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MUNICIPAL FINANCE IN SMALL CITIES

By

Hafiz A. Pasha

And

A.F. Aisha Ghaus

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Urbanisation is proceeding at a rapid pace in most developing countries. For low and middle income economies of the world, the average annual growth rate of urban population is twice that of the overall population (see Table 1). This growth differential is even more pronounced in China, where the growth rate of urban population at 4.3 percent per annum is over three times the total population growth rate. This has led on the one hand to the

TABLE 1

EXTENT OF URBANISATION IN DEVELOPING COUNTRIES

Country	Population (Million) 1992	Share of Urban Population (%) 1992	Average Annual Growth Rate (%) 1980-92	Overall Population Growth Rate (%) 1980-92	Population in Cities/Towns with population below 1 million (%)	
					1970	1992
Bangladesh	114.4	18	6.2	2.3	53	46
India	883.6	26	3.1	2.1	68	66
Nigeria	101.9	37	5.7	3.0	74	71
Pakistan	119.3	33	4.5	3.1	51	47
China	1162.2	27	4.3	1.4	52	65
Sri Lanka	17.4	22	1.5	1.4	100	100
Egypt	54.7	44	2.5	2.4	47	48
Indonesia	184.3	32	5.1	1.8	58	64
My an mar	43.7	25	2.6	2.1	77	67
Phillipines	64.3	44	3.8	2.4	71	64
Thailand	58.0	23	4.5	1.8	35	40
Turkey	58.5	64	5.6	2.3	63	67
Brazil	153.9	77	3.3	2.0	51	49
Malaysia	18.6	45	4.8	2.5	85	76
Korea, Rep	43.7	74	3.4	1.1	25	27
Mexico	85.0	74	2.9	2.0	57	59
Low and Middle Income Economies	4610	36	3.7	1.9	59	63

SOURCE: World Development Report, 1994, World Bank.

emergence of 'mega' cities with populations in excess of 10 million and on the other hand to a vast multitude of small cities and towns at the rural urban interface performing a wide variety of service and trading functions.

According to estimates of the World Bank for developing countries, over one billion people lived in 1992 in cities and towns with population of less than one million. The corresponding number for China is over 200 million, where such settlements have exhibited considerable dynamism and growth and have increased their collective share in urban population from 52 percent in 1970 to 65 percent by 1992. It is anticipated that over the next decade these cities and towns will have to accommodate an additional 160 to 200 million migrants from the countryside of China. Therefore, the success of future development and modernisation efforts of the country will hinge crucially on the institutional and financial capacity of small towns of China to provide employment, housing and a modicum of basic municipal services to the large number of rural migrants.

The objective of this paper is to assess the prospects and mechanisms available for financing the process of urban development in small towns of relatively low income developing countries and to present the existing international experience in this area. Section 2 highlights the salient features of growth of small towns generally and derives implications regarding household levels of affordability, levels of demand for municipal services and potential local sources of revenue. Section 3 discusses issues of institutional structure and capacity and focuses in particular on the range and level of functions that can be performed efficiently by municipal governments in small towns. Section 4 highlights the problems of financial management relating to the operation of municipal budgets and the process of revenue administration. Section 5 describes the pattern of municipal finances in smaller jurisdictions and identifies major potential sources of revenue. Finally, in Section 6 are presented the conclusions.

2. GROWTH OF SMALL TOWNS

2.1 Rural-Urban Linkages

Small towns generally owe their existence to the presence of rural-urban linkages. As agricultural development proceeds and the rural economy makes the transition from subsistence to market-based farming, the prospect for stronger urban-rural linkages increases greatly. This explains why the rate of formation of new towns and the rate of growth of existing settlements increases rapidly at intermediate stages of development, as is being observed currently in many developing countries, including China.

Smaller towns and cities often represent better locations for agro-based industrial activity in view of greater proximity to agricultural production centers and for the same reason are better equipped to provide services for the modernisation and improvement of agriculture. Linkages are both forward and backward in character. The latter arise from the marketing of agricultural inputs like fertilisers, pesticides, tractors, agricultural machinery, etc., while the former involve wholesale trading in agricultural produce and agro-processing of agricultural raw materials. Initially, most of the economic activity in small towns is informal and small-scale in character of labor-intensive nature. Development of small towns at the rural-urban interface can potentially create a 'synergy' between the process of rural and urban development rather than a conflict.

