METROPOLITAN CITY FINANCES IN ASIA AND THE PACIFIC REGION: ISSUES, PROBLEMS AND REFORM OPTIONS

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METROPOLITAN CITY FINANCES IN ASIA AND THE PACIFIC REGION: ISSUES, PROBLEMS AND REFORM OPTIONS

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Asia and the Pacific is witnessing the world’s fastest urbanization in history. In the period 2000-2025, 1.1 billion people are projected to migrate into Asian cities and the region is now home to more than half of the megacities worldwide. Providing quality jobs, housing, urban infrastructure and public services for these new urban migrants and supporting sustainable development of the region’s large metropolitan areas would be a significant fiscal challenge for many governments.

The current approach of revenue mobilization for cities and municipal fiscal reform efforts are unlikely to meet the substantial financing needs. Instead, there is a need for a metropolitan public financing strategy that is integrated into national urban development plans and matches national development objectives.

The governance arrangements in metropolitan areas would be critical for such strategies to succeed. Compared to fragmented governance structures, the area-wide metropolitan governance model, which allows for effective coordination of service provision and revenue mobilization in the broad metropolitan areas, offer the most promising prospects. When the jurisdiction boundary is large enough, public service delivery can have better coverage and be more efficient, more revenue productive tax bases would become available, debt repayment capacity can be enhanced, and fiscal disparities can be reduced. While these changes may come at a cost of diminished local government control in some countries, reforms towards area-wide metropolitan governments would be a step in the right direction.
Financing Asia-Pacific’s big cities also requires a broad mix of revenue tools for metropolitan governments, including property and land taxes, transport or fuel taxes, user charges, and broad-based local business, sales and consumption taxes, or surcharges on national taxes. In many cases, the availability and efficiency of these revenue tools depend on the extent of local fiscal autonomy. Accordingly, the intergovernmental transfer schemes should be rationalized in such context.

Three central elements for a successful metropolitan public finance strategy can be highlighted. First, there is no universal solution, and policy choices should be aligned with local policy objectives. Second, where local fiscal autonomy is deemed important, local governments should be provided with adequate space for revenue mobilization. However, at the same time, they should be constrained from accessing intergovernmental transfer and special subsidy regimes. Third, higher level governments might consider establishing a commission to study the feasibility of a special regime for metropolitan area finances.

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I. Introduction

The United Nations 2030 agenda for sustainable development calls on countries to engage in fundamental restructuring of governance and finance to help realize the objectives of sustainable and equitable development and significant reductions in poverty. These goals are very ambitious and will be expensive to attain because they require ensuring access to affordable housing and basic services, slum upgrading and provision of safe, affordable, accessible and sustainable transport systems, with special attention to the needs of those in vulnerable situations. Even to move in the direction of such goals, Asian countries must find ways to produce public services more efficiently, to govern metropolitan areas with a better eye toward ensuring equity in the provision of services, and to mobilize more resources through taxes and charges for services.

The focus in this paper is on the last of these areas, revenue mobilization by local governments in metropolitan areas. This analysis is meant to help policy makers in the Asia Pacific region in two ways: by providing a policy framework for an overall city financing strategy, and by identifying some of the specific options for increasing metropolitan local government revenues. As is discussed at some length in this paper, the issues of governance, service delivery and revenue mobilization are not easily separated in developing a metropolitan fiscal strategy.

Some important limitations to this study should be made explicit. The first is the virtual absence of comparative fiscal and economic data for individual metropolitan local governments. Though the large international agencies are on record as identifying urbanization as a key factor in shaping economic and social development in low and middle income countries, none have stepped up to the task of tracking the financial condition on individual metropolitan areas (See Box 1).

A second limitation is the important topics that are not covered here, mostly because each would require a separate treatise and would take us too far from the central concern of this paper. These include notably, land policy, housing finance, public-private partnerships, local public administration, and regimes for debt finance.

Finally, there is the question of which metropolitan areas in the Asia Pacific region are good candidates for the reform options discussed here. No specific list of cities is proposed here, other than to say that our focus is on the large urban agglomerations. But even here, we note that some Asian Pacific countries are committed to continuing with a centrally-driven revenue system, and to finance local governments with intergovernmental transfers.

This paper begins with a discussion of why revenue mobilization by big city governments has become an important question, and how the development of a proper framework for metropolitan finance might be approached. We turn then to a critical review of the governance and finance practices in metropolitan areas in the Asia Pacific region, and to a discussion of the reform options that might be part of a way forward.
Box 1. The absence of comparable fiscal data for individual metropolitan areas

Though some information about individual metropolitan cities is available, it is not possible to do an extensive comparative analysis. The best comparative information available, that includes developing countries, is the IMF’s Government Finance Statistics Yearbook (GFS). But neither the IMF nor the other international agencies regularly report fiscal data for individual subnational governments. Audited financial reports for individual local governments are available for most cities, but these often are not reported in the same format. This hole in the available data has been lamented for decades, but no government has yet stepped up to the task (Keare, 2013). On this matter, we would underscore the comments by ESCAP (2015, p43).

… such coherent and comparable data is almost impossible to come by. Urban data collection and reporting have simply not kept up with the needs of urban planners and city managers. This ‘data deficit’ is affecting planning of city development, as well as the understanding of urban change, including complex social change. When public and private policymakers prepare urban policies and plans or compare urban trends and conditions, they are forced to use urban data that are often incomparable and incompatible.

II. Why is urban government revenue mobilization an important issue?

Many large urban places seem to be settling on an economic strategy that would eliminate the barriers to capturing the agglomeration benefits that lead to productivity increases. But urban economic and population growth also is bringing an unprecedented increase in the demand for local public services and infrastructure, and here a policy strategy has not emerged. A key component of such a strategy could be increased revenue mobilization by metropolitan local governments.

A. Urbanization

The urban population of the Asia-Pacific region more than doubled between 1950 and 1975, doubled again between 1975 and 2000 and is projected to almost double once more between 2000 and 2025. In absolute terms, the current quarter century (2000-2025) is projected to add an estimated 1.1 billion people to the region’s urban areas. (ESCAP, 2015). The region currently hosts 17 of the world's 28 megacities (cities with more than 10 million people) and is expected to be home to 60 percent of the increase in the world's urban population between now and 2030. Mobilizing adequate resources to address infrastructure needs, basic public services and housing for the expanding urban population will be no small task for central and local governments in the region.¹

The benefits of urbanization to economic development are well known (Krugman, 1991; World Bank, 2009; Yusuf, 2013; Henderson, 2015; Glaeser and Joshi-Ghani,2015; Ahluwalia, et. al., 2014, ESCAP, 2015). Agglomeration effects allow firms to capture economies of scale, more exchange of ideas increases labor productivity and innovation, access to a larger and more specialized labor market helps relax supply constraints and

¹ Most of this increase is in China and India, but significant urbanization is also taking place elsewhere in the region.
increases productivity, and a more advanced infrastructure and education system leads to productivity increases. The Asia-Pacific region has done particularly well in capturing the benefits of urbanization. In a ranking of Global cities according to their competitiveness, 13 of the top 50 are in the Asia-Pacific region (A.T. Kearney, 2010).

As shown in Table 1, it is not uncommon for individual metropolitan areas to account for a disproportionate share of national gross domestic product (GDP) in the Asia Pacific region (OECD, MGI, 2011).

Table 1. National population and GDP shares of metropolitan areas in the Asia-Pacific region

<table>
<thead>
<tr>
<th>Metropolitan Area</th>
<th>Population (Millions)</th>
<th>Percent of national population</th>
<th>Percent of National GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok</td>
<td>10.1</td>
<td>12.6</td>
<td>29.1</td>
</tr>
<tr>
<td>Jakarta</td>
<td>10.2</td>
<td>11</td>
<td>16</td>
</tr>
<tr>
<td>Manila</td>
<td>11.5</td>
<td>10</td>
<td>37.2</td>
</tr>
<tr>
<td>Beijing</td>
<td>21.1</td>
<td>2</td>
<td>3.43</td>
</tr>
<tr>
<td>Mumbai</td>
<td>20.7</td>
<td>2</td>
<td>6.16</td>
</tr>
<tr>
<td>Istanbul</td>
<td>14.3</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>Karachi</td>
<td>15</td>
<td>8</td>
<td>20</td>
</tr>
<tr>
<td>Colombo</td>
<td>5.6</td>
<td>27</td>
<td>40</td>
</tr>
<tr>
<td>Yangon</td>
<td>4.35</td>
<td>8</td>
<td>23</td>
</tr>
<tr>
<td>Dhaka</td>
<td>17</td>
<td>11</td>
<td>35</td>
</tr>
<tr>
<td>Hanoi</td>
<td>7.7</td>
<td>9</td>
<td>12.6</td>
</tr>
<tr>
<td>Kathmandu</td>
<td>5</td>
<td>18</td>
<td>33</td>
</tr>
</tbody>
</table>

Source: The author.

B. Budgetary pressures facing large cities

Providing public services in cities of low and middle-income countries with populations of 5 to 20 million poses great challenges. This would be true even if the infrastructure were not already so inadequate, the housing stock so insufficient and the concentration of poor families so great. Continued in-migration together with this backlog suggests that marginal fixes to the national system of fiscal decentralization or taxation will not resolve the public financing problems of large urban areas. For example, if the projected annual costs of urban infrastructure of an additional 2-5 percent of GDP are only approximately correct, it is well beyond the reach of most developing countries where taxes average about 16 to 17 percent of GDP and have not increased greatly in the past four decades (Bahl, 2014).

The tax base of large metropolitan areas is growing and could make a significant contribution to this financing gap if the revenue potential in big cities could be tapped by the local governments. But most big cities in the Asia-Pacific region do not have access to broader tax bases (see Table 2). Finding a way to mobilize more local government

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2 The rankings are based on five factors: business activity, human capital, information exchange, cultural experience, and political engagement.
revenues is not the only problem. Resolving the financing gap will require settling on the right degree of fiscal decentralization within the metropolitan area, finding a way to coordinate the work of many different government agencies, upgrading the quality of the local government staff, and developing a viable plan for resource mobilization. Things are much more complicated than simply finding the money.

On the more optimistic side, the timing for metropolitan fiscal reform in the Asia-Pacific region may be good. The heavy investment needed to maintain a competitive infrastructure and an adequate quality of public services will also lead to an increased property and consumption tax base that can be captured by the right kind of revenue mobilization system. And if the commercial and industrial sectors remain competitive, and if the middle class emerges, there may be an increased willingness to pay for local services.

