This favorable impact on local government revenues can, however, be offset by important constraints. Local governments may have little opportunity to capture the increases in taxable capacity associated with urbanization. For example, the central government fixes B_j by specifying the tax bases available to local governments; t_j , the tax rate, is commonly fixed by the central government; and in some cases even tax collection, r_j , is largely a central government matter. In sum, there is no correspondence between the expected increases in expenditures and in revenues in response to a given increase in urbanization. The resulting gap or deficit will vary from place to place and will depend on the public service responsibilities and discretionary fiscal powers of local governments.

User Charges

The revenues generated by user charges (C) may be represented as

$$(10-7) \quad C = \sum_i \left(\frac{C_i}{Q_i} \frac{Q_i}{P} \right) = \sum_i (c_i q_i P)$$

where C_i is user charges collected for urban service i , Q_i is the quantity of service i consumed, c_i is the unit charge for service i , and q_i is the quantity of service i provided per capita.

In contrast to urban taxes, user charges for services show a direct link between the quantity of services provided and the revenues generated to finance those services. The extent to which user charges cover the cost of provision of services depends, however, on how the average price charged, c_i , compares with the average cost of providing service, e_i .

The evidence on the relations between city size and the c_i/e_i ratio is mixed. On the one hand, autonomous public utility agencies in large cities seem able to charge high enough rates to cover increasing marginal costs and sometimes to generate a surplus. The same result seems to hold for special assessments on urban landowners, for example, in Korea (Doebale 1979) and Colombia (Doebale, Grimes, and Linn 1979). Urbanization thus seems to create a demand for these services and a capacity to pay full costs. On the other hand, some services (notably transport and housing) do not generate enough revenue from charges to cover their full costs. The problem here is that urbanization also generates a great many social costs, such as congestion and pollution, and poverty problems that may dictate holding c_i below e_i .

External Funds

Grants and loans (G) are not under the control of local authorities but depend on the decisions of higher-level authorities. Whether urbanization brings more grant assistance to local governments depends on how the revenue sharing system operates. For example, if grants are distributed according to population or on the basis of local tax collections, as in a shared tax, urbanization may generate an increased inflow of external resources. The same may be true if grants are made on a cost reimbursement basis.

In the functional relation $G = G(P, Y, Q_i)$, one would usually expect to find partial derivatives such that $dG/dP \geq 0$, $dG/dY \geq 0$, and $dG/dQ_i \geq 0$.

In other words, grants tend to vary directly with city population size and with the amount of services provided under a system of per capita or cost reimbursement grants. External resource flows may increase or decrease in response to increases in per capita income in the city, depending on the grant system. A tax sharing scheme will channel more funds to cities as urbanization proceeds, whereas a formula that equalizes grants across jurisdictions may have the opposite effect.

Policy Options for Urban Fiscal Reform

It may be concluded with some certainty that public expenditure requirements increase with urbanization in absolute terms and probably also in per capita terms. Most often, urbanization also enhances the revenue capacity of urban governments, but revenue growth in most cities has been hampered by the limited revenue authority granted to local governments and by their poor revenue efforts. As a result, revenues have not kept pace with expenditure needs, and service deficits have resulted. There is little reason to expect that this situation will change significantly in the future.

This conclusion raises the question of the constraints on reform. In principle, an urban fiscal gap can be closed in four ways: increased local revenue effort with unchanged revenue authority, increased local revenue authority, increased transfers from higher-level government, or reduced responsibility for expenditures. With these alternatives in mind, the reform question may be addressed by focusing separately on the expenditure and revenue sides of the budget and by noting important interrelations between the two sides.

The Reassignment of Functions

A common response of higher-level governments to city fiscal crises has been to assume responsibility for

certain urban services such as public utilities, roads, education, and health. In addition to arguments of relieving financial pressures, efficiency and distributive concerns are often cited as justifications for such reassignment. Because of the difficulties of measuring the efficiency and equity gains, however, it is difficult to justify such proposals. In any case, two important considerations weigh heavily against this approach to resolving urban fiscal problems. First, the transfer of specific functions to higher-level government reduces the local authority's potential for responding to urban policy issues and problems. This is undesirable because many urban development activities are interrelated and require an integrated approach to planning and implementation, and local authorities are often better equipped to provide such planning than are national ministries or special-purpose agencies. Second, national governments often assume only the responsibility for making capital investments and leave it to the local authorities to operate and maintain the facilities. This turnkey approach tends to burden local authorities with facilities that are often beyond their financial and technical capacity to operate and maintain and that may not reflect local preferences.

Increased Local Taxes

The judgment about which taxes are most appropriately allocated to local authorities depends in part on the perspective of the decisionmaker. From the central government's perspective the main goals are to (1) limit local competition for the important national tax bases (broad-based wealth, income, and expenditure taxes); (2) limit the local use of taxes that are mainly exported to other jurisdictions; (3) provide local authorities with a reasonably buoyant revenue base; (4) avoid local reliance on regressive taxes; (5) encourage the use of taxes that are most easily administered at the local level; and (6) encourage the use of taxes which are closely linked to urban infrastructure and congestion costs, to internalize some of the externalities in the urban economy.

