Multilevel Finance, Cities and Sustainable Development

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G-24

Coalition for Urban Transitions
A New Climate Economy Special Initiative

Overview

- **Unconventional view of sustainable development**, role of cities and need for financing
- **The role of national policies and institutions to achieve overall resource envelope**
  - Coordination of investment design and taxation, across levels of government, together with
  - National taxes for overall revenues, redistribution/transfers to lower levels, creating an economic space, and ease of doing business
  - Governance and spatial redistribution
  - Political economy of reforms
- **Subnational policies and governance for accountability and effective provision: some exciting on-going policy based work (LSE/CUT in China and Mexico)**
  - Importance of own-source revenues
  - Clarity of spending responsibilities and governance
  - New approaches to property taxation—beneficial taxation
- **Fiscal anchors to leverage private financing, and preconditions:**
  - Municipal bonds
  - PPPs

Sustainable development and cities

Sustainable development financing gaps

- **Major role for clean, compact and connected cities** in generating sustainable employment generation and meeting SDGs
- **But huge infrastructure and service delivery gaps**, including education, health care and transport, recently costed by IMF
    - Additional spending projection for 2030 $2.6 tr (2.5% world GDP; EMEs 4% of 2030 GDP (Indonesia 4% GDP); LICs 15% of GDP--IMF January 2019)
    - **Recommendation of additional 5% of GDP for revenues and improving expenditure efficiency** are clearly important (e.g., for countries like Pakistan and Indonesia)
