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SOURCES OF MUNICIPAL FINANCE

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SOURCES OF MUNICIPAL FINANCE

OVERVIEW:

The sources of funds available to municipal governments generally derive from three categories. Central governments may redistribute their resources to lower levels through direct transfers. These may be regular budget allocations to support the management of units of local government, or special distributions made to further certain purposes. Examples of the latter include block grants issued to municipalities in the United States, which generally provide funds for special projects on a competitive basis, and the financing of efforts too large for local government to afford or which offer benefits beyond the community in which they are located.

A second important source of funds is taxes, although the ability to impose various categories of taxation on the part of municipal government may be restricted by the central government. Local borrowing, often in the form of bonds, offers a third significant source of funds, particularly for capital expenditures. These sources and their usefulness for recurring and capital expenditures at the municipal level will be examined in turn.

STRENGTHENING LOCAL FINANCE:

The traditional case in which the central government maintains control over the country's financial resources offers broad disadvantages as well as advantages in comparison with a decentralized system. First, it is often emphasized that central government control impedes innovation at the local level as well as permits authoritarian decision making that does not take local desires into account. It may be inefficient in allocating and managing resources as well as unresponsive. It is also possible for a central government to provide or to withhold resources due to political considerations.

Strengthening local government finance can improve the efficiency of a country's public sector and reduce the reliance of local government on central government transfers. Decentralizing government revenue gathering and spending alone is not sufficient for better management. In many countries, the transfer of resources from the central to local levels of government is an important source of municipal revenues, particularly for large projects. Grants from the central government may help to correct fiscal imbalances between richer and poorer regions, or to maintain such balance in the case of regions which experience periodic fluctuations in production and income.

On the other hand, transfers remove decision making from the local level and put it in the hands of central government officials. This may be appropriate for projects that have spillover effects or impacts which extend beyond the limits of municipal influence. A highway built in one area, for example, clearly benefits those in adjacent communities whether they have to help share in its cost or not. Local government may also fail to capture all of the benefits of educational investments, as education increases labor mobility and may well facilitate urban migration.[1] Removal of decision making from the local level also inhibits the development or strengthening of democratic processes at the community level.

Efficiency must be the principal criterion for deciding whether decisions governing the sources and applications of resources are left in the hands of the central government or decentralized to other levels. Efficiency must also govern decisions concerning which municipal activities are to be financed with what resources. In order for municipal governments to operate in a way which maximizes their income and its use, they must have "...revenue authority commensurate with their spending responsibilities."[2]

Therefore, in applying this concept of efficiency to municipal financing, there should be a match or consistency between sources and application of resources. Urban services are best financed by local taxes, while public utilities can be established on a self-financing basis. Social services, due to their lack of cost recovery, should be supported by grants.[3]

Strict application of such principles may lead local governments to consider financing only those services whose benefits are most likely to be retained at the local level. Road networks and education, as mentioned above, contribute to the mobility of goods and labor, and may result in residents' use of them to leave. The ability of a municipality to fully capture all of the benefits of its expenditures and investment is limited, but local analysis may wisely include a realistic assessment of the benefits likely to be retained over the life of any project undertaken.

Urbanization results in increased demands for public services and expenditures. While urbanization often enhances the revenuegenerating capacity of local governments, actual revenue growth is often impaired by limitations in authority to raise revenues and by inadequate selection or implementation of revenue effort.[4] This fiscal gap may be closed by 1) increasing local effort to acquire revenues without increasing revenue authority, 2) increasing local revenue authority, 3) increasing transfers from the central government, or 4) reducing local responsibility for expenditures.

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[1] World Bank, Chapter 7 of unpublished report at AID Office of Housing and Urban Programs. Report is unidentified except for the label "PSW,"hereafter used as the relevant citation.

[2] Ibid.

[3] Ibid.

[4] Roy Bahl and Johannes Linn, "Intergovernmental Fiscal Relations in Developing Countries," in The Economics of Urbanization and Urban Policies in Developing Countries, George S. Tolley and Vinod Thomas, eds., World Bank, 1987.

