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Governing and Financing Cities in the Developing World

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Policy Focus Report Series

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About This Report

Metropolitan cities are engines of growth and modernization in developing countries. They present special opportunities and many challenges. Among the biggest challenge is how to govern these rapidly growing urban agglomerations and how to finance the investments and operating costs needed to meet the needs of people and of businesses in metro cities. Drawing both on theory and worldwide practice, this report explores alternative metropolitan governance and management approaches and assesses various financing tools, including locally raised taxes and user charges. It also explores external financing, such as transfers from higher-level government, borrowing, private-public partnerships, and international assistance.

This report draws substantially on the book *Financing Metropolitan Governments in Developing Countries* (2013) edited by Roy W. Bahl, Johannes F. Linn, and Deborah L. Wetzel, and on the contributions by the various chapter authors.

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Executive Summary

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Central city São Paulo, 2013.

The economic activity that drives growth in developing countries is heavily concentrated in urban areas. Big cities are linked to the global economy and are most likely to propel poorer countries to become competitive and prosperous. But the same advantages that drive investment and growth in metropolitan areas draw migrants who need jobs and housing, lead to burgeoning demands for better infrastructure and social services, and result in increased congestion, environmental damage, and social problems. The challenges for metropolitan governance and public finances are to capture a share of the economic growth to adequately finance the growing expenditure needs, and to organize and manage cities so that the urban economy functions efficiently and sustainably, services are delivered cost-effectively to all, and citizens have a voice in governing the city. At the same time, a fine line must be walked to avoid over-regulation and over-taxation, which might chase away private investment and entrepreneurial initiative in a world where investors and entrepreneurs have many choices of location.

This report identifies the current issues of importance in metropolitan governance and finance in developing countries, describes the practices, explores the gap between the practice and theory, and lays out reform paths to consider. It explores urbanization trends and economic growth, highlights the growing role of metropolitan cities, and considers the resulting metropolitan and service delivery challenges. The report addresses the twin core issues of urban governance and finance: how to manage complex vertical and horizontal urban governance structures; and how to raise the necessary financial resources needed for efficient, equitable, and sustainable metropolitan growth.

Two overarching findings stand out. First, assessments are based on collections of case studies because there is a lack of comprehensive and representative data. It is, therefore, not possible to compare the practice in all metropolitan areas in developing countries, or even in a majority of them. Second, within the 50 or so metropolitan cities considered here, practice often deviates from theory, and there is a wide variation in the practice. Both findings suggest using caution in drawing conclusions across countries and cities. In the industrial countries, however, there is better information for evaluation and more uniformity in the basic approach.

Three general reform recommendations arise from what information is available.

- *Policy makers and planners at the local and higher levels of government need to "think metropolitan" in addition to "thinking jurisdiction."* Regionwide plans for service delivery and financing need to become more a part of the fiscal landscape, even at the cost of some loss in home rule at the lowest levels of government.
- *Metropolitan local governments need to be given more discretion over their budgetary outlays, service delivery, and financing decisions.* Many countries have too much central and provincial control, and some of the advantages that local governments can bring are lost.
- *Many developing countries need to adopt asymmetric systems of intergovernmental fiscal relations in which the metropolitan areas are given differential powers and responsibilities relative to other subnational jurisdictions.* Because developing countries are more centralized in their governance, such changes need to be enabled by higher-level governments.

This study does not conclude that there is only one model or "best practice" for service delivery or revenue mobilization instruments. There are too many trade-offs involved, and people in different countries have various preferences for governing and financing themselves in addition to having different cultures and politics. However, there are some promising avenues for improvement.

- Several governance models can address external costs, such as pollution, congestion, and service delivery, while preserving some degree of home rule at the jurisdiction level. However, future metropolitan-wide regional governments will play more of a role in addressing metropolitan service needs.
- The costs of meeting infrastructure needs and dealing with slums are staggering. Debt finance is a promising avenue to raise funds for infrastructure if metropolitan local governments are given the resources to support debt and if borrowing is properly controlled. Land-based levies and public-private partnerships (PPPs) can also be effective instruments for financing local government capital projects, but they require significant metropolitan governmental capacity.
- User charges and property taxes are dramatically underused as revenue-mobilization instruments in almost all metropolitan areas in developing countries due to pervasive political obstacles.
- The property tax is an effective and fair way to finance services, but adequate local financing will require broad-based income or consumption taxes.
- Intergovernmental transfers must play a role in metropolitan finance because of the external benefits associated with local public services (e.g., pollution control). Grant financing can play much less of a role than it does now.
- Donors can also help address the finance and governance problems in developing countries.

All of these options should be considered in light of the complexities and needs of metropolitan areas in developing countries.

CHAPTER 1
Metropolitan Growth in Developing Countries

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Metro Manila seen from Barangay Pitogo, 2013.

URBANIZATION TRENDS AND ECONOMIC GROWTH

The rate of urbanization in developing countries is projected to reach the 50 percent mark in the next decade (United Nations 2008). According to current estimates, the world population will grow from approximately 7 billion in 2012 to over 9 billion by 2050, and virtually all of the population increment will be absorbed by urban areas in developing countries (figure 1). With some 70 percent of the population living in urban areas by 2050, it is also no surprise that, while cities will be centers of wealth and relative prosperity, the number of urban poor may well exceed that of the rural poor (Yusuf 2013).

The number of megacities (with populations greater than 10 million) is projected to increase from the current 19 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 developing countries. By 2025, there will be 48 cities with populations between 5 and 10 million, and three-fourths of these will be in developing countries (United Nations 2008).

It is not uncommon for individual metropolitan areas to account for more than one-fourth of national GDP in industrial countries (OECD 2006). The same is also true in developing countries. For example, the shares are 27 percent in Istanbul and 52 percent in Buenos Aires (Braun and Webb 2012;

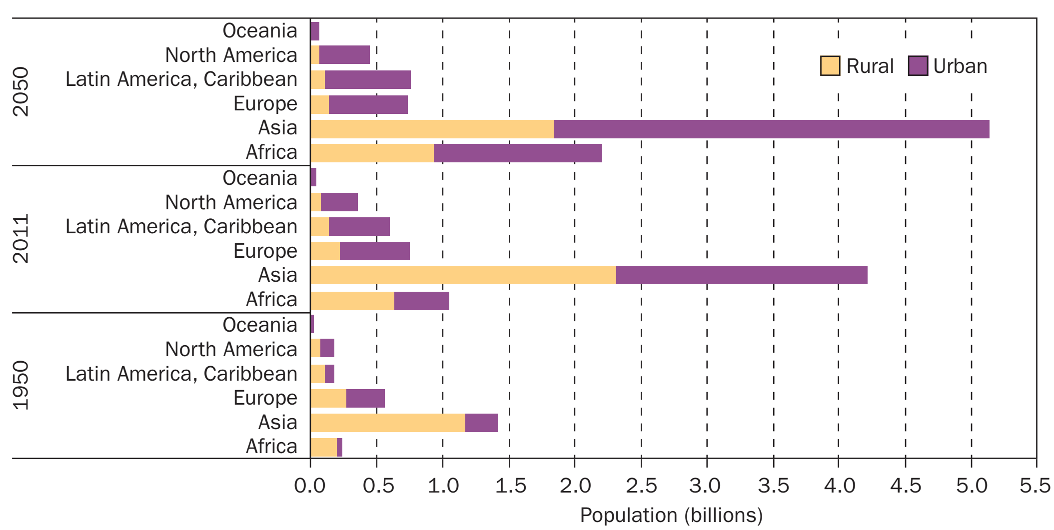
OECD 2007). It should be noted that the term "metropolitan area" refers to the built-up space covered by large cities, including their suburban areas. This definition is similar to the one used by the United Nations of "urban agglomeration," which includes the population "contained within the contours of a contiguous territory inhabited at urban density levels without regard to administrative boundaries" (2008, 13). Cities are the hubs of economic growth, because they permit economies of scale and agglomeration, they offer efficient labor markets for employers and workers, they allow for human exchange and networking that foster innovation and the spread of ideas, and they provide social and cultural amenities not readily available in rural areas and small towns.

At the same time, there are significant costs to metropolitan growth, especially if it is poorly managed. Life-threatening air pollution in Beijing and Delhi, severe traffic congestion in Bangkok and São Paulo, and the pervasive urban slums, corruption, and crime in many cities in developing countries attest to the challenges of metropolitan development. And the benefits and costs of metropolitan growth are not limited to the largest cities themselves. The positive effects include the growth of firms that supply metropolitan area industries and the 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 to the metros, as the most talented workers move there to seek better opportunities, and the political friction that metropolitan-area dominance sometimes causes (Smoke 2013; Sud and Yilmaz 2013).

The key factors that drive strong and sustainable metropolitan income and employment growth are: (1) an economic base that is competitive in domestic and global markets; (2) strong transportation and IT linkages within the cities and to the rest of the world; (3) a concentration of human capital skills; and (4) quality governance that supports metropolitan growth and captures the opportunities that urban growth generates (Yusuf 2013).

The poster children of effectively managed metro areas are in China (Hong Kong,

FIGURE 1
Rural and Urban Population by Major Regions, 1950, 2011, and 2050 (billions)



Source: United Nations (2012).

Shanghai), India (Bangalore), Korea (Seoul), and Singapore. 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. 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. Yusuf (2013) cites Karachi, São Paulo, Cairo, Manila, and Johannesburg as examples of cities that are growing but are not generating exports or importing new technologies. They are not effectively confronting the economic, social, and environmental challenges of rapid metropolitan growth.

GOALS AND CHALLENGES

There is no question that big challenges are in store for the metropolitan areas in developing countries:

- Not only will an increasing number of cities be megasized (10 million and greater), but they will be clustered in multi-metro-regions/corridors. Regional planning will be an 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 problem.
- With globalization, metroeconomies are highly integrated in the economic and financial global economy, and will need to be more competitive. In particular, the growth of the footloose service sector in these metroeconomies requires "smart growth" strategies by cities. The development of IT services will be a key factor.

New building in Kinshasa, Congo, 2013.

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Overloaded bus in Karachi, 2010.

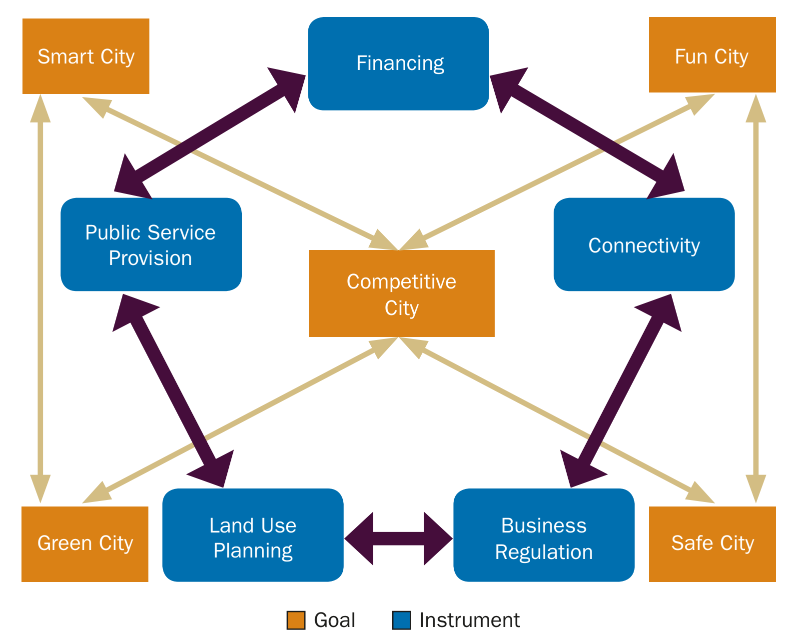
- The delivery of adequate services in metropolitan areas should be part of an effective metropolitan growth strategy. This goal will be especially challenged by the large populations living in slums.
- Metropolitan areas will need to be at the forefront of the response to climate change challenges and green growth opportunities (Wetzel 2013; Yusuf 2013).

Although this report is concerned mostly with the governance and financing of metropolitan areas, it helps to place the governance and finance aspects into a context of the broader metropolitan planning and management challenge. Figure 2 (p. 8) summarizes core elements of an effective metropolitan development strategy by highlighting the main objectives and instruments of urban management (Linn 2014). The central objective for urban planners and managers would be to create a *competitive* city—that is, a city that attracts modern investment and skilled workers. Subsidiary goals are the creation of a smart, green, safe, and fun city. *Smart* means access to modern information, communication, and transport technology that connects business, government, and the people of the city with each other and with the rest of the world. *Green* refers to efficient and sustainable use of energy, water, and air. *Safe* means protection from crime and from natural disasters, including the potential ravages of climate change. Finally, *fun* refers to the amenities of culture, heritage, sports, and green spaces. All five objectives interact with each other, so that the achievement of one supports the success of the others.