    - But proved ***very hard to achieve—despite decades of IFI support***
- **Much of the needed spending is at subnational/city level**,
    - But the problem is that in many cases subnational tax instruments, and decision making even weaker than at national level

Financing discussion focused on “complex” and ill coordinated instruments that do not work

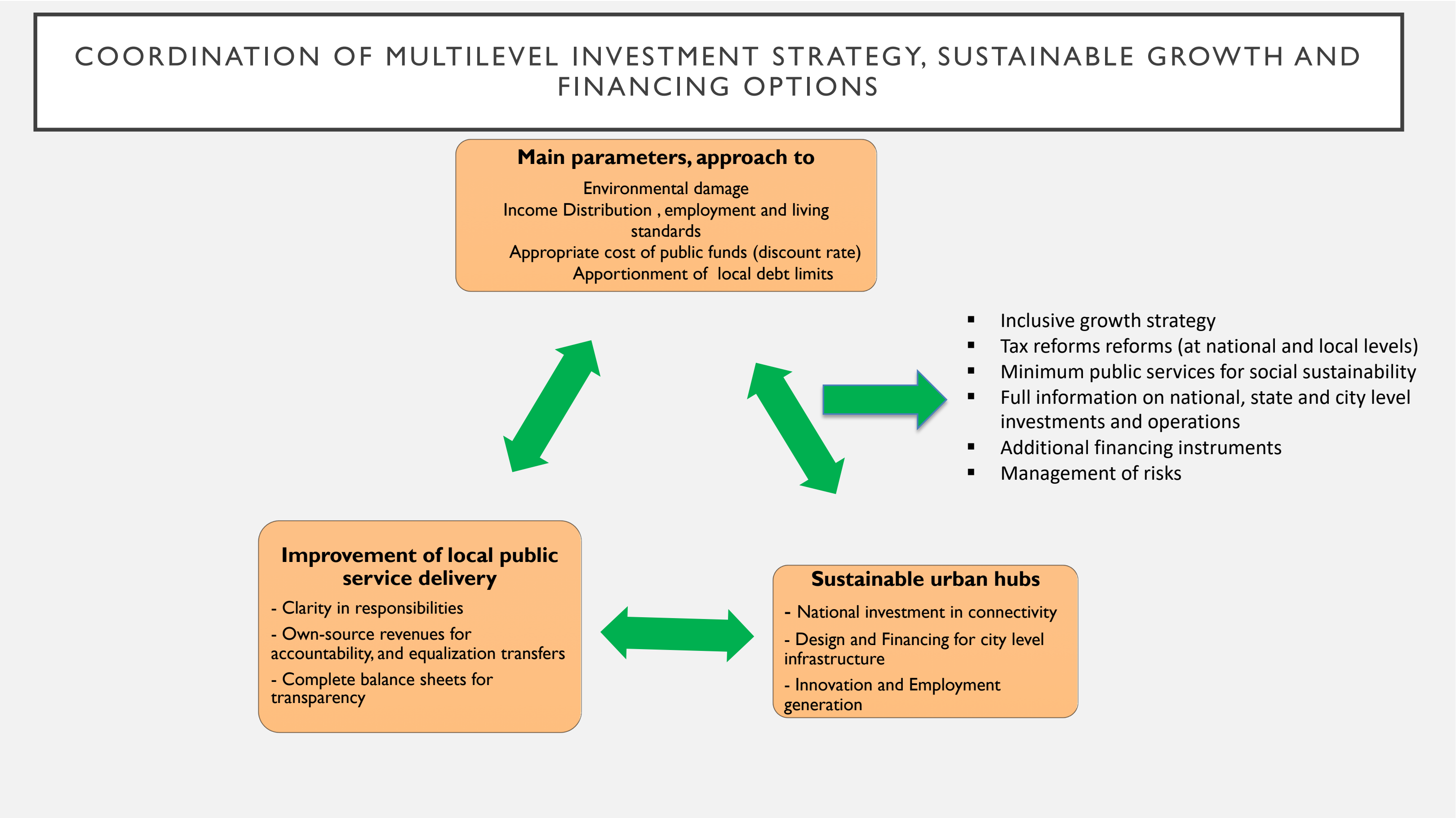
- **National level**
  - **VAT with multiple rates, split bases and exemptio**ns for “deserving investment and distributional purposes”
    - Fail to meet objectives or raise revenues (Tanzi: *Termites of the state—why complexity leads to inequality)*
  - **Income tax with complex structures that only cover formal sector wages, made worse by payroll taxe**s for “Bismarkian social security systems”, and advanced means tested systems (Levy: “Good intentions, bad outcomes”)
    - Inequality enhancing and potential poverty traps
  - **Transfer systems that “fill gaps” for sub-national deficits**
    - destroy incentives
- **Local level—not adequately addressed**
  - Advanced US-type property taxes based on real time valuation and ownership changes
    - Very hard to implement in developing or emerging market countries
- **Municipal bonds,** become perverse without local tax systems, and full information
- **PPPs, especially at local level**, exacerbate incentives to hide liabilities, and engage in game play, especially without complete balance sheets (full GFSM2014 standards)
- **Land value capture:**
  - Partly land sales, that can degenerate into land grab without proper balance sheets and oversight, off-budget PPPs that turn into slush funds
  - Betterment levies—desirable in theory, but depend on working property tax systems

