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Introduction. Local Government Finance: The Challenges of the 21st Century.

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Local Government Finance: The Challenges of the 21st Century

Second Global Report on Decentralization
and Local Democracy

GOLD II
2010



United Cities and Local Governments
Cités et Gouvernements Locaux Unis
Ciudades y Gobiernos Locales Unidos

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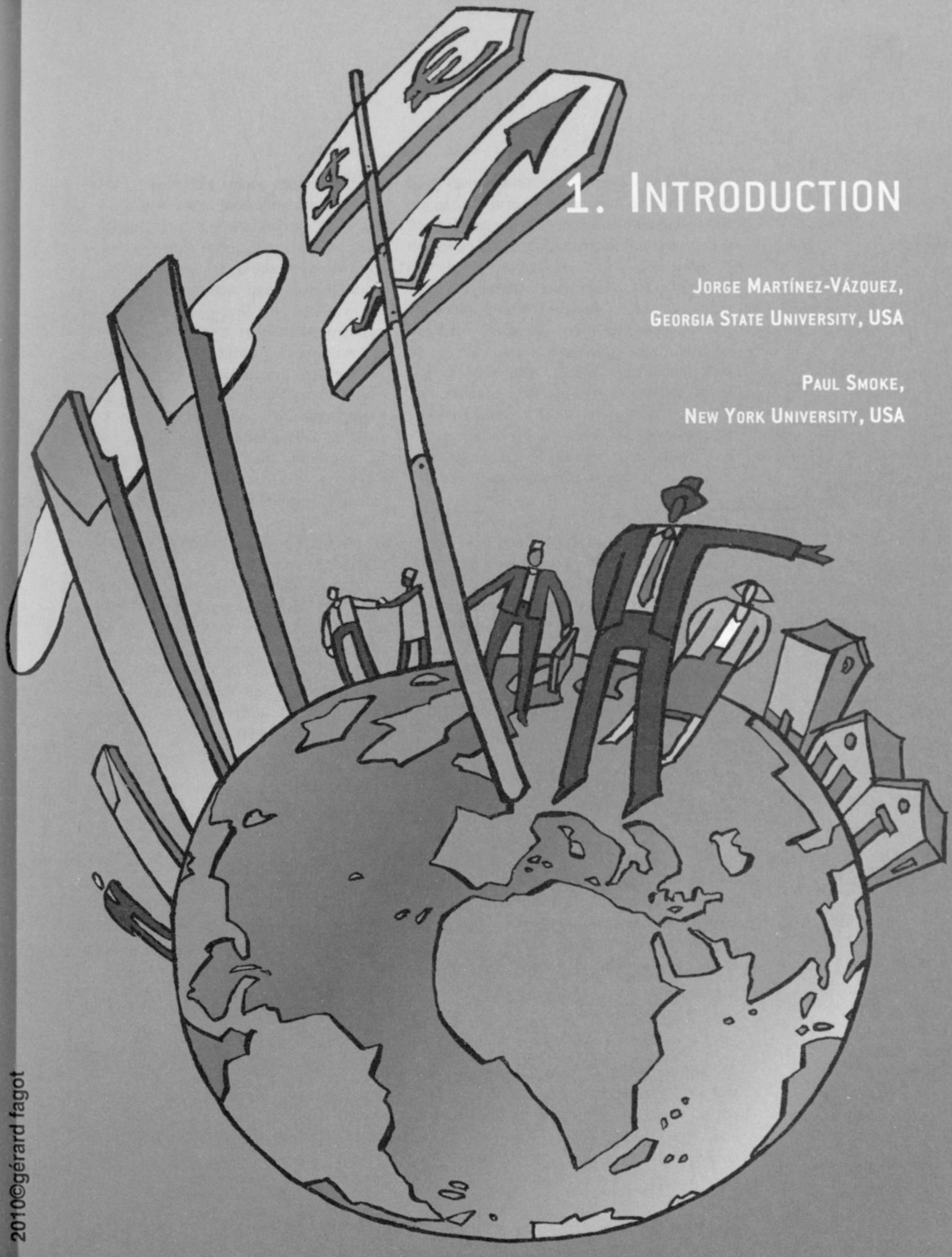
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1. INTRODUCTION

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Local governments around the world today play a key role in facilitating development and improving living standards. As more robust governance mechanisms are adopted and civil society develops even where they have historically been weak, local governments have grown to operate in an increasingly open and responsive manner. Today they are considered by many central governments to be important partners in dealing with a range of public policy issues and functions, including building more efficient and equitable social service systems and providing significant portions of key infrastructure that supports economic development and improves the quality of life.

