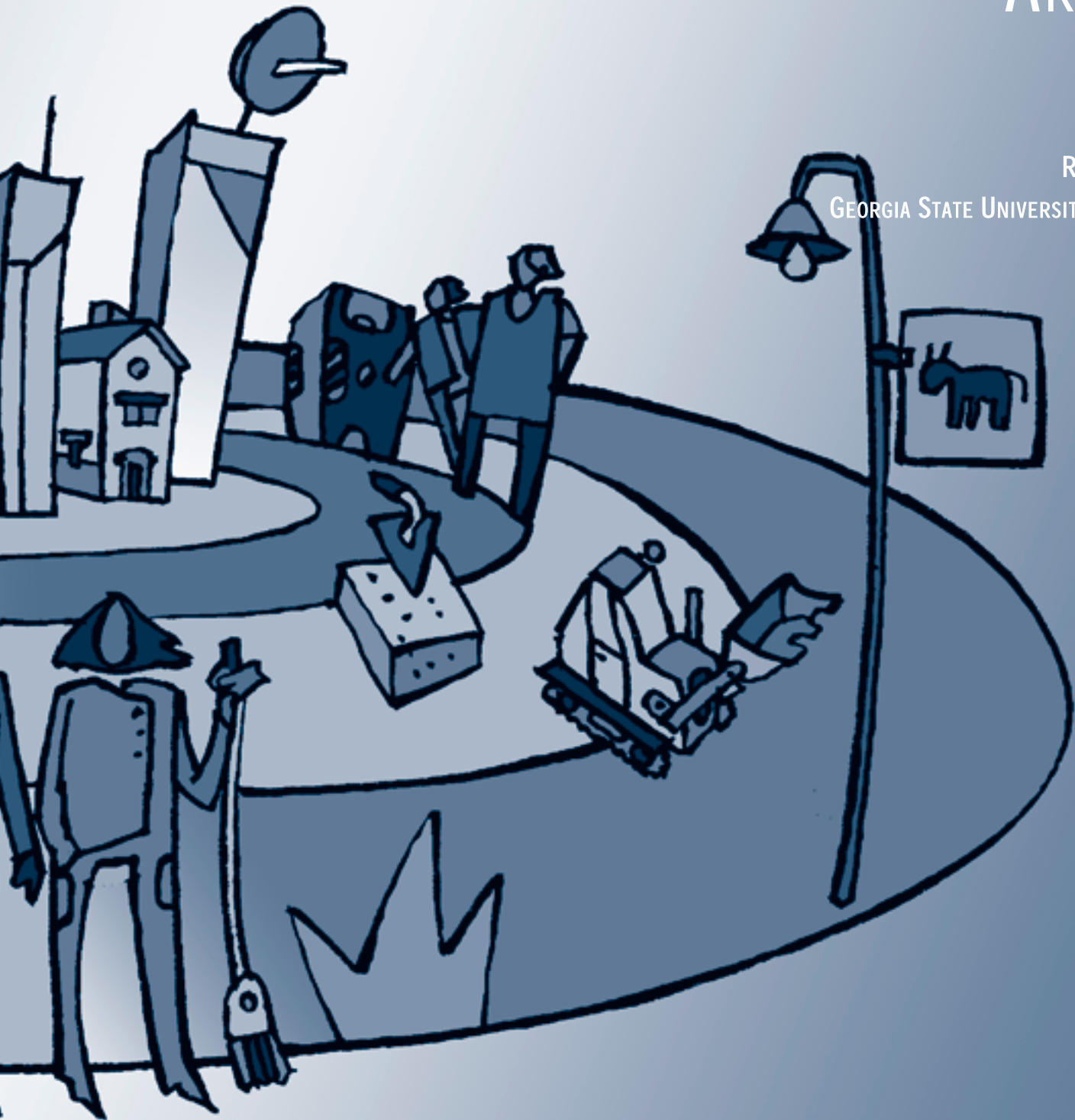


9. FINANCING METROPOLITAN AREAS

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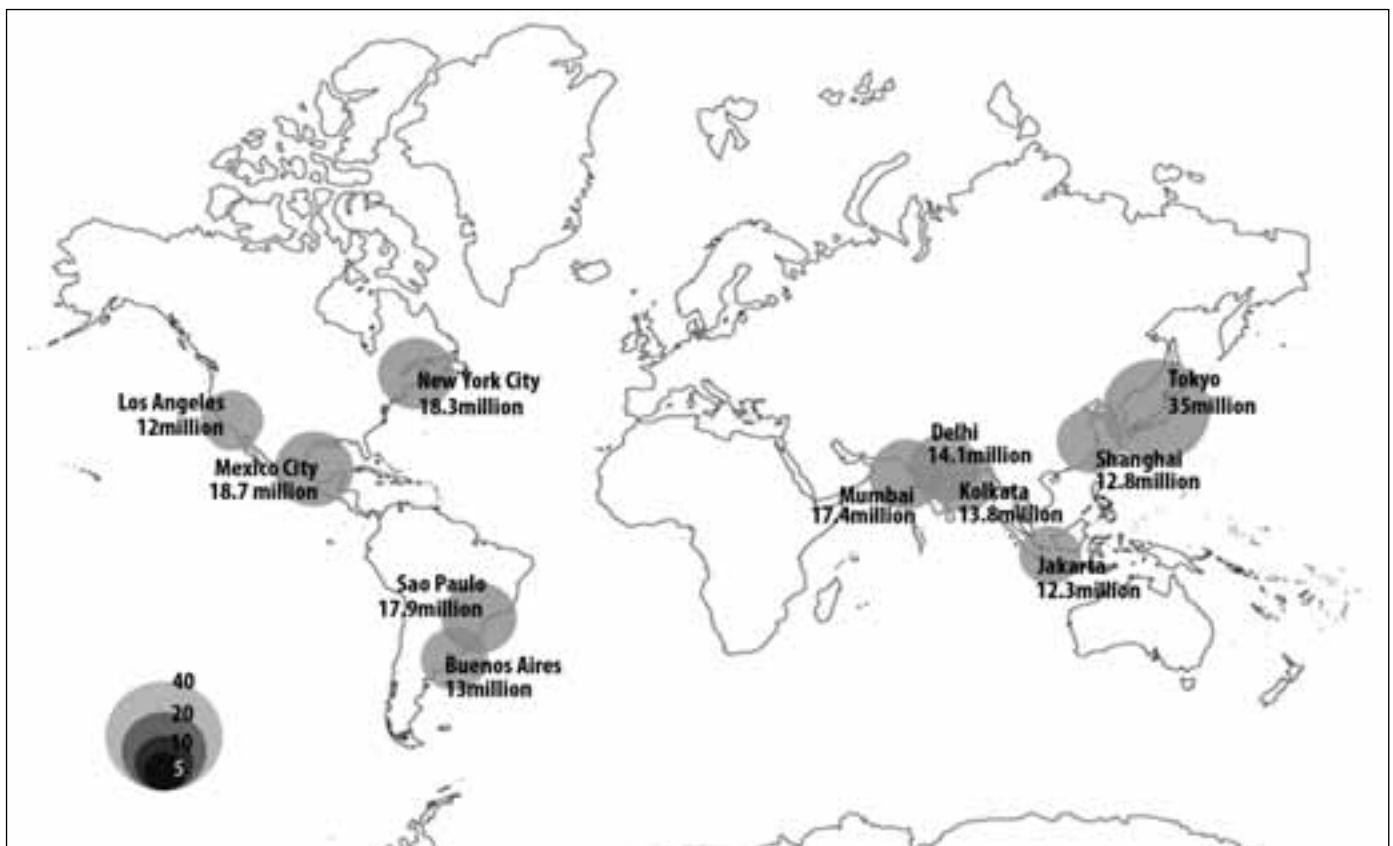
The world population will approximately double by 2050 and virtually all of this growth will be absorbed by urban areas in less developed countries, (United Nations, 2008). The number of megacities (population greater than 10 million) is projected to increase from the current 19 to 27 in 2025. By 2025, about 10 percent of the world's urban population will reside in these cities.