2.2 Economic Base of Small Towns

Given the sources of growth of towns, the *economic base of* such urban centers consists primarily of trading and service activities for the rural hinterland. As such towns grow they generally progress to also performing industrial, administrative and cultural functions. Much of this development is spontaneous in character and needs to be supported by municipal authorities through provision of infrastructure which promotes rural-urban linkages.

2.3 Income Levels and Affordability

Small towns generally represent the first change of residence for rural migrants. There is evidence of the 'leap frogging' phenomenon whereby some migrants subsequently move on in search of better economic opportunities to larger cities. The likelihood of this is greater if the prospects for gainful employment at the initial location remain uncertain.

Income levels are generally low in small towns because human capital endowments of residents, consisting primarily of unskilled rural migrants displaced from agriculture, are limited and because of the nature of economic activity pursued at such locations which is characterised primarily by informal and small-scale modes of production. Poverty levels are high in small towns in relation to larger cities and per capita incomes are a fraction (1/2 to 2/3 usually) of the national average. The consequences are that levels of effective demand and willingness-to-pay for municipal services are low. Simultaneously, the tax bases relating to property values, incomes, value of sales, etc. are small and narrow in view of the need to exempt a high proportion of tax payers. The basic challenge confronting municipal governments in small towns is to raise enough revenues through taxes and user charges to

5 finance the investment and on-going provision and maintenance of basic municipal services like drinking water, sanitation, roads, etc.

2.4 Potential Sources of Revenue

The international experience with regard to the development of municipal finances in small cities and towns is one of limited success in resource mobilisation in view of the lack of taxable capacity. Generally, the local tax to gross regional product ratios observed are below one percent. Conventional local sources of revenue like the property tax have small yields because residential property values (rent or capital values) are low, the tax base of large-scale industry is limited and taxation of commercial property is restricted by the high degree of fragmentation and informal nature of trading activities. In fact, in many countries, small towns with populations below 25,000 are not declared as rating areas for purposes of property taxation because of high costs of collection in relation to potential revenue yields. Land prices of publicly developed plots are also unlikely to fetch large surpluses over development costs because of low real estate values in relation to these observed in metropolitan cities.

The search for revenues in smaller municipal jurisdictions, therefore, has to be oriented towards unconventional sources. This requires an understanding of the economic functions and base of such areas and the exploitation thereof of any revenue generating opportunities, frequently through the adoption of innovative tax instruments. For example, most urban jurisdictions in South Asia have found a large and growing tax base in the movement of goods from external (local and international) sources to within the municipal boundaries. A tax called octroi has been imposed on goods entering the jurisdiction for sale, use or

6 consumption and collected from transport vehicles at posts located at the urban periphery.

Even with small, flat rates of taxation revenue collections from the tax are large and in many small towns account for over 60 percent of total revenues. However, the common implication of entry/exit taxes is that they tend to fall mostly on basic items like food, building materials, etc., and are, therefore, regressive in character.

Non-tax revenues also represent a promising source. The resource mobilisation strategy in this area ought to focus on the nature of rural-urban linkages. This will require relatively unconventional investments in urban development like farm services-cum-community centers, weigh bridges (at product markets), upgrading of public transport terminal facilities, recreational facilities (for rural households), construction of guest houses and development of markets for livestock products and for general trading purposes, etc., and the levy simultaneously of appropriate fees, licences and rental charges. In many countries, there are significant examples of small, dynamic municipalities which generate almost half the revenues from such non-tax sources.

3. INSTITUTIONAL STRUCTURE AND ISSUES 3.1 Forms of Multilevel Government

The constitutional division of powers among various levels of government can be broadly categorized as unitary or federal. A unitary country has a single or multi-tiered government in which effective control, including decision-making, of government functions rests with the central government. A majority of countries have adopted a unitary form of government. Examples of multi-tiered unitary constitutions include Egypt, Japan, Korea, Indonesia, Turkey, Spain, United Kingdom and China. China, in fact, is a good example of a unitary government which is quite decentralised. In 1980 sub-national governments secured significant autonomy from the central government and China can therefore be effectively considered a decentralised federation even though the legal structure continues to be centralised.

The federal form of government has a multi-tiered structure with decision making shared by all levels of government. This system is conducive to greater freedom of choice, political participation, innovation and accountability. Federal countries broadly conform to one of the two models, dual federalism and cooperative federalism. In the former fiscal tiers are organised so that the national and state governments have independent authority in their areas of responsibility and act as equal partners. Local governments do not have any constitutional status and are simply extensions of state governments. In cooperative federalisms various levels of government have overlapping and shared responsibilities and all levels are treated equally as partners in a federation. Canada, India and Pakistan broadly conform to the first model while United States and Brazil are examples of the latter.