The road to this point, however, has been far from smooth or easy, and many challenges to effective local governments persist to various degrees. Decentralization has been uneven and has faced major obstacles. In many countries intergovernmental systems remain problematic in various respects, and local governments are not adequately equipped to perform their functions well and to become more effective partners of higher level governments in meeting pressing common goals.

This report builds on the 2008 First Global Report on Decentralization and Local Democracy (GOLD I), which provides a broad based overview of local government systems around the world. GOLD II focuses on a specific aspect of decentralization—the fiscal architecture and performance of local governments. This topic was chosen for GOLD II because fiscal architecture is fundamental to ensuring that local governments can deliver public services and function successfully in meeting other essential responsibilities.

Increasing fiscal decentralization (measured as the subnational share of total national public expenditures) has been a global trend in recent decades. There are, however,

significant variations across and within regions. Local budgets account on average for 25 percent of public expenditures in the European Union, for example, but less than 5 percent in many developing countries. If fiscal decentralization is evaluated in terms of expenditure and revenue autonomy, there has been progress, but it has been uneven across countries and generally less robust on the revenue side. Global experiences also demonstrate that intergovernmental fiscal relations are not fixed—they tend to evolve with social, political, economic, demographic and technological forces that affect the overall role of the public sector.

GOLD II takes the pulse of the current state of the local public finances around the world with the main goal of identifying and analyzing the principal challenges that local governments face in providing public services more efficiently and equitably. The report also offers concrete recommendations for priority policy reforms regionally and globally.

Why is Local Government Finance Important?

The potential importance of local government finance is based on two main pillars. The core rationale is that local governments are well positioned to improve how public resources are used and the extent to which diverse citizen needs are satisfied. The second justification is the role that local governments could potentially play in dealing with several significant contemporary global challenges that broadly, although differentially, affect virtually all countries.

The Core Rationale

The conventional case for decentralization is grounded on two basic propositions. The first is that local governments are closer to the people than the central governments, and they have superior access to local information

that allows them to respond better to the needs of citizens. The second is that they face stronger incentives to perform well on local matters than the central government, so that they are in a better position to derive the most from public resources at their disposal and are more likely to seek innovative means of doing so. These two propositions are related: access to local information and incentives to use it well must work synergistically to produce better results.

Although the value of local governments in this regard is well recognized, and there is some supporting if uneven empirical evidence, there are caveats. Close collaboration and innovative institutional arrangements are needed between local governments and higher levels of government to provide services that involve economies of scale or affect multiple local governments.

Equally important, the validity of the two basic propositions regarding the benefits of local governments depends on meeting fundamental requirements. At a minimum, there must be sufficient autonomous local government powers and resources, satisfactory local technical and managerial capacity, and adequate incentives (electoral and beyond) for local governments to be held accountable to their constituents and to behave in a fiscally responsible manner. Central governments can play a role in helping local governments to meet these requirements, but this requires time and ongoing support in countries where they are not in place. Thus, appropriate implementation—the sequencing and pace—of intergovernmental fiscal reforms is just as important as sound design.

Global Challenges and the Role of Local Governments

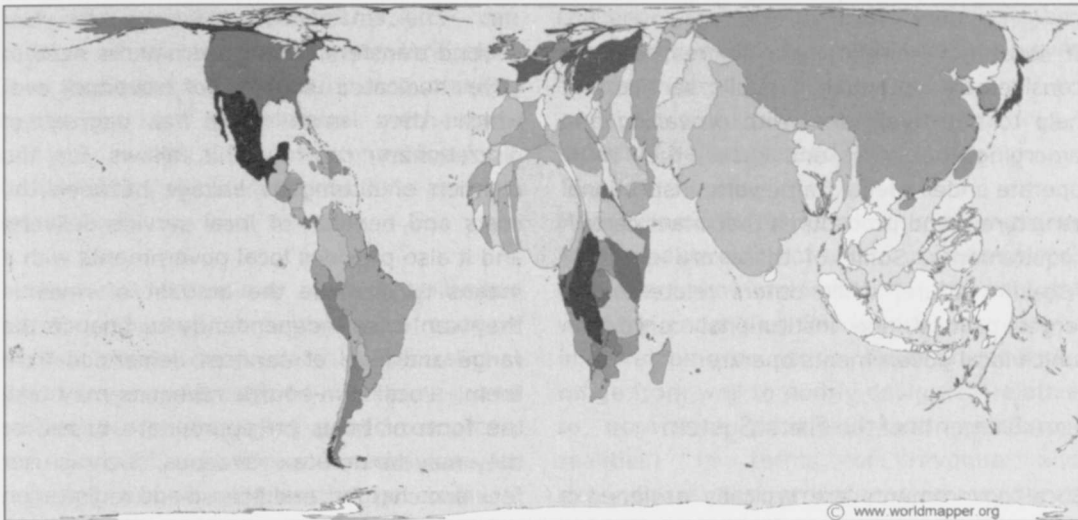
In addition to the general desirability of decentralization if appropriately designed and