Metropolitan area governments in many countries will need to find a way to manage populations of 5 to 20 million, and provide affordable services (Figure 9.1). To arrive at the right formula for governance and finance they will be required to settle on the right degree of fiscal decentralization within the metropolitan area, coordinate the work

of many different government agencies and public companies, and find a viable plan for resource mobilization.

The financing of government services in large urban areas is more complicated than resolving the problem of financing the expenditures of a single city government because the common pattern is for many different governments and public enterprises to provide services within a single metropolitan area. It involves a balancing act in determining who governs, who manages and who pays. Furthermore, at almost every turn, there is a political dispute about the "right" balance of power among these governments.

Figure 9.1 Population size of the 11 Largest Metropolitan Areas



Source: http://www.metropolis.org/publications/metropolitan_regions

1. *Ideally, we would include a comparative analysis of fiscal indicators for governments providing services in metropolitan areas. Unfortunately there are no such data available other than in individual case studies, and even these are not readily comparable. The IMF (various years) provides a compendium of government finances for all countries in the world, reported in a specified format, but no data are reported for individual local governments.*
2. *Oates (1972) has offered an approach that serves as a starting point for most students of this subject. For application to metropolitan areas, see Bahl and Linn, 1992; Bird and Slack, 2004; and Slack, 2007.*
3. *A vertical program is one where the service is delivered in the metropolitan area by a higher level government, and where the funds do not pass through the budget of any local government budget.*
4. *For discussions of metropolitan area governance, see OECD (2006), and Jouve and Lefèvre (2002).*

This chapter is about the financing of government services in metropolitan areas. The scope of this review is both governance and finance. These two topics cannot be separated because the arrangements for financing public services in metropolitan areas are largely driven by the service delivery responsibilities assigned to the various governments and enterprises. But, countries make different choices for structuring and financing their service deliveries, and so the problems that arise can differ greatly from country to country. In this review we consider a sample of metropolitan areas in both developed and emerging and developing economies. The choice of the sample is based on the availability of information rather than on any formal attempt to have a “representative” coverage.¹

In the next section of this chapter, we consider the theoretical underpinnings for choosing among the various possible metropolitan governance structures. In sections following, the governance and finance models that are used around the world are reviewed, and their advantages and disadvantages are discussed. The chapter concludes with a discussion of the range of policy reform options that appear to be open.

Theory and Metropolitan Governance

Can economic theory point the way to best practice metropolitan governance and finance? Certainly not in any precise way, because the political economy dimension is so important. Still the economic model can provide a useful framework for evaluating the practice.² The problem is often defined as choosing the population size of a local government that will maximize the welfare of its residents. The core argument is the now-familiar “decentralization theorem”, the

basic rule of efficient expenditure assignment is to assign each function to the lowest level of government consistent with its efficient performance. The apt phrase is that “people get what they want” so the overall public welfare is enhanced (Bahl and Bird, 2008). If the story ended here, metropolitan governance would be in the hands of small, independent municipal governments.

For some functions, however, assignment to the lowest level of government does not lead to an efficient performance. One reason why, is the presence of external effects in the delivery of the service, and the other is the presence of economies of scale. This pretty much defines the questions to be answered in structuring metropolitan public finances: should individual local governments carry the public financing load, is a metropolitan government necessary for managing and financing area-wide services, what physical area should the regional government encompass, and how important should state/federal vertical programs be?³ Once these questions are answered, expenditure responsibilities can be assigned and finance will follow function.

Government Structure in Metropolitan Areas

Countries and metropolitan areas have reacted differently in deciding on a governance arrangement for service delivery. Some have created very fragmented structures with strong decentralization of responsibility and power, while others have created a more regional approach. Almost all have tried to strike some balance between capturing the efficiencies of area-wide government and maintaining local control.⁴ If there is a general conclusion that can be drawn about the

choices actually made, it would seem to be that the sentiments for local control have largely held off the formation of metropolitan governments. One way to think about the various approaches to metropolitan governance is in terms of the *emphasis* of the structure adopted: jurisdictional fragmentation, functional fragmentation, or metropolitan government.

Jurisdictional Fragmentation

Under this approach, many general purpose local governments operate in the same metropolitan area with some degree of independence in choosing their package of public services and their tax, user charge, and debt financing arrangements. In some cases there also is an overlying metropolitan government, and in most cases there are region-wide special districts.

The advantage of the jurisdictional fragmentation model is that it keeps government close to the people, but, the welfare gains from this “home rule” model will come at some cost, usually failure to capture economies of scale and operating within a set of boundaries that are often too small to internalize important external effects or to allow coordinated service delivery. Jurisdictional fragmentation can lead to large fiscal disparities among local governments in the metropolitan area, since they almost surely will have different financing and service delivery capacity.

Developed Countries

The jurisdictional fragmentation model best characterizes governance in most U.S. metropolitan areas. The traditions of home rule in the U.S. are strong; there is an acceptance of competition among local governments and a higher tolerance for

fiscal disparities than is the case in many European countries. There have been numerous attempts to establish metropolitan governments in the U.S. but almost no successes.⁵ The typical arrangement is well illustrated by the New York City region which includes over 2,000 governments (Benjamin and Nathan, 2001).

Strong traditions of home rule are also found in Europe. “Local Governments in the Nordic countries fiercely defend their rights to collect own-source taxes. They argue that their own-source taxation results in accountability and makes the behavior of the local population and local councils more responsible” (Lotz, 2006, p236).

The Copenhagen metropolitan region is an example of a jurisdictionally fragmented structure. Its population of 2.4 million is governed by 45 municipalities, which are the dominant tier in terms of service delivery and taxation, and by a National Capital Region. The Capital Region is an elected area-wide government that has health care as its primary responsibility, but it has no taxing powers.

The population of the city of Paris is about 2 million, but another 6 million people live in the inner suburbs. Local governance in this agglomeration is kept by 80 municipalities, 3 departments, and numerous companies that provide public services. The Stockholm metropolitan region includes 65 municipalities and five counties (OECD, 2006a), and 50 municipalities are contained in the Randstad (Holland) metropolitan region (OECD, 2007a). Metropolitan Vancouver includes 21 municipalities and about 2 million people.

Emerging and Developing Economies

The core provision of many local services in Manila is the responsibility of 11 cities

5. For a discussion of the history of reform of local governance in the U.S., see Campbell and Birkhead (1976). For a discussion of recent efforts, see Phares (2009).

and 6 municipalities whose boundaries are contained within the metropolitan area. Each has a local council that is popularly elected, and a defined set of expenditure responsibilities and revenue entitlements. These 17 local governments are overlapped by a supra Metropolitan Manila Development Authority which is responsible for planning and coordinating area-wide functions.

Governance in the Mexico City metropolitan zone is another example of jurisdictional fragmentation (OECD, 2004a). The metropolitan area is overlapped by a Federal District and its 16 municipal-like sub units, the States of Mexico and Hidalgo with their 59 municipalities, and the federal government. All of the lower-tier local units in the two states have elected governments but the boroughs within the Federal District have no taxing powers.

The metropolitan municipality of Istanbul overlaps with 73 municipalities. The municipalities, however, have no legislative powers. The Sao Paulo metropolitan region, with a population of about 18 million, is made up of 39 municipal governments with no overlapping metropolitan government. Coordination is attempted by agreement or compact among these municipalities, through a number of agencies and councils (World Bank, 2007).

Functional Fragmentation

A second approach to metropolitan governance is to emphasize *functional fragmentation*. Under this model, the delivery of a single function or a particular set of functions is placed under the control of either a public company, or a special district government. In fact, some degree of functional fragmentation exists in almost all metropolitan areas, but the way in which this is done varies widely.