In the pursuit of these five goals, city planners and managers have five principal sets of instruments at their disposal: the provision of public services, land use planning, business regulation, connectivity, and financing. As in the case of objectives, there is a close interrelationship between instruments: effective public service provision creates the foundations for better connectivity and has to be linked to land use planning, while business regulation can support or impede effective service provision, land use implementation, and connectivity. And effective financing is critical for the effective provision of metropolitan public services and regulation, and vice versa.

The expenditure demands that growing metropolises place on city fiscal systems are a particularly important issue. 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

FIGURE 2
Goals and Instruments of City Development Strategy



Source: Linn (2014).

demand for services will remain high, costs are rising, backlogs are severe, management is problematic, and the special problems of slums are overwhelming. The factors that will drive increases in public expenditures in urban areas include: (1) population growth; (2) growing per-capita incomes; (3) business demands to upgrade the infrastructure and the public amenities necessary to attract and retain a strong labor force; (4) the need to address the negative externalities that come with urbanization, such as pollution (e.g., 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. There also are supply-side factors that disproportionately drive up unit costs of service provision in urban areas. Some of these are due to diseconomies of scale. Labor and land costs also are higher in metropolises than in smaller cities and rural areas. Examples are the costs of handling refuse collection and solid waste disposal, managing traffic congestion, dealing with pollution, and needing to dig deeper or go farther afield to find potable water supplies, etc.

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 (that have reduced congestion), seaports, and airports (Yusuf 2013). Infrastructure to support new residential developments is consistent with the goals of strengthening the amenities of cities, while infrastructure to support industrial parks is in line with the goals of capturing agglomeration economies. Modern hospitals and an education curriculum that supports the new economy are also in step with the strategy that focuses on new investment. Innovations in governance, such as e-governance, are signs of progress that most political leaders would like to be associated with; there is political appeal in being linked to what is new and all the visibility that comes with it.

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 work and upgrading, roads and streets may need repair, and solid waste disposal may be surviving on a temporary solution. The delivery of social services is often outdated; for example, school classes are overcrowded, health clinics are improperly staffed or supplied, and environmental regulations are unenforced. As necessary as they are, expenditures to address the backlog in services can, at the margin, be seen as crowding out expenditures that contribute to attracting new investment (Glaeser 2011).

What then are the best estimates for urban expenditure according to the literature? There are two core challenges: the need for urban infrastructure and the needs of the urban slum population. This accounting leaves out most of the costs of provision of education, healthcare, and social protection, which are often the responsibility of the metropolitan authorities as well, although the national (and provincial) governments also tend to be involved in these areas.

There is unfortunately no data set that will allow an international comparison of infrastructure expenditure needs in developing countries. Kharas and Linn (2013) extrapolate 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 (Ingram, Liu, and Brandt 2013). By comparison, subnational government taxes in developing countries average only 2.3 percent of GDP (table 1, p. 10). Case studies of metropolitan areas provide evidence on the magnitude of unmet infrastructure needs. For example, Wetzel (2013) reports that the City of São Paulo has maintained capital spending levels at 8 to 10 percent of its total current expenditures, which is well below investment needs. Mumbai metropolitan local governments could cover only one-tenth of infrastructure needs, even if borrowing was at full capacity (Pethe 2013).

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Communal tap for drinking water in Soweto, Johannesburg, South Africa, 2005.

© LW YANG/CREATIVE COMMONS

KTX (Korea Train Express) high-speed rail at Seoul Station, 2008.

TABLE 1
Fiscal Decentralization: International Comparisons for the 2000s

	Subnational Government Expenditures		Subnational Government Taxes	
Region	**Percent of Total Government Expenditures**	**Percent of GDP**	**Percent of Total Taxes**	**Percent of GDP**
Developing Countries	18.8 (16)	5.1 (20)	11.4 (16)	2.3 (20)
Industrial Countries	27.8 (26)	13.9 (26)	22.7 (24)	6.4 (25)

Sources: Bahl, Linn, and Wetzel (2013); IMF (various years).

Note: Data reported are unweighted averages for the 2000s. The numbers in parentheses are the number of countries included in the comparison.

Most cities in developing countries face the challenge of slum improvement (World Bank 2008). Poor people—city-born and immigrants—live in overcrowded and unhealthy shelter conditions without access to clean water and sanitation, tenure security, jobs, education, and health services. They are restricted in 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, there were about one billion slum dwellers 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 (Freire 2013). The total 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, or $60 billion a year (Freire 2013). This would require a six-fold increase over what is currently being spent.

If we add up these estimates of infrastructure and slum improvement expenditure needs we end up with a total of about $180 billion per annum. These are substantial financing needs, with a large share likely to be concentrated in the metropolitan areas. As Bird and Slack (2013) point out, the per-capita expenditures of local governments in metropolitan areas tend to be higher than for other local governments in a country. But, even then, current levels of per-capita expenditures fall woefully short of those in industrial countries, and especially so in the cities of the poorest countries, as table 2 documents.

This then defines the challenge for metropolitan authorities: how to effectively raise and deploy the resources needed to fund the huge expenditure needs created by the continued rapid growth of cities in developing countries. The remainder of this report will first address the question of how metropolitan areas are governed and managed by considering the vertical links to national and provincial authorities, the arrangements of horizontal governance within metropolitan areas, and the implications for urban management. It will then consider the various ways in which metropolitan expenditure needs can be financed by drawing on their own resources, and on resources from higher-level governments, borrowing, private investors, and international aid agencies.

TABLE 2
Budget Revenue per Capita, 1998 (US$)

City	Budget per Capita
Stockholm	5,450
Singapore	4,637
New York	3,609
Seattle	2,372
Dar es Salaam	11
Bujumbura	8
Nairobi	7
Phnom Penh	5
Lagos	2

Sources: Freire (2013); data from United Nations (various years).

CHAPTER 2
Governing and Managing Metropolitan Areas

Typically, the responsibility for governance and service delivery in a metropolitan area is fragmented in two ways: vertically among central, provincial/state, and local governments; and horizontally among municipalities, area-wide local governments, special purpose districts, and public enterprises. Rarely is there enough coordination among these governments (Rojas 2008). Moreover, local governments, metropolitan administrations included, are generally thought to be less capable of effective management than are higher-level authorities, especially the national government.

THEORY

The so-called decentralization theorem states that expenditure assignments should be at the lowest level of government unless efficiency considerations dictate otherwise (Oates 1972). The theorem is based on the principle that "home rule"—that is, control by voters at the local level over what is spent and what is financed in a jurisdiction—is best, unless economies of scale, spillovers, or externalities require control over service provision and financing at a higher level of government. For metropolitan areas, this implies that "property-related" services and their planning and management (i.e., roads

Entrance to Dharavi, the largest slum in Mumbai, 2008.

and public transport, water and sewerage, electricity, and residential and industrial waste collection and disposal) should clearly be local responsibilities. Social services (i.e., education, healthcare, and social protection) would be shared responsibilities among national, provincial, and metropolitan authorities, due to spillovers and externalities. Moreover, metropolitan areas ought to be mainly self-financing because: (1) they have ample economic resources and thus potential fiscal capacity compared to nonmetropolitan local governments; and (2) self-reliance in financing likely results in a better match between the preferences of local residents for public services and the level of revenues raised. However, if institutional capacity is weaker at the local level, if the risk of capture by special interests is greater, and if the existence of scale (dis-)economies and externalities is hard to prove, the theory of decentralization becomes less clear in its guidance, with the result that no hard and fast lines can be drawn.

A further complication is that the decentralization choice that so perplexes central-local relations in developing countries can also be applied to the question of governance within metropolitan areas (Bahl 2013). Applying the decentralization theorem at the metropolitan level means that if there were no economies of scale in service provision and no externalities, and if only economic efficiency were 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 and externalities, political economy considerations are important, and preferences for strong local autonomy vary across countries and regions. So, how metropolitan governance is finally structured depends on the relative strength of the demand for home rule versus the demand for more efficiency in service delivery.

While the idea of an area-wide delivery or coordination of public services is easy to accept in principle, changing the laws to restructure government or mandate coordinated service delivery for the entire urban area is extremely difficult. The metropolitan area is an economic concept with boundaries that expand de facto as the size of the labor market area expands. In practice, the concept of metropolitan areas is mostly used for planning purposes. Plans to coordinate public services on a metropolitan-area basis usually are not fully implemented; and, even if they are, they tend to be limited in terms of the area covered and the functions considered. Local governments on the other hand are elected (or appointed) units that govern areas defined by political boundaries that fragment the metropolitan area (Bahl 2013). The idea of metropolitan governance across political boundaries has therefore not been easy to sell.

PRACTICE

The practice of metropolitan governance varies considerably. Table 3 summarizes the patterns in the allocation of service responsibility for eleven metropolitan areas in the developing world. While by no means representative of the full range of possibilities, the table reflects well the bewildering variety in practice among countries and cities. Any taxonomy of the various models used is likely to oversimplify things, but the following section classifies governance systems according to the horizontal (intrametropolitan) and vertical (federal-provincial-local) arrangements for service delivery and taxation.

HORIZONTAL ARRANGEMENTS

The structure of governance within metropolitan areas is usually a mixture of 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 as well as how they value local autonomy on the one hand and technical efficiency on the other. At one extreme are the Mexico City metropolitan area, where services are delivered by two states, a federal district, and over 50 local-level governments, and São Paulo, which includes 39 autonomous municipalities (box 1, p. 14). Johannesburg and Cape Town, at the other end of the spectrum, are metropolitan governments that deliver their assigned services on an area-wide basis with little autonomy at the submetropolitan-area level. In between

TABLE 3

Service Delivery Responsibilities of Selected Metropolitan City Governments

Function	Metropolitan Cities										
	Istanbul	Jakarta	Manila	São Paulo	Buenos Aires	Bogotá	Mumbai	Addis Ababa	Dar es Salaam	Kampala	Johannesburg
Transportation											
Roads – Arterials	M	M	N, M	M, C	N, M	P, M	P, R, C	R, Z, C	M	N, M	C
Roads – Streets	C	M	C	M, C	M, C	M, C	C	R, Z, C	M, C	M	C
Public Transportation	M	N, M	Private	M, C	M	M	N, P, C	M	M	M	C
City Services											
Water & Sewerage	M	M	Private	M, C	M, C	M, C	C, RP	M	M	M	C
Waste Collection & Disposal	M, C	M	M, C	M, C	M, C	M, C	P, C	M	N, M	M	C
Electricity Distribution	Private	N	Private	N/A	Private	N/A	P, C, Private	R, Z, C	N, M	M	C
Social Services											
Primary Education	N	M	N	M, C	C	C	C, Private	M	M	M	P, N
Secondary Education	N	M	N	P	C	C	C, Private	R	N, M	M	P, N
Housing	N/A	N, M	N, C	P, M, C	C	C	P, RP, Private	R, Z, C	M	N/A	C
Public Health	N	N, M	N	P, M	C	M, C	C, P	R, Z, C	N, M	M	C
Hospitals	N	N, M	N, C	P, M	C	M, C	C, Private	R, Z	N, M	N, M	P, N
Social Welfare	N	N, M	N	P, M, C	N, C	N/A	C, P	R, Z, C	N, M	M	C
Other Services											
Fire Protection	M	M	C	M, C	C	M, C	C	M	M	M	C
Police	N	N, R, M	N	P	N, C	M	P	N, R	N, M	M	C, N

Source: Sud and Yilmaz (2013).

N: National Government; P: Provincial/State Government (for federal countries); R: Regional Government; M: Metropolitan Government; C: City Government; N/A: Not Applicable (for Ethiopia Z: Zone)

Notes:

Johannesburg: There is single-tier local government for the metropolitan area. Constitution defines several functions as shared among different levels, but table entries depict responsibilities as they exist in practice.

Mumbai: Metropolitan-wide bodies and parastatals (public companies) undertake major service functions, but these are essentially arms of the state government. There is no metro-regional government concept.

are all sorts of arrangements. Manila's 17 cities and municipalities are overlaid by a metropolitan government with some area-wide responsibilities, and metropolitan Mumbai relies on central and state-owned parastatals (public companies) for metro-wide service delivery.

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

Developing and middle-income countries have much to learn from the experience industrial countries have with metropolitan governance, about how they have handled

BOX 1

São Paulo: Planning and Budgeting in a Fragmented Metropolitan Area

With a population of 11.9 million, São Paulo is the biggest city in Brazil. The São Paulo Metropolitan Region (SPMR) is governed by 39 municipalities, including the largest among them, the municipality of São Paulo. The SPMR faces major problems: a declining industrial base; major transportation, congestion, and pollution challenges; slums; disparities among municipalities in access to services and revenue capacity; and significant indebtedness at the local level. The horizontal fragmentation of metropolitan government and the weaknesses in municipal administration have made it difficult to address these problems.

