

LOCAL URBAN GOVERNMENTS FINANCING A COMPARISON BETWEEN COUNTRIES^a

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ABSTRACT

This paper is intended to analyze, in a comparative perspective, the financing mechanisms of urban local governments in two groups of countries. The first group refers to a sample of OECD countries. They are rather decentralized, and have institutional features which date back many years from now. The scope of responsibilities faced by these countries' urban governments, as well as the resources they run are quite substantial relative to developing countries. The second group is constituted by a number of Latin American countries. They are, in general, less decentralized and have the characteristic of not having a well established institutional structure. This has experienced various changes over the recent years, one of them being a process of transferring responsibilities to local tiers of governments, a tendency which in general, has not been accompanied by an increasing capacity to get resources neither from the central government nor from the local financial market.

SINTESIS

Este trabajo pretende analizar, desde una perspectiva comparativa, los mecanismos de financiamiento de los gobiernos urbanos locales en dos grupos de países. El primer grupo se refiere a una muestra de países OECD. Son bastante descentralizados, y tienen rasgos institucionales que se remontan a muchos años. El alcance de las responsabilidades que tienen los gobiernos urbanos en estos países, como también los recursos que manejan son bastante sustanciales en relación a los países en desarrollo. El segundo grupo está constituido por un número de países latinoamericanos. Son en general, menos descentralizados y tienen la característica de no poseer una estructura institucional bien establecida. Esto ha experimentado diversos cambios en los últimos años, siendo uno de ellos un proceso de transferir responsabilidades a los niveles locales de gobierno, una tendencia que, en general, no ha estado acompañada de una capacidad creciente para obtener recursos ni del gobierno central, ni de los mercados financieros locales.

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1. INTRODUCTION

The interest in urban government financing impinges upon the attempt to modernize the State, a very appreciated target among western economies in recent years. The swing experienced in the view of the State as a mighty power in the 60s and 70s, is dramatically changing toward a more market oriented approach, which very much emphasizes the need to permit a higher degree of autonomy in the management of local governments¹. This implies a decentralization of the State, and a stronger role of local decisions regarding the use of their resources and the design of mechanisms to raise revenues. This last aspect of the problem is the one we deal with in this work.

Within the context of the conventional theoretical wisdom concerning the proper way to finance local governments, this paper is intended to compare the financing mechanisms of urban local governments between two blocks of countries. The first group includes a number of Latin American countries, in which an active process of decentralization and modernization of the State has been in progress for some years now. They have rather centralized governments, a phenomena which can be observed in the sizes of the cities, some of them being among the biggest in the world. On top of that, whilst in some cases the amount of resources used by local governments as a proportion of the whole government budget is quite substantial, the degree of autonomy they have to decide on the allocation of funds as well as in the capacity to generate more revenues through local mechanisms, is usually very limited. The second group of countries is constituted by four selected OECD countries. All of them have recently experienced some kind of reform regarding the financing mechanisms of local governments. They are also part of the

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¹ See Stein R. (1992).

aforementioned trend in the view of the state. Developed economies are relatively more decentralized concerning the scope of maneuver given to local governments.

This paper is divided in three sections. The first one deals with the theoretical framework behind the proper way to finance local governments. The second section is a comparative overview about the relative participation of local governments in the general fiscal budget of the two blocks of countries and their main revenue sources. Finally, section three addresses each type of specific revenue source in a more detailed way.

2. THEORETICAL FRAMEWORK

Three basic principles are universally recognized as good properties to be found in a tax system. It should be economically efficient, easy to administer and as equitable as possible. Despite the obvious relevance of the two last characteristics, the bulk of the literature on public finance has emphasized the identification of those public sector financing schemes which introduce undesirable changes in economic agents' behavior. In the case of local governments, the three former principles are still valid. It must be added, though, that local governments usually get an important part of their resources by selling urban services.

A basic feature of local governments is the fact that, the existence of a community which provides public goods and services in a very well defined geographic area within a particular country, involves the acknowledgment of a decentralized structure of government. In this context, a general rule which defines the efficient way to local governments is the so called "Principle of Fiscal Equivalence". The original idea corresponds to Olson (1969) and it constitutes a differentiating element between the central and local governments. This concept is closely linked to the "benefit principle" in the use of different sources of public financing. It refers to the necessary correspondence between the benefits generated by the local government and the payments, either in the form of taxes and/or user charges, made by the beneficiaries. On the basis of Olson's idea, many authors have managed to formalize the distorting effects of different mechanisms intended to finance local governments².