A main advantage of functional fragmentation is that the autonomous agency is likely to be more technically efficient because it is specialized. The salary schedule may be outside the normal civil service so that the agency can attract and retain higher quality workers. It also may be more efficient in its operations because it has a large enough area of coverage to capture economies of scale. Because it is usually the only entity in the urban area responsible for the function, the problems of coordination for that function are considerably less than under a jurisdictionally fragmented model. Finally, a public company may have access to a dedicated revenue stream (e.g., an earmarked tax, a compulsory transfer from the city government, or user charges), and if well-run, has arguably a greater potential for debt finance than would a general purpose local government.

There are drawbacks to the functional fragmentation model, depending on the approach taken. First, it will almost certainly be less under the direct control of local voters as would be an elected municipal council, for example. In this respect, some degree of local autonomy is lost. A second concern is that the autonomous agencies may be single purpose and therefore unable to contribute to coordination of service delivery across functions. Although there are some exceptions, most special districts are single purpose.

Developed Countries

Functional fragmentation can take a number of forms, including the assignment of several area-wide functions to a single government or agency. The Greater Vancouver regional district consolidated all functions provided previously by special districts, most notably hospitals, water and sewer, capital expenditures, and solid waste management. The governing board includes

elected local government representatives, but it is a voluntary organization and has no authority to implement policies.

The financing of special districts and public companies can take many forms. Since the services delivered are often amenable to pricing (e.g., public transportation, garbage collection), user charges provide a base level of revenues. In other cases, they are partially financed by compulsory transfers from the city budget, or they might be profitable enough to subsidize the city budget.

In Stockholm, a holding company was organized by the city to manage several city owned companies that provide services such as public housing, real estate management, port operations and water utilities. These public companies are in a surplus position and have been paying dividends to the city budget. The same is true in the case of two energy companies in which the City of Oslo holds equity.

The City of Paris participates (or is part owner) in several enterprises that provide services ranging from transportation to social services. These are financed by user charges and by compulsory transfers from the city budget. The City of Paris pays about one-third of its subsidies to the public transport companies and covers almost half the budget for the *Prefecture de Police*. Transfers to the municipal company in charge of social programs accounts for a significant percent of budget expenditures by the city government.

The City of Madrid makes compulsory transfers to the two public companies that provide transportation services. In the Italian metropolitan cities, the transfers to the companies providing transportation, waste collection and disposal, and water treatment services account for about 25 percent of total metropolitan city govern-

ment expenditures. Milan, however, earns significant dividends from its companies. The City of Lausanne has fully incorporated the electric company into its budget, and the company maintained a surplus position during the late 2000s.

The water boards in the Randstad region in the Netherlands – with responsibility for flood control, water quality, and wastewater treatment – are another example (OECD, 2007a). These are local, independent public authorities that are democratically elected. The eleven boards in the Randstad region do not have administrative boundaries that are coterminous with municipalities. The water boards have taxing powers: a water board charge and a pollution levy.

Emerging and Developing Economies

Public companies play an important role in delivering services in the metropolitan areas in transition countries. Sometimes the relationship between the city government and the public companies is quite complex. For example, the City of Riga provides services through 42 companies in which it holds ownership and through the heating company where its equity stake is 49 percent. Most of these companies are self-supporting, but the transport enterprise claims about 10 percent of the operating budget of the city.

In Zagreb, most capital spending (and some current spending) is the responsibility of a holding company that was created following the merger of 22 municipal companies. The City of Zagreb uses more than 15 percent of its budget for subsidy payments to the holding company. In other eastern European metropolitan cities, it is more a matter of the city supporting the loss-making activity of a single company, notably transportation. The metropolitan cities of Sofia, Budapest, and Odessa are examples.

Special purpose agencies can be important in managing and financing public service delivery in developing countries. Sometimes this is because the special district status gets the service delivery function separated from the politics at the local level, sometimes it makes management easier and arguably more professional, and sometimes it is an easier route to a dedicated revenue stream and debt finance.

Public companies are set up by the local governments, as is the case of public transportation in Bogota, Colombia. They also can be multi-function, as for the water, energy and telecommunications company in Medellin, Colombia. In some cases, the special purpose agencies can become the dominant player in local government finance. Webster (2000, p7) points out that over 65 percent of urban infrastructure expenditure in metropolitan Bangkok is made by state enterprises, as compared with approximately 25 percent by the national government and less than 10 percent by the city government.

Metropolitan Government

The third general approach is *metropolitan government*. Under this model, general services are provided by an area-wide metropolitan government. Typically the metropolitan government is elected and has significant powers to regulate the service delivery and financing in the metropolitan area. While there are a number of area-wide governments in large urban areas, few of them have this range of powers. More often, they have a limited range of functional responsibilities, and govern alongside lower tiers of government. The emphasis under this approach is regional governance but usually with some degree of local autonomy protected.

There are significant advantages to this approach, most notably a built-in coor-

dination in the delivery of all functions assigned to the metropolitan government. This gives a potential for better resource allocation by comparison with the case where responsibility for local services is divided among multiple municipalities and special purpose governments. The metropolitan government form also offers a greater *potential* for equalization because the quality of local services is not tied to the wealth of each local jurisdiction as it is in the case of jurisdictional fragmentation.

Metropolitan governments often have a large enough area of coverage to capture economies of scale and to internalize externalities. This could result in both lower costs of service delivery and efficiency gains.⁶ Finally, because factors are less mobile across than within metropolitan areas, there are more choices for efficient taxation. There also may be significant tax administration economies in an area-wide approach to revenue raising.

The metropolitan form of governance also has significant drawbacks. The most important is that it diminishes the power of local voters to influence the local budget. In effect, the election of the local council is replaced by election of local representatives to the more distant metropolitan council. A second drawback is that metropolitan governance often brings intergovernmental conflict. If lower tier local governments exist under a metropolitan arrangement, they may resist the leadership (and especially the dominance) of the metropolitan government.

Finally, the boundaries of the metropolitan government may not be drawn large enough to fully capture the benefits of area-wide governance. In this situation, one of the most significant advantages of metropolitan government may be substantially diminished.⁷ For example, New York City

6. *If it does not result in lower cost of providing services, it may result in the provision of a higher level of services due to a "leveling up" effect.*

7. *A comparison of metropolitan area boundaries with governance boundaries in many cities is given in OECD (2006).*

has a population of 8 million but accounts for less than 40 percent of the population of the New York metropolitan region. In this case, services provided outside the metropolitan government boundaries are not coordinated with those provided inside and some of the advantages of area-wide governance are lost. A similar situation exists in Toronto, which holds only about one-third of the population of the metropolitan region. In Copenhagen, where 45 municipalities make up the greater Copenhagen metropolitan area, the region-wide government – the National Capital Region – includes only 33 of these.

Developed Countries

About the closest the U.S. has come to area-wide governance is the Metropolitan Service District in Portland, Oregon. This metropolitan government includes 25 cities and provides area-wide services for transportation, solid waste and a number of environmental concerns. But Portland (“metro”) is a far cry from a comprehensive regional government. As Lefèvre (2008) notes: “By U.S. standards, metro is an innovative metropolitan arrangement; yet by European standards, it is critiqued as a weak metropolitan governance arrangement with limited responsibilities and resources.”

Canada presents some interesting contrasts in the structuring of metropolitan government. Toronto approximates a true metropolitan government. It replaced the former two-tier metropolitan government with a single tier metropolitan city in 1998 (Slack, 2000; OECD, 2009a). All local government functions, including those previously invested in special districts and underlying municipalities, rest with the new metropolitan government. Two other structural reforms in Canada, however, took a less centralizing approach.

Vancouver created a regional government with some service delivery responsibility but the lower tier municipalities were left as the dominant local government units. Montreal used an amalgamation of municipalities to create two stronger core cities, but left in place a fragmented local government structure.