From the local perspective, criteria 3, 4, 5, and 6 are likely to be equally relevant, although they may vary in strength. For example, local governments are likely to place a greater emphasis than higher-level governments on buoyancy and administrative ease and perhaps a different emphasis on equity and efficiency. As regards criteria 1 and 2—competition with national tax bases and nonexport of revenues—local authorities are likely to have priorities exactly opposite to those of higher-level government. Since the broad-based taxes tend to be the more buoyant, and the most easily tapped, local governments desire access to them. Reliance on taxes which can be shifted to taxpayers outside the jurisdic-

tion will naturally also be politically attractive to local governments.

Given these sometimes contradictory goals, it appears that the property and motor vehicle taxes are, on balance, the most desirable and least objectionable of the major tax instruments that could be delegated to local jurisdictions. From the central perspective, they do not compete substantially with national taxes, and tax exporting is likely to be limited, particularly for large cities.⁷ From the local perspective, too, these taxes are largely appropriate. Local access to broad-based consumption, income, and wealth taxes is generally not granted by national governments—a reflection of the overriding influence of central government objectives. Exportable taxes, such as selective excise taxes, octroi (a tax on goods brought into a town), and tourism and hotel taxes, are popular among local authorities but tend to receive only mixed blessings from the central authorities or to be prohibited. They are sometimes tolerated mainly because they reduce local governments' claims on national tax resources.

The empirical evidence on the actual use of taxes by local governments in the cities of developing countries is fully compatible with the gist of this discussion (Bahl, Holland, and Linn 1982). The practical difficulty is that the scope for transferring additional taxing authority to local governments may be severely circumscribed by national economic development policies. Rather than expect the allocation of new revenue authority, it may be more realistic to argue for reduced central government limitations on the use of taxes already collected by local governments. Such policies, together with local measures for the improvement of local tax effort, will permit local government to better reach the growth in taxable capacity that comes with increased urbanization.

User Charges

From the national perspective, an effectively administered set of user charges would seem to be the most appropriate source of local government revenue. User charges do not compete with central government revenue bases; they are largely nonexportable; they can have desirable revenue, efficiency, and equity characteristics; and they are administratively feasible at the local level. It may therefore come as a surprise that national governments have sometimes counteracted local authorities' intentions to mobilize more resources through increases in user charges. There are two reasons for these interventions: national governments are concerned about inflation and want to limit the impact of rising local public service charges, and they fear the political repercussions of price increases for urban services, since urban consumers are often quite

emphatic in their opposition to increases and at times even endanger the political stability of the country through riots and the like. Local authorities also have mixed attitudes about raising user fees, partly for the same political reasons that concern the national government and partly because they may have come to rely on central government transfers to finance significant portions of their public service investments.

On balance, however, it appears that local service charges have become increasingly important sources of additional revenue, particularly in cities in which local authorities provide public utility services. In many cases user charges have been utilized effectively by local authorities in lieu of alternative revenue sources and have contributed to the general financing of the local government. It is in the area of user charges that judicious support by central authorities for local revenue raising efforts, in place of the frequently practiced obstructionism, may be most productive in closing the urban fiscal gap.

Grants

An increase in fiscal transfers from the central to local governments is another means of coming to grips with the urban fiscal gap. There are a number of good reasons for developing a system of revenue sharing between different levels of government: the greater administrative efficiency of collecting taxes centrally, the need for the central government to work to equalize the revenues of local governments, and—the traditional justification—the need to provide incentives for efficient local government decisions on resource allocation. For large cities, however, it is unrealistic and inappropriate to expect that transfers will reliably and permanently fill the fiscal gap. The pressures on the central fisc tend to be such that transfers to local authorities are the first to be cut when national austerity programs are implemented.

The Politics and Prospects of Urban Fiscal Reform

Reform proposals to alleviate the fiscal problems of urban governments are commonplace. Although the nature of these proposals has varied from place to place, in line with local conditions and with the makeup of the study team, it is clear from a review of the evidence on urban public finance reform that the proposals have far outnumbered the reforms.⁸ Major local government fiscal reforms in the last twenty years have taken place mainly in the industrial countries. Examples are Germany (consolidation of communes and reform of revenue sharing arrangements), Sweden (consolidation of

communes), and the United States (reform of revenue sharing arrangements). Among the developing countries the rule would seem to be that changes in urban finance arrangements come slowly and that it may take decades for fundamental changes to take place, if they occur at all.