The ability to control local resources and the goods and services they are able to provide, however, can be critical to the creation of democratic systems at the community level. Participation in decisions concerning how this fiscal gap is closed, the amount of resources generated, and the types of expenditures made are important to the institutionalization of democracy in the municipality. People are more likely to participate in as well as perceive the potential benefits from democracy if they are truly able to influence decisions by their municipal government that will have a direct impact on them.[5]

TAXES:

Municipal governments empowered to levy taxes on their residents have numerous options to consider, each with its own set of costs involved in its implementation and enforcement, which must be compared with the projected streams of resulting benefits. The provision of a buoyant revenue base that is easily administered and not regressive is the objective for most municipalities. In this regard, property and motor vehicle taxes are the most popular and result in the fewest from the central governments which have to permit their local implementation. One reason for their lack of resistance from the central government [6] is their lack of "exportability" to other units of government.

There are several advantages to the use of property taxes as significant sources of municipal revenue. First, all municipalities have some taxable real estate, and its existence is not related to the level of local industrialization. A property tax system can include outlying areas in the tax base, presuming that some benefit is provided in exchange for levying charges on those resident cutside of the boundaries of the taxing authority. The property tax is broadly based and can distribute the tax burden across the entire population, potentially including all who might benefit from the services provided or development activities sponsored by the municipality.[7]

In principle, property taxation allows for the raising of significant revenues at low rates of taxation. Property values are improved by the provision ef services which the municipality is capable os providing once the flow of property tax revenues begins. The resulting cycle of improvement--higher values--better services is ideally based on an equitable situation in which property owners benefit directly from the taxes they have paid.

This equitability can be enhanced by systems which permit exemptions on properties with values below a certain amount, whose owners might be presumed to experience hardship from any additional expense. Similarly, exemptions may also be granted to those owners who have been unable to afford to make minimal improvements. Fundamentally, as real estate

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[5] Ibid., p. 130.

[6] Ibid., p. 131.

[7] PSW, op. cit.

is immobile, little of the taxation imposed on property will be shifted from owners to others.

The efficiency and widespread acceptance of the property tax is evidenced by its virtually universal use in industrialized and developing countries as a means of financing local government. Several countries have reassigned its use from central to local governments.[8] Data for urban local governments in selected governments in selected developing countries show that property taxes typically account for 5% to 25% of recurrent receipts, with this proportion being even higher for Africa. Countries with high levels of inflation, in contrast, are at the lower end of this receipt level.[9]

A good estimate of the tax base is essential to the analysis of property tax performance as a fully exploited source of municipal revenue. That is, the total value of all property on which the tax is charge must be known, consistently recorded, and able to be updated.[10]

Property taxes are more sensitive to population changes than consumption or income taxes are. This makes them suitable for use in urbanizing areas experiencing population growth.[11] The design of new systems or restructuring of old ones to make them more efficient are advised to consider the following six steps designed with the objective of collection efficiency in mind:[12]

1. Definition of the tax base, including political decisions as to which properties should be taxed.

2. Discovery and identification of properties to be taxed, including property inventories, tax mapping requirements, and cadastral systems.

3. Define tax liability, that is, determine whether the owner or the occupant or user of the property is to be taxed.

4. Decide on valuation methods: For example, some systems are based on annual rental value, while others use market value or differentiate among varied uses of properties subject to taxation.

5. Determine the rate of taxation. This must be high enough to make property

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[8] Ibid.

[9] Ibid.

[10] Research Triangle Institute, Municipal Financial Analysis Handbook.

[11] International City Management Association, A Revenue Guide for Local Government.

[12] PSW, op.cit.

taxes worth collecting. While governments need flexibility in setting rates, it is advised that rates which are less than 1% of capital value, or less than 10% of rental value, are likely to be too low to warrant collection. Flexibility is needed in order to maintain the value of property in real terms between valuations. Revaluation is recommended each five years at a minimum. This is sufficient if price increases are captured through indexing the tax base or increasing the rate. The lack of indexation contributed to the deterioration of real property tax revenues during periods of high inflation in Latin America.

6. Billing and collection efforts must seek a balance between convenience and penalty, with a system of documenting delinquencies and the swift imposition of fines essential to adequate collection.