There are other examples of area-wide governments in OECD countries. In Madrid, the Autonomous Community of Madrid is responsible for the metropolitan area, which is about the same size as the functional urban region of Madrid (OECD, 2007). Underneath the Community is 179 municipalities, including the City of Madrid, which accounts for about half of the population of the metropolitan area. The functions of the Community are broader than those of the municipalities.

The Tokyo metropolitan government has substantial responsibility for service provision to a population of about 12 million persons (Togo, 1995; Tokyo Metropolitan Government, 2010). It has a prefecture (state) status in Japan’s intergovernmental fiscal system. Below the metropolitan government are 23 special wards in the core area, in addition to 26 cities, 5 towns and 1 village. All have elected assemblies. The special wards carry out service delivery for designated functions on behalf of the metropolitan government, while the municipalities are general purpose local governments.

The Greater London Authority (GLA) was created in 1999, as a senior level of government in metropolitan London, with a provision to elect a mayor and, separately, an assembly. The GLA is responsible for a number of functions, including transport, economic development, environmental protection, and police. About 80 percent of expenditures are made for transport and

police. It is financed by central government grants (63 percent), user charges (20 percent) and property taxes (10 percent) (Bird and Slack, 2004). In part because resources are so limited, it would be difficult to classify London as a strong metropolitan government. The underlying 33 boroughs are independent of the GLA and provide basic urban services such as education, housing, social services, street cleaning, and roads. There is a clear separation of expenditure responsibilities between the upper and lower tiers of government in the metropolitan area.

Emerging and Developing Economies

Metropolitan government has had an easier road in many emerging and developing economies. Oftentimes, area-wide governments were in place and their boundaries simply grew with their populations, while in other cases they were created to meet specific needs. In many cases, democratically elected local governments are relatively new, and home rule traditions are much less entrenched. Moreover, the weak level of infrastructure in place and the strains placed on city finances by migration, make area-wide government an easier sell.

Before 1994, Cape Town, South Africa was composed of 61 local government entities. This number was reduced to 6 general purpose governments and a metropolitan authority in 1996, and finally to a single local authority, the "Unicity" of Cape Town in 2000 (OECD, 2008). The gross inequity in services provided and the need for local input and coordination of area-wide services, were driving forces behind the consolidation.

A somewhat different model was adopted in Manila, where the Metropolitan Manila Development Authority (MMDA) exists to

manage area-wide functions while the local government units are responsible for local functions. The local government units (cities and municipalities) are governed by elected councils while the Chair of the MMDA is appointed by the President and its membership is prescribed by law. The formation of the MMDA (and its predecessor bodies) was a result of the concern for delivery of area-wide services and the perception of government that the well-being of Metropolitan Manila is a national priority. The history of metropolitan governance in Manila has been one of a struggle for power between the metropolitan government and the lower level local governments.

Taxes, Charges, and Transfers⁸

Culture, economic structure, and politics all play a role in determining the particulars of a public financing regime in metropolitan areas. But there also is a theory of tax assignment that points the way to "best practice" in financing metropolitan services.⁹ The guidelines from this theory are generally followed in many (most) developed countries, but are less often followed in the emerging and developing countries.

The Theory of Tax Assignment

Is there a best way to finance public service provision in metropolitan areas? Are there guidelines for identifying those tax revenue sources most appropriate for financing local and area-wide governments in metropolitan areas? The answer to both questions is a qualified "yes".

Four considerations might guide tax assignment decisions in metropolitan areas. The first is accountability. In order to make elected local government officials more accountable to their voting constituents, it is

8. For other papers on this topic, see Bahl and Linn (1992), Bird and Slack (2004) and Chernik and Reschovsky (2006).

9. One of the best statements of the theory is McLure (1998). For reviews and applications, see Musgrave, 1983; and Martinez-Vazquez, 2008.

necessary to give these officials some independent taxing powers. The accountability rule for tax assignment fits lower tier local governments in those metropolitan areas where the city council is elected. Those who hold fast to the representation rule of taxation would tend to limit non-elected governments to cost-recovery user charges. If there is to be general taxation by a non-elected body, it should be enabled by a referendum.

The issue is more complicated when it comes to metropolitan government or area-wide special purpose governments. If the area-wide government is elected, taxing powers will enhance accountability to voters. This would apply, for example, to the cases of the Portland, Toronto, or London metro areas, where the leadership of the metro government is elected. Some area-wide governments (special districts such as New York's Port Authority or Toronto's Services Board) are led by appointed officials. In this case, accountability to voters will not be enhanced by taxing powers. These agencies should charge for services rendered, but their monopoly powers should be regulated. In yet another arrangement, the council of the metropolitan government may be made up of all elected mayors in the metropolitan area. Because of the large membership of the council, this arrangement may allow a single elected mayor to hide from being accountable to his home constituency. There are many examples here, including the Greater Vancouver Regional District.

A third principle, and the one that seems to be followed most religiously in developed countries, is "correspondence", i.e., local governments should not levy taxes whose burden can be exported to those who do not benefit from services delivered by the local government (McLure, 1998). This principle imposes a

tight restriction on local governments in jurisdictionally fragmented metropolitan areas. It suggests that lower tier local governments should rely only on benefit taxes¹⁰ and on taxes on immobile factors. Metropolitan governments and area-wide special districts, on the other hand, can be given access to some broader-based taxes because labor is less likely to cross jurisdictional boundaries.

Finally, the theory of tax assignment also calls for consideration of the relative costs of tax administration in deciding on the level to which a tax will be assigned. Local governments, particularly in developing countries, might be denied access to certain taxes for this reason, while area-wide governments in metropolitan areas could have some inherent advantages in tax administration.

Tax Assignment: The Practice

Do countries follow the general "rules" laid down by the theory discussed above? Most developed countries do make tax assignments that are in step with good practice (though there are exceptions). Metropolitan area governments in developing countries have many fewer taxing options, and appear to be less in step with what many policy analysts see as best practice.

Developed Countries

Higher income countries appear to have given more attention to the issue of structuring governance in large metropolitan areas and to finding ways to finance these structures. Examples of the "special" financial arrangements that have been put in place include (a) granting metropolitan governments both city and state level status (Tokyo, Shanghai, Berlin), (b) providing for special taxing powers (New York City) and (c) instituting special intergovernmental transfer arrangements (London, Rome). A

Table 9.1: Selected Special Revenue Treatments for Metropolitan Local Governments

Government	Special Treatment
Copenhagen National Capital Region (OECD, 2007)	Financed 75 percent by Central Transfers and 25 percent by Municipal Transfers
Tokyo Metropolitan Government (Tokyo, 2010)	Metropolitan government has both prefecture (state) and municipal taxing powers and expenditure responsibilities
Toronto (Slack, 2000)	Metropolitan City with no underlying tier of government, created by a Provincial Act.
Community of Madrid (OECD, 2007)	Has both State and Metropolitan Government Features, and State Taxing Powers
London (GLA)	Special central Transfers cover about two-thirds of Expenditures
Netherlands: Independent, elected Water Boards	May impose a water board charge and a pollution levy.

Source: http://www.metropolis.org/publications/metropolitan_regions

10. A "benefit tax" in this case could refer to any tax where the revenues raised are borne by those who benefit from the services financed. A residence-based income or payroll tax would qualify, but an origin based business tax would not.

11. The largest revenue source is the corporate income and registration tax. Tokyo and New York are the largest metropolitan governments studied here that rely to any significant degree on taxes on corporations.

sample of such special arrangements is described in Table 9.1.

One underlying objective in many developed countries is to increase the fiscal self-sufficiency of metropolitan local governments. In some countries in the sample reported in Figure 9.2, this strategy has succeeded. The Tokyo metropolitan area government has both city and prefecture (state) status, hence it has access to a broader tax base than do other local governments in Japan. About 70 percent of all metropolitan government revenue is from local taxes.¹¹ Toronto has a more traditional financing structure for a local government. It relies primarily on the property tax and user charges. The Toronto metropolitan city funds about 60 percent of its budget from property taxes and

user charges. The property tax alone accounts for about 41 percent of revenues (OECD, 2009a).