Olson himself acknowledges that the challenge of moving in the direction of a more benefit oriented scheme of financing local governments, is usually in conflict with two other important targets. The first one deals with the need to provide public goods at the minimum feasible cost. It might be the case that the optimum jurisdiction size is not compatible with the corresponding size of the jurisdiction under analysis. There might be some overlapping of jurisdictions, in which case a

² See for example Gordon (1983).

benefit oriented financing system is difficult to enforce. The second problem has to do with the significant development of communications and ways of interaction between geographical areas, a phenomenon which dilutes fiscal correspondence. This fact, which is known in the literature as the "spill-over effect", is particularly relevant in funding urban infrastructure, being a serious problem in the provision of any other local public service whose benefits do not permit an easy exclusion of those users who do not belong to the corresponding jurisdiction.

In addition to the arguments given by Olson, the practical application of the correspondence principle faces at least one more important weakness. It relates to the equity principle mentioned before. Whilst the argument that the equity targets are more efficiently achieved through an appropriate focusing of expenditures on the provision of low income basic demands for social services such as education and health, the evidence provided in this study shows that local government funding is usually biased in favor of progressive forms of taxing and charging for services. The political problems involved in the use of technically efficient sources of funding by local governments are probably very well exemplified by Thatcher's introduction of the poll tax in the late 80s in Britain. Although it was a close substitute of the classical text book lump sum tax, the political conflicts that it provoked proved to be very difficult to deal with³.

The stylized facts which refer to the mechanisms used by local governments to finance their services are certainly diverse. There are, however, some common features with respect to the kind of local government revenue sources used. One of them, which very often provides a significant proportion of the whole budget, is the property tax. Some authors contend that this tax can be considered a benefit tax, as long as it reflects the payment for the services provided by the local government. Since this tax usually corresponds to a rate over the property value, the tax base itself might be a good index of the quality of urban services being provided by the local government. Aronson and Hilley (1986) argue though, that this is most plausible with respect to such local governmental services as fire protection, street improvements, sewerage construction and operation, and street lighting. Though present, spill-overs to the community are not very significant in these cases. It is in the expenditures on education and very often community health, usually a very important component of local public services, where the link to property values is almost nonexistent. The benefits are spread beyond the recipients, making the property tax only partially a benefit tax.

A second very important source of local government revenues are the transfers made by the central government in favor of decentralized tiers of government. They are known as grants, and represent a basic element in a modern state's resource allocation. Byrne (1994) distinguishes five reasons why there might be a case for

³ See Desmond King in "Development in British Politics 4" (1993), edited by Dunleavy, Gamble, Holliday, Peele.

grants. First, the central government will wish to encourage the development of certain services, such as education or national health. Second, some geographic areas might face a dramatic lack of revenue sources relative to the rest of the country. Third, grants may seek to compensate local authorities for their varying needs to spend, especially when the cost of living in that particular area is higher with respect to other areas. Fourth, there may be some interest from the central government in equalizing, either vertically or horizontally, local governments' incomes. Finally, there are cases in which the central government may decide to compensate the local government for any restriction imposed on the collection of local revenues. In many cases, local property tax rates are centrally fixed, determining a limit to the resources to be collected by the local jurisdictions. In short, behind grants there may be a response to different kind of slipovers between tiers of government. The very acknowledgment that national targets involve some kind of collective commitment to achieve specific targets, implies that local government decisions on expenditure must be subject to some kind of intervention from the national government. An important problem of grants has to do with the potential lack of incentives of local governments to improve tax collection and tax evasion.

Another source of revenues for local governments that is worth mentioning is the charge of fees for some local public services. Although this is very much in line with the principle of fiscal correspondence, its use is very often limited by the unfeasibility in charging some services. The use of streets through toll fees is probably one of the local services in which this kind of charging is becoming a feasible mechanism of rising revenues. It must be said that the introduction of more advanced technology in the measurement of the use of streets is likely to improve this mechanism. It should be added that the concession schemes between the local governments and the private sector is another way to enhance service charging.

Finally, some controversy still exists as to the practice of issuing local public debt to finance local jurisdiction expenditures. This is a common mechanism in some OECD countries, although the nature of the debt and the uses for which it is raised differs very much from country to country. Whilst the bulk of this debt is geared to finance local government investment, the availability of funds is essentially fungible. This might lead to financial problems at the local level, which are likely to cause pressures on the central government.