While property taxes often are the principal source of municipal revenue, tax diversifications is important to consider for long term planning. For example, a sales tax may be charged in addition to property taxes. Sales taxes are more elastic than property taxes due to the fixed supply of real estate. The fact that land is in finite supply may impede the ability of property tax revenues alone to keep pace with economic growth and resulting demands for municipal services. "Balancing an income inelastic source with a more elastic source results in a more stable overall revenue yield." [13] Also, a sales tax may provide income from nonresidents who come to urban markets to purchase goods. It is best to note, however, that a sales tax is inherently regressive, as low income households tend to spend a greater share of their income on the purchase of goods and services than do those with higher incomes, who may be able to choose to save a portion of their earnings.

Even within the system of property taxes locally, diversification is possible based on different uses of properties. However, each additional level of complexity adds to the administrative burden on the taxing authority . There are two additional advantages of the property tax in comparing it with other options. First, to be effective, it must be based on clear titles. The process of providing clear titles to property owners itself has been found to increase their investment in the property, resulting in greater productivity which could in itself lead to increased taxable incomes. Second, a system based on clear titles and able to establish liens on properties is difficult to evade. [14]

Other forms of taxations available to municipalities include business taxes. These can take the form of license fees for industries, trade, or professions; tax on gross sales or gross revenues, and sales taxes at the level of consumer purchase. Levels of such taxes can be tailored to local conditions, taking into account the competition from nearby markets. Revenues produced will increase with urbanization and its expanding demand for businesses

[13] Research Triangle Institute, op.cit., p. 18.

[14] Ibid.

and professional services. Local taxes such as these were found to provide 80% of revenues in San Salvador and 75% in La Paz. Business licenses alone accounted for 40% of locally-raised revenue in the Philippines.[15]

While such fees can provide an increasing flow of resources to urbanizing areas, it is important not to use these as a barrier to thy growth of new businesses. An exemption may be granted to new or very small businesses, often without a large impact on the revenues accruing to local government. In Cartagena, Colombia, for example, an exemption of 70% of small businesses led to a reduction of only 1.2% in revenue liability.[16]

By the same token, the small scale on which most retail establishments operate in developing countries may make the administrative burdens involved with implementing a sales tax overwhelming in comparison with the resulting revenues. The imposition of a personal income tax is another potential source of municipal revenue. However, this tends to be narrow in its coverage and difficult to administer. There also tends to be little experience in its administration in developing countries. In fact, "..experience demonstrates that local income taxation requires close coordination between central, state and local governments on assessment and collection." [17]

Income taxes may contribute to unemployment. One advantage, however, is their ability to reach nonresidents who work in urban areas and who otherwise would not pay for the benefits that they receive in terms of local economic development and infrastructure.[18]

Taxes on motor vehicles offer a potentially important source of income to municipalities as well as one which is efficient and equitable. Ownership of vehicles is concentrated in urban areas and among those who are relatively better off. Its application to local residents is consistent with local capital investments and their requirements of road maintenance and traffic management. A common barrier to the implementation of such a tax is the lack of authorization to local governments to do so. Jakarta, however, is one example of successful implementation of a motor vehicle tax, as 37% of municipal revenue is generated in this manner.[19]

Selective excise taxes such as license fees, stamps, and poll taxes, are common in developing countries, but these are often charged at the discretion of tax collectors. Municipalities

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[15] Ibid.

[16] Ibid.

[17] Ibid.

[18] Research Triangle Institute, op. cit.

[19] PSW, op. cit.

investigating these as possible revenue sources might consider their effective and impartial execution as well as their administrative and compliance costs first.[20] Hotel charges and other fees on services used most frequently by tourists and businesspeople from other areas are likely to be less discretionary. These function to tax the use of local services and facilities by nonresidents.[21]

Taxes on motor vehicles offer a potentially important source of income to municipalities, as well as one which is efficient and equitable. Ownership is concentrated in urban areas and among those who are relatively better off. Its application on local residents is consistent with local capital investments and maintenance of roads and management of traffic. A common barrier to the implementation of such a tax is the lack of authorization to local governments to do so. Jakarta is one example of success in this area, with automobile taxes providing 37% of local revenue.[22]

The concept of a betterment tax may be useful to target the costs of necessary improvements to those who benefit. For example, in the case of a new road the costs may be shared between the owners of adjacent properties through the imposition of a tax and the users of the road, who must pay a toll each time they travel on it. The betterment tax is a useful method of cost recovery for projects whose benefits clearly accrue to identifiable categories of users who can be compelled to pay for the improvements received. Arguably, a betterment tax also "...actsas a device for the efficient rationing of public services."[23]