implemented, a number of specific and interrelated global trends present great challenges to individual countries and the broader international community and reinforce the potentially important role of local governments. First, the world is facing multiple environmental and resource crises, such as global warming, energy shortages and food security concerns, which have emerged prominently in domestic and global policy circles in recent years. These crises individually and collectively impact local governments in very specific ways, but local governments may also be in a strong position to help respond to them.

Second, increasing urbanization (see Figure 1.1), which exacerbates the crises mentioned above and generates great public service needs, is a pervasive global trend, especially in developing countries. A majority of the world's residents now live in urban areas, and the share is expected to exceed 60 percent by 2030.¹ According to the United Nations (UN), 95 percent of the urban growth in the next two decades is expected to be in Asia, Africa and to a lesser extent in Latin America, and it will be focused in small and medium sized cities. Rapid urban growth also implies an increasing urbanization of poverty. If current trends persist, one out of five persons will live in urban slums by 2030. The struggle to meet the Millennium Development Goals and advance the global fight against poverty may be won or lost primarily in the urban areas of developing countries. Increasing urbanization also creates a need for innovative mechanisms to govern and serve metropolitan areas that are growing in size, complexity and number. Developing sound intergovernmental relations and an appropriate fiscal architecture in metropolitan areas present daunting challenges because many different governments and public enterprises are typically involved in service provision in

1. United Nations
Department of
Economic and Social
Affairs Population
Division

Figure 1.1: Expected Urban Growth Between 2002-2015



Note: Territory size shows the proportion of all extra people that will start living in urban areas between 2002 and 2015, in each territory.

Source: World Mapper; City Growth (2005)

a metropolitan area. Despite the challenges, some analysts believe that local governments can play an important role in meeting the demands of urbanization and metropolitan governance.

Third, many countries around the globe face a considerable backlog of infrastructure demands and anticipate the emergence of new ones, in great part because of urbanisation. Addressing the challenges of urbanization and the growth of large metropolitan areas lacking adequate basic infrastructure will require substantial investments in the coming decades, often in sectors for which local governments have major responsibility. According to one estimate, investment in infrastructure and basic services in the order of 200 billion USD annually will be required over the next 25 years to meet these shortfalls.² The demand will be greatest in developing countries, but advanced industrialized countries must also invest to

deal with their aging populations and infrastructure. Special local investments in resilient infrastructure will be needed in many countries that face a growing risk of natural disasters.

Finally, the global financial and economic crisis that began in 2008 is deeper than anything experienced since WWII in terms of employment, income, and financial wealth losses.³ The crisis has distressed practically all central governments around the world and it has affected most local governments in some ways as well. At the same time, there is considerable diversity in how local governments across different countries have fared. While some local governments have seen their funding cut and all types of expenditures reduced, others have actually experienced a growth in funding and have increased certain types of expenditures. In some countries, local governments may be able to play a significant role in mitigating the effects of the global financial crisis.

2. World Bank (2005) estimated the investment needs in public infrastructure in developing countries, amounting to 600 billion USD per year over the next 25 five years. However, these figures include all public infrastructures, whether national (energy, communications and information technology, transport; water and sanitation, etc.) or urban (local roads, local water supply, and sanitation, waste disposals, schools, street lightning...).(World Bank. 2005. "Infrastructure and the World Bank: A progress report", The World Bank). The UCLG Committee on Local Finance estimated one third of this amount, i.e. 0.4 percent of World GDP, needs to be channeled to urban infrastructure (UCLG. 2007. UCLG Policy Paper on Local Finance, UCLG)
3. UCLG, *The Impact of the Crisis on Local Governments.* (UCLG. 2009. "China", The Impact of the Global Crisis on Local Government. UCLG).