At the core of the metropolitan governance challenge in São Paulo is the fact that municipalities are constitutionally placed on an equal footing with state-level government, and neither the national nor the state-level authorities are empowered to force municipalities to cooperate under a metropolitan-level governance structure. Over the last few decades various ad hoc solutions have been tried to deal with this conundrum, such as the organization of a metro-wide Development Council and of "consortia" for planning and coordination, and the creation of metropolitan enterprises and executive committees for specific functions, such as transportation. Selected municipalities have also formed subregional consortia for specific functions (port management, watershed protection, etc.). However, none of these approaches offers lasting ways to resolve the coordination deficit and tensions between state-level and municipal-level authorities and among municipalities in the SPMR.

These horizontal and vertical governance problems have been reinforced by weaknesses in municipal financial management. The absence of effective municipal investment planning and the lack of effective municipal financing mechanisms, despite some creative new funding instruments (such as bonds for enhanced development rights), have served as obstacles to metro-wide coordination in infrastructure investment and finance.

Another effort at improved metropolitan governance was undertaken in 2011, when a new set of metropolitan planning and coordination mechanisms were established under state law. This includes a metropolitan development council for planning and land use, transport, housing, sanitation, and environment, etc., with representation from state and municipal authorities; a consultative council of key metropolitan stakeholder groups; technical groups for specific issues; a regional enterprise for investing in and financing selected metro-wide functions (transport, housing and sanitation, and environment); and a regional development fund that supports municipalities with finance and technical assistance. It remains to be seen whether and how this new set of institutional mechanisms will overcome the longstanding metropolitan governance challenges in São Paulo.

Source: Wetzel (2013).

the tensions between the demands for local control versus area-wide government, and how they have financed this growth. This experience can help identify the governance choices that are feasible when constraints on revenue mobilization and service delivery capacity are relaxed. The experience in industrial countries suggests that time and economic growth will lead metropolitan governance practices in developing countries toward workable decentralized structures. But, in the short run, rapid population growth and scarce resources are limiting choices in developing countries, and the movement away from fiscal centralization is proving to be difficult. It will be a long time before the governance in Mumbai or Mexico City settles into a structure such as those adopted by Toronto or Copenhagen.

VERTICAL ARRANGEMENTS

The defining feature of public finance and governance in most developing countries is centralization. As Sud and Yilmaz (2013) point out, there are only a handful of developing countries where local governments are specifically recognized 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; table 1, p. 10). 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 is the responsibility of central or state government.

To a large extent, the success of metropolitan-area public finances depends on how vertical intergovernmental relations are structured (Smoke 2013). 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 whether they will be given a differential fiscal treatment. In some countries, local governments in metropolitan areas are not treated differently (Bird and Slack 2013). In others, a differential treatment usually takes one of the following forms: (1) provincial city status (box 2, p. 16); (2) special expenditure assignment and taxing arrangements for cities of different sizes; (3) special arrangements under the intergovernmental transfer system (Bahl 2010); and (4) special status for national capital cities (Smoke 2013).

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

Finally, 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 the law, but regulations that are too stringent can undermine local authority and create obstacles to good performance (Smoke 2013). Arguably, more problematic are the controls imposed by sector ministries (e.g., infrastructure, education, and health), which can significantly limit local government expenditure discretion, as has been the case in Colombia and Peru (Bird 2012; Martinez-Vazquez 2012; Smoke 2013).

IMPROVING SERVICE DELIVERY

The poor record of service delivery by local governments in developing countries has

BOX 2

Special Status for Metropolitan Areas: 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. An interesting question is 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. In China, for example, the four largest cities are treated as provinces and have the powers of both provincial government and local government. Many other examples can be found in the industrial and developing world.

There are some clear advantages to this approach. It allows for area-wide governance that can internalize potential external effects, but it also allows for significant autonomy in making budgetary decisions. The provincial-level city administration becomes much like a state in a federation, but usually with more manageable boundaries and sometimes 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 the adoption of 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 area-wide governance advantage is lost. This is the case of Buenos Aires and Mexico City. Another disadvantage is the hinterland problem; for example, if Mumbai were made a state in India, it would leave the present state of Maharashtra without its most important revenue generator. A third disadvantage is that city-states or provinces 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, 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 by the higher-level government.

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, the inability to capture economies of scale, expenditure mandates imposed by higher-level governments, and an inadequate revenue base. Sud and Yilmaz (2013) argue that the institutional weaknesses of local governments that stand in the way of providing good services are an even bigger problem than the shortage of resources. They also point out that a major reason for a lack of capacity at the local level is the inadequacy of the civil service system that often accords local government officials a lower status, including lower salaries, fewer chances for advancement, and 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 World Bank review of 190 of its municipal development projects, covering about 3,000 municipalities, reports significant improvements in urban public management (World Bank 2009). And the quality of public services delivered in metropolitan cities is far better than that provided in the rest of the country (Bird and Slack 2013). The coverage of basic water and sewer services is higher, health clinics are more accessible, and the scope of services provided is broader. This discrepancy 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.

Mahalaxmi Dhobi Ghat, an open-air laundromat, where workers wash the clothes from Mumbai's hotels and hospitals, 2008.

The 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 (Bird and Slack 2013; Smoke 2013; Sud and Yilmaz 2013).

Another key element of improved urban management is increased accountability of the service providers to their clients—that is, 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, contractual obligations, etc.—will vary with the political and administrative system and culture. But, without such accountability, there will be few incentives for public—national, provincial, or metropolitan—and private providers to improve the management and delivery of metropolitan services.

FISCAL STRUCTURE AND DATA

In theory, one would expect that metropolitan-area governments spend more than other local governments in a particular country and that they rely more on their own resources than do other jurisdictions. The per-capita cost of service provision may be higher or lower in cities, depending on the balance of economies and diseconomies of scale. The higher the per-capita incomes, the greater the demand is for public services. Stronger political clout is likely to raise spending in large cities above that of smaller towns and rural areas. At the same time, the concentration of economic activity and the higher incomes in the cities also offer a greater local revenue capacity, which can be tapped to fund the higher level of expenditure needs. Hence, the conclusion is reasonable that metropolitan areas would be expected to be more self-financing and, in particular, draw less on intergovernmental transfers from higher-level government (Bahl and Linn 1992; Bird and Slack 2013).

The extent to which metropolitan governments rely on one or the other of these different types of financial resources varies widely across cities in the developing world, as table 4 demonstrates for a sample of countries and cities in a qualitative manner.

Table 1 (p. 10) showed that subnational governments in developing countries spend a lower share of GNP than do those in industrial countries. Unfortunately, however, we have no reliable comparative data on how much individual local governments spend or how they finance their expenditures (box 3, p. 20). Based on a review of the literature and information for specific cities, Bird and Slack (2013) conclude that metropolitan areas generally spend more per capita than the smaller cities and rural local governments. They specifically cite

TABLE 4
Local Government Revenue and Expenditure Autonomy in Selected Metropolitan Cities

Function	Istanbul			Jakarta*			Manila			São Paulo			Buenos Aires		
Revenue-Mobilization Authority of Local Governments															
Control Over:	R	B	C	R	B	C	R	B	C	R	B	C	R	B	C
Property Tax	🔴	🔵	🟢	🔵	🔴	🔵	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢
Taxes on Vehicles	🔴	🔴	🔴	🟢	🟢	🟢	🔴	🔴	🔴	🔵	🔵	🔵	🟢	🟢	🟢
Fees	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢
User Charges for Services	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢
Expenditure Authority															
Control over Expenditures from Own-Revenue		🟢			🟢			🟢			🟢			🟢	
Control over Expenditures from Intergovernmental Transfers		🟢			🔵			🟢			🟢			🟢	
Intergovernmental Transfers															
Distributable Pool		F			F			F			F			F	
Distribution Across Local Governments		F			F			F			F			F	
Purpose of Transfers		UCBG			UCBG, CEG			UCBG			UCBG			UCBG	
Management of Transfer System		🔴			🔴			🔴			🔴			🔴	
Do Local Governments Have Discretion to Borrow?		International 🔴 Domestic 🟢			🔵			🟢***			🔵			🔵	

Source: Sud and Yilmaz (2013).

R = Rate Setting; B = Base Setting; C = Collection

🟢 = Full control of the local government; 🔴 = No control of the local government; 🔵 = Partial control; F = Formula based; AH = Ad hoc; UCBG = Unconditional block grant; CEG = Conditional earmarked grant.

* The property tax is in the process of devolution to the local government level, which will give full authority over the base setting, collection, and, up to a limit, the rate setting.

Jakarta is currently piloting bond issuance.

** In theory, the city has control over setting rates but, in practice, the state exercises considerable control through its approval powers.

*** Local Government Units (LGUs) are accorded the power to undertake loans and borrowings subject to a statutory debt limit (annual debt service cannot exceed 20 percent of income).

the six metropolitan areas of South Africa that "account for only 34 percent of the population but 59 percent of total local government expenditures in 2007–2008" (Bird and Slack 2013, 137). Bird and Slack also find that central-city spending is higher than in suburban jurisdictions, citing specifically the case of São Paulo. They also conclude that metropolitan areas, within the central-city jurisdictions, have higher fiscal capacity and hence higher revenues than do other local jurisdictions. At times metropolitan local governments are also treated favorably compared to other jurisdictions by having city-state status, special taxing authority, or special transfers from higher-level governments (Bird and Slack 2013). These findings confirm what Bahl and Linn (1992) concluded two decades earlier.

In line with theory, one might expect that own-resources would consistently fund a larger share of expenditures in metropolitan

TABLE 4
Local Government Revenue and Expenditure Autonomy in Selected Metropolitan Cities (continued)

Function	Bogotá			Mumbai**			Addis Ababa			Dar es Salaam			Kampala			Johannesburg		
Revenue-Mobilization Authority of Local Governments																		
Control Over:	R	B	C	R	B	C	R	B	C	R	B	C	R	B	C	R	B	C
Property Tax	🟢	🟢	🟢	🔵	🔵	🟢	🟢	🟢	🟢	🔵	🔴	🔵	🔵	🔴	🟢	🟢	🔴	🟢
Taxes on Vehicles	🟢	🟢	🟢	🔴	🔴	🔵	🔴	🔴	🔴	🔵	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🟢
Fees	🟢	🟢	🟢	🔵	🔵	🟢	🟢	🟢	🟢	🔵	🔴	🔵	🔵	🔴	🟢	🟢	🟢	🟢
User Charges for Services	🟢	🟢	🟢	🔵	🟢	🟢	🟢	🟢	🟢	🔵	🔴	🔵	🔵	🔴	🟢	🟢	🟢	🟢
Expenditure Authority																		
Control over Expenditures from Own-Revenue		🟢			🟢			🟢			🔵			🔵			🟢	
Control over Expenditures from Intergovernmental Transfers		🟢			🔵												🟢	
Intergovernmental Transfers																		
Distributable Pool		F			F, AH			F			F			F, AH			F	
Distribution Across Local Governments		F			AH			F			F			F, AH			F	
Purpose of Transfers		UCBG			UCBG, CEG			CEG, UCBG			CEG, UCBG			CEG, UCBG			UCBG	
Management of Transfer System		🔴			🔴			🔵			🔵			🔵			🔵	
Do Local Governments Have Discretion to Borrow?		🔵			🔵			🔵			🔵			🔵			🟢***	

areas, but the available data do not confirm this. Table 5 (p. 22) compares the breakdown between own-resources and transfers (including shared taxes) for 24 cities in developing countries (along with data for selected cities in industrial countries). The results describe a wide range of experience: in 13 cities, own-source revenues contribute 50 percent or more of all metropolitan-level revenues, with four cities raising over 90 percent of their revenues locally (Addis Ababa, Pretoria, Seoul, and Pune). However, for the other cities, local revenues contribute less than half. For Istanbul, the share of own-resources was only 25 percent. Interestingly, this diverse pattern is not unlike that in industrial countries (table 5, p. 22). Tokyo, with 94 percent of own-source financing, is an outlier on the high side; Bucharest, with 17 percent, is on the other end of the spectrum.

BOX 3
Data Limitations

There are very little comparable data available to describe or track the fiscal performance of metropolitan-area local governments. Neither of the two major sources of fiscal information, the IMF and OECD series, reports data for individual local governments or attempts 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, they are for individual countries. And, even here, many countries do not report this information on a comparable basis.

The absence of comparative information is a serious and persistent constraint to understanding the fiscal performance of metropolitan-area fiscal systems, as earlier noted by Bahl and Linn (1992). Given the expected explosion of urban population in the next two decades, it is crucial to know more about the public finances of urban areas, and especially of metropolitan cities. Without such data, it is not possible to benchmark important indicators such as tax effort, infrastructure spending, fiscal disparities, or how the metropolitan areas fit within the transfer equalization system. It is also not possible to evaluate fiscal decentralization strategies, to assess borrowing capacities, or to research 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 IMF 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 could be another 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 urban governments, and it could entail defining the database, working out the method of aggregation on a metropolitan-area basis, and assembling the data on a comparable basis. The resulting annual compendium, "The State of Metropolitan Finances," would be of enormous value.