Table 2. Revenue bases of local governments in selected metropolitan areas of Asia-Pacific countries

<table>
<thead>
<tr>
<th>City/Metropolitan Area</th>
<th>Access to broad based, local non-property tax</th>
<th>Major Revenue Source</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mumbai</td>
<td>Yes</td>
<td>Octroi</td>
<td>Octroi is a terminal tax, known for its distortive effects on trade.</td>
</tr>
<tr>
<td>Beijing</td>
<td>No (see comment)</td>
<td>Transfers</td>
<td>Chinese cities have access to the national government tax base through shared tax transfers</td>
</tr>
<tr>
<td>Jakarta</td>
<td>no</td>
<td>transfers</td>
<td>Does not participate in general revenue sharing, but does receive a special share of the national income tax</td>
</tr>
<tr>
<td>Manila</td>
<td>no</td>
<td>Local sources, including a turnover tax on certain local businesses</td>
<td>Poorest local governments in the metro are more dependent on transfers</td>
</tr>
<tr>
<td>Istanbul</td>
<td>No</td>
<td>Transfers</td>
<td>Very little local government taxing power</td>
</tr>
<tr>
<td>Saigon</td>
<td>No (see comment)</td>
<td>Transfers</td>
<td>Vietnam cities have access to the national government tax base through shared tax transfers</td>
</tr>
<tr>
<td>Bangkok (BMA)</td>
<td>No</td>
<td>Transfers</td>
<td>Local governments have access only to minor taxes</td>
</tr>
<tr>
<td>Kolkata</td>
<td>No</td>
<td>Transfers/own source</td>
<td>Approximately equal shares of financing from own source and transfers.</td>
</tr>
</tbody>
</table>
1. Public servicing needs

It almost certainly costs more to provide services in large metropolitan areas because of higher factor costs (labor, land), and because of cost duplication in metropolitan areas where many municipalities provide the same services. To some extent this is offset by the advantages of economies of scale, but there is little solid evidence about the cost savings involved (Fox and Gurley, 2006; Bahl, 2013).

Metropolitan areas require special public services to accommodate their large populations and more dense living conditions. This might include a larger and more complicated road network, and mass transit to address congestion. More dense living conditions and urban poverty may require heavier outlays on security, special firefighting equipment to deal with tall buildings, and the like. Poor sanitary conditions in high-density environments are common in many neighborhoods of large cities in the region. The metropolitan population is usually better educated and higher income than that in other areas, and may demand more from their governments in terms of the quality of public services delivered. They may also demand better amenities, such as recreation, a cleaner environment and open space. Empirical studies carried out in Indian metropolitan areas have produced results consistent with this (Sridhar, Bandyopadhyay and Sikdar, 2008).

Metropolitan area local governments have a greater taxable capacity than do those in the rest of the country, and this is reflected in higher levels of spending. A golden rule may be that finance should follow function, but oftentimes the availability of funds plays a major role in dictating how much will be spent. The boom in local tax revenues in the richer cities in metropolitan Manila has shown up in significantly higher expenditures in those cities. For example, the per capita expenditures in the richest city (Makati) are three times higher than the metropolitan average (Nasehi and Rangwala, 2011).

However, a high level of public expenditures in metropolitan areas may not lead to a high quality of local public services. Based on reasonable evidence, we can speculate that public service levels in many of the world’s largest cities are well below minimum standards. A commissioned study in India in the early 2000s estimated that actual expenditures in urban areas covered only about one-third of expenditure needs. More recent research suggests that the situation may have worsened since that time (Bandyopadhyay and Rao, 2009). A survey of India’s cities finds that they fall “well short of not only the level of services to which international cities aspire but even a “basic “standard of living for their residents” (MGI, 2010, p54.).

2. Infrastructure

Keeping up with capital facility needs is perhaps the major financial challenge facing metropolitan cities. Ingram, Liu and Brandt (2013) estimate, with an income driven model, that developing countries will require an annual amount of about 2.8 percent of GDP for new infrastructure investment in urban areas, and an additional 2 percent of GDP for maintenance. Present levels of revenue mobilization suggest that this is well beyond the overall fiscal capacity of governments in developing countries. Individual country studies also paint a bleak picture of the prospects for covering the infrastructure gap. Estimates for India are that new investment in urban infrastructure will rise only to about 1.14 percent of GDP over the next 30 years (Ahluwalia, 2014).

3. Slums

Slum improvement focuses on three activities: investment in infrastructure and public service amenities, improvement of shelter, and security of land tenure. The two latter
activities are multi-government tasks, necessarily led by central or state governments. The improvement of local public services may fall in large part to the metropolitan local governments, depending on expenditure assignment, but in general is almost always well beyond the limits of their present access to finance. For example, over half of the population of Mumbai lives in slums with little by way of access to water or sanitation. Most do not have access to health and education. Rao (2009) and Bandyopadhayay and Rao (2009) cite statistics that underline the magnitude of the problem: just 78 percent of slum dwellers use tap water; only 37 percent use communal toilet facilities and 24 percent walked 0.2 to 0.5 km to latrine facilities; there is little by way of solid waste disposal; and only 84 percent of slums had approach roads that would service motor vehicles.

C. The financial condition of Asian cities

A general perception is that large cities are incurring chronic deficits because of burdensome service costs, overborrowing and inadequate revenues. This may well be true, but comparing cities according to their fiscal health is not easily done. In part, this is because data are not readily available to do this, and in part it is because there is not a good, conceptual definition of fiscal health.

Defining fiscal health is especially difficult. The accounting definition of fiscal condition focuses on budget balance. On the surface, this seems straightforward: Does the city government raise enough revenue from its regular sources to cover the amount it spends? But even the straightforward definition can give a misleading picture. There may in fact be a budget deficit that is covered by irregular transfers from higher level government (bailouts), deferred payment to creditors or to public pension funds, or short term borrowing from banks. All of this might be effectively hidden in the accounts and so it is difficult to get meaningful results from accounting statements of financial condition.

Moreover, a balanced budget does not give information about the quality of public services delivered, or about whether present levels of tax burdens are sustainable. A straightforward comparison of total expenditures and total revenues of Asian cities shows large financial surpluses, as for example, in Manila and Jakarta. But in fact, neither city spends their full budgeted amounts for various reasons, e.g., intergovernmental transfers are received too late in the fiscal year, the local governments do not have the capacity to spend the full amounts of revenue available, capital projects are delayed, etc. It would be difficult to attach a conclusion about fiscal health to these surpluses.

III. Reform directions for metropolitan local government finances in Asia-Pacific region

The fiscal framework in place in most countries in the Asia pacific region is one that features centralized tax systems, user charges that do not recover costs, and limited local government budgetary autonomy. As a strategy to promote urban economic

3 In parts of this paper, I draw from some of my previous work on this subject, and from Bahl and Bird (forthcoming).
development, this does not match up very well with the task of capturing the revenue opportunities that accompany urbanization.

To be sure, there are important and useful fiscal initiatives underway in the metropolitan areas of low and middle-income countries in Asia. Many of these are consistent with supporting the new metropolitan economies. Some countries have arranged new government structures and have made sweeping changes in expenditure assignments (Indonesia), some have encouraged increased revenue mobilization by urban local governments (The Philippines), some have relaxed debt finance restrictions, some have created new, targeted grant programs for large cities (India), some have resorted to the sales of land to support spending needs (China) and some have begun to rely on capturing part of the land value increases that have come with urbanization. But mostly, these reform measures are carried out in an ad hoc or piecemeal way and not as part of an overarching metropolitan fiscal strategy.

What is needed is to replace the present ad hoc approach with the implementation of a metropolitan public financing structure that matches up with an urban economic development strategy. How to do this within existing economic and political constraints is the difficult question. Relatively few countries have even tried to institutionalize an urban economic development strategy.

Table 3. Major intergovernmental fiscal reforms in recent years: selected metropolitan areas

<table>
<thead>
<tr>
<th>Metropolitan Area</th>
<th>Reform</th>
<th>Implications for Local Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manila</td>
<td>Reform of local government code in 1991 devolved tax and expenditure responsibilities and powers</td>
<td>No broad-based taxing power was devolved to cities</td>
</tr>
<tr>
<td>Jakarta</td>
<td>“Big Bang” decentralization of expenditure responsibilities in 2001</td>
<td>No provision for strengthened local revenue raising powers</td>
</tr>
<tr>
<td>Beijing</td>
<td>Various reforms to intergovernmental fiscal system including elimination of the “local business Tax”</td>
<td>Share of VAT earmarked for local governments has increased, land revenue rationalized.</td>
</tr>
<tr>
<td>Mumbai</td>
<td>Constitutional Amendment of 1974 defining the powers or local government; State Finance Commission initiatives recommending strengthened local revenue bases.</td>
<td>State governments have resisted movement to implement the constitutional amendment. No strengthening of local revenue powers</td>
</tr>
<tr>
<td>Bangkok</td>
<td>2001 amendment to decentralize responsibility for expenditures, and to guarantee adequate revenues</td>
<td>No initiative to increase local government revenue raising powers</td>
</tr>
</tbody>
</table>

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*We use the term metropolitan area to refer to the built-up space covered by large cities, including their suburban areas. This is like the definition used by the United Nations (2008, 13) for urban agglomeration, which includes the population “contained within the contours of a contiguous territory inhabited at urban density levels without regard to administrative boundaries.”*
A. What theory suggests about local revenue mobilization

Subnational government revenue mobilization can be an important component of a fiscal decentralization strategy. There are three justifications. First, the standard of accountability of government officials is much higher when they must finance some public services with taxes on local residents. The result of this accountability may be a better quality of public services, a package of services that fits local preferences, and a greater willingness to pay.

Another potential gain from local government autonomy is an increase in the overall rate of revenue mobilization, reflecting both the presumably greater willingness to pay for services that are more in tune with local preferences and in some instances, perhaps, by the potential comparative advantage of subnational governments in collecting certain taxes. Although the amounts involved may not be large, the potential revenue gain from decentralized taxation may nonetheless be significant for developing countries where the average ratio of tax to GDP is low (Bahl and Bird 2008).

B. A policy strategy for metropolitan regions

Governments in the Asia Pacific region might form a metropolitan strategy that can accommodate the delivery of local benefit services in the entire labor market area, that can respect jurisdiction boundaries if called for, and that can allow the implementation of effective coordination mechanisms for the provision of local government services. The metropolitan fiscal strategy could include local financing to cover at least the local benefit services provided in the metropolitan area. Two general features are essential to a metropolitan fiscal strategy: (a) a system that can accommodate the special needs and stronger capacities of the metropolitan local governments, and (b) a recognition of interactions among revenue assignment, expenditure assignment and the structure of metropolitan governance. These are discussed below.

1. Asymmetry in the intergovernmental fiscal system

Many countries treat all local governments the same in their intergovernmental fiscal systems. Others create a special space for metropolitan local governments. A start toward special fiscal arrangements for metropolitan finance has been made in China where four large cities have provincial status, in Korea where the metropolitan cities have provincial status, and in Indonesia and Thailand where Jakarta and Bangkok have been given provincial status. Still, however, none of these cities has significant revenue autonomy.