There is a strong rationale for decentralised decision making on grounds of efficiency, accountability, manageability and autonomy. Ideally decision making should occur at the lowest level of government consistent with the goals of allocative efficiency. Thus the optimal size jurisdiction for different services will vary with the extent of economies of scale and benefit-cost spill-overs. Each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision.

3.3 Allocation of Responsibilities

Fiscal federalism literature provides broad guidance in delineating expenditure responsibilities among member units in a federation. These basic principles, presented in Box 1, are relevant even for unitary states. Based on these criteria a guideline can be devised as to which functions are best provided by national and by sub-national governments respectively. Assignments of public functions to sub-national (local or regional/state) governments can be based on various considerations like economies of scale, appropriate packaging of local public services to improve efficiency through information and coordination economies and enhanced accountability through voter participation and cost recovery, cost/benefit spillovers, proximity to beneficiaries, and consumer preferences.

Based on these principles of expenditure assignment and the guidelines discussed above the following options for decentralisation may be appropriate. Local public services that could

BOX 1 CRIETERIA FOR EXPENDITURE ALLOCATION

1. *Efficient provision of public services:* Public services are provided most efficiently "by the Jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such prevision." However, some degree of central control or compensatory grants may be warranted if: costs and benefits are realised by non-residents; service requires area larger than a local jurisdiction for cost effective provision and administrative and compliance costs are high.
2. *Fiscal Efficiency and Regional Equity:* Differential net fiscal: benefit (imputed benefit from public service minus tax burden) arising from different fiscal capacity of the local jurisdictions introduces;; fiscal inefficiencies and regional (horizontal) inequities. It has been argued that the national government should play a role to correct these.
3. *Redistribution of real income:* while the predominant role of the national government in pursuit of vertical equity is well recognised, involvement of sub-national governments in implementing specific programs is essential so that such programs can be tailored to the meet individual jurisdictions' circumstances.
4. *Provision of Quasi-Private Goods: Public* provision of essentially private goods like education, health etc., is justified on grounds of equity. Since benefits accrue mainly to residents of separate jurisdictions, such services are better provided by sub-national governments.
5. ***Economic Stabilisation:*** It is customary to argue that federal government should be responsible for stabilisation.

be decentralised to local governments are presented in Box 2. These are services for which economies of scale are not a major consideration, political proximity is essential, no significant cost-benefit spillovers are anticipated, and distributional considerations are not important. Furthermore, these could he decentralised to local governments regardless of their size or financial capability.

BOX 2

POTENTIAL SERVICES BY LOCAL GOVERNMENTS

- Water Supply
- Fire protection
- Primary education
- Public Health
- Refuse collection
- Neighbourhood parks and recreation
- Street/roads
- Local transit
- Traffic management
- Local libraries
- Local Bylaws enforcement

In addition, land use planning, secondary education and public health are other local public services that could be decentralised to larger urban municipalities (population over 100,000.) These are services for which there is some degree of scale economy but government proximity to the people is important, distributional considerations are less relevant, and benefit spillovers are not serious.

The intent of this analysis is to present a framework for decentralization that could be implemented uniformly across a country to avoid potential controversies arising from nonuniform application. It is wrong to presume, however, that all subnational governments of a particular category and size in a developing country would be equally capable and interested in taking on particular functions. It is essential, therefore, to retain some element of flexibility regarding who does what and how it is done.

10 3.5 Issues in Management, Planning and Coordination

The main factors which impinge on the capacity of local governments and which are instrumental in determining their efficiency and effectiveness relate to accountability; autonomy; and administrative capacity. Accountability for local services in developing countries is generally poor. This can partly be attributed to the unclear functional responsibilities whereby a number of agencies are involved in the provision of the same service. For example, in some countries state governments' provision of services such as primary education and preventive health overlap and duplicate services provided by local governments. These creates inefficiencies in the allocation and use of public resources and require a high level of effective inter-agency coordination which is rarely forthcoming.

The same problems arise because of fragmented service provision in which different parts of a service are provided by different agencies. For example, development planning and implementation functions may be separated from operation, maintenance and cost recovery functions. Finally, there is lack of financial accountability due to the weak link between the cost of local services and perceived payment of local taxes.

Another issue that arises is the lack of local autonomy in planning, development, administrative and financial matters. This particularly arises in "dual federalism" in which local governments are considered only an extension of the provincial governments. In some countries local government budgets are approved by the higher tier of government. This gives the state government control over local development projects and finances, including resource mobilisation. Furthermore, state/provincial governments in some cases have control over administrative matters like hiring, transfers etc of local council staff. This further affects the efficient working of local governments.