A betterment tax may be of particular value as a method of local financing when neighborhood residents seek to obtain access to a particular service or facility. Costs can be estimated and assigned in a manner which does not require an increase in overall municipal revenues or public taxation. In addition to minimizing the impact on public funds, a betterment tax can serve as a self-financing approach to the solution of specific local needs, whose satisfaction can also yield a greater sense of local control and participation. The availability of such schemes at the local level may enhance democratic initiatives as well as prevent "...theimposition of unnecessary services" in the eyes of local residents.[24]

If efficiency and equity are important considerations for municipalities seeking to expand

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[20] Ibid.

[21] Research Triangle Institute, op. cit.

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[23] "Urban Land Development Study: San Pedro Sula, Honduras," Working Paper, U.S. Agency for International Development, Office of Housing and Urban Programs, March 1989.

[24] Ibid.

their revenue bases, certain taxes are best considered only in light of their administrative and compliance costs. Selective excise taxes such as license fees, stamps, and poll taxes, are common in developing countries, but these are often charged at the discretion of tax collectors. Hotel charges and other fees on services used most often by tourists and business travelers from other areas are likely to be less discretionary, and function to tax the use of local services by nonresidents. [25]

The performance of user charges as sources of revenue is determined by billing and collection efficiency, revenues generated compared with the cost of service provision (cost recovery), and revenue per unit of service.

The total revenue that could be collected can be estimated by multiplying the target revenue per capita by the population of the jurisdiction. The value of improved revenue collection is the difference between this and the amount actually collected.

One study postulates four efficiency criteria for the raising of local revenues:[26]

1) If an individual can be excluded from the benefit of a public service unless he pays for it, then user charges are the efficient means to pay for such a service.

2) If exclusion from the benefit of public services through pricing them is not possible, then the generation of general tax revenues on everyone is the most efficient method to pay for these services.

3) If the benefits of a locally-provided service spill over into other jurisdictions or produce nationwide or other widespread benefits, then grants from higher-level governments should finance these services in proportion to their outside benefits.

4) In economies in which macro-level fiscal balance is maintained, borrowing is the appropriate method to finance local capital investment.

BORROWING

As capital projects are planned, the focus is often on the need for the facility to be provided. However, the local government must be able to determine the impact of loan repayments on local finances before entering into the commitment to borrow funds. Projects may appear to be good investments, but may, in fact, turn out to be a drain on the community's financial resources.

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[25] Ibid.

[26] Research Triangle Institute, op. cit.

User charges and benefit financing are suitable means to recover the costs of capital projects. While user charges involve payment as services are received, benefit financing is a development charge, such as a lump-sum payment to recover the cost of infrastructure development from beneficiaries. This is usually imposed on property owners in areas to be impacted by public action--such as the construction of roads or other infrastructure--which results in the increased availability of facilities to these landowners. [27]

A study of public finance in developing countries shows that user charges and benefit financing accounted for one third of all local revenues in the sample studied.[28]

While suitable for local government finance, particularly the recovery of costs of capital projects, it is underutilized. In addition to being efficient, the use of these charges reduces the pressure for tax policies to generate the needed revenues. In nearly all municipalities, there is competition for scarce resources generated by taxes. Water and wastewater, transit, electricity, and telephone service are all amenable to benefit financing and user charges. Their use allows for projects to pay for themselves, and permits managers to be accountable for services.

Certainly the financing of capital projects is unlikely to be possible using current revenues. If grants are not available, or are undesirable based on the accompanying control or influence by the central government, it is possible to consider the establishment of a Municipal Development Fund to institutionalize municipal access to credit.[29]

Other techniques, particularly useful to consider when borrowing is not possible or affordable, include land readjustment or valorization. Land readjustment involves municipal acquisition of raw land, generally on the periphery of the community. The municipality subdivides it, extends services, and returns it to its owners in an amount proportional to their land contribution. The remainder is available for sale or distribution to other residents or businesses. The subdivision to receive services is typically required to donate land for public use, with the value of the land contribution equal to that of the estimated costs of providing services to the subdivided land in need of development. While the land owned in the subdivision or other parcel slated for development is reduced, its value is greater than it was prior to the service extension, thus resulting in a net gain for the land owner which is not made without public compensation. This method works best where the number of property owners is small, as it is less complicated to obtain the agreement of all affected in such cases.