Departure of LSE-CUT and G24 papers

- Systemic approach should use **simple and workable instruments (see Tanzi 2018),** but within a coordinated framework
- **Harmonization of spending decisions** particularly
  - Investment in national and local infrastructure
  - Design and financing of public services for sustainable growth “hubs”
- **Economy wide shadow prices recommended by Eminent Persons** (Stiglitz and Stern) for energy products adopted by IFIs in Katowice
  - Apply also to distributional considerations, and tax design at different levels (Ahmad and Stern 1991)
  - Being estimated for Mexico (LSE/CUT), supplementing work in LAC and South Asia
- **Coordinate tax, spending and financing decisions,** encompassing national and state/provincial/local governments

The integrated approach of the G24 and LSE/CUT papers

Figure 1 Linking taxation and investment to support the growth of compact, connected, coordinated urban hubs



Source: Ahmad, E. (2017), *Public Investment for Sustainable Development,* G24 Working Paper, Washington DC.

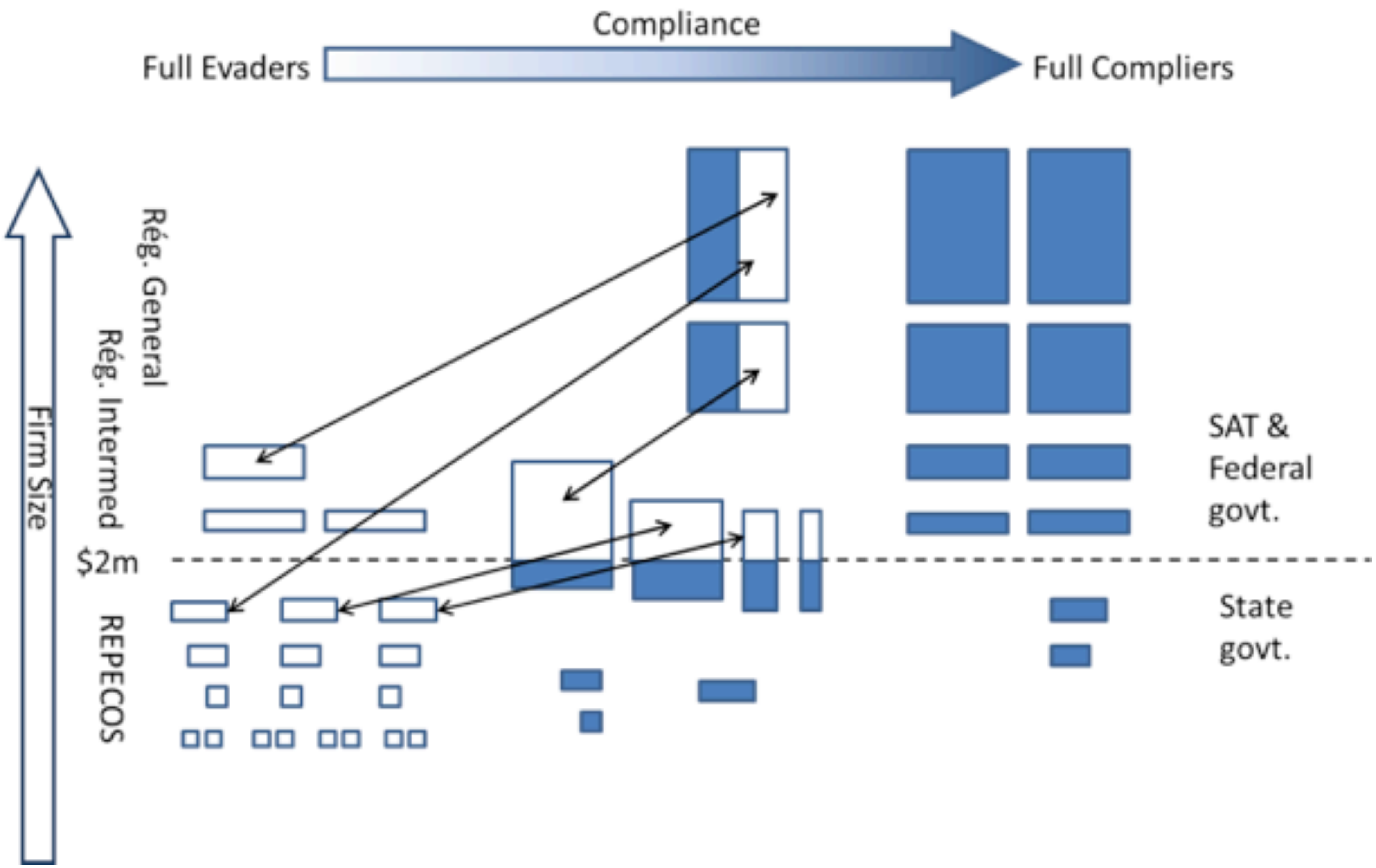
The role of national policies and institutions

Meeting overall revenue targets, creating a “level playing field,” and coordinated access to credit

Examples of recent effective major tax reforms

- Reforms in **Mexico (2013) and and China (**2015—integrated the goods and services tax base) were **aimed at consolidating the VAT base,** to
  - **ease the cost of doing business, improve economic integration and linkages, and stop cheating**
  - critical for **the significant revenue improvements that followed in other main taxes**
- **Laid the basis for a more effective system of income taxes and excises/carbon tax (**in Mexico)
- **But reduced the sub-national own-source "tax handles"**
  - more difficult to raise additional financing through borrowing, bonds and PPPs
  - **Severely limits the prospect of implementing subnational fiscal rules**