There are many ways to enhance the revenue raising autonomy of metropolitan local governments. These might include the power to levy new taxes, the power to set tax rates and user charge rates, the power to control exemptions and preferential treatments, and the authority to impose a sur-rate on a national tax base. Incentives to use these powers could be embodied in a special regime that limits the flow of intergovernmental transfers to metropolitan local governments. This would likely result in a higher “tax
price” for residents and businesses in the metropolitan areas.⁵

A special fiscal regime that provided metropolitan areas with more fiscal autonomy would be a difficult political sell in many countries. In most low and middle-income countries in the Asia-Pacific region, higher level governments are not likely to give up their control over metropolitan finances so easily. In India, states are responsible for controlling metropolitan area local governments but have used that power to delay implementation of the 1974 constitutional amendment that provided a clear schedule of rights and duties of third tier local governments (McKinsey Global Institute, 2010; Mathur, 2014, Rao and Bird, 2014). Such an arrangement does not bode well for the creation of new metropolitan government structures with a special regime. In unitary countries where local governments are usually governed by a central law, their position in the intergovernmental fiscal system is even less secure than in federal countries. Still, metropolitan local governments in unitary countries often have significant expenditure powers, as for example in the case of expenditure assignments in Indonesia (Smoke, 2013) and in China (Bahl, Goh and Qiao, 2014). But neither Indonesia nor China devolves any significant amount of revenue power. China is not likely to devolve taxing powers to subnational governments, but in the case of Indonesia, there has long been a call for more revenue raising authority at the urban government level. In many countries in the Asia Pacific region, higher level politicians will be dug in against relinquishing power by creating a special regime for metropolitan local governments. Higher level governments want to shape local government priorities in the public sector to move toward goals that are in step with central (or state) government objectives. There also is the fear that giving the large local governments access to a broad-based tax will crowd out some central government taxes and diminish the size of the revenue sharing pool. But this firmly entrenched system of revenue centralization in the Asia Pacific region may be overtaken by the sheer magnitude of metropolitan fiscal problems. Many countries in the region are characterized as making a low tax effort, and have found it difficult to overcome the obstacles to increased levels of taxation. But the demands for new urban services and additional infrastructure spending may become too much of a problem to ignore. At some point, the easier way to go may be to create a special fiscal regime for the large cities and to let them manage their own fiscal affairs.

2. Government structure, expenditure assignment and local revenue mobilization

The reform options for an efficient system of local government revenue mobilization in metropolitan areas will depend on the structure of government in the metropolitan area and the assignment of expenditure responsibilities. These are crucial considerations for those who would structure an enhanced revenue system for local governments in the region. Since governance and expenditure assignment regimes will differ from city to city, so too will the best options for revenue mobilization.

The link between revenue mobilization and metropolitan government structure is especially confining. If the local government’s boundaries cover the entire metropolitan area, broad based taxes may be levied with less economic distortion because there is less

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⁵ This means that residents and businesses in metropolitan areas would pay a higher level of taxes for public services received than would residents and businesses in other local government areas.
possibility for one municipality to export the tax burden to another. But in a
metropolitan area where there are numerous municipalities, there will be more mobility
across jurisdiction boundaries, tax burdens will be exported, and wide fiscal disparities
may result. This will limit the possibility of developing efficient broad-based taxes in
jurisdictionally fragmented metropolitan areas.

The link between efficient local revenue systems and expenditure assignment is an
equally important consideration. To a large extent, the assignment of revenues to the
local governments in an efficient system is driven by the functions for which local
governments are responsible, e.g., some functions are best financed by user charges,
some by general taxes, some by intergovernmental transfers, and so on. The model is
summarized in box 2.

**Box 2. Matching expenditure assignments with local revenue instruments**

An efficient local government revenue system will reflect the services that it is assigned to deliver
(Bahl and Linn, 1983).

- For publicly provided goods and services, where the benefits accrue to individuals within a
  jurisdiction and where the exclusion principle can be applied in pricing, user charges are the
  most efficient financing instrument. This would include most public utilities.

- Other local government services, such as general local administration, traffic control, road
  maintenance, street lighting, security, primary schools, local clinics and parks and recreation are
  local public goods whose primary benefits accrue to the local population. They are most
  appropriately financed by taxes and licenses.

- For services in which substantial spillovers to neighboring jurisdictions commonly occur – such
  as health, higher education, and certain types of infrastructure expenditures – provincial or
  national intergovernmental transfers should contribute to financing.

- Borrowing is an appropriate arrangement for financing capital outlays that have a long service
  life, e.g., public utilities or mass transit.

**IV. Government structure in metropolitan areas**

Three basic approaches to metropolitan governance are jurisdictional fragmentation,
which emphasizes home rule; functional fragmentation, which emphasizes technical
efficiency; and metropolitan government, which emphasizes coordination and
internalizing externalities (Bahl and Linn 1992). In practice, the advantages and
disadvantages of these three forms of metropolitan governance play out in a compromise
that attempts to capture the benefits of a favored approach while minimizing some of its
costs. The result, almost always, is a mixed model of metropolitan governance.⁶ The
pros and cons of the different arrangements are summarized in table 4. There is no one
pattern of metropolitan governance that is generally followed in Asia.

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⁶ This three-way classification is useful because it allows a focus on the kinds of governance tradeoffs
that can be made, and it lends itself well to a focus on less developed countries. But it does
oversimplify, as would any taxonomy. For even less simplified, but very useful classifications, see
### Table 4. Alternative metropolitan government structures

<table>
<thead>
<tr>
<th>Government structure</th>
<th>Emphasis</th>
<th>Advantages</th>
<th>Disadvantages</th>
<th>Examples in Asia-Pacific</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jurisdictional Fragmentation</td>
<td>Home Rule</td>
<td>Voters have more control over services delivered and tax levels</td>
<td>Does not address spillover effects, coordination is difficult, can lead to large fiscal disparities</td>
<td>Manila, Kolkata</td>
</tr>
<tr>
<td>Functional Fragmentation</td>
<td>Technical Efficiency</td>
<td>Professional management, can capture economies of scale, may have access to a dedicated revenue stream</td>
<td>Less directly accountable to local voters, coordination with other services can be difficult</td>
<td>Mumbai</td>
</tr>
<tr>
<td>Metropolitan Government</td>
<td>Coordination of service delivery, technical Efficiency</td>
<td>External costs can be internalized, economies of scale can be captured, broad based taxes are more feasible, fiscal disparities can be eliminated</td>
<td>Government decisions are more distant from local voters, intergovernmental conflicts with lower tier neighborhood governments, diseconomies of scale</td>
<td>Jakarta, Beijing, Bangkok</td>
</tr>
</tbody>
</table>

### A. Jurisdictional fragmentation

Under a jurisdictional fragmentation approach, many general-purpose local governments (municipalities) 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 many cases, there also is an overlying metropolitan government of some sort, or a region-wide special district, or a mechanism for cooperative agreements, but the emphasis in service delivery is on the role of the underlying cities and municipalities.

The advantage of the jurisdictional fragmentation model is that it keeps government close to the people. Because the population of the fiscal decision-making unit is smaller than it would be if governance were areawide, the local government bureaucracy and local politicians are more accountable to a relatively small constituency to whom they are known. Residents are more likely to get the package of services that they want under a fragmented government arrangement. This also means that local governments in the metropolitan area can compete for residents and businesses with the package of public services and taxes that they offer.

The advantages of this home rule model will come at some cost: a failure to capture economies of scale, and operating within a set of boundaries that are arguably too small to internalize important external effects or to allow coordinated service delivery. Jurisdictional fragmentation also can lead to large fiscal disparities among local governments in the metropolitan area, since constituent local governments almost surely will have different expenditure needs and different financing and service delivery capacity. The unit cost of service delivery may be higher because of so much duplication of administrative services, and because of the failure to capture economies of scale. Finally, the jurisdictional fragmentation model leads to some confusion about accountability. Metropolitan residents may live in municipality A, work in municipality B, and shop in municipality C, and may be uncertain about who to hold responsible for the quality of public services provided.
The jurisdictional fragmentation model is the choice for governing metropolitan areas in many low and middle-income countries, including some in the Asia Pacific region. The sixteen cities and one municipality in metropolitan Manila are responsible for those services whose benefits are thought to be contained within local boundaries (Manasan 2009, p338; Diokno, 2009). Each is entitled to levy a property tax and a local sales tax, and they are self-governed. The Metropolitan Manila Development Authority (MMDA), the overlapping areawide government, is responsible for planning and for delivering or coordinating services with a regional impact, such as transportation, flood control, sewerage, urban renewal, zoning, health, sanitation, and public safety.

The local government units in metropolitan Manila (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 history of metropolitan governance in Manila has been one of a struggle for power between the metropolitan government and the lower-level local governments, and this has compromised the coordination objectives of the MMDA (Smoke, 2013).

The Kolkata metropolitan area is governed by three municipal corporations (including Kolkata), thirty-eight municipalities, and twenty-four rural local governments. The municipal governments are dominant in terms of service provision and revenue raising (Sridhar and Bandyopadhyay, 2007). The Kolkata municipal Corporation covers 20 percent of the land area of the metropolitan area but 37 percent of the population. The Kolkata Metropolitan Development Authority (KMDA) has responsibility for planning and carrying out major infrastructure development in the metropolitan area. The KMDA is a state agency, though some elected local representatives are on its board. It is financed by grants from the federal and state governments. The Kolkata metropolitan council is like that in Manila, but seems to have more buy-in from the municipal governments and the state government. The appointed Chief Minister of the State chairs the committee, and there is provision for coordination between state government ministries and the metropolitan government. It is required that all municipal development plans coordinate with the metropolitan development plan.

B. Functional fragmentation

Under the functional fragmentation approach, the delivery of a single function (or a related grouping 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, including those with many municipal governments, but the arrangements vary widely, as does the degree of emphasis placed on the use of public companies and special districts. Public companies can exist side by side with either a fragmented local government arrangement or an area-wide metropolitan government.

A main advantage of functional fragmentation is that an autonomous agency or a public company is likely to be more technically efficient than the general government because it is specialized, it may be able to attract and retain higher-quality management and staff, and it serves a large enough population 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 or a special district government may have
access to a dedicated revenue stream (e.g., an earmarked tax, share of the budget of a higher-level government, a compulsory transfer from the city government, or user charges), and if well run, it has arguably a greater potential for debt finance than would a general-purpose local government.

The major drawback to this approach is that public companies and even special districts are less directly accountable to local voters than would be an elected municipal council. This depends on how the board and the management of the autonomous agency are determined, and here the practice varies widely.

Special districts play an important role in financing services in the metropolitan areas of low and middle income Asian countries. An autonomous agency of the Mumbai municipal corporation is responsible for electricity and bus services and has shown good management successes. India also makes use of para statals, which are public companies operated by various departments of the state (or federal) government. The 21 para statals operating within Mumbai account for a large share of total infrastructure spending in the metropolitan area (Pethe, 2013). Some of these para statals route their funds through various metropolitan agencies, and in such cases coordination problems in service delivery are made more manageable (Pethe, 2013).