Land readjustment is also most effective--and its benefits most apparent--in markets in

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[27] PSW, op. cit.

[28] Ibid.

[29] Ibid.

which the price of land is increasing, and where local appraisals are reasonably accurate as well as acceptable to affected landowners. It is well to note that the improved lots resulting from land readjustment projects are likely to have higher market prices; therefore, these costs might be projected prior to assuming their availability for low income housing or other benefits expected to assist households with limited resources.[30]

Valorization involves the sharing of the cost of public service provision among the properties receiving these benefits. Like land readjustment, this is done in proportion to the benefits received.[31] Valorization obviously involves the transfer of funds from landowners to the municipal government, and is a method of recovering project costs. Land readjustment may be used when the municipal government has obtained the resources needed to develop land, and when there is interest in capturing the benefits of its development for economic development or other public purposes.

As municipalities become involved in borrowing resources for capital projects, it is wise to understand and develop a balance between the financing of long-term debt, recurrent expenditures, and the maintenance of existing facilities. Generally, it is advised that a municipality devise a capital improvement program which includes projections of resources as well as demand for services. Needs for equipment replacement and major repairs must also be projected. Long-term borrowing is best confined to those items which cannot be financed from current revenues. At the other extreme, the borrowing period should not exceed the useful life of the project.[32]

The World Bank has found that "...tariffrevenues generally underestimate the benefits of infrastructure investment." [33] It advises that total willingness to pay is a reasonable proxy for the valuation of benefits of such projects, in contrast with the traditional view that benefits may be inferred by observed increases in the price of land.

With regard to recovering the costs of infrastructure projects, the sponsoring local authority basically has two choices in establishing rates: It can obtain indirect payments raised by local revenues, such as property or other taxes; or it can require direct payments of rates or fees collected from actual beneficiaries based on their use. While the latter appears more equitable, such a choice must also be based on the sponsor's ability to enforce collection. The cost recovery method is therefore best determined by the possibility of identifying direct

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[30] "Urban Land Development Study: San Pedro Sula, Honduras." Working paper, U.S. Agency for International Development, March 1989.

[31] PSW, op. cit.

[32] Ibid.

[33] Yoshitsugu Kanemoto, Estimating Benefits of Infrastructure Through the Analysis of Land Value, Water Supply and Urban Development Department, World Bank, August 1985.

beneficiaries and the potential for individualizing expenditure as well as receipts.

One problem with identifying direct beneficiaries results from the accounting system used by the local authority.[34] This is likely to be based on public accounting and budgetary unity, in which receipts are not attributed to particular expenditures. Thus, accurate record keeping that permits efficient billing and collection may require training, reforms, and new systems.

One recommendation for overall project cost recovery is that funds from the central government be used for core financing of capital facilities, using special funds devised for this purpose. Housing Guaranty resources from A.I.D. may be used for such purposes. Local user charges might then be levied to cover the extension of facilities (such as water lines), and for their maintenance and use. Betterment fees--in which charges are made to landowners of properties which will be accessible to new services--are also recommended to contribute to cost recovery. Otherwise, plots adjacent to development will benefit disproportionately to the cost of providing the service.[35]

While there are no guidelines for how much to charge property owners proximate to improvements, or how much less to charge those who live further away, the basis for such decisions may be the estimate of the overall cost of the service. Decision makers must then use their discretion to develop a scale of fees, including betterment charges, that address their needs and concerns. For various types of infrastructure development, it should be possible in the planning stages to propose "benefit factors" which correspond to the differences in property values in various zones emanating from the facility.[36]

Many communities, such as growing areas in the United States, seek to pass on all costs related to new development to incoming residents. However, it is argued that projects with true community-wide benefit should not be charged only to new residents, as such policies discourage development and the related benefits--such as expanded local markets--which could benefit established property owners as well as newcomers. Clearly such an approach would discourage legitimate new settlements. In response, U.S. courts have agreed that development fees and exactions can only be used to recover true development costs--not function as a deterrent to development.[37]

Generally, those facilities that will primarily benefit new residents or open up new

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[34] PADCO, Mechanisms for Cost Recovery of Municipal Investment in Trunk Infrastructure, USAID Office of Housing and Urban Programs, January 1988.