Metropolitan local governments in some the Nordic countries and Spain rely primarily on individual income taxes, and New York City makes heavy use of a combination of retail sales tax, personal and corporate income taxes, and business taxes. Stockholm's local governments cover about 80 percent of their expenditures from local sources, primarily from an earned income tax. In Paris, the principal local tax was applied on economic activities –a tax on immobile capital but limited to added value. This was replaced in 2010 by combination of a tax on property, a share of locally collected VAT and a variety of low return charges on network activities, which

globally have meant a loss of autonomy and a drop in revenue.

Metropolitan local governments in other developed countries do not have significant taxing powers (Slack, 2007). The Greater London Authority receives most of its revenues from central government grants. The Stuttgart Regional Authority has no taxing authority. The Greater Vancouver Regional District is financed primarily by user fees and intergovernmental transfers.

Emerging and Developing Economies

In practice, large urban governments in most emerging and developing economies do not rely heavily on local taxation. Despite the arguments that local governments in metropolitan areas could feasibly handle a greater range of taxes, most are limited to

property taxes and user charges as the main sources of revenue. There are some exceptions to this general pattern, notably Brazil, and these are taken up below.

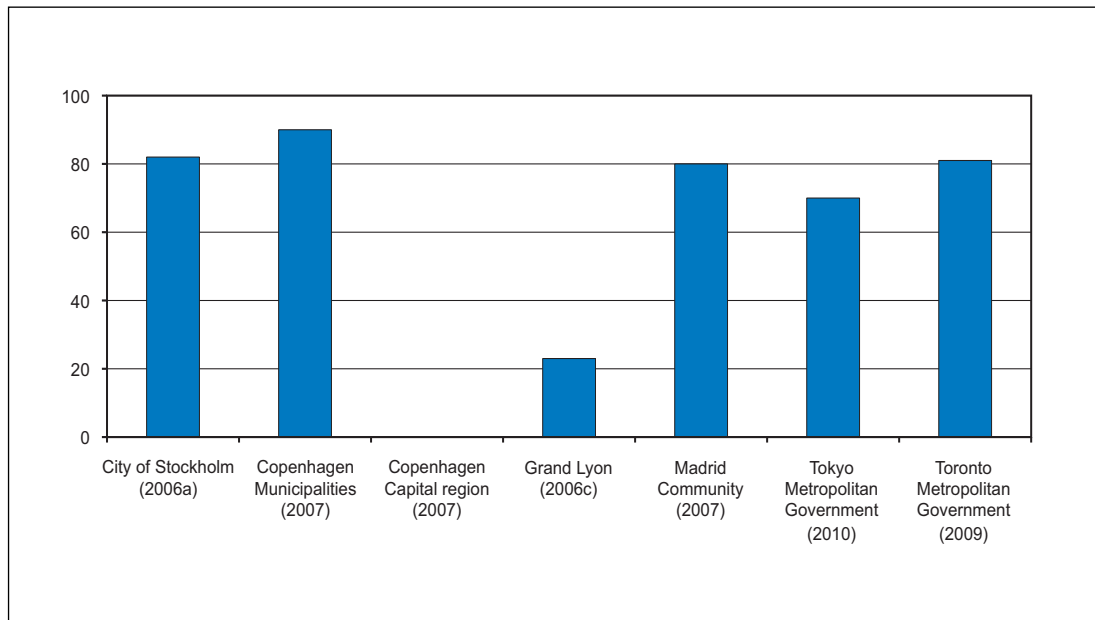
Property Tax

Almost everyone's choice for a major instrument of local government taxation is the property tax. It passes many of the theoretical tests of a good subnational government tax, but it is costly to administer and it is politically unpopular.

Developed Countries

Among the developed countries, property tax is a favorite among the English speaking federal countries, but it is much less important among non-English speaking countries and unitary countries in general

Figure 9.2: Percent of Revenues Raised from Own Sources by Selected Metropolitan Local Governments



Source: All information taken from OECD Territorial Reviews with the exception of the Tokyo Metropolitan Government taken from (<http://www.metro.tokyo.jp/ENGLISH/PROFILE/index.htm>)

(Lotz, 2006). Property tax revenues account for one-half or more of local government financing in the Toronto, Montreal, and Melbourne metropolitan areas, and it accounts for 34 percent of the budget in New York City.

Different patterns emerge for some metropolitan area local governments in other OECD and transition countries. Municipalities in the Netherlands, including those in the Randstad region, receive less than 5 percent of revenues from the property tax. There is no local government property tax in Sweden or Norway (OECD, 2006a, p176). In Copenhagen, the primary revenue source of municipalities is the income tax, and property taxes play only a minor role. The same is true in Stockholm, Tokyo, and in the Swiss cities. The property tax is somewhat more important in Madrid at the city level, but financing is dominated by income taxes levied at the regional government level. In Busan and Daegu, Korea, the property tax is an important source of local financing, but most of the revenue is derived from property transfers.

Emerging and Developing Economies

Governments in most emerging and developing countries do not seem to have bought into the idea that the property tax is a good fit for financing services provided in metropolitan areas. While it is true that property values are growing in most metropolitan areas, valuation in most countries fails to capture this growth. This seems to be the case even in countries with large metropolitan areas (Mathur, et. al., 2009; de Cesare, 2004). Moreover, delays in general revaluation are commonplace, significantly lowering the revenue-income elasticity of the property tax. The property tax as practiced in developing countries generally fails the tests for a good subnational government tax in terms of its

high administrative cost and its unpopularity with voters.

There is a great deal of variation in the extent to which the property tax generates meaningful revenues for metropolitan cities. In Cape Town, about 20 percent of metropolitan government revenues are derived from a tax levied against the capital value of land and improvements. This is about the same share of revenues that is received from intergovernmental transfers.

The primary source of revenue for municipalities in the Mexico City metropolitan area and in the Istanbul metropolitan area, is the property tax. However, in neither case are the local governments empowered to set the tax rate or determine the tax base. The result is that there is relatively little autonomy for the metropolitan local government to determine its revenue level, and in both cases the property tax falls well short of its potential. There is some local government discretion in metropolitan cities in India but the results are much the same. The low yield is largely attributed to the poor administration of the tax. For example, in Mumbai only about 70 percent of properties pay taxes, and in Kolkata properties are assessed at about 20 percent of their value (Mathur, et. al., 2009).

Income and Payroll Taxes

The individual income tax can meet many of the tests for a good metropolitan government tax. It can generate significant revenue from an elastic tax base. It is roughly consistent with the correspondence principle in that the burden falls mostly on those who benefit from the services provided, though correspondence problems do arise with respect to those who cross provincial borders to reach their place of work.¹² Its administration can be simplified by a direct piggyback on the income tax of a

12. *The correspondence principle would call for a residence-based income tax, and for non-residents to file returns and pay an amount that would serve as a benefit charge for local services received. For a discussion, see McLure (1998).*

higher level government, or by information sharing with a higher level government.

Perhaps the major drawback of the personal income tax, as a metropolitan local government revenue, is that it is cyclically sensitive and can leave a local government in a difficult financial position during an economic contraction. This sensitivity is of greatest concern where there is little diversification in the city revenue structure and where the central government does not have the financial strength to compensate for the revenue losses. During the recent economic down turn, personal income taxes in the cities of Riga, Bucharest, and Budapest all declined significantly and had a major budget impact. By contrast, Stockholm and Lausanne also rely on income taxation, but neither suffered as much budgetary stress during the economic contraction because their revenue structures were more diversified.