Finally, lack of administrative capacity, reflected in inadequate staff level and poor quality, is also a problem constraining effective local government functioning in developing countries, especially in small towns. Altogether, it seems that local governments in smaller towns and cities should perform all the functions (development, maintenance, cost recovery, etc.) related to the provision of only a few of the basic municipal services like water supply, sanitation, public health and intra-urban roads. This will ensure that the limited financial resources and institutional capacity are not stretched too thinly. The objective of small town governments must be to do a few things and do them well. Other services like education, health, residential plot development, etc., may be left to higher levels of government. This is, in fact, the commonly observed pattern for most developing countries. The available international data indicates that on the average almost 90 percent of the municipal budget in small towns is accounted for by administrative overheads and costs of services like water supply, sanitation and roads.

4. FINANCIAL MANAGEMENT 4.1 Institutional Capacity and Staffing Levels In most municipal governments, especially in smaller jurisdictions, the major constraints to financial management in terms of the operation of budgets (flow of income and expenditure) and revenue administration is the low quality of human resources available for performing this function. This is the consequence of limited resources and of the public sector remuneration structure which is uncompetitive in relation to the private sector. The

12 accountant in a small municipal government is usually a low level government functionary with limited professional credentials and training. Revenue administration is also underdeveloped with inadequate recording of taxpayers and billings. Frequently, this function has been privatised and handed over to contractors. Contracting systems vary ranging from fixed commissions to pre-emption of revenue beyond a committed level of income. Privatisation has proved to be efficient in raising revenues or reducing costs as long as the bidding processes for appointment of contractors remain competitive.

4.2 **Accounting Standards and Practices** Financial practices are generally based on single entry cash accounting on an annual basis. The financial systems are traditional in character and elaborate procedures of documentation have been established primarily to facilitate financial control and prevent leakages of funds. The financial records are usually structured by a chart of accounts which identifies main service categories and within each category separates costs of staff (establishment), supplies (contingencies), repairs and new works (development expenditure). There is very little emphasis on development of management information systems to facilitate financial decisions.

Financial management reforms within local governments must include, first, improvements in billing and collection. Separation of basic functional responsibilities between assessment, record-keeping and collection is needed. Financial records frequently do not show clearly who should be billed and by how much. Also, the gains from computerisation are high. Second, there is little recognition of the need for proper cost accounting by service to enable correct pricing decisions. Many maintenance items appear as development expenditure and hence the usefulness of the accounting system is reduced. Third, budgetary control operates

13 as a blunt tool with little regard for overall targets and priorities. Financial control also needs to be extended to more effective cash flow management and creditor/debtor management.

4.3 Expenditure Planning

Expenditure planning is seldom undertaken in a multi-period framework. Budgeting of expenditures tends to focus on detail rather than on strategic decisions. Consequently, municipal budgets, especially in small towns, are of little use as planning documents. The link between expenditure and income raising decisions, which forms the basis of budgeting, is generally not clear.

In many local governments, particularly those with elected councillors, the practice is for available funds (especially for development) to be allocated, more or less, equally among wards on the basis of considerations of equity. This leads to a fragmentation of the development effort and a strong bias against investments in trunk infrastructure. Also, project approval procedures tend to be bureaucratic and cumbersome in character and involve little economic appraisal in terms of costs versus benefits.

4.4 Audit Procedures

The audit function is centralised usually within the relevent department at the state/provincial government level. The primary focus of audits is to assist the municipal administration in maintaining accurate accounts and protect against fraud, misappropriations and waste. Audit manuals generally exist and specify the normal checks. However, the overall planning of

14 audit and the auditing standards to be applied are not clearly defined. Furthermore, auditing techniques such as systems audit and statistical sampling are not used.

4.5 Revenue Administration

Revenue administration has generally not been given the priority it deserves in view of the limited tax base available to small municipal governments. The incentive to raise collections is reduced in the case of local governments which rely heavily on subventions and grants-in-aid from higher levels of government. In addition, the inability to achieve economies of scale raises costs of collection in relation to revenues generated and weakens the case for investments in tax administration. Consequently, in most small municipal governments departmental collection is fragmented and ineffective. The response is either the handing over of this function to a higher level of government or privatisation through appointment of contractors. The former runs the risk of reducing fiscal autonomy while implied costs and scope for tax payer harassment in the latter case may be high. It is essential that even small municipal governments develop an adequate tax administration which can be deployed to collect revenues efficiently from a few major sources.

