



Brian Dollery · Harry Kitchen
Melville McMillan · Anwar Shah

Local Public, Fiscal and Financial Governance

An International
Perspective

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PREFACE

This book is a part of a two volume series on local governance: *Local Public Finance and Economics: An International Perspective* as volume 1 and *Local Public, Fiscal and Financial Governance: An International Perspective* as volume 2. This series is intended to serve as a comprehensive guide/reference for policymakers, practitioners, policy analysts and interested researchers, scholars and students in local public governance and local public finance and economics worldwide. The series would also be of interest to government officials, policymakers and public policy students internationally as it provides a comprehensive coverage of issues and presents a synthesis of lessons from worldwide experiences in local economic and fiscal governance. The series would also serve as useful reference books for undergraduate and graduate courses in public economics. The existing literature on local public finance and economics has typically a country-specific focus, mostly of an industrial country, for example, *State and Local Public Finance* by Ronald Fisher, published by Routledge in 2016, has a US focus. Also, the literature does not give special attention to local public governance issues. This series attempts to fill this void by providing a state-of-the-art synthesis of the academic literature and supplementing it with lessons of experience from both industrial and developing countries. The series further presents one of the most comprehensive treatments of local economic and fiscal governance issues. Some of the newer topics covered include neo-institutional perspectives on the role of local government, tax instruments for environmental protection, output-based intergovernmental transfers, fiscal rules and fiscal discipline, combating corruption, measuring, monitoring and evaluating local government

performance, municipal mergers, intermunicipal cooperation and political economy of local government reform. In view of this, we hope that this series would be of interest to a wider range of audience in both industrial and developing countries.

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This book represents the knowledge gained from several decades of research and teaching local public economics to graduate and undergraduate students in Australia, China, Japan and North America. In addition, it captures the practical experiences of policy-makers and practitioners from industrial and developing countries gained through policy advice, senior policymakers and high-level executives' retreats, conferences, workshops, seminars and short courses. The authors are grateful to students, practitioners and policymakers around the globe for enriching their knowledge with the insights gained from these interactions.

The authors are also grateful to their families and the editors of Palgrave Macmillan for their support and encouragement for completion of this volume.

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With special contribution by:

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PART I

Introduction and Overview



CHAPTER 1

Introduction

1.1 INTRODUCTION

The role of local government has expanded in a large and increasing number of countries. This shifting of responsibilities is a product of a quiet, even silent, revolution over several decades during which countries have been re-examining and revising the roles of their governments. Shifting responsibilities and authority to local government—that is, decentralization—is a widely observed outcome and notably so in developing and transition countries where political decision-making is commonly highly centralized.

Much effort and many resources have gone into promoting economic growth and reducing poverty, the results and effectiveness of which are often questioned. Where citizens have little voice in determining local public services, expanding the role of local government through decentralization is recognized as offering potential for enhancing economic well-being and expanding faith in government. Realizing that potential, however, is challenging. There are many examples of successful decentralized countries, but decentralizing countries successfully is difficult. Part of the difficulty is that there is no one best model. Patterns of decentralization among successful countries are diverse and they have evolved in the context of history and culture. Efforts to decentralize must recognize the country context, but even in designing a basic structure, although the principles are straightforward, there are many possible pitfalls and diversions as well as, often significant, opposing interests. Hence,

decentralization programs have had mixed results. The objective of the exercise is to enable people to be more engaged in their government and for local governments to do more for their people. Furthermore, success requires that governments represent local preferences; that is, they be responsive, transparent, accountable, equitable and honest. In effect, empowering local governments and empowering their citizens. Achieving these ends, however, is demanding.

This book is part of a two-volume set aimed at assisting those pursuing decentralization and specifically seeking expansion of the role of local governments and the empowerment of their citizens. The initial volume, *Local Public Finance and Economics: An International Perspective*, focused on principles and best practices for local government. The main topics there covered organization and responsibility assignment, service delivery, sources of own revenues, intergovernmental transfers and borrowing. This volume, *Local Public, Fiscal and Financial Governance: An International Perspective*, extends the previous analysis. The major topics are fiscal and financial management, pursuit of government integrity and accountability, and reform imperatives. Volume I was primarily concerned with local government design to achieve a quantity and quality of local public services matching local preferences and enhancing local well-being. Volume II encompasses a broader perspective as reflected by the term governance. Local governance is a more comprehensive concept defined as the formulation and execution of collective action at the local level to serve the public interest. It encompasses the direct and indirect roles of public and private institutions and organizations and the networks within and among them that structure local collective decision-making. As such, this approach draws additionally upon fields including public choice, new public management and the new institutional economics. In part due to the emphasis on governance, public administration and administrative issues receive considerable attention in this volume. The governance perspective is believed to provide a stronger foundation for analyzing the pressures that globalization and the information revolution place upon citizen-state relations at the local level and to enable better policies for local government to address both market and government failures.