Developed Countries

New York City has long levied an earnings tax, and until 1999, the liability was with commuters as well as residents. The earnings tax now finances about 16 percent of the city budget. The major source of local government revenue in Cleveland is an earnings tax.

Urban government income taxes are more prevalent in Europe than in the U.S. and Canada, and in many cities are the dominant sources of local government revenue. The piggy back approach to income taxation offers considerable advantages to some metropolitan local governments. It allows local rate determination while avoiding the issue of defining the tax base or administration of the tax. The primary revenue source for Swiss cities is a piggyback personal income tax. Rome levies a residence-based income tax, on a base

defined by the central government. The principal municipal government revenue source in metropolitan Copenhagen is the individual income tax (OECD, 2009). The tax base is defined by the central government, and collections are made by the central government. In theory, the 45 municipalities in the metropolitan area are free to set the tax rate, but since 2002 a centrally imposed freeze on the tax rate has been in place. About 80 percent of municipal revenue is raised from the income tax. The Capital Region, the metropolitan area-wide government in Copenhagen, has no taxing power.

Local governments in the metropolitan region of Stockholm rely almost exclusively on a local tax on the earned income of residents. The base is defined by the national government, but local governments are free to set the tax rate. The major concerns with the earnings tax in Stockholm are (a) that such complete reliance on it leaves the municipalities vulnerable to cyclical movements in the economy, and (b) the equalization formula that limits the revenues a local government can receive, provides a significant disincentive to revenue mobilization.

The area-wide government in Madrid (The Community of Madrid) relies on the individual income tax for most of its revenues. The tax base is defined by the central government,¹³ but the regional government (community) may choose the tax rate (subject to some restrictions) and is entitled to one-third of revenue collections (OECD, 2007).

There is less use of corporate income taxes at the local government level in metropolitan areas, arguably because of cyclical sensitivity of the revenues and of a fear of driving away investment. However, there is some practice. Both Geneva and Lisbon

13. *The Community may provide certain preferential treatments, thereby lowering the tax base.*

derive significant revenue from a surcharge on the corporate income tax. New York City derives a significant amount of its budget revenue from the corporate income tax.

Emerging and Developing Economies

The Eastern European Cities use a different model of local income taxation. In these cases, it is a sharing of central income taxes based on collections in the city (Zagreb and Bucharest) or collections from residents (Riga). The central government sets the "local" tax rate, e.g., 26 percent in Riga in 2008. The City of Zagreb may levy a surtax of up to 30 percent on personal income tax collections, and presently it levies a rate of 18 percent.

In general however, subnational government income taxes are rarely found in emerging and developing economies. There are four reasons for this. The first is the administrative problems that would be posed. The second is tax competition. Central governments in some developing countries rely heavily on this source of revenue, and even have trouble collecting much from the personal income tax (Bird and Zolt, 2005). The third reason is that income taxes often carry income distribution goals and these are perceived to be the exclusive responsibility of the central government. Finally, income generation in the formal sector is concentrated in most developing countries, and it is not likely that much revenue would be generated outside the metropolitan areas.

States and the Federal District within metropolitan Mexico City, finance a part of their budgets from a payroll (wage) tax. They are free to choose the tax rate, define the tax base and administer the tax. The tax is collected from employers.

There are three problems with the Mexican payroll tax that need to be reckoned with. First, it is a tax on wages, and if levied at a high enough rate, could drive some employment to the informal sector. Second, since it is levied at the place of work, it will result in some tax exporting to non residents.¹⁴ Third, it is cyclically sensitive and can create significant budget problems during an economic contraction.

Sales Taxes

Sales taxes are an attractive option for financing the provision of local public services in metropolitan areas, because with a significant share of consumption taking place within the large urban areas, the revenue potential is considerable. Also, as the point of tax collection for most transactions is identifiable, administration is feasible in developed countries and in some developing countries. However, metropolitan government sales taxes raise the possibility of introducing unwanted distortions in resource allocation, if they are not properly structured.

Developed Countries

The retail sales tax is an important source of revenue for many local governments in U.S. metropolitan areas (e.g., about 11 percent of the total revenue budget in New York). In Canada, local governments in metropolitan areas are mostly limited to the property tax, and cannot levy a general sales tax, though many local governments do impose various selective sales taxes. In Italy, regional governments levy a value added tax on an origin basis (Bordignon, Giannini and Panteghini, 2001). Bird and Slack (2004) have argued that this form of business taxation deserves wider attention. Local government sales taxes are not widely used in the metropolitan areas of Eastern Europe.

14. For a discussion of the payroll tax in Mexico, see Diaz-Cayeros and McLure (2000)

Emerging and Developing Economies

In theory, a destination-based sales tax could satisfy the conditions for a good local government tax in emerging and developing economies. In theory, it could be levied at either the metropolitan government level or at the lower tier of metropolitan government. Theory and practice, however, do not always come together because of administrative constraints in most emerging and developing economies.

A value added tax (VAT) is usually levied by central governments as a destination-based sales tax. Unfortunately, in most developing countries, there is no realistic prospect that the tax administration will be able to support a subnational government VAT.¹⁵ A value-added tax levied at the metropolitan city level is almost certainly not feasible, except perhaps in the special case where a metropolitan city covers a large area and has the legal status of a state/province, e.g., Shanghai or Berlin. A better route would be a surcharge on the state government levy or a revenue sharing arrangement with the state government. Here there is some experience. One fourth of the state value added tax in Brazil is distributed to municipalities on a basis of point of collection. A similar arrangement exists for province-level cities in China (Fu, 2007).

Retail sales taxes are not administratively feasible in developing countries, even in large metropolitan areas. A large percent of sales takes place in the informal sector, and a destination-based retail sales tax would likely swell this number even more. Informal sector retailers usually do not keep accurate books of account, and small merchants often keep a "special" set of accounts for tax purposes.

A gross receipts tax levied on all sellers in the formal sector, on an origin basis, can

be revenue productive. But, this will create distortions by shifting tax burdens from producing to consuming regions, by introducing a cascading effect on prices, and by discriminating against formal sector sellers. An origin-based sales tax is also subject to the "headquarters problem" or the problem that arises when firms pay their tax bill at the central office location. While all of these reasons suggest that a gross receipts tax is not a good choice for financing governments in metropolitan areas, reason is sometimes outweighed by the appeal of a significant revenue take.

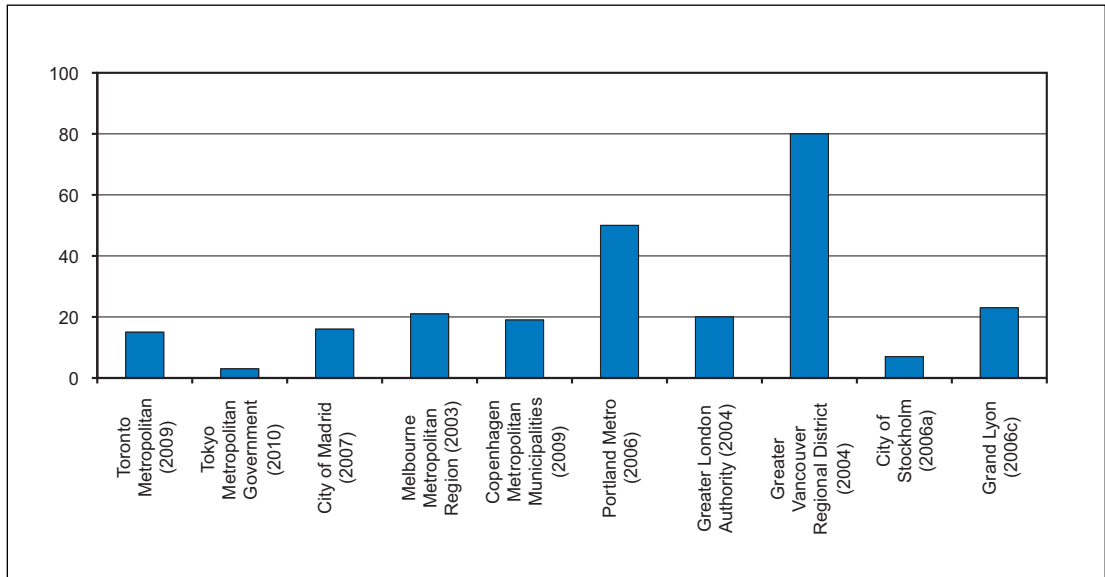
The major own source revenue of Brazilian municipalities is a tax on services (ISS), almost all of which is collected by the largest municipalities (Rezende and Garson 2006). The ISS and the urban property tax together account for about 60 percent of total local tax revenue. Buenos Aires, both city and province, levy a gross receipts tax. The tax is complicated because the tax rate varies widely by type of product. Bogota derives much of its revenue from a gross receipts tax. The business tax in the Philippines is levied on gross receipts and accounts for about 30 percent of local revenues (Taliencio, 2005).