3. A COMPARATIVE OVERVIEW

If we have a look at the figures on the share of local municipal government budgets as a percentage of central government revenues, the first noteworthy aspect refers to the clearly higher participation of lower tiers of governments' expenditures in developed countries relative to Latin American ones.

As a general remark, it must be said that there exists a positive correlation between per capita income and the percentage of total tax revenues going to state and local governments within this group of countries⁴. This certainly hides numerous features of individual countries, but it suggests that a higher degree of decentralization is likely to be found as countries achieve more advanced stages of development. In addition to this stylized fact, OECD countries have shown a tendency to decentralize the financing system and to widen the range of responsibilities given to local governments in recent years. During the 1970s, Belgium, Holland and Denmark moved in this direction. Countries like Spain, France and Portugal took similar steps more recently. The exception to the rule is the case of Great Britain. In countries like Holland, Spain and the United States, these changes have been carried out under the name "New Federalism"⁵.

A comparative view in terms of the relative participation of local government incomes relative to the whole government incomes can be observed in Table 1. The clearly higher participation of local governments in the group of OECD countries reported, suggests that Latin American countries are relatively more centralized. This is likely to be a multidimensional phenomena which, as was mentioned previously, can also be observed within OECD countries.

TABLE 1

**PARTICIPATION OF LOCAL GOVERNMENT INCOME
RELATIVE TO THE CENTRAL GOVERNMENT
CONSOLIDATED BUDGET**

OECD Countries		Latin American Countries	
Denmark (1991)	33.2	Bolivia (1990)	11.0
Sweden (1992)	40.4	Brazil (1991)	15.8
Norway (1990)	25.8	Colombia (1990)	15.1
United Kingdom (1992)	10.6	Chile (1991)	10.7
United States (1992)	21.7	Paraguay (1990)	2.9
Germany (1991)	30.8		

Source: Case Studies developed for the Project CEPAL/GTZ. Fiscal Decentralization in Latin-American.

⁴ See L.Letelier (1995).

⁵ See for example; J. Owens (1992).

Although very often the term "local government" involves a number of different kind of jurisdictions⁶, the former argument can certainly be extended to urban local governments. In the case of the four OECD countries under analysis, the United States is formed by 83,186 local governments, from which 47 percent are counties, municipalities and townships. The remaining 53 percent are special government and school districts. In Germany, local communities are a total 8,505. The basic distribution of functions among central government, states and communities is defined within the context of a cooperative federalism model. This general approach was introduced in 1969, when the Federal Legislation became insufficient to coordinate policies⁷. The case of Great Britain corresponds to an organization established in 1974. This created an organization of governments at two levels; counties and districts. This was done in England, Scotland and Wales. In the whole UK, there are 56 counties and 485 districts. The fourth country included in this survey is Spain. It has 8,056 municipalities. There is a wide variety of sizes in municipalities, which introduces some difficulties in its efficient administration⁸.

TABLE 2

LOCAL GOVERNMENTS REVENUE SOURCES OECD COUNTRIES
PERCENTAGE OF DIFFERENT REVENUE SOURCES
ON LOCAL GOVERNMENTS BUDGETS*

	U.K.(1)	U.S.A.(2)	Germany(3)	Spain(4)
Grants	50.8	40	26.2	38.9
Taxes	39.2	37	34.2	33.9
Income Tax Sharing	15.3			
Property Tax			4.1	19.27
Sales Taxes				0.28
Business Tax	22.2		14.8	9.22
Vehicle Tax				5.14
Council Tax	17.0			
Other Tax Revenues		0.005		
Charges	10.0	23.	39.1	27.2

*Capital Grants are included

(1) Source: Hall and Smith. 1995. Capital Receipts are not included.

(3) Source: Bundesministerium der Finanzen, Finanbericht 1990.

(4) Source: Castells and Villanova (1992)

⁶ Some of them might be geographic areas while others are administrative jurisdictions.

⁷ See Spahn (1991).

⁸ See Castells and Villanova.