1.2 OVERVIEW

This section provides both an overview and a summary of the topics in the book and summaries of the chapters. The chapter reviews are organized by book parts and in numerical order.

1.2.1 Part II: Local Public, Fiscal and Financial Management

Part II is an examination of a number of the more conventional topics of local public finance, but it extends the analysis by delving further into options and alternatives. The chapters in Part II cover tax and particularly property tax administration, budget and accounting methods, and fiscal discipline.

1.2.1.1 Chapter 2: “Local Tax Administration”

The success of any local tax system depends critically upon its administration. A successful administration must treat taxpayers (and potential taxpayers) fairly, be efficient and keep corruption and evasion to a minimum. Issues to be addressed in striving for a successful local tax administration are examined in Chap. 2. A central question is who should be responsible for the administration of local taxes. Should it be central governments, the independent local governments, some blend of the two or, perhaps, an autonomous agency? Central administration affords advantages in scale and scope and separation from local taxpayers while local administration, for example, offers familiarity with local conditions, association with local government (use and need for funds), and diligence in collecting local taxes. Autonomous agencies can provide potentially advantageous independence from politicians and from the civil service. The typical arrangement is a mix of central and local administration with the senior government determining the local tax base (primarily a revenue assignment matter) and being responsible for establishing standards for local tax administrative staff and (perhaps with local government associations) staff training. Local governments should be responsible for setting local tax rates. Assignment of the administration of the collection, enforcement and auditing of the taxes depends upon the capacity of local government and the degree of autonomy that central government is prepared to grant. Improving local tax administration has many facets. Among those are identifying taxpayers, minimizing ambiguities and loopholes, coping with the informal economy, controlling corruption, improving compliance,

enforcing collection, handling appeals and undertaking performance reviews. Local tax administration can be complex, but establishing an effective and fair system is critical.

1.2.1.2 Chapter 3: “The Practice of Real Property Taxation in the World”

Property taxes are widely used and are an important and growing source of own revenue for local governments. As such, Chap. 3 serves as a primer on property tax practices worldwide. Some of the major features are noted here. Across OECD (Organisation for Economic Co-operation and Development) countries, property taxes amount to 1.6% of GDP (gross domestic product) on average. In a sample of developing and transition countries, the average is only 0.005% of GDP but that amounts to 40% of local government taxes. Taxes on real property—that is, land and improvements—dominate property taxes and the immobility of such property makes it suitable for local taxation. Since expenditures in improvements are sensitive to taxation, property tax rates applied on improvements may be lower than those on land. Assessments for property taxes are typically on market value, especially in developed countries. But even there, although more so in developing and transition countries, an alternative tax is sometimes used, one that relies on readily identified characteristics such as area and/or use. Market values are most readily estimated where there is an active property market and property characteristics are well known, but where market transactions are unusual, value might be approximated from depreciated cost or discounted income. While assessments of capital value are most common, rental value is used in some places. It is customary that senior levels of government regulate assessment methods to ensure uniform practices, but it is ideal if the local authorities set their own tax rates so as to better match local taxes with local preferences. Different types of property (e.g., residential, commercial, industrial, agricultural) may be taxed at different rates. For example, residential rates are frequently lower than those on commercial and industrial properties. For political reasons, taxes from non-residential property usually subsidize residential services—a feature that can distort the property tax as a benefit tax within municipalities. Certain types of properties (e.g., religious and government buildings) are subject to special consideration. In addition, special arrangements may be made to promote economic development or renewal and/or to reduce property tax burdens on particular groups (especially low-income households). In addition to local general-purpose governments,

property taxes often support a variety of services provided by special districts (e.g., school authorities with independent taxing powers). Because boundaries typically do not coincide, to ensure the same tax rates apply across overlapping jurisdictions and to provide proper information in the case of determining senior government aid to local authorities, senior governments may need to ensure that valuations relative to the assessment bases (e.g., market value) are uniform across local governments. As with other forms of taxation, a property tax system will be accepted only if it is considered fair which includes having a trusted complaint and appeal mechanism. Real property taxation is a valuable and important source of revenue for local government but one that seems underutilized especially in many developing and transition countries.