Altogether, the potential gains from improvements in financial management by municipal governments are high. This will not only help in mobilising more resources but also in utilising them more efficiently for maximum impact on the level and quality of services provided.

5. MUNICIPAL FINANCES

To finance their expenditure liabilities local governments have access to two major sources of income. These can broadly be categorised into locally raised revenues and external revenues. Local governments generally have fiscal powers to raise revenues from various taxes, user charges and other sources like licences, fees, rental income etc. Substantial variation exists in the pattern of financing of local services among different cities in developing countries. Taxes usually finance the highest proportion of local expenditures. For a sample of 50 small cities in developing countries, the average share of tax revenues is 45 percent. Non-tax revenues consisting of user charges, fees, licences, rental income, etc., have a share of about 30 percent and the remainder, 25 percent, is accounted for by external revenues like grants-in-aid and revenue sharing transfers from higher levels of government.

BOX3 CRITERIA FOR TAX ASSIGNMENTS

- Taxes suitable for economic stabilization should be centralized; lower level taxes should be cyclically stable.
- Unequal tax bases between jurisdictions should be centralized.
- Taxes on mobile factors of production should be centralized.
- Residence-based taxes, such as excises, should be levied by subnational governments.
- Taxes on completely immobile factors should be levied by local authorities.
- Benefit taxes and user charges can be levied appropriately by all levels.
- There should be efficiency in tax administration, that is, the level of government likely to have the best information on a tax level responsible for levying taxes on such a base.
- Revenue means should be matched as closely as possible to revenue needs. Thus, tax instruments to further policy objectives should be assigned to the level of government having the responsibility for provision of the service.

5.1 Tax Assignments

The extent of self-reliance of local governments crucially depends in the allocation of fiscal powers. The division of revenue sources among different levels of government constitutes the tax assignment problem. Once expenditure assignment has been agreed on, tax assignment and design of transfers become critical elements in matching expenditure needs with revenue means at various levels of government. Proper arrangements prevent overdependence of lower levels of government on intergovernmental transfers, which can otherwise distort local spending priorities. Criteria used for the assignment of taxes are given in Box 3. Broadly speaking, these emphasize equity (consistency of revenue means with expenditure needs) and efficiency (minimizing resource cost).

BOX 4

POTENTIAL LOCAL TAXES

Property Related Taxes
- Tax on Annual Rental Values
- Tax on Capital Values
- Tax on Transfer of Property

Entry/Exit Taxes
- Octroi
- Export Tax

Entertainment Taxes
- Tax on Cinemas
- Tax on Dramatic and Theatrical Shows
- Tax on Feasts
- Tax on Advertisements

Head Taxes
- Tax on Professions, Trades
- Tax on Hearths
- Tax on Births and Marriages
- Poll Tax

Transport Taxes
- Registration and Annual Tax on Non-Mechanised Transport
- Registration and Annual Tax on Motor Vehicles

Resource Taxes
- Royalties
- Conservation Charges

'Sin' Taxes
- Betting and Gambling Tax
- Tax on Lotteries
- Tax on Race Tracks
- Tax on Alcohol
- Tax on Delinquints

Taxes on 'Bads'
- Taxes on Motor Fuels
- Effluent Charges
- Congestion Tolls

Taxes on Production
- Excises

Taxes on Sales
- Single-Stage Sales Tax

Taxes on Transactions
- Contracts Tax

Taxes on Animals
- Slaughter Tax
- Livestock Trading Tax

Surcharges
- Personal Income Tax
- Sales Tax

5.2 Major Potential Local Taxes

Based on the above principles, the major potential local taxes are presented in Box 4. These broadly include taxes on resources, property, sales, bads/sins and user charges. Taxes on resources is a good local government instrument because of the immobile nature of the tax base. Taxation of real estate is suitable to recover costs of public service provision related to properties. If the tax base is harmonised, single-

17 stage sales tax can be levied by any level of government and can provide a broad-based and buoyant source of revenue for local governments also.

Most local governments rely heavily on property related taxes (including taxation of rental values and transfers). Sales tax, levied in various forms, is also an important source of revenue. As mentioned earlier, in some South Asian countries, like Pakistan, octroi (an entry tax) constitutes the single largest source of local revenue. Besides these, popular local taxes include taxation of vehicles, gasoline and entertainment.

