PANEL ON MUNICIPAL FINANCE AND LOCAL FISCAL SYSTEMS[1]
(Policy Unit 5)

HABITAT III OPEN-ENDED INFORMAL CONSULTATIVE MEETINGS
FRIDAY 29 APRIL 2016, CONFERENCE ROOM 3

10 A.M. – 11 A.M.

Presenter
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Moderators
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Panelists

- Jane Anyango, Executive Director and Founder, Polycom Development Project, Kenya
- Raquel Cecilla Kismer de Olmos, Director of the Institute of Administration, Government and Economics, UNTREF, Argentina
- Tadashi Matsumoto, Project Manager, Division Public Governance and Territorial Development Directorate, OECD, Japan
- Slaven Razmillic, Researcher, Centro de Estudios Publicos, Chile
- Peter Tyler, Professor, Department of Land Economy, University of Cambridge, UK

Municipal governments oversee the provision of public goods and services to a growing majority of the world's inhabitants. Accordingly, improving the capacity of local governments to fund those services, and the transparency and accountability of the funding process, impacts the quality of life and level of citizen engagement in the political process.

VISION

Steady economic growth requires properly financed and functioning municipal governments, supporting institutions, and infrastructure. Municipal finance is the operational fulcrum on which the success of ongoing future rapid urbanization rests.

Across the world, municipal finance systems rest on the rules of the game (i.e. policies, constitutions, laws, and legislative frameworks) and comprise the following four key components: (1) expenditures; (2) revenues; (3) financial management; and (4) borrowing. The relative strength or weakness of these components determines whether a local government is able to deliver public goods and services to meet the basic needs and preferences of its population. It should be stressed that country circumstances, and the concrete characteristics of municipal finance systems within these components, vary widely. An appraisal of the strengths or weaknesses of these

1 Information Habitat III Policy Unit 5 and its Policy Paper is available at www.habitat3.org/the-new-urban-agenda/policy

components can help national, subnational, and local governments identify interventions that can improve the performance of their respective municipal finance systems and provide strategies that empower key actors charged with implementation.

KEY MESSAGES

- A viable, strong, and responsible fiscal future requires that national governments enable local governments to have access to significant sources of tax revenues as well as nontax revenues (i.e., charges and fees). Revenue sufficiency and revenue diversity are key to a municipality's ability to deliver services to its constituents. It is also critically important that own-source revenues should be complemented by intergovernmental transfers that address the gaps in expenditure needs and fiscal capacity across cities. This—coupled with an enabling framework that allows the mobilization of revenue raising instruments like borrowing, public–private partnerships, and land value capture to support infrastructure investment—is critical to fiscal health. Together, these financing options should be enshrined in law, policy, and practice.

- Building the foundation for a fiscal future that can fulfill the promise of the New Urban Agenda requires coalescing commitment, political will, and capacity for execution and reform among various layers of government—national, regional, and local—and other key actors in these strategic areas. The strategies outlined in this paper cannot happen in a vacuum. Consensus at the national level regarding their importance, however, will heighten the likelihood that these principles will be ingrained in meaningful ways in regional and local policy and practice. Accordingly, achieving sound fiscal systems requires a framework of intergovernmental relations and cooperation. It must operate around a shared vision of the importance of these principles coupled with the commitment of leaders to ingrain them in policy (via reform) and to make adequate investments to build the capacity of officials to execute in accordance with them.

PRIORITY POLICY OPTIONS/RECOMMENDATIONS

1. ***Rules of The Game***
   - Empower municipalities and local officials to:
     - establish and collect user charges and fees to cover expenditure costs;
     - share project execution, in addition to financing costs and responsibilities, via arrangements with private and public sector stakeholders;
     - expand local revenues through changes in property or sales taxes;
     - receive intergovernmental transfers from taxes collected by the central government;
     - use fiscal tools like municipal borrowing and land value capture to raise funds to support economic development and infrastructure;
     - and marshal resources to support credit guarantees or other credit enhancements to facilitate favorable borrowing.