REFORM OPTIONS

Overall, the picture of how to govern and manage metropolitan areas appears murky in theory and highly variable in practice. However, on balance, greater decentralization of public service responsibility and stronger metro-wide governance approaches —supported by efforts to build local capacity, local coordination, and accountability mechanisms—are appropriate and ultimately unavoidable. Continuing rapid urbanization has overtaken present metropolitan governance structures' capacity to coordinate services, provide infrastructure, and make use of regional financing tools. No single magic bullet will reform all countries, because the taste for fiscal decentralization within metropolitan areas varies from place to place. For sure, though, the reform process must begin with the central government (or state government) paying greater attention to how metropolitan areas are governed, exploring and instituting asymmetrical approaches to the governance arrangements of large versus small cities, and taking a metropolitan (versus a submetropolitan local government) view of reform choices. One likely result of this reform direction

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Building homes and hospitals in Addis Ababa, Ethiopia, 2013.

is that while metropolitan-level authority will be increased, some degree of "home rule" at the local government level will be lost.

If the potential loss in home rule from area-wide 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 experience of Mumbai is any indication, is a very difficult matter (Pethe 2013). In practice, this approach has had 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 39 municipalities have autonomy guaranteed by the constitution, leaving each with a veto power over coordination programs for service delivery (box 1, p. 14). 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 involved parties together to find solutions.

The following six reforms measures could benefit service delivery in urban areas:

1. Clear up the often confused division of responsibilities between 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 local employees' capacity to deliver services. Achieving this goal involves undoing a multitude of policy sins including freeing up local governments to make budgetary decisions such as personnel decisions, upgrading the status of local government employees in the civil service system, and improving management techniques.
3. Increase local authority and provide incentives for local revenue effort so that more efficient infrastructure can be put in place and properly maintained.

4. Do a better job of capturing economies of scale in service delivery, and of addressing external effects stemming from local government budget decisions in metropolitan areas. This might be done through more effective coordination of service delivery among local governments or, better yet, by internalizing the externalities by creating area-wide governance and service delivery.

TABLE 5
Own-Source Versus Transfer Financing in Selected Metropolitan Areas

Grant Financing of Unified and City-State Metro Areas (percentage of total revenues, calculated for each city)

Metro Area	Population (Millions, Most Recent Year)	Tax Sharing (May Include Tax-Base Sharing)	General-Purpose Transfers	Specific-Purpose Transfers	Total Grants*	Total Transfers**	Own-Source Revenues
Unitary Metro Areas (n=9)							
Addis Ababa	3.1	0	0	0	3.1	3.1	96.9
Bern	0.3	0	0	0	24.4	24.4	75.6
Canberra	0.3	0	27.8	14.6	42.4	42.4	57.6
London	7.2	0	25.6	53.0	80.6	80.6	19.4
Melbourne	3.5	0	0	0	14.2	14.2	85.8
Prague	2.3	40.4	NA	NA	19.3	59.7	40.3
Pretoria	2.0	0	0	0	9.9	9.9	90.1
Toronto	5.1	0	0	24.0	24.0	24.0	76.0
Yogyakarta	2.0	0	66.5	7.2	73.7	73.7	26.2
Average* **	2.9	4.5	36.4	13.7	32.4	36.9	63.1
Unified Two-Tier Governance: City-State Metro Areas (n=14)							
Bangkok	2.5	24.0	7.0	20.0	27.0	51.0	49.0
Beijing	15.0	29.2	36.6	5.2	21.8	51.0	49.0
Berlin	3.4	39.1	38.3	21.9	40.2	79.3	20.7
Brussels	1.0	36.0	3.0	0	3.0	39.0	61.0
Busan	3.7	3.0	2.0	13.0	15.0	18.0	82.0
Istanbul	13.4	65.0	10.0	0	10.0	75.0	25.0
Madrid Community (City)	6.0 (3.1)	64.0	0	5.0	5.0 (39.0)	69.0 (39.0)	31.0 (71.0)
Montreal	3.4	0	0	0	24.0	24.0	76.0
Seoul	10.4	0.8	0	0	8.3	9.1	90.9
Shanghai	17.4	32.9	24.7	1.5	26.2	59.1	40.9
Tirana	0.6	0	8.5	17.9	26.4	26.4	73.6
Tokyo	13.0	0	0	0	5.7	5.7	94.3
Warsaw	1.7	40.0	NA	NA	14.0	54.0	46.0
Zagreb	0.8	67.7	0	0.1	0.1	67.8	32.2
Average* **	5.4	28.7	6.4	12.2	18.6	47.3	53.7

5. Improve local officials' accountability for the quality of service delivery by instituting various mechanisms and discouraging the practice of allowing higher-level governments to appoint local officials.

6. Provide technical assistance and training to local authorities as needed to build up their planning, management, and revenue-mobilization capacity.

TABLE 5
Own-Source Versus Transfer Financing in Selected Metropolitan Areas (continued)

Grant Financing Under Horizontally Coordinated or Fragmented Metro Governance (percentage of total revenues, calculated for each city)

Metro Area	Population (Millions, Most Recent Year)	Tax Sharing (May Include Tax-Base Sharing)	General-Purpose Transfers	Specific-Purpose Transfers	Total Grants*	Total Transfers**	Own-Source Revenues
Horizontally Coordinated Mandatory Two-Tier Governance (n=3)							
Belgrade	1.7	41.5	9.0	0.1	9.1	50.6	49.4
Copenhagen	2.4	0	7.0	10.0	17.0	17.0	83.0
Skopje	0.5	50.0	5.5	3.7	9.2	59.2	40.8
Average* **	1.5	30.5	7.2	4.6	11.8	42.3	57.7
Horizontally Coordinated Voluntary Two-Tier Governance (n=1)							
Helsinki	1.2	0	0	0	10.3	10.3	89.7
Uncoordinated Two-Tier Governance (n=2)							
Bucharest	2.0	60.0	7.6	15.4	23.0	83.0	17.0
Chişinău	0.7	24.0	15.0	5.0	20.0	44.0	56.0
Average* **	1.3	42.0	11.3	10.2	21.5	63.5	36.5
Uncoordinated/Fragmented Single-Tier Governance (n=12)							
Abuja	1.4	0	60.0	0	60.0	60.0	40.0
Cape Town	3.0	0	20.0	0	20.0	20.0	80.0
Chennai	6.3	24.0	0	0	10.0	34.0	66.0
Delhi	13.9	17.9	0	0	9.0	26.9	73.1
Hyderabad	4.1	25.0	0	0	15.0	40.0	60.0
Jakarta	18.9	46.3	0	0	0	46.3	53.7
Kolkata	15.0	0	0	0	58.4	58.4	41.6
Mexico	18.4	0	38.0	32.0	70.0	70.0	30.0
Milan	7.4	0	0	0	33.0	33.0	67.0
Mumbai	21.0	0	0	0	20.0	20.0	80.0
Pune	3.8	0	0	0	9.0	9.0	91.0
Washington, DC	5.0	0	12.0	14.0	26.0	26.0	74.0
Average* **	9.8	9.4	****	****	23.1	32.5	67.5

Source: Adapted from Shah (2013).

NA = not available or not applicable.

* Total grants refers to general-purpose plus specific-purpose transfers.
** Total transfers refers to tax sharing plus total grants.
*** Average refers to the average share of total revenue calculated for all cities.
**** There are only a few observations that provide composition of grants and the sum of these averages would not be consistent with the average for the total grants.

CHAPTER 3
Own-Source Financing

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Classroom in Kibera slum, 2013.

Urban governments, broadly speaking, have two main ways of raising revenues to meet the expenditure challenges they face: own-revenues and external financing. Own-revenues consist of user charges and taxes collected by local authorities, while external financing consists of transfers from higher-level governments, borrowing, public-private partnerships (PPPs), and funding from international aid organizations. This chapter deals with own-source financing, and the next chapter covers external financing.

This report details how various sources of revenue—own-source revenues and external sources—contribute to metropolitan financing, which helps explain why actual practice is so diverse and deviates so often from theory.

The low level of own-revenues raised by subnational governments in developing countries is cited often as a failing of the intergovernmental fiscal system (Bahl 2013; Bird and Slack 2013; Ingram, Liu, and Brandt 2013; Martinez-Vazquez 2013). However, implementing a strategy to increase local revenue mobilization will be difficult. Subnational governments frequently underuse the authority they have, but more typically they have only limited revenue authority to begin with. Central (state) governments are loath 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 anxious to have the accountability that comes with increased taxing powers. There also is a more purely political dimension. Increased local taxing power may enhance the success and, hence, the visibility of local politicians, who may be present or future political rivals. On top of this is the limited assignment of expenditure responsibilities given to subnational governments in many developing countries, although recent decentralization efforts have often resulted in revenue gaps, as more unfunded mandates were handed down to local authorities.

THEORY

Martinez-Vazquez (2013) points out that there is no unified theory of revenue assignment that will enable an identification of the best division of taxes between local governments and higher levels of government. However, he argues that the principles of benefit taxation and optimal taxation can provide useful guidance. 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 to the extent that higher-level governments have lower costs per unit of tax collected (due to their recourse to more efficient taxes or due to more efficient administration of a given tax).

Applying these general principles of optimal local revenue mobilization is, however, not without problems, even in theory. Beneficiaries of services may be difficult to determine due to externalities or because multiple agencies are involved in the provision of the service. And the many dimensional costs of local tax instruments are likely to be difficult to estimate accurately (Martinez-Vazquez 2013). Nonetheless, some practical guidance can be derived from the benefit principle and the optimal tax theorem (Bahl and Linn 1992; Bird and Slack 2013; Martinez-Vazquez 2013).

- User charges are an efficient and feasible instrument for local taxation on services for which beneficiaries and costs can readily be identified—such as water and sanitation, garbage collection, electricity, telecommunications, and district heating. Special assessments and betterment levies that recoup the cost of infrastructure investments from the beneficiaries are also among such charges. Modest fees may also be appropriate under the benefit principle for various regulatory services that a metropolitan government provides, including property registration and various permits. Charging beneficiaries for the actual cost of services has multiple advantages: it results in an efficient use of the service, it provides signals for investment in expansion of service, and it raises revenues to cover costs in an administratively feasible manner.
- Some local taxes approximate the benefit principle and can be levied at rates that approximately cover the costs of providing certain services. Among them are the local property tax and levies related to land value increases, as the value of local service provision is capitalized in the value of urban land. Motor vehicle taxes, which to varying degrees recoup the costs of infrastructure investment, congestion,

Haze of pollution in Beijing, 2006.

and pollution can also be justified on the grounds of the benefit principle or its corollary—the principle that "she who causes the costs, pays." Even flat-rate local income taxes can to a certain extent be justified on the grounds of the benefit principle, since high-quality local services will support the economic growth and income-generating capacity of a city. But if they are levied locally, they would best be collected in tandem with national income taxes and then remitted to the metropolitan local government.

- Local business taxes, excises, and sales taxes may also be appropriate for metropolitan governments, to the extent that they reflect the costs and benefits of business services provided by the local government. However, unless carefully designed, they may distort trade and business investment decisions, as is the case with corporate income taxation, cascading turnover taxes levied on all local sales, and taxes levied on commodities entering a city (such as the Indian *octroi,* a kind of import duty on goods entering the city, which distorts trade flows and is poorly administered). The value-added tax, while in principle an excellent tax when levied at the national level, is difficult to administer at the local level and, hence, not likely a good choice for metropolitan governments.

PRACTICE

As noted, there are no reliable, comparable data to allow a comprehensive international comparison of how metropolitan-area public services are financed (box 3, p. 20). Martinez-Vazquez (2013) uses country case studies to survey the practice in large cities (table 6). Unfortunately, the data allow only a quantification of the role of various taxes, not of user charges. For the practice of raising local taxes, there is a great variance across metropolitan areas, but as a general observation, there is little conformity between theory and practice. Martinez-Vazquez specifically points out two systemic weaknesses related to the failure of local governments to use their taxing potential. One is the limited assignment of revenue-raising powers to subnational governments, and the other is the bad design and administration of those local tax instruments that are assigned. The reasons for these weaknesses lie with political economy constraints, the frequent incompatibility of metropolitan government structure with region-wide taxation, the fact that the usual candidates—user charges and property taxes—cannot be or are not 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. In fact, transfers often act as a disincentive for local revenue mobilization by providing metropolitan politicians with a relatively easy alternative to the politically more difficult choices of raising taxes or user charges.

Despite the data limitations, we can glean useful insights from the practice of employing various sources of own-revenues in the metropolitan areas of developing countries.