C. Metropolitan government

Under the metropolitan government model, most general services and infrastructure services are provided by an areawide local government. In practice, area wide governments often share fiscal powers with lower tiers of government or publicly owned companies. This gives local governments some sense of home rule, even though most power is vested in the overlying metropolitan area government.

There are several versions of areawide governance. One is the large city that includes most of the urban population in its boundaries (e.g., Beijing and Jakarta). Another is the large city that dominates public services provided in the metropolitan region but does not include all municipalities that are within the labor market area (e.g., the case in Mumbai). Yet another version of areawide governance is an appointed agency usually charged with planning and coordination responsibilities, often for capital facilities. In some cases, these metropolitan authorities have responsibility to deliver region-level services.

The significant advantages of the metropolitan government approach are the internalizing of spillover effects, the built-in coordination in the delivery of functions, the better opportunity for capturing economies of scale, and the possibility for accessing a broad tax base in an efficient way. This gives a potential for better resource allocation compared with dividing responsibility for local services among several municipalities and special-purpose governments. The metropolitan government form also offers greater potential for equalization because the quality of local services is not tied to the wealth of

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7For discussions of metropolitan-area governance, see Bahl and Linn (1992), Bird and Slack (2004), Jouve and Lefèvre (2002), OECD (2006), and Slack (2007), and Bahl (2013).
each local jurisdiction, as it is with jurisdictional fragmentation. To some, the areawide approach to governance has so much upside that it is a hard recommendation for governance in big cities (MGI, 2010).

On the other hand, the metropolitan form of governance diminishes the power of local voters to influence their 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.

The boundaries of the metropolitan government may not be large enough to fully capture the benefits of area wide governance. This problem might be resolved by annexations or consolidations or by appointing a commission to redraw jurisdictional boundaries, as was done in South Africa (Ahmad 2003). But more often these changes are politically difficult to accomplish and outgrown boundaries stay in place. A particularly interesting problem with boundaries is the case of Beijing, where the integrated urban area can be seen as including parts of adjacent Hubei province and Tianjin city-province, which would create a super metro with a population of more than 50 million.

There are numerous examples of metropolitan governance in low and middle income countries in the Asia-Pacific region. Four of China’s large cities have provincial status and are empowered to manage the fiscal affairs of their underlying district governments. The Chinese provincial cities have no taxing powers but are responsible for the provision of most public services. (See Box 3) Istanbul is a special case because the metropolitan area includes both a provincial Administration with an appointed leadership, and a metropolitan municipality with an elected leadership. The metropolitan municipality performs most of the major urban functions and the provincial administration performs some area-wide functions and oversees coordination. Beneath the metropolitan municipality are 73 local-level municipalities that perform mostly neighborhood functions. The result in Istanbul is a centralized system with most fiscal decision making at either the metropolitan municipality or the provincial administration level (OECD 2008a).

<table>
<thead>
<tr>
<th>Box 3. China’s system of subnational government revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>In most countries of the world, the dividing line between a local tax and an intergovernmental transfer is whether the local government has some discretionary power to determine revenue by setting the tax rate or tax base (Bird, 1999). In China, revenues to local governments come from three different sources. Shared taxes are returned to local provincial governments in some proportion to where they are collected. The rate and base is set by the central government, and may be changed only by the central government. Most of these taxes are collected by the central tax bureau, though the business tax (now being phased out) was collected by the local tax bureau. The tradition in China is to refer to these as “local taxes”, but the international terminology would follow the general definitions and refer to them as “intergovernmental transfers”. Conditional and unconditional grants are made to provincial governments and are referred to in China and internationally as “intergovernmental transfers”. Non-tax revenues and user charges do give subnational governments some discretion in determining the amount of revenue raised, and the amount of cost recovery.</td>
</tr>
</tbody>
</table>

A similar terminology issue arises in the case of Viet Nam.
Bangkok is a single tier provincial city whose governance extends to the entire metropolitan area. It overlays 18 districts, each of which has a directly elected local council. Local government budget decisions are limited by central mandates and controls, and Bangkok has relatively little revenue raising power. The situation is similar in the Hanoi metropolitan area.

V. Financing metropolitan governments: practice and reform options

The call to strengthen the financial condition of metropolitan local governments has been given for a long time (Bahl and Linn, 1992). But mostly the call has not been taken up, primarily because of some combination of resistance by higher level governments and weak administrative capacity at the local level.

A. Property and land taxation

Reform recommendations for urban government finance in low and middle income countries almost always center on an upgrading of the property tax. Large cities have a comparative advantage in levying a successful property tax (McCluskey and Franzsen, 2013). The tax base is stronger because property values are high and continuing to rise, and because the tax administration system has improved and metropolitan areas have demonstrated an ability to absorb new technologies. External donors continue to invest significant resources in strengthening the capacity of local governments to levy the tax. Moreover, the property tax has some features of a benefit levy and there could be more willingness to pay because public services tend to be better in metropolitan areas.

Yet, property tax revenues account (on average) for less than one percent of GDP and less than 4 percent of all tax revenues in developing countries. Even in the large metropolitan areas where property values have risen dramatically, land and property taxes sometimes do not carry a heavy load in financing urban government services.

There does not appear to be a groundswell of popular support to emphasize property tax financing of local government services. Taxpayers and their elected officials seem to be of one mind about not liking this tax. And their reasons are understandable. The amount of tax paid is known to the property owner (vs. e.g., that of the VAT), so he believes that he has a more realistic feel for the burden and for the public services he might expect in return. Taxpayers often feel that they pay more in taxes and charges than they get back in services, and elected government officials do not want to raise expectations about public service levels, so both groups probably are happier when actual tax liabilities are less transparent (as in the case of sales taxes). The bad reputation of the property tax also comes from the notional definition of the taxed base and the judgmental nature of the assessment – “how much would your house sell for if you sold it” or “what is the normal rent that might be paid for the flat that you own”. Finally, the property tax is paid on unrealized increases in the wealth of a taxpayer who feels (rightfully?) that her capacity to pay has not increased in step with her new assessed value.

Is it time for Asian countries to give up on the property tax, and move on to subnational government’ sales taxes, as some Latin American Countries have done? (See box 4). Is
it better to live with the distortions that come with a local sales tax to capture its revenue potential? Or should Asian and Pacific countries continue to work on the property tax in hopes of finding the breakthrough reform that will make it efficient, revenue productive, and more acceptable to taxpayers?

The recommendation here is to stick with the property tax, but to pair it with at least one other broad-based, revenue productive local tax. The property tax just has too many desirable features to be abandoned. It can approximate a benefit levy for some local services, is not regressive in its distribution of burdens, probably has less harmful distortive effects than consumption taxes, has significant revenue potential, and cost-effective administration is within reach. Moreover, it is available to local governments and the laws for its implementation are usually in place. Certainly, it cannot carry the entire financing load for metropolitan local governments, or even a majority of the financing, but it can make a more significant revenue contribution than it does now.

Box 4. Subnational government sales taxes in Latin America

The metropolitan city of Buenos Aires has province status and derives over half of its tax revenues from a turnover tax levied on total sales revenues. The turnover tax levied in the metropolitan city of Bogota (Colombia) accounts for about 40 percent of local tax revenues. The tax rate and tax base are set by local councils (within allowable limits) and administration is by the municipality. Other taxes on gross sales are limited to certain sectors. Brazil’s service activity tax (ISS) is a municipal government tax on local services, almost all of which is collected by the largest municipalities (Rezende and Garson, 2006). It is an important source of revenues for the third-tier subnational local governments and raises about twice as much revenue as the local property tax.

1. Revenue performance

The best comparable data on the revenue yield of the property tax in developing and transition countries (IMF, various years) suggests an average yield equivalent to only about 0.6 percent of GDP (Bahl and Martinez-Vazquez, 2008). On the other hand, property tax revenue often plays an important role in the budgets of some local governments (see table 5). In the 36 largest cities in India, the property tax accounts for 28 percent of own source revenue (Mathur, et. al. 2009). De Cesare (2012) reports a survey of 64 municipalities in Latin America that shows the property tax to account for an average of 24 percent of local government tax revenue. This gives a different perspective on the issue, i.e., that the property tax in developing countries is an important part of the strategy for local government finance even if it is not an important part of the strategy for overall government revenue mobilization. Moreover, the revenue dependence on the property tax is even greater in many of the large cities.

Table 5. Property tax revenue performance in selected metropolitan cities

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Belo Horizonte (Brazil)</td>
<td>No data</td>
<td>31.2</td>
</tr>
<tr>
<td>Cape Town (South Africa)</td>
<td>20.5</td>
<td>41.1</td>
</tr>
<tr>
<td>Rio de Janeiro (Brazil)</td>
<td>17.5</td>
<td>25.0</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>3.78</td>
<td>5.10</td>
</tr>
<tr>
<td>Location</td>
<td>Value 1</td>
<td>Value 2</td>
</tr>
<tr>
<td>-----------------------</td>
<td>---------</td>
<td>---------</td>
</tr>
<tr>
<td>Kuala Lumpur</td>
<td>44.9</td>
<td>93.0</td>
</tr>
<tr>
<td>Makati City (Manila)</td>
<td>34.0</td>
<td>41.0</td>
</tr>
<tr>
<td>Manila City</td>
<td>28.0</td>
<td>54.0</td>
</tr>
<tr>
<td>Quezon City</td>
<td>21.0</td>
<td>33.0</td>
</tr>
<tr>
<td>Kolkata</td>
<td>46.0 (2007)</td>
<td>27.4 (2007)</td>
</tr>
</tbody>
</table>

Source: McCluskey and Franzsen (2013); Mathur, et.al., 2009.

2. Property tax structure in Asian metropolitan areas

Property tax practices vary greatly across metropolitan areas in the Asia and Pacific region. Some countries tax rental values (India), some tax capital values (Philippines), some are very liberal with exemptions (Pakistan), some focus their tax on land use (China), and some impose a very low rate (Indonesia). Even where countries tax the same base, they may assess it differently. For example, Manila and Jakarta both tax the capital value of property, but Manila uses comparative sales to tax land and depreciated replacement cost to tax buildings while Jakarta uses formula tables for both land and buildings.

This means that there is not likely to be a single reform solution that will fit all the cases. Moreover, because there are so many key components to the tax (for example, identification and valuation of properties, collections, tax rates and exemptions), reforms must necessarily focus on details. This is not to say that there are not common problems that plague city governments in most urban areas and that keep the property tax from reaching its potential. In fact, most metropolitan areas fail to administer the tax efficiently, i.e., they do not assess property as the law requires, they do not include all properties in the tax base, and they do not collect full property tax liability. The following cases of big city practices in Asia gives some indication of the way these problems hold back property tax revenue mobilization.