   - Enhanced understanding of the strategic priorities that should be enshrined in law through awareness of legislative frameworks that are working for their peers in government on a global scale as a guiding consideration for policy design.

2. ***Expenditures***
   - A precondition for holding local officials accountable is the establishment of a financial accounting system that allows for the auditing of local budgets and financial transactions.

- Higher level governments should provide local governments with sufficient access to resources, either directly through intergovernmental transfers or indirectly by authorizing revenue instruments, so that local governments have sufficient revenues to provide the services.
- Higher level governments can strengthen incentives of local officials to improve expenditure efficiency through well-designed performance-based grants or by providing incentives to improve local government expenditure efficiency through cooperative agreements to consolidate delivery of services, to share infrastructure, and, if possible, to facilitate new metropolitan-area intergovernmental collaboration.
- Local governments can improve long-term expenditure efficiency in the realm of capital finance by intentionally connecting the work of spatial and economic development planners and public finance offices so that plans and activities are coordinated in the long run, particularly around efforts to close yawning infrastructure funding gaps.
- National and state/provincial governments must expand intergovernmental transfers to municipalities, accounting for the extra expenditures associated with devolved expenditure responsibilities and the ability of local governments to raise revenues given the mix of revenue sources they have at their disposal. Sound implementation of expenditure authority also requires strengthening local government accountability to residents. Implementing an anti-corruption regulatory framework and increased capacity building can help make governments more accountable to their residents.
- National governments will need to enable local governments to raise new sources of revenues—for example, through land value capture instruments—to help finance new infrastructure investments.
- Local governments will need to develop and maintain capital accounts in order to prioritize new capital expenditures and infrastructure maintenance needs. Many local government public services, can be produced at lower cost exploiting economies of scale

3. *Revenues*

- There is a strong need to strengthen the basic pools of funds available to manage financial obligations in two areas: fiscal transfers; and own-source-revenues.

Fiscal Transfers

- Aggregate transfers should be sufficient to cover or narrow fiscal gaps. It is important to take full account of increases in the scope of the responsibilities of municipalities as a result of factors such as demographic growth or additional functional mandates.
- Improved grant design must also be prioritized. In many countries, grants are allocated to municipalities on an ad hoc, non-transparent basis or replicate previously established patterns of resource distribution that are both inefficient and inequitable.
- Fiscal transfers should be allocated on the basis of clear and transparent formulas that reflect an underlying policy objective and provide for grant predictability so that local governments can budget effectively. Local governments should be allowed to determine expenditures in line with local needs in order to promote enhanced accountability and expenditure efficiency.
- Policy should limit grant proliferation. It is not uncommon for countries in which the intergovernmental system is evolving to experience periods in which municipal grants proliferate rapidly. Donor programs, driven by multiple objectives, can compound and aggravate the situation. The goals of grants from the central government should be aligned, and the number of grants should not expand to the point where the system as a whole becomes difficult to monitor and control, or where the municipalities receiving them are overwhelmed.
- Policy should establish a framework for efficient transfer execution. In many countries, grants to municipalities are frequently delayed, sometimes very significantly, engendering cash flow problems

and difficulties in expenditure planning. A lack of predictability regarding how much will be allocated and when the funds will be accessible can be a major impediment to effective budget execution and investment programming.