The same great heterogeneity in the size and general features of local governments can also be found in Latin American countries. In 1992, there used to be about 14,000 localities in Latin America, from which approximately one third (4,495) belonged to Brazil. The number of municipalities for countries like Argentina and Colombia is roughly the same (1,030), as well as their population. With the exception of Mexico, which concentrates 2,378 municipalities, for a number of other countries, the number ranges from 200 to 330. A significantly smaller number of local governments can be found in Costa Rica, Panama and Uruguay. Another interesting feature is the high percentage of urban population, a figure which is very close to 85 percent in countries like Argentina and Chile. Lagging behind this urban participation, we can observe the cases of Colombia, Brazil and Venezuela for which the same figure is in the order of 70 to 75 percent. The aforementioned diversity reflects serious inequality problems regarding territorial and wealth concentration.

The available information with respect to revenue sources in Latin American local governments, can be seen in Table 2. Since the classification by type of revenue is subject to numerous peculiarities linked to specific countries, there are only two items which are directly comparable between the OECD and the Latin American cases. On the one hand, the participation of taxes in all revenues is roughly the same for the two blocks of countries. Grants, on the other hand, tend to be prominent in Latin America, reflecting the region's historically limited autonomy of local governments.

TABLE 3
PERCENTAGE OF DIFFERENT REVENUE SOURCES
ON LOCAL GOVERNMENTS BUDGETS
LATIN AMERICAN COUNTRIES

	Brazil	Bolivia	Colombia	Chile
Grants	62.7	54.7	47.8	42.7
Taxes	22.3	22.8	38.8	32.9
Property Tax	8.3	7.4	12.4	12.6
Business Tax			18.1	9.2
Vehicle Tax			3.2	7.4
Other Taxes	14.1	71.3	5.2	3.7
Non Tax Sources	15.0	4.6	10.4	12.4
Other Sources		17.9	3.0	12.0

Source: Project on Central Decentralization CEPAL/GTZ. Fiscal Decentralization in Latin America.

4. THE CASE OF SPECIFIC REVENUE SOURCES

4.1. Taxation

4.1.1 OECD Countries

In the United States, five tax revenue sources are relied on exclusively by the State and Local governments. They are property taxes, general sales and gross receipts taxes, motor vehicles and operators licenses. The property tax is, in terms of revenue productivity, the dominant local tax. In 1984, it provided about 75 percent of local tax revenue. This dependence on the property tax is particularly important for school districts, where particular tax provides almost 100 percent of the total income.

The case of the U.K. is probably the closest example of a clear attempt to move in the direction of an economically efficient and benefit oriented tax. This was made through the introduction of the now quite well known poll tax in the late 80s. This tax replaced the community based property tax, and it became the domestic rate for the British local governments. It consisted of a flat-rate levied on all individual adults, determined by the Council every year. This feature changed the basis of local taxing in Britain by shifting from a property-based to an individual tax. A very important aspect of this tax was that, despite its lump-sum tax resemblance, personal circumstances strongly affected the amount paid. Some people were entirely exempt, for a wide number of reasons. Others were entitled to tax rebates up to 80 percent depending on their income. Some paid twice when they had a second house. The non-domestic or business rates were also subject to reforms at that time. Instead of each local authority determining its rate level, the rate (poundage) is set centrally. It differs in Scotland, Wales and England, though it is the same for all local governments within each of the individual nations. These reforms were made by M. Thatcher and they gave rise to numerous criticisms. Most of them referred to the poll tax⁹. Byrne (1994) provides a long list of weaknesses of the poll tax. Two of them seem to be the most important ones. The first one refers to its obvious regressivity. Since each individual adult paid the same regardless of incomes and means, "it was a relatively greater burden on the poor". The second important difficulty of the poll tax, was its enormous administration problem, which involves registering charge payers, keeping track of those who are mobile, securing payment, processing claims to rebates or exemption, etc.

The political resistance to the poll tax, and the various practical problems in its application, allowed only a short life for it. The local Government Finance Act 1992 abolished the poll tax in 1993. It was substituted by the council tax. This tax

⁹ Desmond King (1993) contends that the principal reason why M. Thatcher was replaced was her "calamitous" reform of local governments finances, the poll tax.

combines the personal characteristic of the poll tax with a property element. It is based on the value of people's property and the assumption that there are two adults in the household. The amount paid depends on the value of the house, which is classified in one of eight bands. Although it also allows some rebates and exceptions to the rule, these are not many and they are certainly easier to identify than the ones defined for the poll tax.

