

# **THE CHALLENGE OF CITY FINANCES THINKING BEYOND THE MUNICIPAL INCOME-EXPENDITURE GAPS – SOME PERSPECTIVES FROM ASIA**

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## **1. OPENING REMARKS**

Most studies on local government finance suggest that the finances of city governments in Asian countries are in an unsatisfactory state. Few city governments are able to raise resources that are sufficient for meeting their expenditure obligations. This state of affairs i.e., the gap between what the city governments raise and what they require, is explained largely in terms of the relative inelasticity of the tax domain of city governments compared with that of the higher governmental tiers; absence of autonomy with city governments for making choices with regard to tax bases and tax rates; and the indiscriminate addition of state mandates onto the city governments portfolio.

This presentation does not propose to further dwell on this state of affairs, as it would do no more than to update the statistical component of the income-expenditure gap of city governments in the Asian economies. Perhaps, it is suffice to point out that city governments in this region continue to face ever-widening fiscal gaps, and stagnant, often even declining, levels of city-based infrastructure and services. The revenue significance of city governments in comparison with the other tiers is insignificant; according to quick estimates, the revenue income of city governments ranges between 0.4 and 4.5 per cent of the gross domestic products, the corresponding proportions for expenditures being 0.6 and 5.5 per cent. Their share in the total publicly-raised resources varies between 2.5 and 9 per cent in the different Asian countries.

This presentation instead focuses on the challenges that city governments in Asian countries are faced with and likely to face as many of the recent initiatives particularly those that relate to globalization and decentralization begin to firmly set in. The directions of the impact that opening up of the economies and decentralization initiatives have exercised on city governments are still in the process of evolution, but the prognosis is that their affect will be extraordinary which will impact not only the finances of city governments but the functioning of city governments itself.

## **2. CHALLENGES THAT THE CITY GOVERNMENTS ARE FACED WITH**

### **1. Changes in the expenditure obligations of city governments**

The expenditure portfolio of city governments is slowly expanding to include even those functions that have traditionally been within the ambit of the higher tiers of government. What is puzzling about the emerging expenditure portfolio is that it now includes functions that have redistributive attributes – a development that is incompatible with the generally-applied

principles that govern the allocation of public functions between the different governmental tiers. The implications of this development for financing redistributive programmes and their possible inter-jurisdictional impacts are still to be understood.

## **2. Joint occupancy of expenditure responsibilities by several governmental tiers**

An important feature of decentralization initiatives in many Asian countries is that there is far less clarity with regard to the division of functional responsibilities between the different levels of government. New trends suggest that several tiers of government have concurrent responsibility for the same function. These trends have opened up a debate on who, i.e., which level of government will finance such responsibilities, who will implement them, and who will be held accountable in case of non-performance.

## **3. Reform and restructuring of city-level taxes, in particular property taxes, and aligning of user charges with costs incurred on service provision**

Few Asian countries have made changes in the revenue portfolio and revenue-raising powers of city governments. The common explanation is that "other taxes" have inter-jurisdictional implications, and are, therefore, inappropriate for city governments. Instead, city governments in many Asian countries are focusing attention on internal reforms of city-level taxes, e.g., using better methods for assessing market values of properties, and putting in practice improved cadastral records and the like. Similarly, there is a wider acceptance of the principle of cost recovery in the fixation of user charges, and improved methods of subsidy targeting for services such as water supply.

## **4. Rationalization of the inter-governmental transfer system**

Inter-governmental transfer system is undergoing a dramatic transformation, essentially in response to the situation created by the decentralization initiatives. The "negotiation" for grants which has sustained city governments in a major way, is gradually being replaced by a system that is characterized by formula or criteria-driven grants and transfer system. The new system recognizes the principle of entitlement - that city governments have an entitlement to a share of the revenues raised by the higher tiers of government. Decentralization unaccompanied by any change in the fiscal portfolio of city governments has meant, in many Asian countries, larger transfers to city governments, defeating, in a sense, the spirit underlying such initiatives.

## **5. Little progress in matters relating to autonomy of city governments in choosing tax bases and fixing tax rates**

The Asian countries have made little progress in matters of granting autonomy to city governments. They continue to exercise control on their tax bases and tax rates, defying Richard Bird's concept of a truly local tax. "A local tax is one which is (i) assessed by local governments, (ii) applied at rates decided by local governments, (iii) collected by local governments, or simply one (iv) whose proceeds accrue to local governments.

## **6. City governments access to capital markets**

A major development across Asia has been the expansion of capital markets and their access by city governments. Although still used sparingly – Republic of Korea, India, and the Philippines being a few examples where it has come into use – access to capital markets has helped firstly, to shed inhibitions with regard to the use of capital market funds for city infrastructure; and secondly, to recognize that city infrastructure financing is an inter- generational issue. Capital market access in Asian countries is accompanied by other linked initiatives such as laying down a minimum debt coverage ratio and making institutional arrangements for guaranteeing safety of investments.

## **3. CLOSING REMARKS**

These developments combined with the participation of the private sector in city infrastructure development, financing and management have led to a number of questions: (i) is the monopoly of city governments for service provision breaking down, (ii) is the distinction between local public goods and private goods as sharp as the earlier literature suggests, and (iii) do the recent developments suggest that the theories of fiscal federalism need to be revisited.

Asian region is large, varied and complex, and offers an extraordinarily interesting laboratory for examining the challenges of city finances. It is moderately urbanized (40.2%, 2005), and urbanizing at moderate rates (average annual rate of 2.68%, 2000-2005). At the same time, it is overwhelmingly large in terms of size, having absorbed 67% of the net increase in global urban population during 1990-2000. The governance structures that the Asian countries (some of them) have put in place are out of the ordinary, and represent an interesting mix of unitary and federal systems. Evidently, the challenges that city governments in Asian countries face are also out of the ordinary. A paper under preparation is expected to capture them.

## **Annex 1**

### **DECENTRALIZATION INITIATIVES**

1. Cambodia      Law on the Administration and Management of Commune/Sangkat, January 12, 2001 and Sub-Decree on Decentralization of Powers, Roles and Duties to Commune Sangkat Councils, February 21, 2002.
2. India            The Constitution (seventy-fourth) Amendment Act on Municipalities, 1992.
3. Indonesia      Law No.22 of 1999 regarding regional governments and Law No.25 of 1999 concerning the fiscal balance between the Central Government and the Regions.
4. Japan            Decentralization Promotion Law of 1995 and Decentralization Promotion Plan, 2000.
5. Korea            Local Autonomy Law, 1995.
6. Pakistan        Local Government Ordinance, 2001.
7. Philippines     The Local Government Code of 1991.
8. Thailand        The Decentralization Plan and Process Act of 1997.  
The Decentralization Master Plan of 2000.
9. Sri Lanka        The 13th Amendment to the Constitution, 1987.
10. Vietnam        Decree No.93/2001/ND-æ of December 12, 2001, on decentralizing state management powers in same fields to Ho Chi Minh City Government.