The choice of which local taxes to exploit in small municipal jurisdictions depends upon the size, buoyancy and mobility of the respective tax base, incidence (burden by income group) and ease of collection. These characteristics are highlighted in Box 5 for different local taxes. The largest potential tax bases are likely to be observed in the case of entry/exit taxes and surcharges followed by taxes on sales or production. In small towns the tax bases of entertainment taxes, transport taxes, taxes on 'bads', etc., will generally be small.

The most dynamic tax bases are likely to be observed in the case of entertainment taxes, property-related taxes, 'sin' taxes, taxes on sales and surcharges. As opposed to this, the tax base for head taxes, resource taxes and exit/entry taxes will tend to grow slowly. As highlighted earlier, local taxes ought to be levied on immobile bases. This problem is likely to be most severe in the case of entry/exit taxes, transport taxes, taxes on production and sales. This will weaken the case for imposition of such taxes. From the viewpoint of ease of collection, which is of particular importance in small towns with limited capacity for tax administration, the best taxes are resource taxes, entertainment taxes, entry/exit taxes and surcharges.

BOX 5 CHARACTERISTICS OF DIFFERENT LOCAL TAXES IN SMALL TOWNS						
Type of Taxes	Size of Tax Base	Buoyancy of Tax Base	Mobility of Tax Base	Incidence of Tax	Ease of Tax Collection	Case for Imposition by Small Towns
Property-Related Taxes	Small/Medium	Medium/High	Low	Progressive	Low	High
Entry/Exit Taxes	Large	Low/Medium	Medium/High	Regressive	Medium/High	Medium
Entertainment Taxes	Small	High	Low	Progressive	Medium/High	High
Head Taxes	Medium/Large	Low/Medium	Low	Regressive/ Neutral	Low/Medium	Medium/High
Transport Taxes	Small	Medium/High	High	Neutral	Medium	Low
Resource Taxes	Small/Medium	Low	Low	Neutral	High	Medium/High
'Sin' Taxes	Small/Medium	Medium/High	Low/Medium	Regressive	Low/Medium	Low
Taxes on •Bads'	Small	Low/Medium	Low	Progressive	Low/Medium	Low
Taxes on Production	Low/Medium	Medium/High	Medium/High	Regressive/ Neutral	Medium	Medium
Taxes on Sales	Medium/Large	Medium/High	Medium/High	Regressive/ Neutral	Low	Medium
Taxes on Transactions	Small	Low/Medium	Low/Medium	Progressive	Low	Low
Taxes on Animals	Small	Low/Medium	Low	Neutral/ Regressive	Medium	Medium/High
Surcharges	Large	Medium/High	Low	Progressive	High	High

Altogether, based on the characteristics of different taxes, the prime candidates for levy by small town governments are property-related taxes, entertainment taxes, head taxes, resource taxes, taxes on animals and surcharges. This, of course, presumes that such taxes fall within the domain of local fiscal powers. Also, there will always be exceptions and in particular towns, depending upon the nature of the regional economy, imposition of other taxes may well be justified.

5.3 User Charges and Pricing Policies

A proper pricing policy which recovers costs is a pre-requisite for adequate and efficient provision of urban services. However, the concept of self-sustained provision of services is, 19 by and large, underdeveloped in developing countries. Traditionally, there has been an absence of a strong commitment to direct cost recovery through user charges. The pattern of financing of local expenditure is a manifestation of this as only about 20 percent of expenditures are financed directly in a sample of about 50 cities analysed. This proportion is much lower in the case of social sectors.

The major issues in cost recovery in most countries relate to the ability and willingness to pay of beneficiaries for service provision and the administrative feasibility of collection. Since income levels, in general, are low, especially in small towns, and the nature of services provided by local governments like water supply and public health are 'basic' in character, governments generally lack the political will to pursue an aggressive cost recovery policy. The situation is exacerbated by the low willingness to pay of the beneficiaries given the generally low quality of service provision. In addition, issues of cost recovery in some centralised economies, like China, go beyond simply raising the level of user charges. Charges for most urban services like water, sewerage, housing, public transportation, etc. are all linked inextricably to the wage policy. Some countries have experienced with privatisation of the process of collection of charges, and the experience is mixed. As a pragmatic principle, small town governments must move towards attaining at least full operations and maintenance cost recovery with the help of tariff systems which are relatively easy to administer and less prone to leakages.

5.4 Inter-governmental Fiscal Transfers

Intergovernmental transfers are an important source of revenue for local governments in most developing countries. The economic rationale for transfers is presented in Box 6.

BOX 6 RATIONALE FOR FISCAL TRANSFERS

Fiscal Imbalance

A fiscal gap may arise because of structural imbalance between the assignment of revenue sources and of expenditure responsibilities. Such imbalances usually exist due to limited or unproductive tax bases and high level of federal/state taxation which limits local revenue-rising potential.