The property tax in the Mumbai municipal corporation is equivalent to about 1.4 percent of local GDP, which is relatively high (the average for all urban governments in India is about one-fifth this level). It accounts for about 22 percent of all own source revenues, and has a buoyancy of a little less than unity. Yet Pethe (2013) notes that this is seen as a disappointing outcome, because of the rapid increase in property values in Mumbai and the erratic revenue flow in recent years. The collection rate of the tax is only 45 percent, leaving much room for improvement. Surprisingly, the average collection rate for all large Indian cities is only 37 percent (Mathur et al., 2009).

The metropolitan cities in China do not levy an annual, value-based property tax. The State Council has proposed that such a tax should be implemented “when the time is right”. The problems with formulating such a tax, are difficult in part because all land is owned by government, and in part because the infrastructure for property tax administration (assessment, tax rolls, collection mechanisms) must be put in place (Bahl, Goh and Qiao, 2014). China does impose taxes on real property, but these are mostly an

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8 The revenue-income buoyancy of a tax is the percent increase in revenues per one percent increase in GDP.
ad hoc group of levies imposed on land use rather than a property tax system with clearly defined objectives. But together, these taxes account for about 1.6 percent of GDP, which is well above the average for low and middle-income countries (but below that in industrial countries) (Man, 2011).

Jakarta and Manila are interesting cases in the development of the property tax. The tax was devolved to local governments in Indonesia between 2011 and 2014, and early results suggest that the 30 largest urban governments, including Jakarta DKI, will account for about 70 percent of revenue. In the Philippines, the local governments in metropolitan Manila account for 45 percent of total national tax collections (as compared to 20 percent of national population), but the property tax share of local revenues has been declining due to a rapid increase in intergovernmental transfers (McCluskey and Franzsen, 2013).

The success with the property tax as a local government revenue source is due largely to how well they assess and collect the tax. While there is a great deal of variation in this, and accurate data are hard to come by, the results are generally not very good. Mathur, et. al. (2009) surveyed five large Indian cities and found the ratio of assessed to market value to vary between 9 percent and 30 percent. A study of Pakistan’s Punjab province, where Lahore is the largest city, suggests that property is undervalued between 45 and 80 percent (Bahl, Cyan and Wallace, 2015). But there are also success stories. Quezon City in metropolitan Manila, for instance, increased property tax collection threefold between 2005 and 2008 by computerizing tax rolls, by making payments easier, and by eliminating corrupt middlemen (UN-Habitat, 2010). Bangalore (India) revamped its assessment system to a simplified area basis with great success (U.A.V. Rao, 2008).

Other cities in the region have been innovative in their practices, and this has shown up in improved revenue flows. Delhi, Chennai, and Kuala Lumpur have used a self-declaration approach to identify properties for the tax roll and this has resulted in a significant increase in the coverage of the tax. University level courses in valuation have been introduced in Manila and Kuala Lumpur, and this has helped in establishing a permanent valuation staff in both cities.

3. The determinants of revenue performance

Arguably the most important reason why property tax revenues are equivalent to so small a percent of GDP in low and middle-income countries, and in Asia and the Pacific, is that fiscal decentralization (the empowerment of local governments to make fiscal decisions) has not been a leading development strategy. Subnational governments account for about 28 percent of total government expenditures in industrial countries but only 18 percent in developing countries. Since the property tax is primarily a local government tax, it is used more sparingly in low income countries. In an econometric analysis of the variations in the property tax share of GDP across 70 developed and developing countries, Bahl and Martinez-Vazquez (2008) found that higher levels of decentralization increased the use of property taxation.

Other barriers to increased revenue mobilization are important. The administration of the tax is costly. The absence of a full and up-to-date survey of all land (urban and
rural), records of title that enable a completion of the tax roll and a determination of tax liability, reliable data on the sales price of properties, and good valuation expertise are expensive problems to fix. At current yields of the property tax, it is difficult to justify such outlays, even in metropolitan cities. The result is that most developing countries improve their administrations with marginal upgrades rather than with comprehensive reforms. Revenue increases, it follows, are also marginal.

The weak revenue performance in Asian countries is also due to the social engineering of the property tax, and to the political rent-seeking that dramatically narrows the base. Government-owned property is exempt in most places, owner-occupiers pay less property tax than almost anyone else, low income families (and sometimes all families) are benefitted by a threshold exemption, and the not for profit sector tends to be favored with a tax preference. The revenue consequences can be substantial. A study of Punjab province in Pakistan estimates that bringing owner-occupied property fully into the tax base would triple the level of property tax revenues (Bahl, Cyan and Wallace 2015).

Sometimes local government property tax revenues are low because policy and administration are in the hands of central governments that are not very interested in the amount of revenue raised for local governments. The story is an old one. Central government politicians just do not have adequate incentives to increase property taxes that would benefit urban local government budgets. Indonesia is a good example of this situation. The property tax and property transfer tax were shared responsibilities between the central and subnational governments until 2009 when they were devolved. Before that time, when policy and administration were centralized, revenue growth was almost flat. The implementation of the devolution includes both policy and administration and is focused on empowering local governments to adapt their property tax structures and property tax administration systems to the local environment. While the early results are somewhat promising in terms of revenue mobilization, local governments have been slow to move their property tax towards its full potential. The property tax takes time to implement, and it is still too early to make a full evaluation (Kelly, 2014; Haldenwang, et.al, 2015).

The weak performance of the property tax can also be due to “crowding out”, i.e., the availability of other sources of subnational government tax revenues that are seen as superior to the property tax. In Argentina, sales taxes (primarily the turnover tax) account for about two-thirds of subnational government tax revenue while the property tax accounts for only about 12 percent. In Brazil, the local sales tax raises two times more revenue than does the property tax. Colombia’s larger cities raise more from the gross receipts sales tax) than from the property tax. In Mumbai (India) the property tax is 24 percent of local government revenue but the octroi (a form of sales tax on the entry of goods) is 44 percent, and the revenue elasticity of the octroi is significantly larger (Pethe, 2013). In China, central and subnational governments (until recently) raised significant revenues from a gross receipts tax that was earmarked fully for subnational governments, but a broad-based annual property tax is yet to be authorized.

The property tax also is crowded out by intergovernmental transfers in all metropolitan cities. More grants (or more direct expenditures by the metropolitan government in the metropolitan area) can dissuade local voters and politicians from increasing statutory tax rates, assessment rates or collection rates of the property tax.
Finally, the revenue take from the property tax has been slowed by the actions of higher level governments and by the legal framework that has been put in place. Rent control legislation has all but wrecked the property tax in some Indian cities, rate limits imposed by higher level governments can lead to lower revenues (Manila and Kuala Lumpur), and legislation to exempt government-owned property has eroded the tax base (Hong Kong).

4. The special problem of revaluation

Periodic revaluation and the introduction of a new property tax roll is perhaps the greatest barrier to maintaining the rate of revenue mobilization of the property tax. The base is determined by an appraisal process that must be redone periodically (every three or five years). So, instead of the relatively smooth increases (or decreases) in the income or VAT base, large one-time increases are likely to accompany revaluation. Moreover, preparing the new values is a costly and time consuming affair and putting the new roll in place is contentious and often becomes a media event.

In some urban areas, revaluations are carried out annually, e.g., in Hong Kong and Jakarta. But more normal is provision for tax rolls to be redone on a 3-5-year cycle. Not surprisingly, metropolitan local governments implement new valuation rolls with delay out of fear of voter reactions to large increases in property tax bills. Sometimes, politicians try and minimize their exposure to such situations by giving a simultaneous reduction in the statutory rate, or capping the increase in taxable assessed values. Some metropolitan local governments have indexed their assessments between revaluation periods, but this raises equity problems when property values grow at different rates in different sectors and in different neighborhoods. Some cities in metropolitan Manila have made arbitrary adjustments by revaluing land but holding constant the value of buildings. The failure to revalue can impose a significant revenue cost. Had Punjab province, Pakistan brought in its newly completed valuation roll in 2006, property tax revenues would have doubled (Bahl, Cyan and Wallace, 2011).

5. Taxes on property transfers

Nearly all Asian countries tax transfers of ownership, i.e., impose a tax on the sales price of properties that is paid at the time of exchange. This may be levied as a stamp duty on the transfer document and/or as a separate property transfer tax, or even as a capital gains tax.

There are several reasons why real estate transfer taxes have found their way into tax systems in developing countries, and why their staying power is so great. (Bahl, 2004; Alm, Annez, and Modi, 2004). First, it is an easy tax handle because most buyers/sellers desire a legal record of ownership and therefore will voluntarily comply. Second is the revenue motivation and what might appear to be a very low cost of collection. In more than a few countries, the property transfer tax generates as much revenue as the annual property tax. Third, the distribution of the tax burden tends to be progressive. Fourth, the number of people in the taxpaying population in any given year is much smaller than in the case of most general taxes, hence lessening voter opposition. Fifth, a property
transfer tax might reach that part of the taxable capacity (property wealth) that is not captured by most income tax and value added taxes, and finally, some governments have found advantage in using the property transfer tax to cool down an overheated investment market in real property.

The disadvantages of the property transfer tax are that it imposes a cost on property transactions thereby reducing the volume of formal transactions and slows the development of the real estate market, and the administrative costs can be very high. In low and middle income countries, the tax base often is determined by taxpayer declaration of the sales price. Because of the low probability of being detected as underreporting, and because the property transfer tax often is levied at a high nominal rate, property owners have a significant incentive to understate taxable value. This leads to a revenue loss, but it also leads to a weakening of the data base that is necessary for objective assessment of the annual property tax.

Three alternative paths to reform could enhance revenues and improve land market efficiency. The first is to abolish the property transfer tax and make up the revenue loss with increased levels of other taxes. The second reform direction would retain the property transfer tax, but significantly lower its rates where they are high, and aggressively monitor declared values for transactions. This might be done by requiring certified appraisals at the expense of buyers/sellers, upgrading and expanding the valuation staff at the government level, and imposing significant penalties for under declaration. The third reform path would be to replace the property transfer tax with a tax on capital gains from sales of real property. While this would pose some administrative problems with implementation, these problems would be no more difficult to resolve than those implied for making the present sales tax on transfers work. There has been some experience with capital gains taxes on property transfers, for example in Taiwan (Tsui, 2008).

6. Value Capture

Urbanization and the projected rapid growth of large cities in Asia will bring significant increases in the demand for residential housing and in the demand for land to be used for non-residential purposes. Real estate values also will be driven up by the relaxation of government constraints to urban development (e.g., by zoning changes that allow development on the urban fringe) and by infrastructure investments that enhance the quality of public services. Projections of new infrastructure investments equivalent to 2.5 percent of GDP per year gives some idea of the magnitudes involved.

These value increases are reflected to some extent in the annual property tax base and annual property tax revenues, but not very much because of revaluation lags and because of the low effective rates of the property tax in most Asian countries. Large urban governments in some countries, particularly those in Latin America, have now turned to using various other fiscal instruments to capture a portion of these land value increments to support the financing of public investments and public services. This process is

Land value recapture instruments are most developed in Latin America where practitioners and policy analysts have developed several workable approaches. For a good review of the practice, see Smolka (2013).
generally referred to as “value capture”.