TABLE 6

Distribution of Tax Revenues for Select Cities for the Most Recent Year Available (Percent)

	Barcelona (2009)	Beijing (2009)	Buenos Aires (2007)	Cape Town (2009)	Chicago (2009)	Delhi (2010)	Lima (2010)	São Paulo (2010)	Tokyo (2008)
Property Tax	64.72	8.11	8.97	31.82	39.34	88.79	58.75	38.16	18.95
Sales Tax	11.80	39.32			8.45			53.86	
Vehicle Tax	8.58	0.57	8.72				22.58		2.01
Construction Tax	2.88	3.72							
Resource Tax									
VAT Share	12.02	9.39	78.47						
State Income Tax Share					8.18				
State Sales Tax Share					9.62				
Individual Income Tax		9.29						6.56	42.36
Corporate Income Tax		22.49							23.92
Stamp Tax		1.68	3.84						
Deed Tax		5.39							
Utilities Tax				68.18	8.32	11.20			
Transportation Tax					3.98				
Advertisment Tax						0.01			
Amusement Tax					3.31				
Excise Tax					2.70		8.25		5.60
Gambling Tax							7.90		
Hotel Tax					2.03				
Gasoline Tax					6.67			1.42	
Telecommunication Tax					5.96				
Other Tax					1.03		2.52		7.15

Source: Martinez-Vazquez (2013).

USER CHARGES AND BETTERMENT LEVIES

Students 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 (Bahl and Linn 1992). The charges can be directly related to the use of a service (e.g., the consumption of water or the use of a bus) 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. Special assessments, betterment levies, and development charges may be structured to cover the cost of constructing 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; Freire 2013; Ingram, Liu, and Brandt, 2013).

There is ample evidence that user charges and benefit charges can be structured to support cost recovery, especially in the cases of transportation and public utilities. User charges have formed the backbone of financing for public enterprises that deliver urban services on an area-wide basis. But some analysts argue that metropolitan local governments have not used such charges to the extent they could have (Ingram, Liu, and Brandt 2013; Martinez-Vazquez 2013), and, when they have made use of public service pricing regimes, they often have done it badly (Bird and Slack 2013; Pethe 2013).

The primary reason for the poor experience with user charges is the politics of raising the price of necessary services and,

Public transportation in Buenos Aires, 2013.

hence, the concern that user charges are highly regressive. More likely, the resistance is from residents who use the service 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; Bird and Slack 2013). Moreover, users resist paying higher charges when services are of low quality or only intermittently provided, which is often the case in cities in developing countries.

However, as noted earlier, readily available data, even those based on case studies, do not generally allow for an accurate assessment of the role of user charges in metropolitan finances, in part because, in many cities, services that may have a charge are provided by (semi-) independent utilities whose financial reports are not captured by metropolitan government financial accounts. Bahl and Linn (1992) assembled a sample of comprehensive metropolitan finance data, which showed that once such utilities are included in the consolidated metropolitan financial accounts, user charges actually have contributed significant amounts to some cities' overall finances. According to Bahl and Linn (1992), based on a sample of some 30 cities in developing countries in the 1970s and 1980s, "self-financed" services contributed about 15 percent to total local revenues (including taxes, transfers, and borrowing), while local taxes contributed about 40 percent. However, in a number of cities, self-financed services contributed more than a third of all revenues, and in two cities even more than half. Unfortunately, no data are available on a comparable basis for more recent periods; hence, it is difficult to disprove the common view among urban finance experts that user charges contribute relatively minor amounts to metropolitan finances (Bird and Slack 2013; Martinez-Vazquez 2013). However, it would be unfortunate if, based largely on poor data, potential efforts to rely more intensively on user charges and betterment levies were discouraged, considering the widely recognized beneficial qualities of these revenue sources for funding metropolitan government.

PROPERTY TAXATION

Urban fiscal experts generally consider the property tax the most desirable of local taxes, since it has most of the characteristics of a good local government tax, including the potential to match tax burdens approximately with expenditure benefits, to cause relatively little unwanted interference with market decisions, and to avoid imposing heavy burdens on poor families. 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 and their benefits tend to be capitalized into property values, the case for financing by a property tax (and user charges) is a strong one (Bahl and Linn 1992).

Despite its long-standing appeal to the tax economist, 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 make a comparison of property tax collections among all metropolitan local governments, but a survey of 30 large metropolitan areas carried out by McCluskey and Franzsen (2013) provides some basis for inference about recent revenue performance (tables 7 and 8). Two conclusions stand out in this survey. First, most property tax revenue is collected in metropolitan areas. For example, local governments in metropolitan Manila cover 20 percent of the Philippine population, but they account for nearly half of all national property tax collections. Second, McCluskey and Franzsen (2013) find that the recent revenue performance varies widely, with some large cities showing growth, but others experiencing real per-capita declines. It is difficult to generalize about why some cities do better than others.

One explanation for the frequently weak revenue performance of the property tax is its unpopularity with voters and local political leaders. Property taxes are visible, they are often levied on a subjective, judgmental basis, and they are a tax on 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 in step with the economies in many countries (Shah 2013). This has allowed metropolitan local governments to avoid raising property tax rates or adopting 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.

Additionally, 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

TABLE 7

Importance of the Property Tax in Selected Metropolitan Cities

Metro/City	Percentage of Total City Revenue		Percentage of Local Tax Revenue	
	2005	2010	2005	2010
Belo Horizonte	No data	No data	36.1	31.2
Cape Town	22.6	20.5	33.1	41.1
Durban (eThekwini)	27.9	21.6	40.5	55.3
Hong Kong	6.9	3.78	8.77	5.10
Johannesburg	19.9	16.3	30.0	43.8
Kampala	3.2	10.7 (2008)	20.2	40.6 (2008)
Kuala Lumpur	68.4	44.9	92.0	93.0
Makati City (Metro Manila)	39.0	34.0 (2009)	47.0	41.0 (2009)
Manila (Metro)	27.0	28.0 (2009)	43.0	54.0 (2009)
Muntinlupa City (Metro Manila)	27.0	28.0 (2009)	52.0	49.0 (2009)
Quezon City (Metro Manila)	31.0	21.0 (2009)	44.0	33.0 (2009)
Pretoria (Tshwane)	20.4	19.4	28.4	42.8
Rio de Janeiro	21.8	17.5	34.5	25.0
São Paulo	27.2	24.8	35.0	31.0
Singapore	6.12	5.80	6.90	6.30

Source: McClusky and Franzsen (2013).

TABLE 8

Real Growth in Per-Capita Property Tax Revenues in Selected Metros (US$)

City	2006			2009		
	Property Tax (millions)	Population (millions)	Property Tax per Capita	Property Tax (millions)	Population (millions)	Property Tax per Capita
Belgrade	43.34	1.6	26.46	66.85	2.0	33.43
Belo Horizonte	115.91	4.0	28.98	127.14	4.2	30.27
Bengalūru	56.95	6.8	8.38	137.31	8.0	17.16
Cape Town	285.76	3.2	89.30	319.94	3.4	94.10
Dar es Salaam	2.62	3.2	0.82	3.06	3.6	0.85
Durban (eThekwini)	359.00	3.3	108.79	383.69	3.5	109.63
Johannesburg	364.13	3.7	98.41	321.52	4.0	80.38
Kampala	1.33	1.4	0.95	3.51	1.5	2.34
Kingston, Jamaica	7.28	0.66	11.03	4.12	0.68	6.06
Kuala Lumpur	174.74	6.9	25.32	178.38	7.1	25.12
Manila (Metro)	317.60	14.8	21.46	288.71	16.3	17.71
Porto Alegre	61.82	2.8	22.08	71.83	3.7	19.41
Pretoria (Tshwane)	202.62	2.2	92.10	222.62	2.4	92.76
Rio de Janeiro	430.66	10.8	39.88	395.42	12.0	32.95
São Paulo	1,087.81	17.7	61.46	997.64	18.8	53.07

Source: McClusky and Franzsen (2013).

Notes: The year 2006 was used as the base year and all local currencies were converted to U.S. dollars using the average exchange rate for 2006. The World Development Report consumer price indices (World Bank 2011) were used to determine the real growth in terms of 2006 U.S. dollars for each city. Population figures for 2006 and 2009 are rough estimates.

comprehensive coverage of parcels and to better recordkeeping (McCluskey and Franzsen 2013). But some metro cities are still tied to 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 at a rate that is well below market value. Finally, legal constraints, such as rent control in Mumbai, have held back revenue mobilization (Pethe 2013).

Governments in developing countries have not been standing still on property tax policy, and they have tried many different approaches to defining the tax base. McCluskey and Franzsen (2013) note a trend that suggests 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 an increased interest in area-based systems that levy the tax on the physical characteristics of properties rather than on the assessed value.

Local governments have also tried to reach the property value base with several other forms of taxation besides the conventional tax on the capital or rental value of urban land and improvements. 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

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Housing development in Cairo, 2008.

the administration. The property transfer tax, which is the most widely used alternative tax on property, 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 underreporting in the value of sales contracts (McCluskey and Franzsen 2013). 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 (Bahl and Linn 1992). 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 during a given period.

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 challenges they pose, particularly the tasks of setting a base value and making adjustments for inflation and investments in new improvements.

Finally, 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 (box 4). For all local governments in China, land leases accounted for about 30 percent of revenues in 2011. Land sales have great advantages, namely the revenue potential and the low political cost of raising money in this way. But, even in a unique setting like China, there are drawbacks. These include the sensitivity of land revenues to the real estate cycle, and the riskiness of land value collateral for loans; the fact that the "easy money" might tempt overspending in local government budgets; the opportunity costs of converting land to urban use might be underestimated; and the fact that government-owned land is an exhaustible resource.

More generally, it is not apparent that taxes on urban real estate will be the mainstay of metropolitan governments in the years and decades to come, which is

BOX 4

Off-Budget Land Revenues at the Heart of China's Urban Finances

China's urban population grew threefold over the last thirty years, with 480 million people added to China's cities during this period. Between 2000 and 2010, Shanghai's population grew by 44 percent, from 16 million to 23 million. Remarkably, this rapid population growth did not result in huge slum populations and great infrastructure deficits for two reasons. First, China maintained a tight lid on urban in-migrants, who were not allowed to settle permanently or bring their families. Second, municipal governments rapidly expanded urban infrastructure and, to a lesser degree, urban service provision. They did this by relying largely on extrabudgetary financing, much of it from land-based revenues and high levels of borrowing using land and land revenues as collateral.

Municipal governments in China have big responsibilities: they are in charge of all urban infrastructure, as well as provision of basic education, healthcare, and social protection (pension, unemployment benefits, and social welfare). However, since the fiscal reforms in 1994, local governments have little formal revenue authority, as most of the buoyant revenue sources are controlled by higher-level government, and there are few intergovernmental transfers. Urban local governments responded to this large fiscal gap by developing significant off-budget revenue sources. Most importantly, they used their monopoly over the transfer of land from rural to urban use to extract a large fraction of the land value increment for financing the development of urban infrastructure. This was facilitated by the creation of "Local Investment Corporations" (LICs), extrabudgetary entities that were assigned local land revenues, upon which they were authorized to borrow from banks to fund urban infrastructure investments. In 2010, land-based revenues in prefectural cities of China contributed an estimated 35 percent of all local revenues; in Shanghai, 35 percent of all revenues collected between 2006 and 2010 were based on land-related sources, which contributed to over 50 percent of total revenue growth during this period.

While this financing method enabled urban governments to respond vigorously to the rapid population growth, this approach to urban finance is not sustainable for two reasons. First, the scope of land transfer revenues is constrained by the rate of urban expansion and by a growing opposition from the rural population that finds itself on the losing side of the urban growth process. Second, with their uncontrolled borrowing through off-budget vehicles, urban governments have built up huge debts—exactly how much is unclear, but estimates range from 120 percent to 355 percent of local revenues (or 13–36 percent of GDP). This unsustainable trend in local government indebtedness has now caught the attention of the national authorities, who recognize not only that more control over local borrowing is required, but also that fundamental reform or urban finance needs to be pursued.

Source: Wong (2013).

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Traffic congestion in Beijing, 2008.

unfortunate from the perspective of effective metropolitan revenue mobilization.

NONPROPERTY TAXES

The expenditure assignments of metropolitan local governments are too broad to cover financing needs with property taxes and user charges alone. Other broad-based taxes will be necessary if revenue self-sufficiency is to be enhanced (Bahl and Linn 1992; Bird and Slack 2013; Martinez-Vazquez 2013). As noted, one might also argue that, structured correctly, such alternative taxes could approximately pass the benefits test; a local sales, excise, or income tax could also be viewed as a benefit levy on people living, shopping, or working in the city.

Though several types of nonproperty taxes can meet the revenue test and satisfy efficiency norms to a reasonable extent, these options are not widely used in low-income countries. This said, it should be noted that some metropolitan local governments in developing countries have adopted broad-based taxes (Martinez-Vazquez 2013; table 6, p. 27). The assignment of sales and payroll taxes has been easier where metropolitan local governments have provincial status. In China, the local business tax accounts for one-third of city and provincial revenues (Wong 2013), 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, even where used to a significant extent, 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 according to place of work with no recognition of commuting patterns. Metropolitan Mumbai still relies heavily on revenues from the *octroi*, which distorts trade flows and is poorly administered (Pethe 2013).

Motor vehicles are an attractive target for financing metropolitan services but are generally underutilized (Bahl and Linn 1992; Bird and Slack 2013). 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

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Tricycles as transport at Quinta Market, Quiapo, Manila, 2013.

amounts of revenues, higher motor vehicle taxes might lead to 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's, which has 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 for motor fuel taxes. For governments that have a region-wide jurisdiction boundary, or for regional taxing districts, this tax-shopping problem would largely disappear.