Fiscal Inequity and Inefficiency

Redistribution, an important objective of fiscal policy, is best performed by fce federal government. However, in a federal system "redistribution in kind" through the provision of certain 'merit goods' like education, health, social security is undertaken by lower tiers of government. These levels of government due to inappropriate tax assignments, factor mobility and tax competition may underprovide such services and achieve the equity objectives in only a limited manner.

Furthermore, common minimum standards for public services in a federation are advocated on economic efficiency grounds. Common minimum standards help reduce interregional barriers to factors and goods mobility and thereby contribute to efficiency gains. Given these goals of equity and efficiency, justification exists for transfer of funds to the lower levels of government.

Inter'jttrisdictional Spillovers

Spillovers usually occur because the benefit of a locally provided good or service itself spills beyond the local jurisdiction to benefit those not contributing to the costs of its provision. Examples mclude air and water pollution control, locally educated students who relocate, etc. Intergovernmental transfers can be used to correct for inefficiencies arising from such spillovers.

fiscal Hartnonisation

Net fiscal benefits may vary between different jurisdictions because of factors like differences in fiscal capacity and natural resource endowment, differences in units costs etc. The presence of such differences encourages fiscally induced migration and lead to externalities like unemployment, congestion etc. Therefore, to promote efficiency and equity of the federal system, fiscal equalization transfers may be justified.

Stabilisation

Intergovernmental transfers can also be used to help achieve economic stabilisation objectives. Grants could increase in periods of slack economic activity to encourage subnational expenditures and dimmish

On the whole, there is a strong case for fiscal equalisation because it allows the replication of the financial structure of a unitary state in a federalism while promoting decentralised decision making. Thus, efficiency and equity considerations coincide. The design of arrangements for transfers is also of prime importance. Criteria for such transfers are presented in Box 6.Inter-governmental fiscal transfers may be in the form of revenue-sharing, grants or fiscal equalisation transfers depending on the rationale. If the purpose of the transfer is to correct the problem of fiscal imbalance, unconditional grants or revenue sharing based on "the derivation principle" or the point of collection are generally advocated. If the transfers are made to correct fiscal inequities or inefficiencies arising from a lack of common minimum standards than the desirable form of transfers is conditional, non-matching grants because they do not affect subnational incentives for cost recovery while ensuring compliance with the higher government objectives. Open ended conditional matching grants are the most appropriate kind of transfer to correct for inter-jurisdictional spillovers while fiscal equalisation transfers may be justified to remove differences in net fiscal benefit across jurisdictions.

In practice, however, the design of intergovernmental transfers is not entirely consistent with the economic norms enunciated above. This is particularly true for grants. For instance, equalisation transfer to eliminate differential net fiscal benefits among jurisdictions or selective open-ended matching transfers to compensate benefit spillovers are hardly tried in developing countries. Revenue-sharing and conditional grants are the most popular mode of transfers. Examples of taxes shared withlocal governments include property tax, personal income tax, turnover tax, VAT, liquor tax and excises. The transfers are generally made on the basis of population, per capita income, collection (origin), equal shares, fiscal gap, etc. As a whole, the form of fiscal transfers

BOX-7 ELEMENTS OF DESIGN OF FISCAL TRANSFERS

1) *Autonomy:* The subnational governments should have complete independence and flexibility in setting priorities and should not be constrained by uncertainty associated with decision making at the center. Formula-based revenue sharing or block grants, for example, are consistent with this objective;
2) *Revenue Adequacy:* Subnational governments should have adequate revenues to discharge designated responsibilities;
3) *Equity:* Allocated funds should vary directly with fiscal need;
4) *Predictability:* The grant mechanism should ensure predictability of sub-national government's share by publishing projections.
5) *Efficiency:* The grant design should be neutral with respect to sub-national government's choices of resource allocation to different sectors or types of activity;
6) *Simplicity:* The sub-national government's allocation should be based on objective factors over which the individual units have little control;
7) *Incentive:* The proposal design should provide incentives for sound fiscal management and discourage inefficient practices. For example, there should be no specific transfer to finance deficits.

The above criteria, in certain cases, may be conflicting and therefore, a grantor may have to assign priorities to different factors in comprising policy alternatives.

SOURCE: Shah (1994).

22 from higher levels of government to small towns should be a combination of revenue-sharing transfers plus fiscal equalisation grants. Given the limited taxable capacity of smaller towns, the share of fiscal transfers in total revenue should generally decline with an increase in municipal status and population size.