Potential advantages

There is a strong case for the public sector to confiscate a part of the increment in land values that is a result of government actions. First, this approach is equitable in that it reclaims some of the benefits of government sector actions for the public. If an investment of US$10 million in a new road will increase property values in effected areas by $20 million, why not at least recover the cost of the project from the beneficiaries? Since these land value increments are “unearned” (the property owners did nothing to generate them), it would seem a fair and even efficient approach to cost recovery.

A second important advantage is the generation of revenues to support the public budget. Several inventive schemes have been developed to use expected land value increases to fund the cost of public investments such as road improvements, large scale capital projects and general urban development (Smolka, 2013). Under the right circumstances, this can give the best of both worlds: the developer can move ahead with the project and the government can avoid raising taxes to cover the cost of the infrastructure investment (see box 5).

Box 5. Value Capture

The practice of value capture is widely varied in terms of the fiscal instruments used, especially in Latin America where the approach is most advanced. These include betterment levies (special assessments on beneficiaries to recover the cost of a project), exactions (payment by developers to compensate government for a change in land use that will enhance values or incur costs), land adjustment (recovery from land owners of costs of expansion of urban settlements into the urban fringe), and certificates of additional construction bonds (development rights sold by auction to private firms).

The underlying arrangements in these approaches are pretty much the same. The local government has a marketable product to sell, usually some combination of improved public services, land, development rights, building permits, increased floor area ratios, or zoning changes. The beneficiary (a developer or a property owner) pays for one or more of these products with a portion of the expected increase in land values. The fiscal arrangement through which the beneficiaries purchase the product is often determined by the nature of the project itself, e.g., whether it is a road improvement, a large scale urban redevelopment project, an increase in building heights, or the extension of public services to the urban fringe. Sometimes the government determines the value of the development rights, and in some case the values are determined in the market by auction. Special assessments are levied on beneficiaries to recover project costs and are distributed according to a formula determined by the government.

Note: The floor area ratio is the ratio of floor area to the net surface of the undeveloped land (where net surface is defined to exclude rights of way and environmental set asides.

Source: Smolka, 2013.
International practice

In the Asia Pacific region, property values are growing with urbanization, and prospective public investments are large, so clearly there is potential for value capture. On the other hand, Asian countries have a mixed record on using the property tax to generate revenues from changes in land use. For example, Bangkok and Karachi do not tax vacant or unused land, Jakarta taxes it at the same rate as developed land, though Bangalore, Kuala Lumpur and Manila tax it at a higher rate.

Land Sales and Leases. Another area where urban development and land value increments come together is in the sale or leasing of public land. The issue is of greatest importance where land is owned by the government and land use rights are leased. Perhaps the most prominent example in recent times is the leasing of lands by Chinese local governments. On the one hand, this policy opened the door for financing a large amount of infrastructure that was necessary for the absorption of nearly half-billion migrants to cities. By 2013, it accounted for about one-third of subnational government revenues (inclusive of intergovernmental transfers), and 7 percent of GDP. But, on the negative side, it also involved dispossessing farmers from urban fringe land with little compensation, a significant amount of the money leaked out to private sector activities, and the collateral of land fueled over-borrowing and a debt crisis (Bahl, Goh and Qiao, 2014; World Bank and The Development Research Center of the State Council, 2014.) Moreover, the sustainability of the program depends on the supply of land available and on fluctuations in the price of land. Though revenue dependence on land leases is down from its peak years, regulations on compensation levels and the practice of claiming land has been significantly strengthened.

7. Direction for property and land tax reform

There is no “one size fits all” in the case of property tax reform. But there are some basic principles to guide a revamping of property taxation that might fit most Asian cities. But reform will not be a simple matter, such as “raise the rate”. The property tax has many policy and administrative components that determine its revenue yield and all of these must be factored into any reform. The devil will almost certainly be in the details. The following basic rules for reform could significantly enhance the chances of implementing a successful property tax.

1. The first step is to decide about the role the property tax will play in national development policy, e.g., a target level of revenue mobilization, a tax on property wealth, a stimulus for more intensive use of land, an integral part of a fiscal decentralization strategy, etc. Then the government should begin the reform effort by doing a thorough analysis of the existing property tax and how it might be out of step with the reform objectives.

2. Find a champion. Not many politicians will want to play this part. But those who are strong advocates of fiscal decentralization will be more sympathetic to strengthening the property tax as a source of local government revenue. If the reforms are limited to metropolitan areas, and would lower reliance by big cities on intergovernmental transfers,

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10 Land value recapture instruments are most developed in Latin America where practitioners and policy analysts have developed several workable approaches. For a good review of the practice, see Smolka (2013).
there may be broader support for the reform proposals.

3. Do an audit of the legal underpinnings of the property tax – the constitution, the property tax laws, and the implementing regulations – to make sure that the definition and coverage of the tax base, and the tax rate structure, are clear.

4. If the goal is to stimulate property tax revenue mobilization in metropolitan areas, then proper incentives should be put in place. The most powerful ways to do this are by giving metropolitan local governments discretion to increase property tax revenues and by reducing the availability of intergovernmental transfers.

5. Metropolitan areas should get the division of property tax administration right as between higher and lower levels of government. This should be based on comparative advantage, particularly with respect to who handles the maintenance and upgrading of the cadastre, property transfers and valuation. The weaker the local government capacity, the stronger is the case to centralize such responsibilities, perhaps to a metropolitan tax administration.

6. The infrastructure for property tax administration needs attention. Metropolitan governments should develop a system that generates and records accurate information on property transactions. Such information is essential to developing the value map that underlies a good assessment practice, and to using computerized mass appraisal. Replacing the property transfer tax with a capital gains tax on real property could remove an impediment to accurate self-reporting of transaction amounts.

7. Exemption policy should be a responsibility of metropolitan local government. A broad-based property tax would better serve equity goals. Low income housing might usefully be exempt, or assigned a lower burden, but the practice of exempting owner occupied property, government property, and providing special exemptions should be rethought. At a minimum, all exemptions should be reviewed periodically, the tax expenditure implied should be recalculated and reported annually, and a sunset period should be set to review and reconsider every exemption.

8. Low collection rates are an important constraint to increased revenues. Tougher enforcement and a more realistic set of penalties are likely to be more effective in raising property tax efforts than are attempts to create a more “friendly” property tax.

9. Most countries would do well to concentrate their reform and revenue mobilization efforts on the big cities. The larger tax base is there, as is the better administrative machinery and the greater local public financing needs. Smaller governments and more rural areas are important, but the type of tax imposed is likely to be more rudimentary and these governments will in any case remain more dependent on central (or state) transfers.

10. Finally, there is a more far reaching idea: change the focus of the reform to the creation of a comprehensive system for taxing all land and real property. The base for the annual property tax, the transfer tax and value capture overlap – all tax property values – and could be administered by a single agency. However, each of the three taxes could be levied according to a different rate schedule. The result could be an increase in the revenue yield from property taxes to a level where significant increases in administrative expenditures could be justified.  

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11 For a discussion of this possibility in the case of Pakistan, see Bahl, Cyan and Wallace, 2011.
B. Consumption and production taxes

The property tax rarely lives up to its potential in the cities of low and middle-income countries. In the more highly centralized fiscal systems that characterize most Asian countries, the higher-level government fills the public financing gap with intergovernmental transfers or by providing local services directly. But in those countries where fiscal decentralization is an objective, where the law permits, and where local government structure is compatible, it may be possible for cities to adopt a broad-based consumption or production tax. This could lead to several favorable outcomes: increase the tax price of services provided in metropolitan areas, increase the overall level of resource mobilization, and reduce the claim of intergovernmental transfers on local governments.

But there are dangers in this strategy. Mostly, these consumption taxes are levied as gross receipts (turnover) taxes, imposed at the point of sale. On the one hand, this leads to distortions in resource allocation because they allow the exporting of tax burdens, because they cascade taxes and give advantage to vertically integrated companies, and because of the “headquarters problem” which arises when national firms often pay tax for all branches at the headquarters location. This raises an interesting question. Do the efficiency gains from the additional public services financed, and the additional taxing autonomy, offset these efficiency costs of a gross receipts tax?

The experience with broad-based taxes on commerce in the Asia Pacific region is much more limited than in Latin America. The Mumbai Municipal Corporation raises about half of its own source revenues from the octroi, an entry tax on goods entering the city. Collection is at octroi stations, is based on a complicated rate schedule, and has long been criticized for imposing heavy compliance and administrative costs, distorting the allocation of resources, and opening the door for significant corruption. Octroi was abolished in Pakistan more than a decade ago, and for all of India except Maharasthra state, but it has continued in Mumbai. The revenue required to replace the octroi with a state government grant “… would be of unimaginable magnitude” (Pethe, 2013, p253). When the national government sales tax is introduced in India, it is expected to subsume the octroi, though as Pethe (2016) notes, the replacement for these funds in Mumbai have not yet been worked out.

In metropolitan Manila, a business tax on total sales is imposed by cities and municipalities at the point where the sales take place. This puts the 17 cities and municipalities in competition with one another for tax base, is distortive and leads to significant fiscal disparities across local governments. For example, in 2008, the average level of business tax revenues was equivalent to nearly 40 percent of total local government expenditures in the metropolitan area. The variation in per capita business tax revenue among local governments in metropolitan Manila was from USD169 to USD 5 (Nasehi and Rangwala, 2011).

Another version of the assignment of general consumption taxes is the revenue sharing practiced in transition countries. For example, both Thailand, Viet Nam and China assign a share of the value added tax to regional governments, with sharing on a
derivation basis. However, the subnational governments have no authority to change the rate or base of the tax. In effect, these are intergovernmental transfers because the local governments can take no action to affect the revenue yield.

The Bangkok metropolitan government is partly financed by a share of the VAT collected within its boundaries. India will apparently do the same when its new national sales tax is introduced, but the details are not yet clear. Some metropolitan local governments in Asia levy selective sales taxes, e.g., on electricity bills in Istanbul, Delhi and Jakarta.

C. Taxes on motor vehicles and motor vehicles use

There is a strong case for using the taxation of motor vehicles in the revenue structure of subnational governments (Bahl and Linn, 1992; Bird, 2010). The number of motor vehicles has been growing faster than population and roadway infrastructure in most large Asian cities. This trend is expected to continue as the middle-class population continues to grow. Between 2010 and 2030, the number of passenger vehicles in China, for instance, is projected to increase from 58 to 450 million and from 15 to 135 million in India (ESCAP, 2015).

There is much to be said about using motor vehicle taxation to finance a greater share of metropolitan local government expenditure. The ownership of motor vehicles is not concentrated in the lower income brackets. Driving generates negative externalities -- congestion, air pollution and greenhouse gas emissions -- which will grow worse as the number of private vehicles increases. Motor vehicles are easily taxed, as is their use.