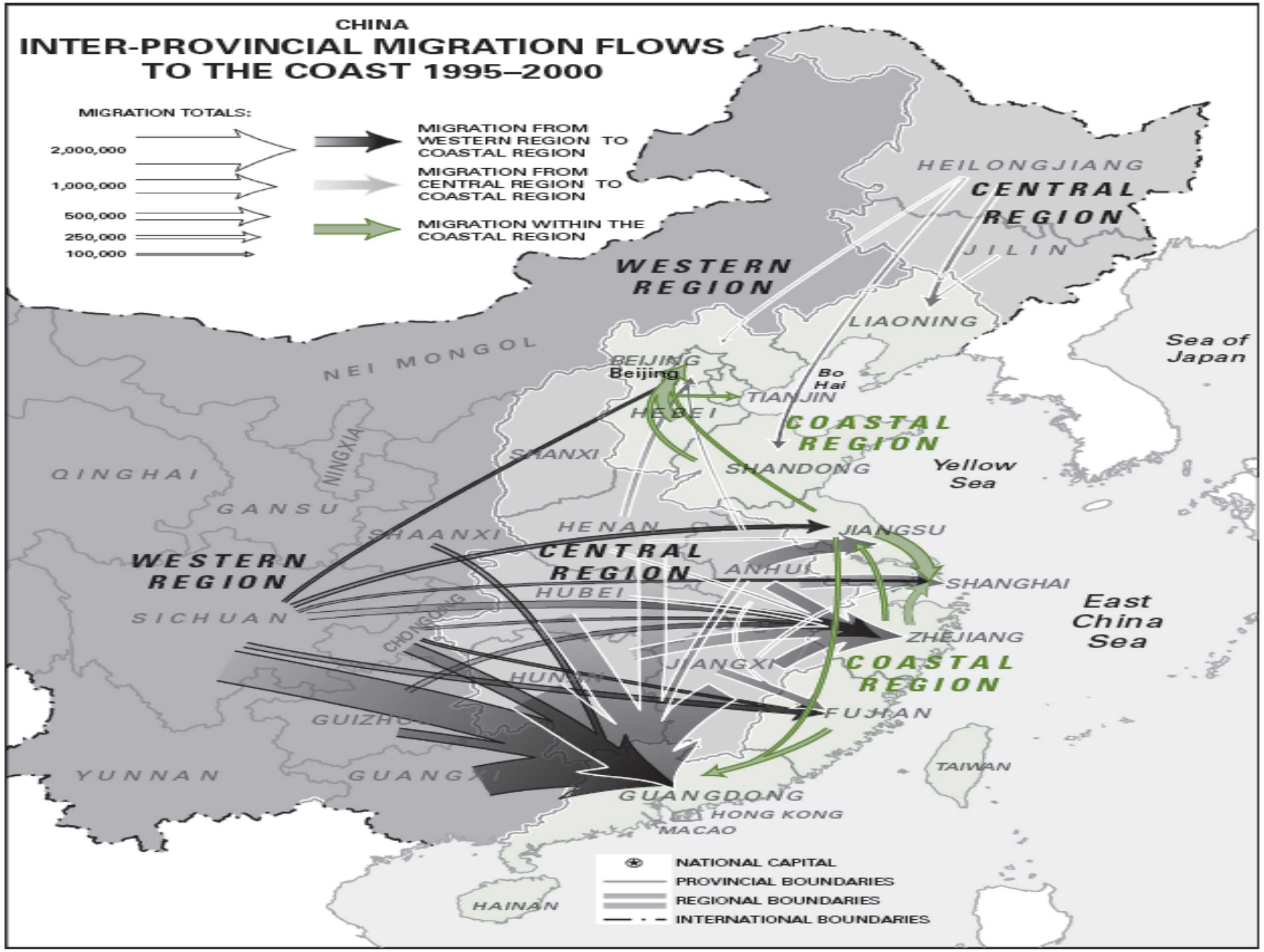
Consolidated base important to stop the cheating



Political economy: Taxes and transfers/investments for growth “hubs” must be taken together

- Carbon tax
  - **Gainers and losers in terms of households** and workers important
  - Compensation mechanisms important for overall acceptability
  - Piggy back can provide flexibility to large and congested cities
- VAT and transfer design
  - **Intergovernmental issues and balance across provinces/states often a stumbling block**
  - China: ensured that no province lost, and ensured that all participated in the gains from a growing revenue base
    - Particularly important was the “Revenue returned” that helped foster the coastal hubs,
    - 150 m people migrated to the coast and
    - 750 m were lifted out of poverty

China: Migration to “coastal urban hubs”



- 150 m to the coast
- 750 m taken out of poverty 1992-2017
- But congestion and pollution in Coastal Metro areas
- Spatial inequalities
- Need for rebalancing for sustainable growth
- But migrants still coming to the coastal areas (Luo and Zhu, LSE/CUT program on China)
- Rebalancing remains an issue, together with interior “interior hubs”

Subnational policies and governance

Revenue-sharing and transfer design options?

- **Often revenue-sharing (and transfers—both tied and special purpose)** needed to close vertical gaps with subnational governments (1 b)
  - Political economy concerns with natural resources (Indonesia)
  - Good basis for overall local budgets if predictable (could vary a lot with natural resources, and cyclicality of VAT)
  - ***May negate the positive incentives with appropriately designed taxes if transfers fill "gaps"***
- **"own-source revenues", should permit:**
  - Some control over base/rates at margin; and
  - Critical for accountability and access to credit
- <u>"Own-source revenues" do not require subnational administration </u>(see column 2b)