1.2.1.3 Chapter 4: “Municipal Budgeting and Accounting”

Budgets are an essential tool of municipal government. They are vital for financial planning and management, for contributing to accountability and transparency, and for avoiding corruption and misappropriation. The roles and methods of budgeting and accounting in municipal government are reviewed in Chap. 4. Two types of budgets are necessary, operating budgets (which focus on resources used up during the, typically annual, budget period) and capital budgets (which address infrastructure financing and outlays). Regardless of the type, budgets have historically been oriented toward financial control—that is, monitoring the inflow and scrutinizing the outflow of funds. More recently, budgets have come to embrace also an output focus and contribute increasingly to expenditure effectiveness through expanded use for management and planning. Because senior governments are (actually or implied) financially responsible for municipal governments, municipal budgets are commonly subject to senior government requirements. Typically, operating budgets must be balanced while borrowing is possible (within limits) for financing capital investments. Senior governments can assist municipal governments (as well as other local authorities and its own agencies) by pooling borrowing requirements, borrowing on their behalf and then on-lending to the individual units. This reduces transaction costs and often interest costs—especially for smaller municipalities. In part, the recommendations of accounting organizations have led to a movement from accounting on a cash basis to accrual (or modified accrual) accounting. Fund accounting—that is, accounting in separate funds for the finances associated with different municipal activities for compliance and/or management reasons—is a

common feature of municipal accounting. Regular and timely reporting is important for effective budgeting and accounting. Reporting includes annual independent audits. Reliable municipal budgets and accounts serve a range of services and interests. Notably, they are valuable internally for the use of policymakers and management, for external interests (e.g., citizens, lenders) and for senior government monitoring.

1.2.1.4 Chapter 5: “Local Fiscal Discipline”

Fiscal discipline is most evident where there is a tradition of fiscal conservatism and well-developed and strong fiscal institutions. Even in such cases, avoiding fiscal indiscipline is likely to require clear and enforced fiscal rules—especially at the subnational level. Subnational, and particularly local government, is susceptible to fiscal lassitude due to weak citizen accountability, interest group capture and heavy reliance upon intergovernmental transfers from governments only weakly adverse to bailouts. Where the incentives for self-imposed discipline are weak, fiscal rules (if backed by senior-level political will) can help. In Chap. 5 the reasons for fiscal indiscipline and approaches to establishing fiscal discipline are explored. Among the effective measures are restricting borrowing to financing only capital expenditures and debt limits. Measures to enhance budget transparency and accountability to local citizens can assist but that still demands citizen attention and concern. Successful fiscal discipline is more probable with a combination of rules, empowering budgetary institutions and, of course, enforcement and responsibility for outcomes. Essential, overall, is political will and that normally depends upon citizens and their representatives together having to bear the consequences of disciplinary failures.

1.2.2 Part III: Local Government Integrity and Performance Accountability

Concerns about increased corruption are cited frequently as a criticism of decentralization. The prospects of more or less corruption are explored in Chap. 6 in the context of local infrastructure investment. Controlling corruption improves government performance, but measuring and monitoring local government performance is a more recent initiative and is examined in Chap. 7. When undertaken voluntarily by local governments, the prospects of performance assessment being utilized effectively and generating rewards are improved.

1.2.2.1 Chapter 6: “Local Public Infrastructure and Corruption”

Criticisms of decentralization include the concern that decentralization promotes corruption—that is, the abuse of public office for private gain or exercise of public powers against public interest. The material in Chap. 6 reviews the fundamentals of corruption in general before examining and contributing to the understanding of corruption as it might arise through the decentralization of infrastructure investment to local government. Although largely unexplored, this perspective is important because local infrastructure represents a large (and normally disproportionate) part of national infrastructure, contributes substantially to citizen well-being and represents amounts of funds that appeal to those inclined toward abuse of power. In addition, it is a topic that provides scope for assessment of whether corruption might be greater or less with decentralization. Corruption is a product of poor governance: that is, the failure of the norms, traditions and institutions by which government authority is exercised. Corruption is an old problem, basically the principal-agent problem, and can be studied in the context of that literature and through the new public management and new institutional economics lenses. Besides being a continuing issue, corruption has many forms, is universal and found in widely varying degrees across countries. Does decentralization—and decentralization of infrastructure investment in particular—aggravate the corruption problem? The evaluation indicates that there are factors (e.g., closer personal relations and potential for interest group capture of local government) that may make decentralization a breeding ground for corruption. On the other hand, there are characteristics (e.g., greater awareness, greater competition and lower transactions costs) that may reduce the potential for corruption. The conceptual models are inconclusive, and empirical analyses, confounded by flawed data, are challenging to interpret. Yet, the few studies specific to infrastructure suggest that decentralization leads to improvement. Clearly, there are opportunities for further research. Nonetheless, there are insights into enhancing integrity in decentralized infrastructure investment. In many cases, making the environment for infrastructure services operate more competitive will generate improvement. Where poor governance is the primary culprit, institutional reform (with all its challenges) will be essential. Regardless, the nature of corruption is very case specific and reforms need to be tailored to the situations in each country and locality.