REFORM OPTIONS

Allowing local governments to collect user charges and local taxes at rates that cover the cost of local services is an efficient strategy and reduces the claims of large cities on the national budget. 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 the recapture of land value benefits resulting from public infrastructure investment, to the removal of subsidy elements in the present system of user charges, to user charges levied at cost recovery levels (Freire 2013; Ingram, Liu, and Brandt 2013; Smolka 2013).

The property tax has not played the dominant role in big city finances that many had hoped for. But the reformers have not given up, and sizeable investments continue to make the tax more productive and fairer. The 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, as described by McCluskey and Franzsen (2013).

Valuation remains the 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—which might be obtained through a properly 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 treatment can lead to a significant increase in revenue productivity and can improve horizontal equity. The potential returns from such actions are great, but they require taking on some powerful special interests. 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 area-wide 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.

If user charges and property taxes do not suffice (and, experience tells us, they usually do not), there are instruments of nonproperty taxation that can support a significant revenue increase. One is to finance a greater share of expenditures assigned to metropolitan governments with region-wide taxes on sales, income, or motor vehicles. There is an especially strong case for metropolitan-area taxation of automobile ownership and use, including motor fuel taxation. The technical difficulty to overcome is to find a way to assess the tax on a destination basis, either by taxing fuel at the pump or by requiring distributors to keep records.

If the metropolitan government structure is fragmented, the direct levy of a broad-based tax may not be feasible. In this case, there is the option to make use of a regional taxing district, and then to 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.

But reality on the ground also tells us that own-revenue sources of any kind are not likely to meet all the expenditure needs of metropolitan areas for various reasons, ranging from better to worse: spillovers and externalities argue for higher-level government funding of some services (e.g., for education, healthcare, and slum improvement); capital outlays for large infrastructure investments cannot be covered by recurrent revenues; weak local administrative capacity or unwillingness of local politicians limits the ability of metropolitan governments to raise revenues effectively; or higher-level governments want to control metropolitan spending. Thus, external revenues (financial resources not raised locally) are an important part of the revenue mix.

CHAPTER 4
External Sources of Financing

The amounts spent for local 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 external sources including intergovernmental transfers, borrowing, public-private partnerships, and international aid.

THEORY

Most policy analysts see an important role for intergovernmental transfers 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 (Shah 2013).

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. Therefore, grants will likely play a significant role in metropolitan finances in developing countries (Shah 2013).

However, there is a good case for the transfer system to be asymmetric in terms of how metropolitan local governments are treated compared to all other local governments. The stronger economic base of metropolitan local governments (and, hence, the higher local revenue-mobilization capacity) suggests that local governments will require fewer transfers than other jurisdictions and that they will not receive equalization grants. But, on the other hand, rapid and sustained metropolitan growth also

Health clinic for the Niger community funded by U.S. European and U.S. African Command, 2008.

generates needs and expectations for rapid expansion and improvements in physical and social infrastructure services, making revenue needs potentially greater than elsewhere (Bird and Slack 2013). Another asymmetry will stem from the different choices made about governance in metropolitan areas. For example, other things being equal, a fragmented local government structure will require more financing from transfers (or through vertical programs) than an area-wide structure because of the need to accommodate externalities and disparities, and because the possibilities for regional taxation will be more limited (Bahl 2013; Shah 2013). In cases where metro areas combine state/provincial and local government responsibility, as is often the case for capital cities, they are often also entitled to a larger transfer share.

Borrowing is another source of finance for infrastructure, but ultimately the loan must be repaid. However, it 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 students of metropolitan finances have argued (Prud'homme 1995; Tanzi 1996). The local revenue-raising capacity and, hence, the 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, which leads to overborrowing. 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 (Pethe 2013).

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

Metropolitan governments need to be especially careful in taking on debt denominated in foreign currency, since this will expose them to exchange-rate risk. Since urban governments do not earn revenues in foreign currency, they do not have a natural hedge and so will either seek to hedge the exchange risk through special provisions, which tend to raise the cost of borrowing, or desist from foreign borrowing altogether.

During the 1990s, public-private partnerships came to be seen by experts as a preferred financing instrument for infrastructure development, especially in larger cities. Presumed benefits included substantial new financing flows into urban infrastructure together with a reduced financial burden on national and metropolitan budgets; improved investment decision making; and more effective construction, operation, and maintenance of capital assets and cost recovery. Many options of structuring PPPs were developed, but all involved some sharing of financial responsibility and risk between private investor, operator, and public authority, with the aim generally to have the private actor assume commercial risk, while the public sector took on policy and political risk.

International development assistance provides support in filling domestic resource gaps for urban investments. The need and opportunities for external support for metropolitan areas in developing countries has long been recognized and was reaffirmed in the establishment of a specific target as part of the U.N. Millennium Development Goals (Keare 2013). Moreover, many aid agencies have been involved in providing financial support for urban development, especially for slum improvement. Kharas and Linn (2013) review the urban development strategies of a handful of the most important aid organizations and find that these entities provide a sound analysis of the urban development challenge, reflect accurate assessments of the financial and management weakness of urban governments, and highlight the need for additional aid resources for urban improvements.

PRACTICE

Practice varies widely across countries and cities for external sources of metropolitan finance, as shown to be the case for own-source finances. In general, practice deviates widely from theory. The remainder of this chapter will review the prevailing range of practices for each of the principal external sources of finance and present some overarching recommendations.

INTERGOVERNMENTAL TRANSFERS

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-sources. The same is true for the metropolitan areas in South Africa. But, in most large urban areas, there appears to be a much greater dependence on intergovernmental transfers (Shah 2013). 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. The metropolitan areas in many developing countries are the places where much of the national revenue is raised. By keeping metropolitan-area local governments more dependent on transfers (versus 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 governments 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. At the same time, elected subnational government officials are not anxious for more power to impose politically unpopular taxes, and often would rather try their hand at lobbying 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, as noted, the structure of broad-based taxes that most subnational governments levy often leads to distortions in economic decisions.

Many countries provide for the same treatment regarding transfers for local governments in metropolitan areas as for other

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Village of Manamathy, Tamil Nadu, India, 2009.

local governments (Shah 2013). The large urban governments may get less on a per-capita basis, as is the case in South Africa, but all local governments are covered under the same transfer regime. In some countries, there is an asymmetric treatment, but this is usually due to special governance structure arrangements, such as provincial-level cities or national capital districts (box 2, p. 16). 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. Transfers of this kind have been used in São Paulo (Wetzel 2013) and in India (Pethe 2013). South Africa makes use of a more formal municipal infrastructure grant, designed primarily to improve services in poor neighborhoods; 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.

Finally, some countries, often with the assistance of external aid organizations, have developed special agencies, known as municipal development funds, to support the development of local government capacity in urban areas. They have used these agencies to channel grants (or loans) to local governments to support capacity building and infrastructure investments. Annez, Huet, and Peterson (2008) note that municipal development funds have been successfully deployed in the Indian state of Tamil Nadu, in Senegal, and elsewhere in South Asia and sub-Saharan Africa. They note that grant-based municipal development funds often involve the use of performance targets or contractual obligations for the local authorities, but that these work only where higher-level governments are ready to punish nonperformance by cutting off the grants.

BORROWING

The practice of borrowing by metropolitan local governments and the success with debt finance varies 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. They could not borrow but created a backdoor route with special-purpose urban investment companies that borrowed on behalf of the municipal government. These were supported by a revenue base that was pledged by the municipal government (Wong 2013). Municipal bonds are used in Colombia, Mexico, Brazil, South Africa, India, and the Philippines (Ingram, Liu, and Brandt 2013; Martell and Guess 2006). Overborrowing has occurred in various cities and has led to some form of bailout in metropolitan cities such as Buenos Aires, São Paulo, and Johannesburg, and more recently in China (Wong 2013). Many countries attempt to control for overborrowing with various forms of fiscal responsibility legislation, though these programs have met with varying degrees of success (Liu and Webb 2011).

Municipal development funds have been used in some middle-income countries to help develop the institutional conditions for local government loan facilities and to assist local urban governments to develop the capacity and propensity to access loan financing, often with external assistance (Annez, Huet, and Peterson 2008; Kharas and Linn 2013). One of the more successful cases is FINDETER in Colombia, which was set up in the early 1990s with World Bank and Inter-American Bank assistance to rediscount long-term commercial credits

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Construction in Buenos Aires, 2009.

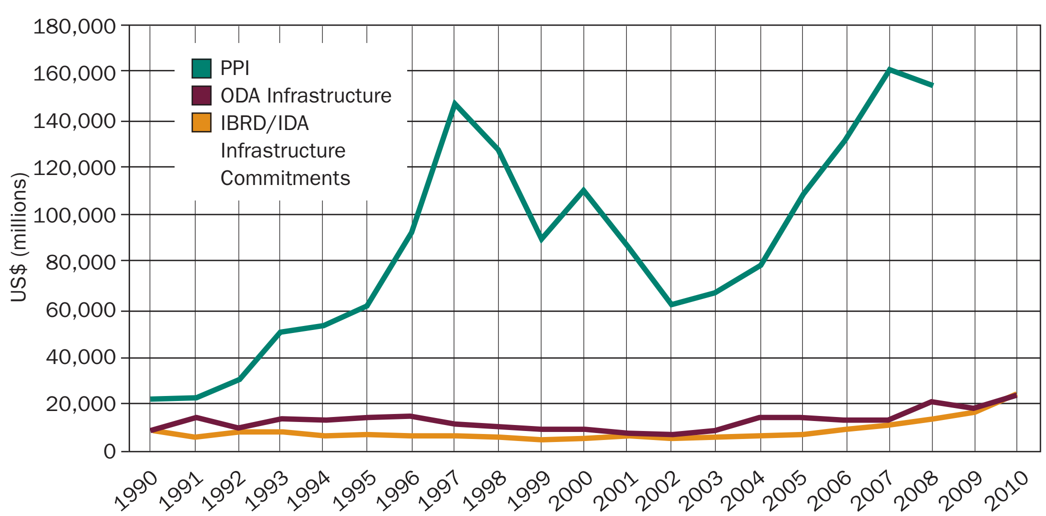
to municipalities. Over time, FINDETER developed into a successfully functioning financial intermediary, supported by local credit rating institutions and improved cadastral services. This led to greater local-government revenue collection and credit worthiness, effective access by municipalities to long-term credit, and ultimately improved urban services (Kharas and Linn 2013).

PUBLIC-PRIVATE PARTNERSHIPS

According to OECD and World Bank data surveyed by Ingram, Liu, and Brandt (2013), PPP financing rapidly expanded in the 1990s and exceeded external, official assistance by nearly ten-fold (figure 3). The largest share of PPP investment in infrastructure has gone into telecommunications, followed by energy. Together, these two sectors accounted for almost four-fifths of total PPP investments from 1990 to 2008. Less than one fifth went to transportation, and only about 5 percent into water and sanitation. Ingram, Liu, and Brandt attribute this differentiation across sectors principally to the difference in the ability to collect commercially viable user charges in the former two sectors as compared with the latter two. However, except for the telecom sector, PPP investments have often bypassed low-income countries. It is, therefore, not surprising that PPPs have added relatively little to urban capital financing in developing countries in the last two decades (Alm 2010; Annez 2007). However, there have been cases in which PPP investments have exceeded external official aid flows even for water and sanitation, and highly visible projects have been financed with PPPs in selected metropolitan areas of developing countries, including urban rail projects in Bangkok, Kuala Lumpur, and Manila (Ingram, Liu, and Brandt 2013).

Annez (2007) and Ingram, Liu, and Brandt (2013) argue that the inherent riskiness of urban investments is the main constraint

FIGURE 3
PPI Trends for Developing Countries, 1990–2008



Source: Ingram, Liu, and Brandt (2013).

Abbreviations: ODA (Official Development Assistance); IBRD/IDA (International Bank for Reconstruction and Development/ International Development Association [World Bank]).

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Bangkok traffic, 2012.

to increasing the flow of private capital. There is a weak record of full-cost recovery, and often local governments are unwilling to stand behind the kinds of tariff levels and regulatory arrangements that would be necessary to attract private investors, especially for longer-term contracts. Pethe describes the failure to use PPP arrangements in Mumbai as being due to a "trust deficit" between the public and private sectors (2013, 259). There also is a weak institutional capacity for dealing with PPPs.

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. 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 Expert Committee for Urban Infrastructure 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" (2011, 101).