In Spain, the most important municipal tax is the tax on urban property. Although the central government sets the tax base, municipalities can set the tax rate, but subject to a lower common limit for all municipalities and an upper limit, which is in direct relation with the local population. The central government also fixes the tariffs to be levied on different categories of businesses. The rates enforced by each separate municipality are subject to very small variations. Businesses should also pay the so called location tax. The base for this tax depends on the area occupied by the business and their location in the municipality¹⁰. For the vehicle tax, once again, the central government fixes the range of the rate but each municipality decides the appropriate tariff. Other local taxes used in Spain include the rural property tax, the capital gains tax on properties sold, the luxury consumption tax and the outdoor publicity tax.

Within the group of OECD countries considered in this study, the case of Germany probably represents a text-book example of the uniformity of living conditions approach regarding local government financing schemes. This is particularly true for the case of taxation, in which the degree of maneuver for local government is rather small. The present system was established in 1969. Previous to that reform, business local taxes were the predominant type of local revenue, a fact which made local government budgets extremely cyclical. In the present system, municipalities have three types of taxes which wholly accrue to this particular tier of government. They are the Municipal trade tax, the real property tax, the local excise tax and the tax on certain non essential spending. However, in the apportionment of tax revenue in Germany, the most important taxes are treated as common taxes. From all of them, the only one which is shared with the community is the Wages and Income tax, from which 15 percent is given to this level of government. Regarding the local government business tax, municipalities are entitled to determine the rate levied, but they have to transfer a proportion of this tax revenues to the Lander and a similar proportion to the Bund. The lower the business tax rate, the more is paid to the higher tiers of government. The average business tax transfer to the Lander is 14 percent. The introduction of five new Landers as a result of the German unification, unfolded important problems regarding the equalization fiscal scheme. Local governments in the east would not receive their

¹⁰ Until 1989, it was levied in all provincial capitals and in all towns with more than 100.000 inhabitants. See Castells and Sole-Villanova (1992).

share of the income tax on the base of the income of the local inhabitants as in the western Landers, but only based on the number of inhabitants.

4.1.2 The Latin American Case

Whilst it must be acknowledged that in recent years there has been important progress in the strengthening of local taxation in Latin America, we must be aware that in most cases the very nature of the tax and also the corresponding rates are centrally determined, leaving a very narrow range of maneuver for the local authorities.

Local taxation in Latin America fundamentally rests on direct taxes such as the property tax, business tax and the vehicle tax. The fact that the property tax is rather easy to collect, makes this tax a very suitable revenue source for developing countries. However, the obvious difficulties to regularly update property values, according to the real market values, introduces a very significant problem¹¹. Car licenses and business taxes are the other two types of important revenues in countries like Chile, Colombia, Brazil and Ecuador, where these levies constitute about an 80 percent of local taxation.

4.2. Grants

4.2.1 OECD Countries

In the case of the United States, Federal Grants were first resorted to in a significant way with the Federal Road Act of 1916 and the approval of the Smith-Hughes Act of 1917. During the 1930s the country experienced a new important increase in the use of transfers. This was the result of the great depression and the need to assist the unemployed¹². The baby boom which followed the Second World War, and was accompanied by the real increase in income provoked by the international economic stability, brought about an important expansion in the demand for local public goods. The demand for nondefense public goods and services since the end of the war grew more than proportionately to the population. Since the responsibility for providing these goods fell on state and local governments, this induced a vertical imbalance which had to be filled by grants. An important item was the demand for schools and education. Between 1950 and 1976, local government expenditures increased from approximately 5 percent of GDP to 9.2 percent¹³. Since the mid 70s onward, this percentage has increased at a rather

¹¹ In some Latin American countries, the fiscal value, on which the property tax is paid, is no more than one third of the real market value.

¹² See Rafuse (1991) and Irwin (1993).

¹³ See O'Sullivan.

slow rate. The importance of grants in local governments' budgets experienced a systematic increase from 1965 to 1975, reaching a maximum of 40 percent of total financing. The fiscal crisis of the early 80s was, to an important extent, the result of this trend. In the case of municipalities, the bulk of these grants go to Education, standing for 52 percent of local expenditures, welfare programs, in the order 76 percent of total expenditures, and communal development and Housing where this percentage is 62 percent.