1.2.2.2 *Chapter 7: “Measuring and Monitoring Local Government Performance”*

Political decentralization and democratization have spread rapidly in developing and transition countries since 1990. Realizing the benefits of those movements, however, has proven elusive largely due to lack of adequate citizen empowerment—often despite notable efforts by local governments. Chapter 7 provides insights into the approaches used in efforts to ensure and enhance local government performance, conceptual foundations, and positive and negative experiences. Performance monitoring measures may be mandatory (as imposed by senior government) or voluntarily undertaken by local government. Examples of common mandatory measures include requiring audited financial statements and restrictions on debt. Examples of voluntary measures include benchmarking programs and sharing information with the public (extending transparency). A FAIR governance framework is recommended—that is, one that is fair, accountable, incorruptible and responsive—and mechanisms for implementation are outlined. An overview of practice indicates that higher-order governments’ involvements are typically requirements to ensure fiscal discipline and fiscal sustainability. While some senior governments impose service delivery reporting requirements on local authorities, such disclosures may function better when they are local initiatives. Examples of failed monitoring efforts can often be characterized as being intrusive and overreaching while generating little or no local benefit. Overall, local governments perform best when their activities are transparent and they are accountable to their constituents.

1.2.3 *Part IV: Local Government Reform Imperatives*

Growth, technological change and certainly decentralization are major forces motivating local government reform. Municipal mergers have been a common policy instrument although the evidence of such consolidations generating net benefits is mixed. Intermunicipal (or, more broadly, inter-governmental) cooperation is an alternative mechanism by which it may be possible to realize the benefits of scale or internalization while minimizing the loss of independence. Essentially all local government reforms are controversial. Exploring the political economy of local government reform can be insightful. These three topics are examined in separate chapters in this section of the book.

1.2.3.1 Chapter 8: “Structural Reform: Municipal Mergers”

Municipal mergers are a frequently advocated and practiced reform of local government systems. The pursuit of cost savings through scale and scope economies and technical/administrative efficiencies (and perhaps other benefits realized via accompanying reforms) are the prime motivation. The trade-offs usually noted are diminished choice and competition and a more constrained democracy. Mergers are controversial and have thus been subject to considerable investigation. The conceptual and empirical perspectives on mergers are examined in Chap. 8, including—in addition to scale and scope and administrative capacities—possible impacts from internalizing spillovers and effects on municipal growth. None of the literature leads to definitive conclusions. To illustrate, Chap. 8 concludes that despite the grounds for anticipating economic benefits from mergers, especially in terms of cost savings through scale and scope economies, these expectations have not been confirmed by the weight of empirical evidence. In addition, it appears that local democracy thrives best, at least in terms of political participation, in smaller jurisdictions. The mixed evidence on the benefits of size perhaps explains the wide variation in the average size of local governments across countries. Mergers, it seems, require evaluation on a case-by-case basis.

1.2.3.2 Chapter 9: “Intermunicipal Cooperation”

Intermunicipal cooperation is an option for municipalities facing the (often disappointing) prospects of mergers and an option for consideration by local authorities considering alternative delivery systems. Intermunicipal cooperation is primarily motivated by the search for lower costs, improved service quality and/or other benefits from expanded production and delivery systems for particular services that seem not to be available from contracting systems with private providers or providing individually. Intermunicipal cooperation takes a wide variety of forms, for example, from informal mutual service agreements to autonomous organizations (e.g., corporations) owned by municipalities. Chapter 9 begins with an overview of the various kinds of arrangements and a survey of numerous taxonomies and features seen to characterize those arrangements. Of particular note is that intergovernmental cooperation—while typically horizontal, can also be vertical—adds flexibility at the task or function level, to the standard central, intermediate and local governmental structure. Turning to conceptual considerations, intermunicipal cooperation facilitates creating service units of more optimal size—a feature consistent with