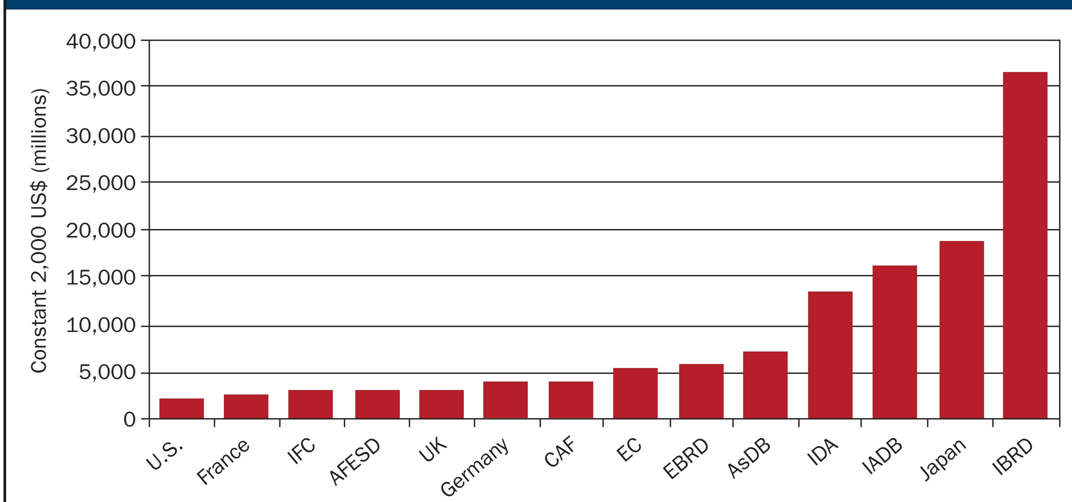
INTERNATIONAL AID

Many donors are involved in providing aid. The World Bank is by far the largest, followed by Japan, and then by the regional development banks (figure 4, p. 44). But, in recent decades, the flow of aid to urban areas has been stagnant and undersized relative to urban investment needs, despite frequent calls for greater support by urban experts in and out of aid agencies (figure 5, p. 45). Aid in urban areas has often been confined to single functions, such as roads or sanitation, without addressing broader, cross-cutting issues of management that might strengthen the sustainability of the interventions that do exist. Africa's urban investment needs, in particular, have been neglected by donors. More generally, implementation of the donors' urban strategies has fallen far short of the stated goals.

This underprovision of urban aid occurred despite the fact that evaluations show that such investments on average tend to be more successful in terms of their development impact than aid to other sectors. Matters have been made worse because the engagement of donors at the country and city levels has generally lacked a long-term strategic perspective and, hence, has been one-off, fragmented, and uncoordinated, rather than systematically sequenced and scaled up for successful interventions.

A key constraint to the sustainability and scaling up of donor-supported programs has been the lack of local financing capacity to maintain and build on the aid-financed initiative, once donor support ceases. This can be traced to either the donors' lack of focus on the fiscal capacity of urban governments or, where donors did focus on this important dimension, their lack of impact on 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 the local governments' resources. And while there have been some examples in which donors systematically tried to help strengthen the borrowing capacity and the institutional and policy frameworks 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 as compared to other urban areas (Pethe 2013). This is in part because many donors are obliged to work with national government-level entities, and in part because metropolitan areas are often not formal levels of government, in contrast to state or municipal authorities.

FIGURE 4
Urban Aid Commitments by Donor, 1995–2008

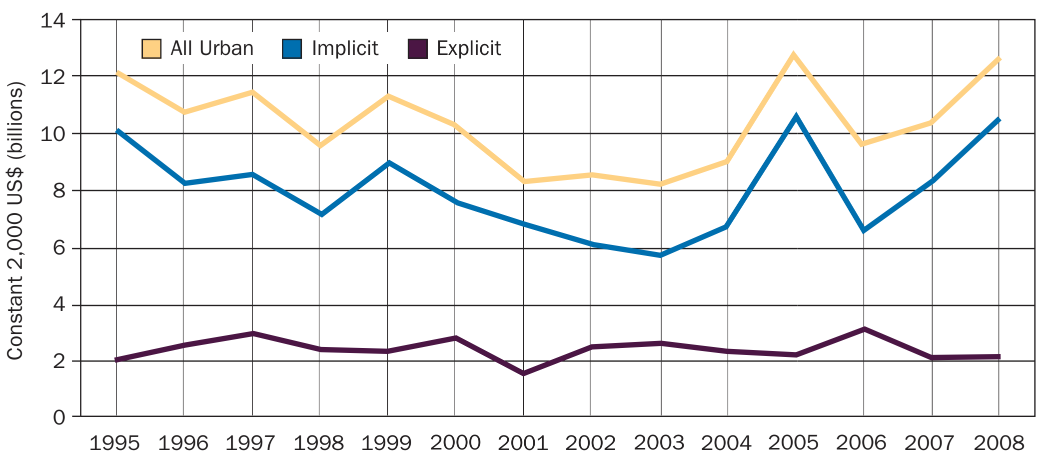


Sources: Kharas and Linn (2013); data from AidData (2011).

Abbreviations: AFESD (Arab Fund for Economic and Social Development); AsDB (Asian Development Bank); CAF (Caja Andino de Formento); EBRD (European Bank for Reconstruction and Development); EC (European Commission); IADB (Inter-American Development Bank); IBRD (International Bank for Reconstruction and Development [World Bank]); IDA (International Development Association [World Bank]); IFC (International Finance Corporation).

FIGURE 5

Urban Aid Commitments as Percentage of Total Aid, 1995–2008



Sources: Kharas and Linn (2013); data from AidData (2011).

Note: "Explicit" aid refers to commitments specifically tagged as "urban" in the OECD-DAC data base; "implicit" aid refers to commitments not specifically so tagged, but for which project descriptions allow identification as aid for urban areas.

REFORM OPTIONS

Reforming Transfers

It is not uncommon for developing countries to restructure their intergovernmental transfer systems. But rarely do the reforms coincide with developing a metropolitan public financing strategy. If they did, the strategy for restructuring transfer regimes for big cities might include three reform components.

The first would focus on gradually weaning the metropolitan local governments from transfers while at the same time ensuring that they have sufficient authority to tax and impose user charges. A hard budget constraint with no "back door" for financing deficits from grants by higher-level government 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 should 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 would 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 richer to poorer local governments within the metropolitan area, and with earmarked grants, such as for slum improvement programs.

A third option is to link institutional capacity building with grant making by

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Railway track running through Kibera slum in Nairobi, 2012.

setting up a municipal development fund. Such funds would provide grants for infrastructure investment but would also support the design and implementation of projects; the development of revenue-mobilization capacity, as well as improvements in operations and maintenance of urban services; and the strengthening of staff and managerial capacity for urban planning, regulation, and financial management. The type of financial support could be gradually shifted from grants to loans as local governments' fiscal capacity improves, or they could be structured asymmetrically, by providing grants to smaller municipalities, while offering loans to metropolitan governments with relatively strong revenue bases.

Reforming Debt Finance

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 be a substitute for repayment capacity of the local government.
- Limit debt finance to capital projects with long lives. Ensure that any exchange rate risk is hedged, either by commercial hedges or by the central government assuming the exchange rate risk.
- 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.

Reforming PPPs

While by no means the silver bullet that early proponents have hoped for, PPPs have made a contribution to financing infrastructure in metropolitan areas, especially in middle-income countries. However, reform is needed in five areas to address the prevailing impediments and constraints (Ingram, Liu, and Brandt 2013):

- The legal framework in the country must be supportive and allow for an arbitration process that puts public and private partners on an equal and predictable footing.
- Cities need to build up—and be supported in building up—the capacity to deal with complex PPP investment design issues and negotiations. This is an area in which higher-level authorities and external aid agencies can be helpful, including through municipal development funds.
- PPP projects need to be carefully planned and provide transparent rules and documents for the participants.
- Improvements in the national and local business climates are critical, since they are important signals to potential PPP investors that they will be treated fairly and predictably.
- PPPs will be more difficult to organize and implement in a fragmented metropolitan governance environment, vertical and/or horizontal. Therefore, it will be important that metropolitan-wide regional planning, negotiation, and implementation authority be established for major PPP projects.

Reforming Aid

A number of changes in donor approaches to metropolitan finance would be beneficial. First, aid donors need to go beyond broad statements of strategy and focus more systematically on the financing and institutional capacity needs of urban governments. Second, 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 (e.g., credits in middle-income countries, and grants in low-income countries) (Annez et al. 2008; Kharas and Linn 2013).

Third, donors could also do better in forming partnerships with each other and pooling their resources for comprehensive and longer-term 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 create and implement longer-term metropolitan development strategies. In doing so, special attention should be paid to urban finance. Donors need to support the development of local revenue mobilization and management capacity, intergovernmental transfer schemes, and debt-management frameworks.

CHAPTER 5

Conclusions and Recommendations

The prevailing theory of metropolitan governance and finance provides useful guidelines for public policy, but it does not provide many firm rules about the best way to govern and finance. Rather, it frames policy choices in terms of a set of trade-offs that imply important costs and benefits. Among these trade-offs are: centralization or decentralization vertically; consolidation or fragmentation horizontally; revenue effectiveness, efficiency, or equity in local revenue generation; central control through categorical grants or local control through generalized transfers; and strict limits on local borrowing or freedom to access credit markets.

Nonetheless, some overall conclusions and directions emerge from metropolitan management and finance over recent decades. Two overarching issues stand out when surveying the practice: first, assessments are based on collections of case studies, because there is a lack of comprehensive and representative data. Second, within the accumulated case evidence of some 50 cities, practice often deviates widely from theory, and there is a tremendous variation of practice across countries. The first finding should not come as a surprise in view of the conflicts between theory and political economy, and the many trade-offs that have been identified. The second finding underlines the need for a much stronger national and international effort in data collection. Both findings suggest using caution in drawing conclusions across countries and cities, and in making recommendations based on "best practice."

Central downtown Astana, Kazakhstan, 2011.

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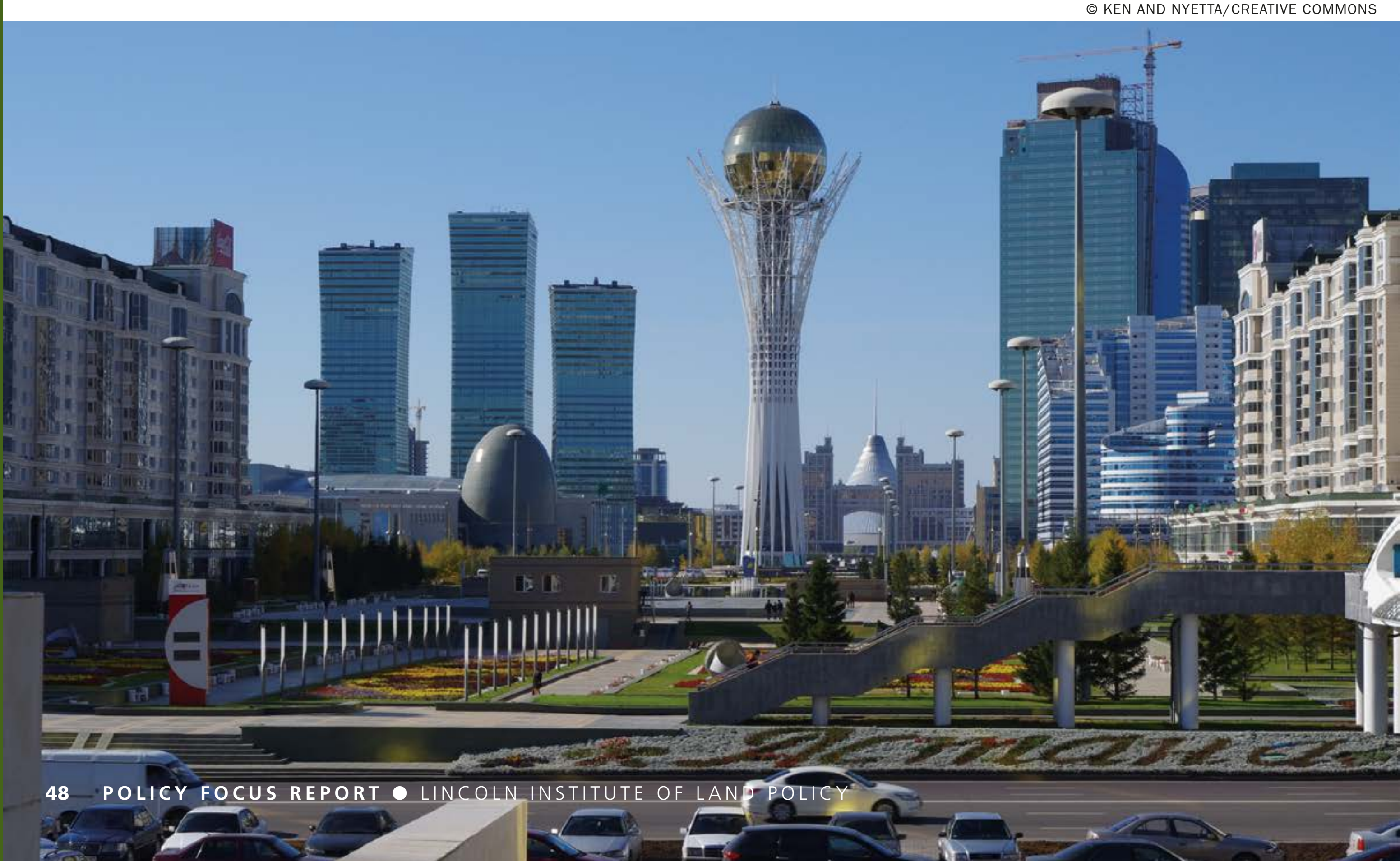