Aronson (1986) distinguishes four types of grants in the US. The first kind, called "Categorical Grants", is designed to achieve specific well defined goals of the national government. This kind of grant involves an important degree of inflexibility in its use, this being its most important weakness. Since more decentralized decisions are usually closer to the free to choose philosophy, Reagan's market oriented swing by the early 80s, put a big stress on trying to consolidate some of these categorical grants programs¹⁴. Many of them were eliminated and some were turned into the so called "Block Grants". They represent a kind of transfer which gives a more substantial degree of discretion to local governments to decide on their use. The Advisory Commission on Intergovernmental Relations (ACIR) defines block grants as those "...assigned... chiefly to general purpose governmental units in accordance with a statutory formula for use in a variety of activities within a broad functional area largely at the recipient's discretion". Grants Revenue sharing and Tax Expenditure are the two other types of grants. The latter type consists of tax deductions in the benefit of local jurisdictions' taxpayers. In some cases, they are allowed to deduct some of the taxes paid to the local government from the federal taxes. The exclusion of local bond interest from the tax base, allows some of these governments to float debt at interest rates lower than the market.

A rather opposite approach, as far as intergovernmental transfers are concerned, is represented by the German case. The basic spirit of its transfer system can be synthesized in the concept of communal fiscal equalization. This also holds for the landers as a whole, and it stresses the general goal of driving each locality to a common benchmark. This usually involves the commitment to make each local government at least as rich in terms of local government's per capita local public resources up to some percentage of the national average. Based on collective welfare arguments, the Germans strive for uniformity of living conditions, specifically in the provision of public goods. In order to achieve this goal, an indicator of tax capacity and expenditure needs is calculated; communities with a tax capacity deficit are subsidized. There exists also a basic redistribution ("shockelausgleich"). The mechanics of the whole system is certainly more complicated, and more importantly, it differs from Lander to Lander. The Landers are free to design their own systems of fiscal equalization among their local governments, but have to observe the framework of the Constitution. Figures

¹⁴ See the Omnibus Budget Reconciliation Act 1981.

reported by Zimmerman (1992) show that in 1985, 27 percent of the local government revenues were the result of transfers from other governments. They are basically vertical transfers from the Landers. The use of horizontal equalization schemes in Germany, is only relevant among Landers. Each Lander can design its own system of fiscal equalization among local governments as long as this is in line with the Constitution.

Although the UK's poll tax represented an important departure from the traditional European welfare state approach, its abandonment in recent years and the significant use of grants, evidences a return to an emphasis on fiscal equalization. Grants were introduced in Britain in 1835, when the central government started to assist the local authorities in the cost of transporting prisoners¹⁵. The relative importance of grants in the whole country has been increasing over this century. This, in turn, seems to be a world-wide phenomenon, and it certainly weakens the power of local governments. The apportionment of general purpose grants is based on the estimation of the Standard Spending Assessments (SSA). The needs of local governments are measured through an index which weights some current and past values of expenditures which are considered relevant for the local governments. The weights are calculated through regression analysis, giving rise to the SSAs, which are separately estimated for each block of services. This involves education, personal social services, car roads and transportation, police, fire protection, capital formation financing and some others. These individual SSAs are used to calculate the general SSA for each local government. This index is ranked thus enabling a redistribution of fiscal resources by the central government. Such a ranking provides a criteria for the central government to distribute the so called "revenue support grant" (RSG). Once the RSGs are distributed, all local governments which choose to spend at the centrally defined SSA level, would be able to set the same tax band given by the average council tax. Insofar as local governments decide to spend more than the corresponding SSA, they have to finance the difference through local taxes. In other words, once the grants are received by the local authorities, they should be able to provide similar levels of services without widely different rate burdens. Since the tax base differs between local governments, this will inevitably lead to some inequality. Hall and Smith (1995) argue that there may be some perverse effects in this redistribution mechanism. Local governments could lobby for a change in the grant distribution formula, which might be even more profitable than pursuing efficiency gains. The British grant system also includes some specific grants. Some of them finance part of the services provided by the local governments, as, for instance, law enforcement and drug abuse control. Some others support the funding of centrally planned programs, as for instance, student awards and housing benefits. The percentage of local authority revenue sources financed by grants is 55 percent. From this figure, RSGs represent 35 percent.

¹⁵ See Byrne (1994).

In the case of Spain, in recent years there has been strong support to municipalities through unconditional grants from the central government. These grants are distributed from the National Fund of Municipal Cooperation. This gives rise to a block grant which is calculated annually. Municipalities receive also some grants from projects financed by the provincial government. The total grants represent at the most 40 percent of the municipal budgets. The block grants are distributed on the basis of the following factors: population (weight: 70 percent), Tax Revenues (weight: 25 percent), units of public schools (weight: 5 percent). The adjusted population and the school units are proxies for local needs. The weight of tax collection is intended to penalize the lack of effort in tax collecting made by the local government.