Charges and Fees

Most analysts argue that benefit charges of one form or another are the most appropriate revenue source for local governments (Oates, 1972; Musgrave, 1983; Bahl and Bird, 2008). It constitutes a charge for benefits received, and may lead to recovery of the cost of providing the service in question. Central governments in many countries cede this revenue source to urban local governments because it does not crowd out central revenues as might a local income tax or a consumption tax.

15. There are efforts and even some experience with implementation. Brazil has long relied on a state level value added tax. India also has implemented a state level value added tax, but is still working out the details of how it will operate, particularly with respect to interstate trade.

Figure 9.3: User Charges as Share of Total Revenue for Selected Metropolitan Local Governments



Source: All information taken from OECD Territorial Reviews with the exception of Tokyo (<http://www.metro.tokyo.jp/ENGLISH/PROFILE/index.htm>) and Greater London Authority and Greater Vancouver Regional District (Bird and Slack 2004)

Developed Countries

User charges are particularly important for financing the operating expenditures of special purpose districts and public companies in metropolitan areas. The comparison for selected metropolitan areas presented in Figure 9.3 gives some idea of the relative importance of user charges in financing metropolitan services. Even these amounts are an understatement, however, because they do not include the user charges levied by public companies. European cities often are full or partial owners in various types of public service companies (e.g., public transit, water, energy, housing) that finance their operations with user charges. Sometimes the charges are supplemented by a subsidy paid from the city budget, and other times the user charge revenues generate a surplus that is distributed back to the city.

Emerging and Developing Economies

User charges are a particularly attractive revenue option for metropolitan local governments in emerging and developing economies. The levy can be linked to service benefits, hence there is more willingness to pay, and both assessment and collection can be easier than in the case of general taxes. On the other hand, charges often are made for essential services, and sentiments can run high when increases are necessary to cover rising costs. Public housing rents, water rates and bus fares are examples.

The City of Cape Town collects about 35 percent of revenues from user charges, mostly electricity, water, sanitation, and refuse collection. While the revenue take is quite large by comparison with other metropolitan cities, there is poor compliance and low collection rates (OECD, 2008). This is

a not uncommon outcome in emerging and developing economies. For example, the Bangkok Metropolitan Administration collects only about 20 percent of charges due for garbage pickup (Webster, 2000, p17). Mohanty, et al. (2007) reported a low rate of cost recovery for the Indian metropolitan cities of Mumbai and Kolkata. By contrast, user fees in Bogota are sufficient to cover operating costs for the city's urban bus transport company (RTI, 2005).

Intergovernmental Transfers

A special treatment as regards the flow of intergovernmental transfers may be reserved for metropolitan cities, sometimes to exclude them from certain flows to encourage self-sufficiency, and sometimes to recognize their special needs. In Rome, for example, a special central transfer equivalent to about 15 percent of the current revenues of the city is given as a recurrent grant to recognize Rome's capital city status. Some metropolitan areas have the same status as states or provinces, in which case they have both a state and a city entitlement to intergovernmental transfers. Also different from other local governments, a special program of intra-metropolitan government revenue sharing may be in place.

Developed countries

Metropolitan area governments in some developed countries do not depend as heavily on intergovernmental transfers as do other local governments. For example, the cities of Stockholm, Paris, Madrid, and Lausanne all raise more than two-thirds of their own financing from local taxes and charges.

A few illustrations may help describe the general practice. Grants play a minor role in financing municipalities in metropolitan Copenhagen. Specific grants account for

about 10 percent of revenues, and these are primarily for reimbursement of agency functions performed on behalf of the central government. On the other hand, the area-wide capital region government, which is primarily responsible for health care, has no independent taxing powers. About 75 percent of its financing comes from central government transfers and 25 percent from municipalities' transfers.

The Madrid regional government receives about 20 percent of its revenues in shared taxes and grants. The municipal governments, however, depend on transfers for about 40 percent of revenues. Large municipalities receive most of their transfers in the form of shared taxes, while smaller municipalities receive formula grants based on indicators of expenditure need and tax effort. Melbourne and Toronto finance only about 15 percent of their respective budgets with intergovernmental transfers.

There are some exceptions to this general pattern. One is Germany, where local governments have few independent revenue sources, and rely almost exclusively on transfers. In the Netherlands, local governments have only limited taxing powers. Equalization is done through transfers.

Emerging and Developing Economies

Metropolitan local governments in emerging and developing economies are heavily reliant on intergovernmental transfers from federal and state/provincial governments though usually less so than are other local governments. There are several reasons for this. Metropolitan cities have a stronger tax base and are sometimes given more legal taxing powers than other local governments. Often times large urban governments have a better ability to collect taxes. They also may have more incentive

to levy taxes than do other local governments. If the higher level governments use equalization grants, metropolitan cities will receive less relative to their population size and therefore will be pushed toward raising more own source revenues.

In Cape Town, only 20 percent of metropolitan city revenues are derived from grants. The major transfer in the system – “the equitable shares grant” – is allocated on an equalizing basis. The result is that Cape Town and the other metropolitan cities in South Africa receive about half the per capita amount that goes to smaller cities.

The Metropolitan Manila Development Authority has no taxing powers and limited authority to levy user charges. It relies almost exclusively on grants from the central and provincial governments and on mandated contributions from the underlying local government units. In effect, the lower tier local governments pay the metropolitan governments for services delivered.

Mexico has a highly centralized financing structure. Sub-national government taxes account for less than 1 percent of GDP. Most metropolitan services are financed from conditional (22 percent of spending) and unconditional transfers. However, the dependence on transfers is significantly less in the Federal District of Mexico than in the other states in Mexico.

About 50 percent of revenues of the metropolitan municipality of Istanbul come from intergovernmental transfers. The most important of these (50 percent of revenue) is the revenue sharing grant which is distributed on a derivation (origin of collection) basis. This basis for distribution favors Istanbul greatly because of its large tax base, and because it receives a share of the tax paid by all companies that are headquartered in Istanbul.¹⁶

Brazil uses both discretionary grants and equalization grants to support local governments. The former, for education and health, probably favor metropolitan cities, but the latter do not. Rezende and Garson (2006, p20) report that the ten largest metropolitan areas, which house 30 percent of the Brazilian population and generate about half of the national GDP, receive only about 13 percent of the divisible pool from shared income and industrial products tax.

The core municipalities in metropolitan areas in Eastern Europe are heavily financed by intergovernmental transfers, often in the form of a shared personal income tax (e.g., Bucharest, Budapest, and Zagreb). Revenues from these transfers were buoyant during the economic expansion of the early 2000s, but contracted significantly in the later part of the decade. In other cases, the transfers take the form of conditional grants that are restricted to particular uses. The City of Zagreb provides decentralized services, but under a strict set of central government earmarks. The revenue structure of Budapest is dominated by intergovernmental transfers of various forms, including both revenue sharing and conditional grants. The central government provides about 70 percent of Sofia city revenues through intergovernmental transfers.