the objective of subsidiarity—while retaining local democratic oversight if not actual decision-making. Those units may involve coordination, joint supply and/or intergovernmental contracts. The primary objective of intermunicipal cooperation is typically to realize cost savings (and/or improved services for the expenditures made) by achieving what may be classified broadly as scale and/or scope economies. Other potential benefits may be improvements achieved through the internalization of externalities and/or advantages that materialize from improvements in or improved utilization of administrative and technical capacities. Transaction costs are a major barrier to successful intermunicipal agreements. Transaction costs involve particularly the costs of bringing the potentially cooperating municipalities together and then keeping them together. This aspect depends very much upon the nature of social networks, the extent or establishment of interpersonal trust and the development of shared understanding. The potential cost of those responsible for not meeting the expectations of municipal governments or living with the consequences—that is, agency costs—is another obstacle. A final potential, and only recently recognized, problem is one that might be called unexpected residual costs. In essence, following an intermunicipal agreement, all or some of the cooperating municipalities may find themselves bearing greater costs than previously in meeting responsibilities not covered by the agreement (e.g., due to loss of economies of scope and funding unanticipated transactions costs). A survey of recent empirical studies seeking evidence demonstrating the benefits of intermunicipal cooperative agreements found the numbers scant and the results contradictory. The problem, in part, is that service quality and change are frequently difficult to measure. Nonetheless, intermunicipal cooperative agreements are many and persistent.

1.2.3.3 Chapter 10: “Political Economy of Local Government Reform”

The reform of local government, even when seen as improving, is controversial. In addition, reform proceeds unevenly, it is discontinuous and typically particular to the specific environment. The consequence is that, beyond the well-recognized “progressive public administration” and “new public management” eras, local government reform has been challenging for scholars seeking to account for its genesis, nature and implementation. The complexity of the subject stems partly from it ranging from being comprehensive to it being quite narrow and specific to a particular aspect of the local public sector; for example, structural, financial, functional,

jurisdictional (as with the scope of authority and competence), and organizational and managerial. The investigation in Chap. 10 distills and guides the reader through the substantial and varied literature, both theoretical and empirical. The theoretical thread encompasses the conceptual contributions on the motivations and shaping of reform and the analytic systems focus on diagnosing and guiding reform—sources of government failure, the influence of the new institutional economics (especially transactions costs and agency costs) and the role of policy leadership. The diversities of reform and institutional differences complicate empirical analysis and commonly constrain it to comparisons among similar countries and/or specific types of reforms. Demonstrated here is a study of reforms in 6 Anglo-American countries and another of 28 European countries. A major conclusion from the first was that despite substantial reforms and changes implemented, the operation of local government was not fundamentally transformed. The European countries clustered into six different types. A relatively common feature was central/state governments downloading more responsibilities than resources and that, in turn, prompted various reforms individually or collectively by the local governments themselves. Overall, it appears that universal general policy measures are few.

1.3 CONCLUSION

Local governance, in looking broadly at collective action at the local level, encompasses a wide perspective of the local public sector. It opens for further consideration alternative tax and tax administration systems, a broad range of budgeting and accounting tools, and expands substantially the examination of local public management and public administration. Curtailing corruption requires the engagement of citizens and civil society. The structure of local government, inter-local and local-state relations are important to local residents. Citizens can be very sensitive to changes in those arrangements (perhaps especially so for mergers) and hence engage in and expect participation. This volume has been directed to discussions of these topics. It is hoped that the book will inform and assist those who are pursuing greater empowerment and improved performance of local government.

PART II

Local Public, Fiscal and Financial
Management



CHAPTER 2

Local Tax Administration

2.1 INTRODUCTION

The ultimate success of a local revenue system depends on the way in which local revenues are administered; after all, the best system in the world is of little use if it cannot be administered in a way that minimizes corruption and evasion and is fair, efficient and effective in its impact on taxpayers.

Revenue systems collectively include local taxes, user fees and charges, fines and penalties along with other miscellaneous revenues. Their administration and use in developing and transitional countries often differ from those in developed and industrial countries (Bahl and Bird 2018; Mikesell 2013). This difference is often attributed to a relatively larger agricultural sector that is not easily taxed in the former and because a high proportion of the economic activity in these countries occurs in the informal (shadow) economy and, therefore, not taxed (Bird 2003, p. 3). This informal economy which erodes the local tax base, it has been suggested, is largely driven by corruption (Schneider 2006; Schneider and Enste 2000). Exemptions that are perceived to be the result of a bribe also undermine the trust in government and the compliance with revenue laws (Dreher and Herzfeld 2005). A recent empirical study found that corruption is negatively associated with overall tax revenue (Baum et al. 2017).

These factors have combined to produce tax systems in transition and developing economies that have been capricious and potentially confiscatory, often resulting in negotiated tax liabilities (Berkowitz and Li 2002).