5.5 Sources of Capital Funding

Municipal governments in most developing countries have limited access to capital funding for financing upfront development costs of lumpy investments in infrastructure. In Pakistan, local councils, especially the small town committees, are compelled to finance development expenditures through revenue surpluses only and access to the domestic capital market is precluded. Such restrictions imposed by state/national governments are motivated, first, by the desire to control the process of credit expansion and the money supply in order to achieve the goal of macro economic stabilisation and, second, by the perception that many local governments are prone towards financial indiscipline and are likely to borrow in excess of their debt repayment capacity thereby running the risk of default. These perceptions are slowly changing but it is unlikely, that, even in the presence of greater financial liberalisation, small town councils will be allowed significant access to capital markets.

Some countries have established arrangements for capital funding for local projects through development transfers from higher levels of government through unconditional or matching grants or project-specific assistance. These transfers are generally discretionary in character and it is difficult for local governments to base their development plans on these flows of funds. In other cases municipal development funds (or banks) have been established. The general experience, however, is that the demand for such funds at near-market rates by small

23 local governments remains low and the benefit from such schemes usually accrues to the richer councils.

5.6 Investment Incentives

Given the relatively low public costs of providing municipal services in smaller towns as compared to metropolitan cities and the likelihood of less pollution, environmental degradation, congestion, etc., a case can be made for diverting private investments to the former locations for creating greater employment opportunities and thereby attracting a greater share of rural migrants to smaller towns.

Various approaches have been adopted to counterbalance locational disadvantages to private investors by offering incentives. In many countries fiscal concessions are offered for location of investments in backward areas. These include tax holidays on profits taxes, customs duty exemption on imported machinery, exemption from production or sales taxes, etc. However, in *many cases these concessions lead to distortions* and *emergence of* tax havens. The alternative approach has been the offering of investment grants or subsidised provision of public services. The general conclusion is that for investment incentives to be successful in inducing development of small towns, these have to be selective and carefully targeted in character, otherwise they tend to become diluted or are misused.

CONCLUSIONS

The principal conclusions that emerge from the paper regarding the development of municipal finances in small towns are as follows:

24 (i) Given the fact that most small towns come into existence because of urban-rural linkages, an effort must be made to exploit the revenue generation opportunities created by such linkages. This may require resort to innovative tax instruments and development of non-tax sources by unconventional investments in urban development like farm services-cum-community centers, public transport terminals, markets, etc., and the levy simultaneously of appropriate fees, licences and rental charges.

(ii) Local governments in smaller towns and cities should perform all the functions (development, maintenance, cost recovery, etc.) related to the provision of only the key basic municipal services like water supply, sanitation, public health, roads, etc. This will ensure that the limited financial resources and institutional capacity are not stretched too thinly. Also, of vital importance to the effective functioning of local governments is the establishment of a legal framework for administration and a clear demarcation of functions and lines of responsibility.

(iii) Potential gains from improvements in financial management by municipal governments are high. These include reforms in financial systems, data and information management, accounting standards and practices, staffing levels and qualifications, audit procedures and expenditure planning. In addition, revenue administration needs to be strengthened and the scope for privatisation of this function examined. The focus of revenue administration should be on a few promising sources.

(iv) A multitude of local taxes are potentially available to municipal governments. In small towns, the strategy should be to select taxes which have relatively large, buoyant and immobile tax bases and where the ease of collection is high and costs of collection are low. Prime candidate taxes for levy generally by small town governments are head taxes, property-related taxes, entertainment taxes, resource taxes and surcharges on taxes of higher levels of government. In the case of individual towns, however, imposition of other taxes may be justified in line with the nature of the regional economy.

(v) As a pragmatic principle, small town governments must move towards attaining at least full operations and maintenance cost recovery in services like water supply and sanitation with the help of tariff systems which are relatively simple to administer and less prone to leakages.

(vi) Inter-governmental transfers from higher levels of government should be an important component of the revenues of small towns. These transfers should generally be a combination of revenue-sharing transfers plus fiscal equalisation grants. Share of fiscal transfers in total revenue may decline with an increase in municipal status and population size.

(vii) Investment incentives need to be offered to divert and generate private investment in small towns. However, these incentives should be selective and carefully targeted in character to have the maximum impact.

26 These are some of the conclusions based on the available international experience in the area. Implementation of the above recommendations will enable small towns to play a more effective role in attracting the inflow of rural migrants and providing them with productive employment, housing and access to basic municipal services.

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