4.2.2 The Latin-American case

The resources involved in these transfers in Latin America is, in general, quite significant. This is so if we measure them as a proportion of GDP, as well as if we do it in terms of the ratio of these transfers relative to the local governments' total revenues. In federal countries, such as Argentina and Brazil, local governments in general run resources which amount to a figure close to 7 percent of GDP. The same ratio for unitary countries, as is the case of Bolivia, Colombia and Chile, ranges between 2 percent and 5 percent. As a proportion of the above mentioned resources, transfers in the form of grants represent more than 50 percent of total local governments' budgets.

As in the case of OECD countries, Latin America exhibits a wide variety of instruments enabling the transfer of resources to lower tiers of government. These transfers represent an important proportion of the funds used by municipalities and other local governments in financing "social investment" as well as productive investment. They are usually geared to finance some meaningful local public goods like health, education and, in general, what we can call social public expenses. The apportionment criteria consider different indicators such as population¹⁶, poverty indexes, tax effort, administrative performance, among others. In the Latin American case, a very important aspect refers to the capacity of this instrument to deal with urban poverty.

Intergovernment transfers are indeed one of the issues which originate an important degree of controversy in the very definition and design of the indexes used, as well as regards to their effectiveness. In the Brazilian case for example, poor regions, in particular low density regions located in the northeast, are clearly benefited as compared to the rest of the country. This is due to the fact that 86 percent of the "Municipal Participation Fund" goes to cities with less than 160.000

¹⁶ Which is still the most important one.

inhabitants. Only 10 percent of this fund is given to state capital cities. A densely populated and economically relevant city such as Sao Paulo is receiving a rather small proportion of the total funds distributed by the central government. The Colombian case faces a similar problem. The distribution criteria in force up to 1993 considered special benefits for municipalities with less than 100.000 inhabitants. This tended to favor small cities located in urban areas, which are not necessarily the poorest ones. That situation was in part remedied with the new Law of Municipal Competence which is in force as from 1993. At the other end, we find the case of Bolivia, in which there has been a redistribution of funds in favor of the indigenous regions.

A noteworthy issue relates to the trend to increase shown by grants over recent years. In countries such as Colombia, Brazil, Venezuela and Bolivia, transfers to local governments have experienced important increases, while even new increases are considered for the coming years.

In the case of countries with unitary systems such as Colombia, Bolivia, Ecuador and Chile, the central government directly transfers resources to municipalities with a great conditionality in its use. Most of these transfers are part of "social investment", that is to say, resources intended to be used in education, health and general welfare. On the other hand, in federal countries such as Argentina and Brazil, transfer schemes are closer to a tax sharing mechanism, in which, while there is an important degree of discretionality in the distribution of resources, municipalities usually have more autonomy in deciding what to do with the grants.

4.3. Loans

4.3.1 OECD Countries

A very common practice in funding local government is to issue bonds and/or to have access to credit from the capital market and/or the central government. Although the convenience of such a revenue source is subject to various problems¹⁷, its use is very common in most of OECD countries.

Two types of debt can be observed in the case of United States. They are the guaranteed and nonguaranteed debt. The first kind refers to a kind of indebtedness which forces the local government to pay back the principal and the interest according to a previously established pattern over time. The second type is linked to the return generated from a particular investment which is financed through the corresponding bond. Probably two distinctive characteristics are very important

¹⁷ For example, the use of nonguaranteed bonds might stimulate imprudent practices.

features in the United States local government issues. First, they are essentially used in order to finance local investment. Second, they are free of federal taxation. The federal government does not tax the interest on state and local securities through the income tax, and the state and local government cannot tax federal securities. It should be mentioned that local indebtedness at the local level is subject to various limitations. Some states set a ceiling on debt as a percentage of the property tax base of the local government. Another mechanism is the requirement that the issuance of debt be approved by referendum¹⁸.

In the case of Britain, local governments are empowered to borrow under the local Acts of 1972 and 1973. An important proportion of this borrowing is drawn from the Public Works Loan Board. This is a government agency which lends to public authorities. Under the Local Government and 1989 Housing Act, local authorities receive an annual credit approval, a device which works as a credit limiting tool. Since these loans are essentially used in investment, capital expenditures are set against the borrowing capacity and the access to some other sources such as capital receipts¹⁹.