Conclusions: Is There an Easy Way Forward?

Removing the constraints to providing an adequate level of public services in metropolitan areas is a subject that is high on the policy reform list in many countries. But the “right” way to deliver public services in large urban agglomerations, and to finance these services, is still an open question. This review shows that the international practice is quite diverse.

16. For a discussion of this “headquarters problem” see Bahl and Solomon (2003).

What is the Real problem?

The underlying problem to deal with in metropolitan governance and finance is finding a way to marry two very different spatial units. The functional economic region has boundaries that are informal and always changing, as one would expect of a labor market area. The “champion” of the region as a government entity is the planner or social reformer who sees the great efficiency and equity gains that would come with regional service delivery. The other spatial unit, the local government, has fixed boundaries. The champions of the local government are voters and their elected officials, who want to maintain control over services provided in the local area. It seems unlikely that these two units, with their differing priorities, will come together easily in support of a general purpose region wide government. The issue is even more complicated by overlapping special districts or public companies whose service boundaries may not be coterminous with either the metropolitan area (labor market area) or the general purpose local governments.

The public policy solution lies in finding a way to deliver some services with a degree of local control and financing, while delivering others on a region wide basis and with a broader finance base. All governments will likely identify with a model that produces better prospects for long run economic growth, and better transportation services and public amenities. Local governments can be moved by strategies that give them some voice and a promise to hold a lid on taxes. But none of these arguments seem to be convincing when it comes to moving basic services away from the local level, or more drastic yet, abolishing local units of government. The practice shows that governance and finance in some metropolitan areas have moved toward this solution, but almost no one

would declare that the delivery of regional services is properly coordinated.

Is there a next step in improving and rationalizing the financing of large cities in metropolitan areas? Three policy directions would seem worth considering.

Governance

It may be time to move away from the good but academic advice that area-wide, general purpose local government are the answer to the public financing problems in metropolitan areas. Home rule is too firmly entrenched to be dismissed, at least in the foreseeable future. Where this shift in emphasis would take public policy is toward emphasizing a two-tier metropolitan structure, probably overlaid by a capital infrastructure district(s) for services that lend themselves to pricing, and a regional coordination and planning district. Attention could then shift to designing a system of taxing and charging that would best fit a two-tier governance.

The above model might also work in emerging and developing economies where there is a tradition of local government, e.g., Manila, Calcutta or São Paulo. In all three metropolitan areas, a kind of two-tiered governance is in place but the revenue mobilization system is not well designed. Where something akin to a metropolitan government is in place, it could be overlapped with an infrastructure district(s) and a coordinating body. A major struggle in such cases would be to insure that the government boundaries grow with the boundaries of the economic region. Again, the question would be how to design a financing system that would match up with the governance system.

How would this differ from the present system? One difference is that the regional

districts would need to be elected and to be viewed as financing districts as well as service delivery areas. Enabling legislation by higher level governments would be required to make this happen. Second, the taxation instruments used by the lower tier governments should be designed to fit the basic efficiency rules of taxation, e.g., no tax exporting. Some sort of monitoring might be put in place to regulate intra-metropolitan practices that distort trade between the member communities. Third, higher level governments should ensure a better match between expenditure assignment and revenue assignment. This would require important changes on the expenditure side – more clarity and fewer mandates – and would require passing more economic growth-responsive tax bases to the metropolitan local governments. Finally, the provincial and national intergovernmental system should be redesigned to give more autonomy to metropolitan area local governments, and at the same time to limit the flow of grants to them in order to encourage local revenue mobilization.

Metropolitan Finance

As always, part of the problem in metropolitan areas is that resources are scarce and do not match up well with the demand for public services. But the level of taxation in some OECD countries is very high and additional taxing space may be limited. In the United States, there may be room for tax increases, but a combination of the federal deficit and political backlash may crowd out most opportunities for increased local government taxation.

Ideally, one could compare the level and structure of taxation across metropolitan areas. Unfortunately, there is scant evidence on the finances of overlapping governments in metropolitan areas, as indicated by the relatively few (and somewhat dated)

special studies reviewed above. More timely evidence is available for core city governments and from the credit rating agencies that regularly evaluate these municipalities.¹⁷

The major stumbling block in developing a model system of metropolitan finance is the lower tier local governments. Those wedded to fiscal decentralization within metropolitan areas will argue for heavy assignment of expenditure responsibility to these local governments. If these local governments are to be moved toward budgetary independence, significant tax assignment is implied. The property tax and user charges alone will not likely carry the expenditure load, so long as the property tax remains so politically contentious. But broad-based taxes in jurisdictionally fragmented metropolitan areas are likely to be characterized by a significant amount of exporting of burdens to residents in other jurisdictions. The recourse is to use a residence-based earnings tax with some sort of compensating mechanism as is the case in Denmark, or to rely heavily on intergovernmental transfers to finance local services.

There is room for metropolitan (area-wide) governments to contribute more to the financing of services in the metropolitan area. A residence-based income tax, with an appropriate commuter charge, would be an attractive alternative. This might be justified first, on grounds that area-wide services provide benefits to non-users, hence less than full financing from user charges would be efficient. Second, this tax could support an intra-metropolitan equalization fund. This would remove the disincentive to lower tier tax effort, as has been observed in some Nordic countries. Intra-metropolitan revenue sharing has much to recommend it relative to a national or provincial program of grants.

17. *The credit rating data, however, is focused on individual local governments. It does not take account of the impact of overlapping governments on core municipalities. For example of a credit rating report, see Standard & Poors.*

Some other taxes that might be appropriate for a metropolitan taxing district are the property tax, or at least the commercial-industrial portion of it, and taxes on motor vehicle licenses. User charges would continue to play a major role in financing the regional district, but grants from higher level governments would not.

For single purpose special districts, revenue mobilization could continue to be centered on user charges, as is the case now. Special benefit taxes, raised within the metropolitan area, could be dedicated to the special district. There is much more room here for public financing. Finally, general taxation to support a service is a possibility (and one that has been tried in several places), but should only be done if authorized by a voter referendum.

In emerging and developing economies, metropolitan cities need to ratchet up the level of own source revenues but have less administrative capacity or legal authority to do so. Unfortunately, the will to increase local taxes is often not in place. If some of these constraints are removed, significant revenues might be raised in the largest metropolitan cities. The most viable options for increasing the rate of revenue mobilization might include:

- Increase the rate and the collection efficiency on user charges. Give metropolitan local governments discretion to set the level of user charges.
- Improve the administration of the property tax so as to raise the overall effective rate. There are many ways to do this, and there is a literature that has explored this at length in developing countries. Among the options that might be considered, in most countries they are removing preferential treatments, increasing valuation rates,

bringing untapped properties into the base, installing a "payment in lieu" for government properties, simplifying payment options and increasing penalties for non-payment.

- Levy taxes on wage income, either directly or as a piggyback on the national government income tax.

Intergovernmental Transfers

Central and state (provincial) governments might adopt an explicit strategy of using equalization grants to discriminate against large cities in order to induce them to make a greater level of tax effort. This is already done in some developed countries. In fact, integrated transfers might be limited to conditional grants that would stimulate spending for a national priority. This financing strategy will of course be limited by the extent to which expenditure responsibilities have been assigned to local governments in metropolitan areas.

In the emerging and developing economies, the metropolitan local governments tend to be more dependent on transfers from higher level governments. This often dampens the enthusiasm of local governments to mobilize more revenues from their own sources. A strategy of replacing most transfer revenue with increased local taxing power would not be met with great enthusiasm by local politicians, because of the political pain associated with imposing taxes. It has been argued in many countries that a significant amount of untapped taxable capacity resides in the metropolitan cities. Authorization of a model of local government taxation, such as that discussed above, could provide an incentive for metropolitan area governments to find a way to tap this capacity.