The Structure and Requirements of Local Government Finance Systems

If local governments are to realize their considerable potential in public service and help to effectively deal with prevailing and emerging challenges and crises, they must operate under a legal framework, institutional structures, and procedures that meet certain requirements. Some of these are explicitly fiscal in nature, while others relate to the larger political and institutional context in which local governments operate.

Core Elements of the Fiscal System

Local governments are typically assigned a range of service delivery and other key functions by constitutional or legal provisions. It is generally accepted that these functions should be appropriate in terms of their relevance for localities and their suitability for local implementation. There is also general agreement that clarity of functional assignment is important to ensure that local governments and their constituents have a consistent understanding of local responsibilities. Sufficient expenditure autonomy is considered critical so local governments can respond to local needs.

Local governments also need access to funds to discharge their functions and to meet evolving expectations of their constituents. Central governments have a comparative advantage in revenue generation, so a major portion of local resources is often derived from shared taxes and intergovernmental transfers. Transfers can be unconditional or conditional, and they may be used for recurrent and capital spending. Transfers should be funded by a stable and predictable pool of resources and allocated by appropriate criteria or formulae. The balance between conditional and unconditional transfers may vary in different contexts, but some unrestricted resources allow local governments to exercise the autonomy that is

central to their own comparative advantage in service delivery.

Beyond transfers, local governments need to have dedicated sources of revenue over which they must have a degree of discretionary control. This allows for the creation of a tangible linkage between the costs and benefits of local service delivery, and it also provides local governments with a means to increase the amount of revenue they can raise independently to finance the range and level of services demanded from them. Local own-source revenues may take the form of taxes on appropriate bases, or they may be non-tax revenues, such as user fees and charges, and license and registration fees, among others.

Finally, as intergovernmental fiscal systems mature, local governments need to have adequate access to infrastructure finance. Some development spending can be funded with transfers, but eventually local governments, particularly in urban areas, need access to the capital market, whether directly or, in less advanced systems, through intermediary institutions with some government involvement. Local borrowing, however, needs to be governed by a suitable framework and adequate fiscal responsibility safeguards.

Non-Fiscal System Requirements

The focus of this report is on finance, but other aspects of intergovernmental systems covered in GOLD I are critical to ensuring effective local governments. As noted above, accountability is central to attaining the potential benefits of decentralization. This is often framed as the political dimension of decentralization, and the mainstream "gold standard" for accountability is regular democratic elections. Not all countries have or want free and competitive local elections, however, and other mechanisms that allow

for citizen engagement with local governments —public access to information, feedback, and complaint mechanisms, etc.— can improve accountability. Moreover, local elections alone are a rather blunt accountability instrument, and non-electoral mechanisms can play a critical role in enhancing local accountability even where elections are well established.

Institutional dimensions of decentralization are also extremely important. Local governments need appropriate organizational structures, well-defined systems and procedures for managing public resources, and suitable frameworks and mechanisms for engaging with other levels of government, private sector firms and nongovernmental actors. Moreover, local governments must possess or be able to develop the capacity needed to properly operate within the institutional framework.

Although these political and institutional aspects of local government systems were covered in GOLD I and are not given primary attention in this report, their role in making fiscal decentralization effective cannot be over-stated. Without adequate accountability mechanisms, appropriate operational systems and sufficient capacity, autonomous local fiscal powers can lead to problematic rather than productive outcomes.

The Global Reality of Local Government Finance Systems

Some countries have long had robust local finance systems with strong development of the components outlined above, and many others have taken steps to develop systems in recent years. At the same time, all countries —from the most advanced industrial to the most fragile developing— face various challenges illustrated throughout GOLD II. Some challenges are related to weak system development and capacity constraints,

particularly in developing countries, or more generally to resource shortfalls. Other challenges are external to the finance system but affect demands placed on it and the way it functions.

System Challenges and Dilemmas

Many elements of local finance systems outlined above do not exist, are incomplete, or have been implemented inconsistently with the underlying framework, particularly in developing countries. Fiscal frameworks range from well to poorly designed (relative to normative principles and contextual realities) in terms of revenue and expenditure assignments, correspondence between revenues and expenditures, transfers, subnational borrowing frameworks, etc. More broadly, overall constitutional and legal frameworks for local government (with respect to legal status, political mechanisms, empowerment, administrative and staffing structures, etc.) range from being well developed to barely having begun.