The roadway construction and maintenance costs, traffic management costs, and the external pollution and congestion costs are likely to differ from place to place. In part, these costs will reflect choices that people make about where they live and work, and how they get around. They also reflect choices that businesses make about where they will locate, and choices that governments make about the kind of public transport network that they are willing to provide. An efficient tax on the motor vehicle sector will bend some of these choices. The challenge will be to find a family of taxes on motor vehicle ownership and use that will raise significant revenue, improve resource allocation, and be administratively feasible. Almost certainly the rate for an efficient tax on motor vehicles will vary from one large city to the next.

1. Motor fuel taxes

From a revenue perspective, the tax on the vehicle sector with the most revenue potential is a fuel tax. The base of the tax (fuel consumption) can be income elastic because of the

12 A “derivation” basis means that the amount of revenue returned to the local government is in proportion to the amount collected.
13 The Chinese are in process of abolishing their business tax, which was levied on gross receipts for a wide range of service activities. This levy was revenue productive (about 30 percent of all subnational government tax revenues). The rate and base were determined by the central government, but all of the revenues were retained by the provincial governments on a derivation basis. This tax is now being folded into the central VAT, of which 50 percent is being shared with provincial governments on a derivation basis (Bahl, Goh and Qiao, 2014).
growth in the number of motor vehicles, but also will respond to changes in the price of petrol if levied on an ad valorem basis. But while it is true that fuel taxes are related both to road usage and to such external effects of vehicles as accidents, pollution, and congestion, the relationships are usually too complex to capture in any precise way with a single tax (Newbery 2005).

The size of these external costs, and the likelihood that they will vary significantly within a country, supports the case for a locally imposed tax on motor fuels. The cost of road investment and maintenance, and the external costs of automobile ownership and use, is much higher in some urban areas than in others, and is likely to be highest in the larger urban areas.

Motor fuel taxes could be levied by either a metropolitan area government or by a transportation special district that covers the entire metropolitan area. It could be imposed as a piggyback on the central government tax on motor fuels with the metropolitan area government having some discretion in rate setting. Collection at the pump is the best option for tax administration, but the technology and the skills of the provincial/local administration may not be ready in some low-income countries. An alternative is to impose differential provincial fuel taxes at the refinery or wholesale level, with the refiner or wholesaler acting as a collection agent for the states/provinces, and remitting taxes in accordance with the destination of fuel shipments.

Provincial and local level motor fuel taxes in developing countries are imposed by subnational governments in only a few middle and low-income countries. Istanbul’s “environmental sanitation tax” is imposed as a sales tax on gasoline. A differentially higher rate for motor fuels under Brazil’s state government value added tax is one example of a destination-based tax on motor fuels. Under Colombia’s gross receipts tax, motor fuels are charged a rate of 1.38 percent.

2. Motor vehicle registration and licenses

A charge for motor vehicle registration and licensing has the potential to yield a quite significant amount of revenue, but it rarely does. There are two general approaches to levying this tax. One is an annual personal property tax, based on the depreciated value of the motor vehicle. Under this approach, the objective usually has more to do with taxing wealth than with approximating a green tax, and takes the form of imposing higher rates on higher-valued vehicles. But taxing according to the value of the car is difficult to justify from an environmental point of view because price is unlikely to be correlated with CO2 emissions or fuel consumption. The other approach is an annual tax based on such features as the age and engine size of vehicle (older and larger cars generally contribute more to pollution), the registered location of the vehicle (cars in cities add more to pollution and congestion), driver records (20 percent of drivers are responsible for 80 percent of accidents), and axle weight (heavier vehicles do exponentially more damage to roads and require roads that are costlier to build) (Bird and Slack, 2013). If technology permits, even more refined pricing schemes could be applied, at least in the most heavily congested urban areas or at border crossings.

Almost all Asian cities levy some form of registration tax on motor vehicles, but it rarely
yields significant revenue. The problems with administering this tax vary from country to country. While there is, in principle, no good reason for under collection, there is sometimes lax enforcement. Sometimes this is said to be due to a feeling that high registration and operating costs are unjust in metropolitan areas that do not have adequate public transport systems. But even without sound arguments, increased automobile taxes of any kind are contentious, and politicians tread lightly.

An interesting dimension of the use of motor vehicle registration is the possibility of using this as an instrument for rationing road use. Singapore’s pioneering program with a restricted license based on congestion levels and peak hour commuting patterns has been a widely celebrated policy. Another less targeted approach uses licenses to limit the number of motor vehicles on the road. In China, for example, Beijing and Shanghai have set a cap on vehicle registrations and established a quota for newly registered license plates.

D. Intergovernmental transfers

Researchers and policy makers usually argue that metropolitan local governments should be more revenue self-sufficient, but rarely is a target amount set for self-sufficiency. At least in theory, we might argue that the target should be set as metropolitan areas needing to raise at least enough revenue from own sources to cover those local government expenditures that provide benefits to the local population and that are not mandated by higher level governments. In other words, only the spillover benefits to non-payers should be supported by intergovernmental transfers. With adequate devolution of revenue raising powers, this rule might work well for a metropolitan areawide government structure (Bangkok or Shanghai) but not for a fragmented metropolitan local government structure (e.g., Manila or Kolkata) because some local governments would not have adequate taxable capacity to raise adequate revenues. In the latter cases the greater self-sufficiency mandate would lead to increased fiscal disparities within the metropolitan area.

1. The current practice

Though hard evidence is not available for all cities in the Asia Pacific region, it is almost certainly the case that local governments in metropolitan areas fund more of their budgets from own sources than do other local governments. Shah (2013) developed a sample of 17 metropolitan areas and calculates an average dependence on intergovernmental transfers of 42 percent of total revenues. But it is hard to find a pattern in these data because the range is from less than 10 percent in Pune (India) to 36 per cent of total revenues in Delhi (Bandyopadhyay and Rao, 2009) to over 70 percent in Istanbul. On average, it is likely that Asian city governments are more dependent on transfers than are those in, for example, Latin America (See Table 2).

14 Technically, we should say that all who benefit from local services should pay the local tax, including nonresidents who migrate in to work, shop, etc. In most metropolitan area-wide local governments, this would be much the same as the local resident population. But in a jurisdictionally fragmented metropolitan area, the daytime population is often quite different from the resident population.
The treatment of metropolitan area local governments in the intergovernmental transfer system varies quite a lot. Many countries do not have a special regime for the large urban areas, i.e., they treat metropolitan local governments the same way as they treat other local governments (Shah, 2013). In other cases, the formula used to distribute transfers may include elements to reduce the amounts flowing to richer areas, or to increase amounts flowing to those areas. If the distribution formula includes an equal share for each government as an element in the formula (India or the Philippines), or includes an equalization feature (Indonesia), the richer provinces and metropolitan areas will not be favored.

In some countries, there are special arrangements for metropolitan areas. Additional resources may be provided to accommodate special needs in metropolitan areas (e.g., national capital districts or giving large cities both provincial and city status), but in others, metropolitan cities are excluded from participation in certain grant programs. For example, the Jakarta metropolitan area is excluded from Indonesia’s general revenue sharing and conditional grant programs on grounds that it already has a fiscal surplus. On the other hand, Jakarta receives a special share of national personal income tax revenues.

Countries that share central government revenues on a derivation basis, i.e., that return the shared tax revenues according to where it is collected, will favor the wealthier provinces and metropolitan local governments. The highest income Chinese metropolitan local governments have provincial status and receive significantly larger per capita amounts of shared taxes. Metropolitan Bangkok receives a significant percent of revenues from centrally-determined surcharges on VAT and excises that are shared on an origin basis (Shah, 2012; Sakon Varanyuwatana and Duangmanee Laovakul (2010).

If the objective is to target specific projects with conditional grants, ad hoc distribution methods are often used and the metropolitan local governments are often excluded. Countries that try to match an index of expenditure needs to an index of taxable capacity, and distribute against the needs gap, will usually discriminate against the larger and wealthier metropolitan local governments. Ad hoc capital grants can be dangerous for metropolitan areas if the continued funding is not guaranteed. Cases in point are the halting of construction of transportation projects in both Jakarta and Bangkok (Shah, 2013).

India has gone the route of a separate program for urban local governments. The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) began in 2005 with the objective of financing public infrastructure on a sustainable basis (See Box6). The grants were conditional in that the money was earmarked for infrastructure and required certain reforms that would improve urban governance. Ahluwalia (2014, pp 49-55) offers a thoughtful critique of JNNURM, noting that the program was hampered by slow release of funds, cost over-runs, inadequate capacity to absorb grants at the local level, problems in monitoring the progress with urban management reforms and enforcing the conditionality, and the inability of state and local governments to back JNNURM with

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15 The simple correlation between per capita revenue sharing transfers to provinces and per capita GDP is -0.91 (Bahl, Goh and Qiao, 2014, p30.)
their own financial resources. While there have been infrastructure improvements from the program, chiefly in the area of water supply and drainage, the main gain may have been to raise the ambition of Indian cities.

**Box 6. The Jawaharlal Nehru Urban Renewal Mission (JNNURM)**

The JNNURM was launched in 2005, under the leadership of the Ministry of Housing and Urban Development, as the largest ever nationwide scheme for urban infrastructure development and service delivery in India. It was designed to improve both infrastructure and urban governance, and included a sub mission of providing basic services to the urban poor. The JNNURM required the urban local bodies to prepare a city development plan and to agree to certain mandatory reforms in urban governance as a grant condition. The mandatory reforms included adoption of double entry accounting, e-governance based on GIS, adoption of management information systems, property tax reform using GIS, and recovery of operations and maintenance expenditures with user charges. The nodal agency for the reform program was appointed by the state government, and the program was financed by a federal grant with matches from the state and urban local bodies.


2. How to reform the grant system

A goal for metropolitan areas should be that they finance most local public services with revenues that are raised from beneficiaries, i.e., from local taxes and user charges. To this end, metropolitan local governments should be empowered to levy new taxes including surcharges on central or provincial level taxes. Intergovernmental transfers to metropolitan local governments should be limited to those that compensate for benefit spillovers, and those levied to address income distribution concerns such as slum upgrading.

In many metropolitan areas, there is a heavy dependence on intergovernmental transfers to finance local public services, and so the transition to a more locally financed system will take time. Replacing grant financing with local taxes and charges will be painful to much of the local population and will need to be implemented gradually. The development of a new tax code and a new administrative structure also will take time. Higher level government leaders, and many local political leaders will need to be convinced that such changes are in the best interests of the country, and this will further slow the transition.

There also is a question of how this separate regime for intergovernmental transfers will be structured in metropolitan areas with a fragmented local government structure. Tax decentralization in such cases (e.g., Metropolitan Manila or Metropolitan Kolkata) would accentuate fiscal disparities, and will mean that the new grant regime will need to include an intra-metropolitan equalization feature.