4.3.2 Latin-American Countries

Although the efforts to decentralize have been substantial in Latin America, they have not been accompanied by a similar pattern in terms of the resources allocated to local governments. That is to say, though the scope of responsibilities given to lower tiers of governments has increased in recent years, the financial capacity to take advantage from this process has not experienced the same progress. This has made the potential access to the financial market particularly attractive. This is particularly so, because the development of local financial markets has also been subject to significant progress in these countries.

With very few exceptions, the common feature of Latin American cities is the rather low capacity to have access to resources through the financial market. On the one hand, the lack of credibility of some urban local governments as a borrower makes it very unlikely for them to issue bonds in the financial market. In the cases of Brazil, Ecuador and Colombia, credit is an important part of local financing. This is subject to some rules which have been relaxed in excess in Colombia. This, in turn, has given rise to some pressure in favor of imposing some limitations on the use of this device. On the other hand, in countries such as Argentina, Venezuela, and Chile, municipalities are not allowed to obtain loans. For this to be feasible, they have to go through a long administrative procedure, requesting the approval of the National Congress. Colombia is at the opposite extreme, as some of these norms

¹⁸ See Aronson J. and Hilley J. (1986).

¹⁹ See Byrne (1994).

have been relaxed in excess. Some pressure is being exerted in favor of imposing some limitations on the use of this device.

Some authors argue that, in the Latin American case, the empirical evidence is not clear as to whether local government deficits are likely to cause macroeconomic instability in the region's countries. It should be remembered, however, that this kind of problems was originated only at the provincial and state levels, and not at the municipal level. This was the case of federal countries, such as, Argentina and Brazil, were due to the lack of a clear and strict regulation, the provincial or state banks have been able to obtain credits from the Central Banks in order to finance their deficits.

4.4. Charges

4.4.1 OECD countries

In the case of Britain, approximately 70 percent of income from user charges comes from rents or related services. There is a wide number of sources of financing which derive from charging fees for different services. Within this category is, among others, the interest on loans to house purchases, and the funds collected by some lotteries. Among the so called trading services, local governments raise revenues by charging for industrial waste disposal, passenger transport, harbors and docks, and a number of others. In the group of personal services, local governments provide child maintenance, old people care, or adult community education classes. There are also some amenities such as sport facilities and car parks.

4.4.2 Latin American countries

An important increase has been observed in the use of charges in Latin American cities during recent years. Despite this fact, this source of revenue continues to have a rather low participation in overall income, and is in the range between 10 percent and 20 percent of the total. In countries such as Argentina, the sole weakness and extreme dependency of the provinces of municipal governments, made this source of revenues a potentially very important one.

Apart from the charges on water supply, sewerage, street lighting and the like, some countries have introduced some special contributions, which are closely linked to land. The revenues so collected are then used in urban development. Countries such as Colombia, Argentina, and Ecuador are good examples of this type. The charge we refer to is the "Improvement Contribution" or "Valuation Contribution". It requires the property owner to pay back part of the valuation benefit obtained as a result of urban infrastructure improvements.

In addition to the former instrument, charges made against urban goodwill is also a common practice. The difference with respect to the "Improvement Contribution" rests on the fact that this payment is made whenever some administrative decisions introduce significant changes in property value of certain areas. This is the case of allowing new business to set up in certain areas, by redesigning the urban regulatory framework. While this mechanism is considered in countries such as Colombia, its most important difficulty consists in the need to regularly update the measure of the property values.

5. CONCLUSIONS

From what has been stated in the paper, it is possible to arrive at some meaningful conclusions which may have a significant impact on work in this area in the future.

First, what we call urban government is a unit which is difficult to define. The great number and wide variety of these governments in the two groups of countries considered is a clear sign of this stylized fact. Second, countries in Latin America tend, in general, to be more centralized than OECD countries. This phenomena suggests that, as Latin American countries achieve higher stages of economic development, their local public finances will become more autonomous. Third, while grants seem to be a very important source of revenue for local governments in both blocks of countries, they represent a higher proportion of total revenues in Latinamerica. This imposes principal-agent problems as regards an adequate use of these grants. It must be added, however, that federal countries in Latinamerica show a clearly different pattern in this respect vis à vis OECD countries. Finally, as regard the use of taxes, property taxation is clearly a very important source of revenue for local governments. This tax can be considered, to a very important extent, a type of revenue which is very much in line with the so called benefit principle. This will be a more accurate description of this tax inasmuch as property values capitalize the benefits from local government services.

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