However, some broad conclusions may be drawn from the prevailing practice:

- *Industrial countries and developing countries have different patterns.* While allowing for significant outliers, developing countries overall tend to be more centralized; their metropolitan areas tend to be more fragmented; their cities are less self-financing and, hence, more reliant on grants; they borrow less and have fewer PPPs; and they rely more on external aid financing, especially in the poorest countries. There does not appear to be a significant movement away from these distinctions.
- *There are few lasting, overall success stories of metropolitan governance and finance in developing countries*. Hong Kong and Singapore have had tremendous and sustained success, but they are special cases due in part to their status as city-states. Bogotá and Shanghai have also become successful cities in recent decades, but they also demonstrate how ephemeral success can be, as significant problems now confront both cities due to changes in city management (Bogotá) or a buildup of legacy issues, including congestion and pollution (Shanghai).
- *Too few central governments have clear strategies for supporting the development of the metropolitan area(s) in their countries*. With few exceptions (e.g., cases of the development of new capital cities, such as Astana, Kazakhstan), national-level authorities do not focus on developing visions and strategies for their metropolitan areas; rather, they deal with them in an undifferentiated manner from other local or regional jurisdictions. They do not coordinate across functional ministries that are involved in metro-area services, regulation, and taxation, and they rarely see their function as one of supporting—rather than controlling—the local authorities in their difficult task of managing the complex and challenging metropolitan dynamics.
- *Political economy is at the heart of the metropolitan finance problems in both developing and industrial countries*. Entrenched interests preserve the status quo; short-term time horizons and misaligned incentives result in putting off difficult decisions; and corruption in and around government undermines effective public service provision and financing. As a result, central governments do not want to give up control and create political competition at the metropolitan level; metropolitan managers do not want to introduce unpopular but essential local revenue measures; competition among submetropolitan jurisdictions prevents effective coordination; and local managers are not held accountable for managing effectively the limited functions they have.
- *Some innovative financing and management practices have emerged*. These include the use of information and communcations technology (ICT) and geographic information systems (GIS) in land use planning and property taxation; land value capture; metropolitan bond issues; municipal development funds for channeling grant and loan finance together with capacity-building assistance; and PPPs in infrastructure finance and alliances in slum improvement.

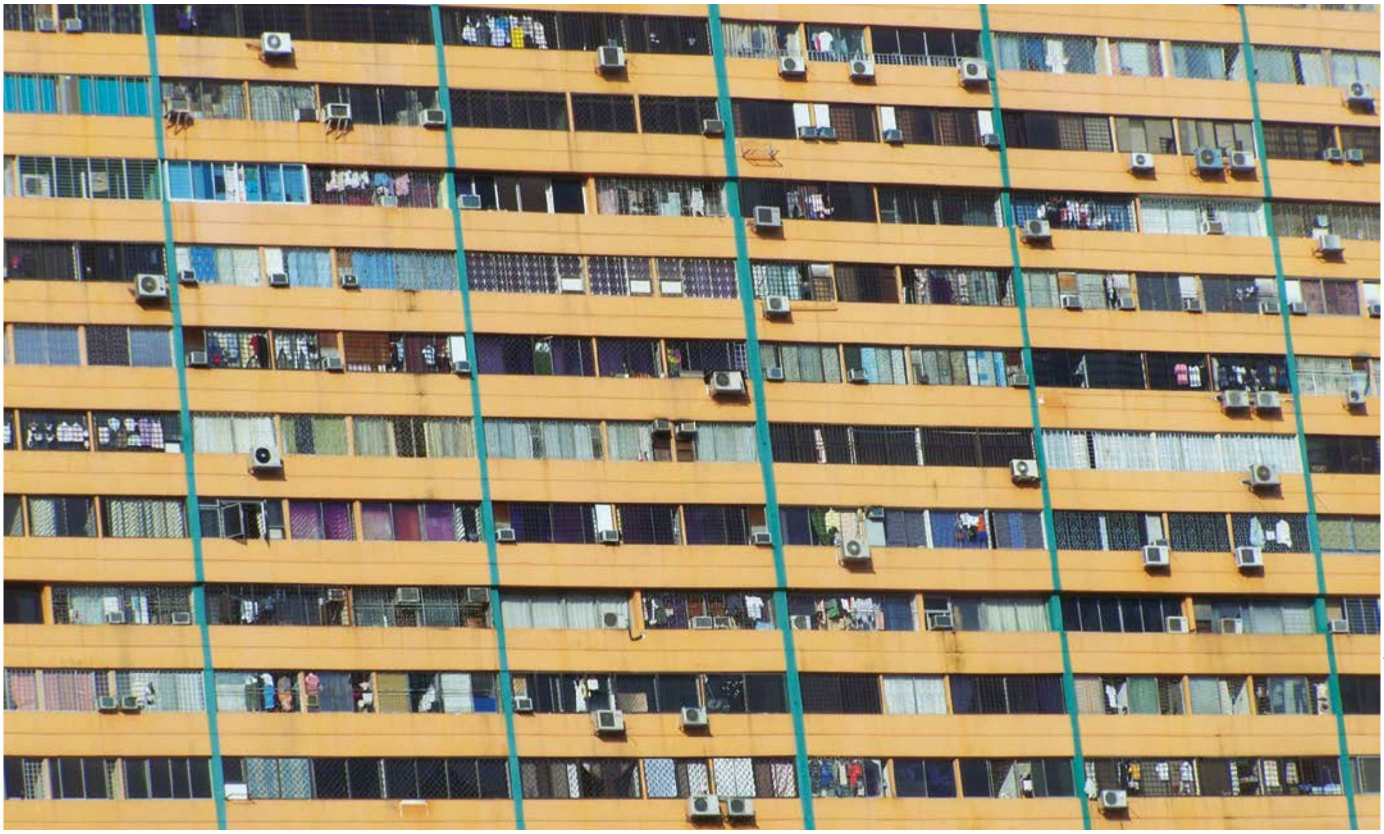
Clearly there are no blueprints, silver bullets, or universal solutions for metropolitan governance and finance reform. Each country and each city has to find its own way.

However, some recommendations can guide national and local authorities, as well as external donors and advisors:

- *Take a long view.* Prevailing national, regional, and local institutions in a country are deeply entrenched. Quick and simple fixes will seldom work and almost never stick. Fundamental and lasting change will take time, perseverance, and the courage to make hard political choices.

- *Understand the history, institutions, and political economy of each country and city*. While solutions to metropolitan governance and finance problems may work in one country and city, they won't necessarily do so elsewhere, unless they are adapted to the specifics of local history, institutions, and political interest.
- *Develop a comprehensive perspective of the governance and fiscal conditions in each country and city.* Even if interventions ultimately are kept relatively narrow and selective (e.g., reform of a particular tax or grant instrument), it is critical that they are seen in the broader institutional context of the country; without an understanding of the context, unexpected constraints or unintended consequences may undermine the effectiveness of the interventions.
- *Allow for the great differences in capacity between low- and middle-income developing countries and their cities, but do not underestimate the institutional capacity of metropolitan areas even in low-income countries.* There is no doubt that metropolitan governments in middle-income countries generally are better equipped to manage complex reform initiatives than are low-income countries, and reforms will necessarily have to reflect the different levels of capacity. However, even in low-income countries, metropolitan areas attract highly skilled people who, with the right support and capacity building, and with effective authority and accountability, should be able to pursue effective metropolitan governance and finance reforms.
- *Get the central government to focus on metropolitan governance and finance.* Even in the rare cases where metropolitan-level authorities have substantial freedom, national government actions will have important impacts on metro areas, and effective oversight will be required.
- *Pay attention to effective governance (to function, finance, and functionaries) and to the triad of autonomy, accountability, and capacity, in the right sequence.* Allocation of financial resources should follow allocation of functional responsibility, which depends on the vertical and horizontal governance structure that is put in place. Effective management and staffing must be pursued for metropolitan authorities to function well. Functionaries must have adequate autonomy to do their jobs well, but they also have to be held accountable for the results and be given the skills and institutional capacity to function effectively.
- *Put in place the right financial instruments.* Again, there is no easy transfer of an instrument from one place to another. However, some innovative fiscal institutions and arrangements are worth exploring, including those mentioned previously: property taxation in general and land value capture specifically, drawing on ICT and GIS; competitive, output-based grants; well-regulated loan finance for infrastructure capital investments; public-private partnerships and multistakeholder alliances; and municipal development funds.
- *Aid donors must pay attention to and invest in metropolitan areas, apply the lessons learned from collective experience, systematically share this knowledge, and help evaluate and scale up what works.* Aid donors must finally recognize that metropolitan areas are the most dynamic part of an economy and provide targeted and appropriately tailored assistance.

If these recommendations were followed, what might the future metropolitan areas look like in terms of the prevailing governance and financing patterns? Broadly



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Crowded homes in Chinatown, Singapore, 2007.

speaking, the typical metro area in the mid-twenty-first century would have the following four key characteristics:

- Authority would be decentralized and governance consolidated at the metropolitan level, with metropolitan governments exercising a great deal of control over function, finance, and functionaries in a way that aligns autonomy, accountability, and capacity.
- Metropolitan areas would be largely self-financing, relying on a combination of well-designed and well-administered property taxes, nonproperty taxes, and user charges to ensure that urban citizens pay for the costs the city incurs on their behalf.
- Metros would finance their large capital investment needs by well-regulated borrowing or rely on public-private partnerships to bring finance and management discipline.
- Metros would rely on grants only to a limited extent; these would be performance-based, competitive, and asymmetrical with nonmetropolitan areas.

Building and sustaining metropolitan economic competitiveness and providing adequate services will be as essential as it is difficult, given the existing backlogs in public services and the expected high rate of urbanization in the developing world. After decades of neglect, due in large part to the lack of effective political pressure on national, provincial, and local authorities, the stars may now align in favor of a metropolitan strategy for many cities in the developing world. With the increase in urban population, the metropolitan area constituency is growing in political power and may be, more than ever, in a position to sway votes. Moreover, the opportunities and the challenges of metropolitan cities are likely to become great and evident enough to force themselves onto the policy agenda of the governments around the world.

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Governing and Financing Cities in the Developing World

The economic activity that drives growth in developing countries is heavily concentrated in urban areas. Big cities generate the most dynamic economic development, the strongest links to the global economy, and the resources to help poorer countries become more competitive and prosperous. However, the same advantages that drive investment and growth in these areas also draw migrants who need jobs and housing, lead to demands for better infrastructure and social services, and result in increased congestion, environmental damage, and social problems. Governments in developing countries face two key challenges: how to capture a share of the economic growth to finance the needed expenditures, and how to manage cities so that the urban economy functions efficiently, services are delivered cost-effectively to all, and citizens have a voice in governing the city.

This report identifies the critical issues and describes current practice, the gap between practice and theory, and potential reform paths. Two core issues are explored: how to manage complex vertical and horizontal urban governance structures, and how to raise the finances to promote efficient, equitable, and sustainable metropolitan growth. The report explores local revenue instruments, with a focus on property-based local taxes and user charges, as well as external revenue sources such as intergovernmental transfers, borrowing, public-private partnerships, and international assistance.

In the 50-plus metropolitan cities considered here, practice often deviates widely from theory and varies greatly across cities. Therefore, it is impossible to make sweeping recommendations for all countries and cities.

Three general conclusions may be drawn:

- **Metropolitan-wide plans for service delivery and financing** should be an essential part of national fiscal planning, even if this approach results in some loss of home rule at the lowest levels of metropolitan government.
- **Metropolitan local governments need more discretion** over their budgets, service delivery, and financing decisions.
- **Many developing countries need to adopt asymmetric systems** of intergovernmental fiscal relations, in which the metropolitan areas are given differential powers and responsibilities relative to other subnational jurisdictions.

Some recommendations can guide national and local authorities, as well as external donors and advisors:

- **Take a long view.** Change will take time, perseverance, and courage to make hard political choices.
- **Understand the history, institutions, and political economy** of each country and city.
- **Develop a comprehensive perspective** of the governance and fiscal conditions in each country and city.
- **Allow for the great differences in capacity** between low- and middle-income developing countries and their cities, but do not underestimate the institutional capacity of metropolitan areas in low-income countries.
- **Encourage the central government** to focus on metropolitan governance and finance.
- **Pay attention to effective governance** (to function, finance, and functionaries) and to the triad of autonomy, accountability, and capacity, in the right sequence.
- **Put in place the right financial instruments.**
- **Influence aid donors** to pay attention to, and invest in, metropolitan areas.

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