For those countries in the region where the traditional centralized approach to urban finance is continued, intergovernmental transfers will remain a mainstay of the urban public finance system. In this case, the central governments should be certain that it has
structured the transfer system to accomplish the objectives it has set for it. But so long as metropolitan local governments can rely heavily on grants from higher level governments, significant increases in revenue mobilization at the local government level will not likely happen.

E. User charges

User charges be moved closer to full cost recovery levels in large cities. This would improve the efficiency of service delivery for the public functions involved, lower necessary local tax rates and reduce the claim of cities on intergovernmental transfers.

The principle behind user charges is simple enough. Let users pay for a service according to how much benefit they receive from it, usually measured by how much of it they use. The binding requirement is that the service must be amenable to pricing. Many services that are typically provided by government fall into this category, including water and sewerage, electricity, mass transit, road use and much more.

When services cannot be priced, but exclusion in consumption is possible, an alternative cost recovery measure is some form of benefit charge or tax. This might include financing for garbage collection and solid waste disposal, a general charge for business services collected through a license, real property registration fees, and special assessments to cover the cost of new public investments.

The revenue potential in all of this is considerable, as is seen by the results in industrial countries where the pricing of public services is widely used. In the US, user charges and fees account for about 35 percent of all own source revenues of local governments (Fox and Slack, 2010).

Most observers of metropolitan city finances decry the inadequate recovery of costs with user charges. While there are not adequate data to make firm comparisons, several case studies of cities have made the point. There are several reasons why cost recovery is not the norm. The one most often cited is redistribution, i.e., most governments are hesitant to zone low income families out of the market for necessities or merit goods. Critics would respond by saying that there are better ways to insure protection of poor families than subsidized prices of government provided services. There is also a perception among some populations that government services are an entitlement that should not be paid for with cost recovery prices. But this argument ignores the fact that the services will be paid for with general taxes that are not necessarily levied on those who benefit from the services provided. Finally, there is the question of what is meant by full cost recovery, and whether it should somehow include the benefits enjoyed by non-users.

VI. What are the options for reform?

The public finances in the metropolitan areas of the Asia Pacific region were long ago ready for reform. The agglomeration benefits that came with urbanization have shown up in a rapid growth in GDP in metropolitan areas that increased the capacity to tax in urban areas. But at the same time the backlog in public services continued to pile up.
New and very different approaches to fiscal reform are called for in many countries, and in the fiscally centralized Asia and Pacific region, the reform medicine will be hard to take.

The place to start is with an economic development strategy for urban areas. Barriers that stand in the way of capturing agglomeration effects should be eliminated, and the migration to cities should not be discouraged. This strategy would call for incentives such as lowering the regulatory costs of interregional and international trade, and increasing investment in transportation networks. But so far, countries have said relatively little about how to develop local government finance networks that would make large city finances more manageable and would generate revenues to support adequate services and infrastructure investment.

What is the way forward? How can countries develop fiscal strategies to support their urban economic development strategies? Three central elements of such a strategy might be suggested.

1. Recognize that metropolitan areas are different from one another and that one approach to increased revenue mobilization in urban areas of the Asia Pacific region will not fit them all. Populations in different metropolitan areas do not necessarily adopt the same objectives for their budgets, and central/provincial governments that are responsible for controlling metropolitan areas are driven by many more motives than economic development. In the end, the revenue raising strategy adopted by China will be different from that adopted in India will different again from that adopted in the Philippines, and so on.

2. Where local autonomy is deemed an important part of the urban area development strategy, a constraint might be placed on metropolitan area local governments that they cover most of their budget expenditures with locally raised revenues, in effect charging a tax price that covers the marginal cost of providing local benefit services. This will require that they be given significant, additional revenue raising powers.

3. Higher level governments might consider establishing a blue-ribbon commission to study the feasibility of a special regime for metropolitan area finances. The scope of this inquiry would include metropolitan government structure, the assignment of expenditure responsibilities, and the assignment of revenue raising powers including taxation, user charges and borrowing, and provisions for accountability.

Beyond these general directions for reform, two reform options might warrant consideration in meeting the revenue mobilization goals in the Asia Pacific region.

**REFORM OPTION #1: DEVELOP A METROPOLITAN FISCAL STRATEGY THAT PROVIDES FOR A SPECIAL GOVERNANCE AND FINANCING REGIME FOR METROPOLITAN AREAS**

Most countries engage in urban planning but relatively few integrate their urban plans

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16 “Local benefit services” are those local-government-financed services where the benefits of the service are enjoyed by local taxpayers. For those locally financed services where the benefits are captured by non-payers, financing should be with intergovernmental transfers.
with a fiscal plan. Urban plans tend to focus on land use and public facility needs but often ignore the fiscal question of how to pay for this and maintain it. In reality, it should be difficult to separate the two.

Most countries do not have a metropolitan fiscal strategy, i.e., large cities are often viewed as just another unit in the local government fiscal system. They sometimes have the same revenue raising power as other local governments, and their entitlements to intergovernmental transfers are often calculated in the same way.

But the continued growth of urban populations and urban economies and the challenges of global competition are pushing systems to change. Many countries are coming to recognize that urban economic growth will not be sustainable without a metropolitan strategy that includes a fix for the underlying governance and financing problems. In the case of many urban areas, the efficient provision of services and their financing has outgrown the jurisdictional boundaries of cities. Many would take the view that the mix of service provision and financing should include regional taxes, delivery of some services on a regional basis, and a revenue model that is focused on more self-sufficiency (Bahl, Linn and Wetzel, 2013, p27).

The short of it is that metropolitan areas need to become more than a convenient way to think about the labor market area, and area wide governments need to be responsible for much more than planning and land use regulation. They need to become local government units with broader service delivery responsibility, taxing and borrowing powers, and elected governments. Metropolitan local governments should have more autonomy in their spending and revenue raising decisions. The case for higher level intervention is much weaker for metropolitan cities than for other local governments in the country.

Areawide metropolitan local governments offer the best future for governance and finance. When the jurisdiction boundary is large enough, spillover benefits and costs can be internalized, and economies of scale can be captured. Metropolitan areawide governments can rely on broader tax bases because their coverage of the economic region is greater. Broader based consumption, motor fuel and property taxes bring fewer distortions because there is less mobility across jurisdictional boundaries. The broader tax base and the larger jurisdiction coverage will also increase the debt repayment power of the metropolitan government. Jurisdictional fragmentation, which emphasizes home rule, does not offer these advantages, and it tends to be characterized by large intra-metropolitan fiscal disparities. Where countries choose to stay with the home rule emphasis that characterizes jurisdictional fragmentation, financing will be more through intergovernmental transfers and horizontal systems of revenue sharing to eliminate unwanted fiscal disparities among municipalities.

Several approaches might be taken to implement this strategy, depending on the individual country circumstances.

1. Create “special” metropolitan city governments within the present regime but with broader taxing and spending powers and more autonomy than other local governments. These powers might include the ability to enact certain new taxes and the freedom to set new tax
rates and user charges, and to control exemptions and preferential treatments. In return for this autonomy, metropolitan local governments would give up much of their claim on the present system of intergovernmental transfers. This would be new policy ground for most of the Asia Pacific region.

2. Part of the strategy might be to encourage metropolitan governments to move to areawide boundaries for service delivery and revenue raising. This might be done in several ways. Convert existing central or state government metropolitan development agencies into elected local governments with significant autonomy to deliver services and raise revenues. Create metropolitan taxing districts. Relax annexation laws, and provide incentives to expand metropolitan boundaries where necessary. To preserve some measure of home rule, an underlying tier of local self-government might be created. The city-barangay model in The Philippines is an example of how this might work.

3. China is a special case. The government is committed to a centralized regime for revenue mobilization. For the time being, local autonomy will be limited to the expenditure and non-tax parts of the budget. On the other hand, metropolitan area boundaries are more or less in place, as is a system of broad-based intergovernmental transfers to finance services, and a supplementary system of land revenues that contributes to financing the costs of urbanization. And, the Chinese government is on record as recognizing the increasing costs of urbanization and the need to improve the revenue base of urban local governments (World Bank and Development Research Center of the State Council, 2014, pxxvi). Another emerging problem in China is how to deal with boundary constraints, i.e., how to service populations and businesses when their activities spill across provincial boundaries.

**REFORM OPTION #2: ENCOURAGE HIGHER MARGINAL TAX RATES IN LARGE URBAN AREAS**

The social cost dimension of the urbanization problem might be addressed by raising tax prices in metropolitan areas to a level that is commensurate with the cost of providing services. “If you want to live and do business in the big city, you have to pay the price.” This strategy will also influence migration and investment decisions in urban areas.

Several policies might begin to move metropolitan areas in this direction.

1. Metropolitan area-wide local governments should be created and should have taxing powers commensurate with the expenditure responsibility assigned to them and with their demands for local public services. Where metropolitan areas continue with a pattern of Jurisdictional fragmentation, they will be financed by higher property taxes and user charges, and will continue to receive transfers from the higher-level governments.

2. A special expenditure assignment regime should be enacted for metropolitan local governments. The regime should make provision for cooperative arrangements and contracting, and for appropriate horizontal arrangements for revenue sharing. All local government employees should be hired, fired and compensated by the local governments. The operating costs of the city would be financed by the city. All local governments in the metropolitan area would be held to a hard budget constraint.

3. Allow metropolitan local governments to impose a higher marginal rate on property and land taxes. Some thought should be given to a metropolitan area wide property tax administration district, funded on a contract basis with the local governments. Provision
should be made for the imposition of value capture mechanisms. Remove any restrictions on tax rates or taxable property.

4. Allow local governments in metropolitan areas to impose higher taxes on motor vehicle registrations, and to impose a surtax on motor fuels, or to share in such a surtax.

5. Local governments in metropolitan areas should be given the power to impose a broad-based tax for general purposes. This might include a sales tax or a business tax, or it might be levied as a surcharge on a national consumption tax with a local option rate.

6. Local governments in metropolitan areas should be enabled to impose higher rates of special taxes and licenses to reflect the benefits from public services in large cities. These might include business licenses, development charges, and surcharges on the national income and sales taxes.

7. User charges should be increased to recover at least operating and maintenance costs for services provided in the metropolitan area. This would include public utilities and transportation services. General business licenses might also be imposed at a higher rate in large urban areas to reflect the level of public services provided.

8. In countries that decided on revenue devolution, local governments in metropolitan areas will no longer participate in the general intergovernmental transfer scheme, or in special schemes, but would be eligible for conditional transfers where the target is to correct for spillovers with national implications.

9. Again, China is different. But the same principle could apply, i.e., the higher cost of provision and the better services provided in metropolitan areas could come at a higher cost to residents and businesses. This could be done in many ways, such as the enactment of an annual property tax without rate discretion, full cost recovery from user charges, higher licensing costs, and more aggressive mobilization of revenues from the motor vehicle sector.
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