[35] Ibid.

[36] Ibid.

[37] International City Management Association, A Revenue Guide for Local Government.

development may recover costs from these beneficiaries.

In planning for the financing of capital investments, municipalities are advised to conform with these four recommendations:

1. Those who will benefit from a facility should pay for its development and operation at a level corresponding to their use.

2. Costs should be amortized over the reasonable life of the project, with no deferral of operating and maintenance expenses.

3. Costs of operation and maintenance should be considered explicitly when designing the project and its financing.

4. Fiscal and administrative responsibilities should be limited to areas where the greatest impact is expected.[38]

Life cycle costs for most types of infrastructure can be obtained for comparison by those proposing new development. Quality and long-term costs should be emphasized. In the U.S., it is found that 29% of all public works expenditures are for maintenance, leading to the recognition of the importance of establishing reserve or sinking funds for these purposes.[39]

Another promising source for the financing of capital projects is through the creation of public/private partnerships for the sharing of equity and ownership obligations. Businesses may be enticed to invest in infrastructure that will enable them to establish or expand productive facilities. Local situation and competition for business development may, of course, affect the potential for such arrangements. Larger private sector concerns may also be approached as sources of long-term credit for the construction of public facilities, particularly those which will benefit their business.

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LAC Economic Indicators

COUNTRY	Income per cap	Interest rate	Inflation off'l(unofficial)	Growth	Delinq.	Debt
CARIBBEAN						
Jamaica	$940	19-35% 24.4%avg	16.5(20)	1.9		4,446m
Haiti	$360		7.9	-0.2		804m
DomRep.	$730	12%limit +14% commission for housing mortgages	16.3	2.3	620(q),BA(pot.)	3,695m
Barbados	$4,233	9.5%	3.3	0.6		
Trin&Tobago	$		6.2	1.3		1,801m
CENTRAL AMERICA						
Mexico	1,830		18.0	2.5	potential 620q	107,882m
Guatemala	$950	14%	12.7	1.2		2,825m
Honduras	$810	14%	4.9(14)	0.7	potential 620q & BA	303m
El Salva.	$860	11-17%	16.5	-0.4	potential 620q & BA	1,762m
Nicaragua	$830	up to 45	11,455	-8.0	620(q) & BA	7,291m
Belize		10%(prime)	1.5	9.4		
Costa Rica	$1,610	22.5%	17.(25)	3.8		4,727m
Panama	$2,240		3.3	2.4	620(q) & BA	5,324m
SOUTH AMERICA						
Colombia	$1,240	44(nom.)	23.7	3.5	potential BA	17,006m
Venezuela	$3,230	42-45	75.0	-0.9		36,519m
Ecuador	$1,040	50-52	30(60)	3.2	potential 620q	10,437m
Peru	$1,470	800+*	7000	0.2	620(q) & BA	18,058m
Bolivia	$630	37.2#	18.0	-0.5		5,548m

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Argentina	$2,390	hyperinflation	(1000)	4.5	620(q) & BA	56,813m
Chile	$1,310	38.5**	10.9	7.4		21,239m
Brazil	$2,020		816('88)	4.1	620(q) & BA	123,932m
Paraguay	$990	24-32***	21(32)	3.4	potential 620q	2,447m
Uruguay	$2,190	95.8##	68.5	1.4		4,235m

*Interest rates reported to IMF range from 791-987%.

#Market is highly distorted due, in part, to maintenance of value clause in all loans issued. Interest rates can be as high as 80 to 100% for loans in bolivianos; but currently are 22-24% for loans in dollars. There are negative expectations affecting the market, according to the RHUDO.

**Real interest rate is 9%; nominal rate reported as 38.5% There are positive interest rates in Chile, as monetary correction is applies daily to loans, which are issued in "unidades de fomento" ("development units") rather than in units of currency.

***Up to 24% interest on housing mortgages through IPVU; 32% including commissions for commercial loans.

##This is the RHUDO's estimate of current rates. Note that there is no private housing finance system in Uruguay.

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