Typical for the developing countries are minor and slow adjustments in urban finance practices, such as the creation of special districts for capital cities with special expenditure responsibilities and revenue authority (for example, Manila and Seoul), enlargement of metropolitan jurisdictions by annexation of adjacent municipalities (as in Bogotá), gradual development of new revenue sources (for example, betterment levies in Colombian cities, land readjustment schemes in Korea, and vehicle taxation in Jakarta), gradual reform of existing revenue sources (property taxation in Jakarta and Manila), reassignments of expenditure functions (Kenya and Zambia), and similar gradual and ad hoc responses to urban fiscal pressures. Major reform proposals have often been shelved or taken up only in very minor respects—examples are local government reform proposals in India and property tax reform in Jakarta. Where major readjustments in the fiscal structure of urban governments have occurred, it was where higher-level governments took over important revenue sources previously allocated to local authorities (Kenya and Iran), where sweeping political changes resulted in major shifts of national policy priorities (Nigeria, Tanzania, and Uganda), or where the fiscal problems became so unmanageable that some drastic reform was unavoidable (removal of most important expenditure responsibilities from rural and small-town councils in Kenya). The lessons from the history of urban fiscal reform proposals and implementation are that major proposals rarely have a chance of adoption and implementation and that gradual, stepwise adjustments of the existing structure toward a more desirable state are all that can be hoped for. Gradual adjustments may, in fact, have a better chance of eventual implementation.

There are three major reasons for the inertia typically found in the face of the need for urban public finance reform. First, policymakers and citizens share an antipathy to the uncertain effects of untested large-scale changes in the economic environment. Second, most major reforms are associated with substantial windfall losses to relatively few among the urban population—mostly among the elites—whereas windfall gains are likely to be spread over a much larger number of people—mostly the less well-off. Third, although there has been a growing concern in developing countries about how to strengthen the capability of urban governments to come to grips with their tasks, progress has tended to become bogged down in a three-way debate over the fiscal decentralization issue that typically involves the

ministry of finance, the ministry of local government, and the city governments.

The ministry of finance, which usually is the strongest party, tends to argue in favor of the status quo. It generally refuses to relinquish control over major tax sources or borrowing and argues that decentralization would compromise the central government's important fiscal and tax policy programs. On the expenditure side, the ministry of finance would rather emphasize central government projects and priorities and is often suspicious of the ability of the ministry of local government to regulate the fiscal operations of local governments. It will agree to a grant system but would prefer the grant pool to be decided on a year-by-year basis rather than take the form of a shared tax. In general, the finance ministry looks on local governments as junior partners in the fiscal process, is doubtful about their management and tax collection abilities, and feels that they can get much more out of their existing revenue authorities without recourse to new sources of revenue.

The ministry of local government—in some countries the ministry of the interior—is usually less influential than the finance ministry and is often less well staffed. It usually argues for an extensive grant system and for other regulatory mechanisms which allow a greater measure of control over local government finances. It would prefer that the total grant pool be determined as a fixed share of some national tax and that the distribution of some or all of these grants be at its discretion. Such a scheme would at the same time limit the susceptibility of the grant system to changing finance ministry budget priorities and maximize the extent of the control of the ministry of local government over local authorities.

Administrations of large cities would prefer more independent taxing power and less central regulation of their finances. If there is a grant system, a shared tax based on origin of collection would be the preferred form and a grant pool determined by the finance ministry and allocated by the ministry of local government would be less preferable.

The sense of competition, the suspicion, and the lack of mutual confidence that frequently characterize the debate between national and local government authorities in developing countries have constantly compromised the potential for success of virtually any far-reaching urban government reform. If reforms are to succeed, a mutually supportive system of local and central government relations must be established.

Notes

1. Perhaps the best comparable fiscal data available for developing countries are those reported in International Monetary Fund, *Government Financial Statistics*. Even this year-

book is more complete for the central government than for local governments; in many cases, local government activity is not reported at all.

2. It might be argued that utility functions become more strongly interdependent during the development process, at least partly because there is more to protect from the dangers of civil unrest. For the basic model see Hochman and Rodgers (1969).

3. See Smith (1974) for evidence that the density of automobile ownership is much higher in the major cities of developing countries than in each country as a whole. Furthermore, Smith and Kim (1979) show that the density of automobile ownership is higher in Seoul and Pusan than in the intermediate-size cities of Korea. Data in World Bank (1975) also indicate a positive association between automobile ownership and per capita income for a cross-section of cities in developing countries (see Linn 1983, ch. 4).

4. Note, for instance, that in the higher-income Latin American countries communal facilities are generally rejected by the population, whereas they have found acceptance in lower-income Asian and African countries.

5. In Colombia, for instance, local teachers and health service personnel were extremely active in the 1970s in pushing for higher wages; they resorted to strikes, protest marches, and sit-ins at the municipal offices.

6. A good example is Korea, where the central government raised local government wages and salaries by 20 percent in 1975 and by a further 30 percent in 1976, both times significantly above the general inflation level (Smith and Kim, 1979). Other examples of centrally decreed salary increases for local officials have occurred, for example, in Kenya, Turkey, India, and Pakistan. In Pakistan, however, the central government offset the increased expenditure requirements by providing a special grant to local authorities. Also, there are documented examples in which local salaries have increased less rapidly than the general price level, as in the case of municipal teachers in Bogotá, where salaries, adjusted for increases in the price level, declined between 1971 and 1973.

7. Note, however, that opposition from groups that are influential in national government circles has been known to hamper the development of effective property and motor vehicle taxation because of its progressive impact, which tends to be borne by precisely these groups.

8. Walsh (1969); Robson and Regan (1972).

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