A common problem with fiscal systems is insufficient clarity in the assignment of local government expenditure responsibilities. Even where responsibilities are reasonably well defined in more advanced systems, expenditure challenges may be created by unfunded mandates from higher level governments and the lack of well developed methodologies and practices to translate expenditure assignment responsibilities into quantifiable resource needs. Degrees of autonomy in expenditure decisions also vary widely.

An overarching challenge with service provision in a multi-level government system is which functions should be undertaken at each level and how levels should interact, including the metropolitan governance issues outlined above. These are tough

decisions since there is a common trade-off between fiscal viability at higher levels and political connectivity at lower levels. In struggling to achieve a balance, countries must consider the benefits and pitfalls of amalgamation versus division, as well as the potential value of creating mechanisms to bridge jurisdictional fragmentation, such as the use of special districts and/or frameworks for voluntary joint initiatives across local governments.

Progress has been made in developing tax sharing and intergovernmental transfers, but problems persist. Transfers may be inadequately or unreliably funded, and the criteria used to allocate resources may be unclearly specified or inappropriate. Despite growing fiscal disparities across localities in much of the world, few countries use genuine equalization grants to increase parity in access to basic services across communities, some of which have low revenue capacity or high spending needs due to demographics or other factors beyond their control. Where equalization grants exist, they may be poorly funded or undermine incentives for local tax efforts or expenditure efficiency. Many countries also struggle with the right balance between unconditional grants, which promote autonomy, and conditional grants, which ensure attention to national priorities.

Challenges to local revenue generation are particularly pervasive. Although there is more agreement about the need for strong expenditure autonomy than there is for revenue autonomy, some discretion is seen as necessary to promote local accountability. Even where taxes that are widely considered to be appropriate local sources, such as the property tax, are allowed, they may not be well used. The property tax is a difficult and expensive tax to administer and tends to be especially unpopular among taxpayers. Even when it is relatively well

administered, its revenue potential may be limited, and other productive revenue sources have often not been assigned to local governments.

Only a few countries in more developed regions have robust systems of local government development finance. Many countries implement capital conditional grant programs and local governments dedicate a large share of resources to financing investments, but the longer-term response to the needs outlined above must include enhancing responsible access to credit for local governments. Some countries have successfully operated financial intermediaries for local governments, but this approach has faced challenges and has been undermined by political pressures in many cases.

These challenges to developing robust local finance systems, and in some countries poor local government performance, have led to instances of backtracking on decentralization. Since the publication of GOLD I there has been an emerging recentralization trend in some countries around the world. Disappointing performance in emerging systems, however, may result from expecting too much too quickly from nascent local governments and failing to adequately support building their capacity to fulfill the roles expected of them.

External Challenges

A number of major phenomena outlined earlier —natural resource crises (environmental, energy, food security), urbanization, infrastructure shortfalls, and the global financial crisis— were framed as problems that local governments could contribute to alleviating. At the same time, it is important to recognize that they also pose considerable challenges to local governments. Dealing with them effectively will require

more resources, greater technical expertise, and considerable ability to negotiate complex issues with a range of interested parties with varying degrees of power. Thus, the extent to which local governments could take action to respond to these serious global threats to development depends on the extent to which they are properly equipped and supported to do so.

In this regard, it is important to note that some central governments seem not to understand their own critical role in providing an environment conducive to local government action intended to meet these challenges. On the contrary, the tendency towards recentralization in some countries seems to have been exacerbated by the response to the world financial and economic crisis. Central governments in a number of African, Latin American, and Eurasian countries have adopted policies of unilaterally interrupting the disbursement of revenue sharing and other transfers. In other cases, central governments have increased control over funding allocations or mandates over how local governments must spend resources.

The Diversity of Experience

Although local government finance is important in many countries and some basic commonalities and challenges as outlined above can be identified, it is important to keep in mind that there are also important differences across regions and countries. As reported in GOLD I, there is great variation around the world in how local governments are structured and empowered. GOLD II demonstrates in more detail that there is also extraordinary variety in how the fiscal architecture of local government is organized and performs both across different regions and among countries within each region.

Historical roots and trajectories have a lot to do with how local government systems

are structured and the roles they play. In much of Latin America, for example, the influence of centralized colonial regimes can be seen, particularly on fiscal matters. At the same time, some large countries, such as Argentina and Brazil, have long traditions of provincial governance, and local governments have, with various interruptions, been more important in Latin America than in other non-OECD regions. In the Middle East and Western Asia, the strong influence of the Ottoman Empire can be seen in still heavily centralized systems, fiscal and beyond, that prevail throughout countries in the region.