Own-source Revenues

- Appropriate devolution of the authority to collect local taxes, to set rates, and to control assessments of tax bases can significantly improve overall effectiveness of local fiscal systems. Local governments need to know how to understand, value, and develop strategies to expand and improve their tax base.
- Flexibility must exist for local governments to adopt the right mix of revenue sources to generate budget stability over time, and to match more volatile sources like consumption or income taxes with less volatile revenues like the property tax or user fees. User charges are generally efficient and politically expedient instruments for local taxation of services like water; or for regulatory functions, like permitting and property registration, where beneficiaries and costs are easily identifiable.
- The property tax is a strong own-source revenue option. An effective property tax system has potential to match tax burdens appropriately with expenditure benefits, to cause relatively little unwanted interference with market decisions, and avoid imposing heavy burdens on poor families, thus making it the most desirable of local taxes. There should be greater local government control over the tax and its proceeds, and easing of administrative difficulties within the system, and methods to ensure fair valuations, exemptions, and accountability.
- Municipalities can use a host of land-based revenues to meet expenditures and direct spatial growth. Value capture tools enable local officials to mobilize for public benefit all or part of the increases in land value that result from community investments rather than the actions of landowners. A long trajectory of international experiences has demonstrated that defraying at least part of the costs of urbanization by recovering part of the land value increments created in the process is feasible and practical.

4. ***Fiscal Management***

- Policies, systems, and practices should encourage multi-year budgeting and planning.
- Robust internal controls should be established that enable local officials to exercise their fiduciary responsibilities and maximize the degree to which resources are spent in accordance with rules and procedures.
- Maintaining asset inventories, adopting modern asset valuation practices, and deploying modern financial management tools are needed to enable municipalities to manage and budget for capital asset costs efficiently.
- Use of modern IT systems is a prerequisite for efficient operations and municipal fiscal management.
- Higher levels of government need to invest in creating sound monitoring arrangements to track key financial metrics and encourage soundness and transparency in accounting. Uniform standards and practices for accounting, such as the International Public Sector Accounting Standards (IPSAS) should be considered for adoption.
- Municipal audit systems and practices should be strengthened, by aligning to international public sector audit standards, to begin engendering a culture of regular and timely audits.
- Citizen participatory planning and budgeting should be considered.
- Systematic capacity building and peer learning should be promoted.
- Performance management systems, like the Public Expenditure and Financial Accountability (PEFA) tool for subnational governments, can be used.

5. ***Municipal Borrowing***

- In *mature municipal debt market* countries, where basic systems are in place and functioning relatively effectively, there are two core policy priorities. The first is to develop more efficient systems of debt issuance. The second is to develop regulations and systems to better manage the risks related to municipal borrowing, such as municipal bankruptcies.
- In *undeveloped debt market countries*, the factors that determine municipal borrowing are generally all so weak that, in the short to medium term, municipal borrowing is unlikely to emerge to any significant degree and is arguably not a policy priority. The focus needs rather to be on the basic elements of well-functioning city governments: stabilizing municipal systems; rationalizing municipal expenditure assignments and buttressing revenue flows; improving municipal budgeting, planning, and project-execution powers; and deepening the financial sector. Once these elements are in place, steps to develop a municipal debt market could then commence.
- In *developing municipal debt market countries*, where cities are growing steadily richer, but are not yet unable to borrow at the levels characteristic of developed market countries, policy and institutional action on the municipal borrowing agenda should be made a priority.

GUIDING QUESTIONS

FOR PANEL ON MUNICIPAL FINANCE AND LOCAL FISCAL SYSTEMS

1. **Importance of National Governments** – describe one action that national governments can take to advance municipal fiscal systems in any one of the core areas of the policy paper (rules of the game, revenues, expenditures, borrowing, financial management, climate finance, public private partnerships, etc.) supported by examples from your jurisdiction or others.

2. **Importance of Key Actors** – describe one example of how local municipal governments can partner/engage key actors to advance municipal fiscal systems in any one of the core areas of the policy paper (rules of the game, revenues, expenditures, borrowing, financial management, climate finance, public private partnerships, etc.), supported by examples from your jurisdiction or others.

3. **Integration of planning & finance** - describe one example of how public finance and planning functions can be integrated/aligned to advance local municipal fiscal systems; or describe an example where the lack of coordination between planning and public finance has led to negative results that can offer lessons learned and areas for policy reform.