A number of regions exhibit considerable intraregional variation. Although centralized systems have dominated the Asia-Pacific region, diversity is evident. Some countries were colonized by Britain (e.g. India and Malaysia) and others by France (e.g. Cambodia and Vietnam), with a few outlier influences (e.g. Spain/U.S. in the Philippines and the Netherlands in Indonesia). Some countries, such as China and Thailand, were never colonized for extended periods. Their systems draw on their own as well as borrowed traditions. Australia and New Zealand differ from other Asia-Pacific countries in that both were British colonies where descendants of colonists stayed and co-existed with indigenous people, institutionalizing but adapting colonial governance conventions. These various influences have resulted in a great variety of local government structures and fiscal systems in the region.

The countries in Eurasia started in fundamentally similar positions with the same initial system of administration and fiscal architectures inherited from the former Soviet Union, but they have opted to reorganize their local governance systems quite differently. In the Africa region, there is a stark contrast between the centralized

local administration traditions of former French colonies in West and Central Africa and the strong local government traditions left by the British in East and Southern Africa, although the latter were often weakened in the post colonial period. There has been considerable effort to decentralize and strengthen local governments across the region, and in many countries there is now a mixture of the local administration and local government traditions.

In Europe, many countries show rich decentralization experiences with strong institutional underpinnings, but the systems vary considerably and face significant policy challenges. In North America, Canadian and U.S. local governments play an important role in the public sector, but they are creatures of intermediate governments (provinces or states) rather than the national government. This leads to internal diversity since each province/state has separate local government legislation, a situation which also occurs in some other countries in other regions, such as Argentina, Australia and India. In the U.S., there is a particularly complex local government structure with thousands of counties, and tens of thousands of sub-county general-purpose governments and special-purpose districts.

These governance traditions across regions, of course, have been subject to evolving political and economic forces over the years that have resulted in many changes to the systems, including to the fiscal architecture. At the same time, the influence of these traditions persists in both obvious and subtle ways. In moving forward with future reforms, it is important to be aware of the nature and strength of this influence and what it implies for the pursuit of viable and sustainable local government finance reforms.

Summary of the GOLD II Mission and Organization of the Report

It is not too dramatic to state that local government finance systems around the world are currently at a crossroads. Efforts to decentralize and more fully empower local governments have been prominent, but they have encountered a variety of challenges, both relatively universal and fairly specific to particular regions and countries. The overall situation has been exacerbated by the emergence of a number of prominent and consequential crises –environmental, economic, and financial– in recent years.

Times of crisis present an opportunity to reflect on how local government finance systems work and how they can be improved. There is, of course, the possibility of overreacting during crises and making shortsighted and ultimately problematic decisions, both small and large, for the sake of getting through difficult times. Such opportunistic reforms may alleviate immediate problems but are likely to ultimately undermine the ability of local governments to meet their responsibilities in effective and sustainable ways.

Moving forward with the reform of local government finance requires systematic analysis of the positive and negative aspects of current intergovernmental systems, as well as careful consideration of how local governments can be empowered and supported to play a more productive role. This introduction has broadly outlined some of the key issues and options that need to be considered on this front. The rest of this report considers these issues and options more deeply at the regional and global levels.

The following chapters focus on specific UCLG regions: Africa (Chapter 2), Asia-Pacific (Chapter 3), Eurasia (Chapter 4), Europe (Chapter 5), Latin America (Chapter 6),

Middle East and Western Asia (Chapter 7) and North America (Chapter 8). Each of these chapters reviews the local government finance systems in the target region and the contexts in which they are operating. The chapters outline intergovernmental systems, with a focus on describing and analyzing the fiscal aspects. Positive and problematic features of local government finance are summarized, and specific opportunities and challenges are highlighted. Finally, each regional chapter closes with a summary of the main issues and regional specific policy recommendations and issues for further investigation.

It is important to note that the regions covered in these chapters vary in terms of the

number of countries included and the level and quality of information available. Thus, some chapters cover a greater proportion of countries than others, and in some cases more attention was given to countries for which better information was available.

Following the regional chapters, Chapter 9 focuses on the special circumstances and challenges of Metropolitan Areas across regions. Finally, the report concludes with an overall summary of key findings in Chapter 10. The final chapter also provides general advice for broad-based policy reforms and future work needed to more fully understand local government finance and to develop and support more detailed reforms both globally and in specifications and countries.