Typology for local taxation and policy

		1a	1b	2a	2b	3a	3b
Key Factors	Central Tax	Shared taxes Central Admin	Joint-Admin	Own-revenue/ Surcharge Joint-	Central	Local Tax Joint-Admin	Local Admin
Rate/ base	CG	CG	CG	LG	LG	LG	LG
Revenue	CG	CG / LG	CG / LG	LG	LG	LG	LG
Administ ration							
Registration	CG	CG	CG	CG	CG	LG	LG
Valuation	CG	CG	CG	CG	CG	LG	LG
Assessment	CG	CG	CG	CG	CG	LG	LG
Bill Delivery	CG	CG	CG/LG	CG/LG	CG	LG	LG
Collection	CG	CG	CG	CG	CG	LG	LG
Enforcement	CG	CG	CG	CG	CG	LG	LG
Services	CG	CG	CG/LG	CG/LG	CG	LG	LG

Central Control — Local Autonomy

Source: Ahmad (2015), “Governance and Institutions”, in Ahmad and Brosio, *Handbook of Multilevel Finance.*

Note: enforcement would include both (1) the maintenance of a common data base on transactions and assets, using tax and third party information, and (2) audit.

Piggy-back on Personal Income Taxes for revenues and enhancing equity

- **National PIT may be inequality enhancing**, if non-wage income poorly covered
  - with split bases, PIT largely applied to formal sector wages—becomes an additional burden with the payroll tax (Mexico)
  - Could generate further informality and base erosion
- **Subnational piggy-back on PIT**
  - Could generate local information on assets (e.g., property registers, cars) to verify non wage income flows, making overall PIT more progressive, together with information from VAT (wages and profits)
  - **Does not require sub-national administration**
- Additional revenues accrue to richer regions, **so an equalization transfer system would be needed**

Piggy back on a carbon tax

- In unitary states, like China and Chile, **the center could legislate a band for a "piggy back",** and the local government could choose where within a band it should set its rate
  - **Easiest to see in the case of say a carbon tax**, where pollution levels vary
  - A local "piggy-back" on a central base and administration maintains the center's tax rate setting capabilities, with some local flexibility
  - Higher rate possible in large metropolitan areas (Mexico City, Jakarta, Guangzhou)
- Most importantly, this delegated tax handle creates ability to seek and service debt while minimizing risk

Alternative model of property taxes

- **The most visible of taxes, so generates the most opposition, unless closely linked with benefits: the Marshallian "beneficial tax"**
- **Simple tax based on occupancy and using flat rate /band depending on location and linked to cost of service delivery**
  - Avoids complexity of full cadaster and complex valuation changes by linking registration and occupancy to costs of service delivery
    - Useful in countries with complex ownership/leasehold/communal structures (China, Senegal,), and can generate 1-1.5% of GDP in a relatively short period
  - Can help informal households access public services
  - Can assist in removing "nuisance fees and charges" that add to the complexity of doing business

Financing instruments and fiscal anchors

Use of “innovative” financing instruments

- Popular misconception to think of **sub-national borrowing, municipal bonds and PPPs as indicators of “maturity**”
- OECD countries have run into difficulty with **off-balance sheet project bonds, and PPPs**
  - Problems with London Underground modernization in the early 2000s; and collapse of Carillion, providing public services
  - Audit report 2018 very critical of operations kept off balance sheet, much more expensive than direct provision
- Problems **magnified with incomplete information on borrowing and PPPs at the sub-national level,** including in OECD countries
  - Both GFSM2014 standards, and sub-national balance sheets are not common in subnational governments in Emerging Market countries
  - Process started in China, but incomplete (part of current research agenda)
- <u>**Municipal bonds important**</u> **but**
  - **require local taxation systems, particularly for property,** as well as
  - **recording on balance sheets**
  - **apportionment** within prudential limits

PPPs—kicking the can down the road?

- Risk-sharing and efficiency over project life cycle are the main objectives, but very ***easy to hide liabilities and avoid debt limits***
  - Problems show up as NPLs of the banking system
- Political economy **of passing the buck to future administrations**
  - Also other jurisdictions
  - The Center carries the can if there are no “own-source revenues”
- IPSAS rules require PPP liabilities to be on SN balance sheets to guide provisioning
  - ***Resisted in EU, as it would add to deficits and debt***
- **Not appropriate instrument for uncertainty** (extensive contract literature)
  - **Bhattacharya et al** (2017) argue for “unbundling contracts”
- **But the efficiency case for PPPs remains on a case-by case basis**, including at SN level, providing the local governments disclose full liabilities and have own source revenue handles to finance additional spending
  - And contracts are tightly defined
  - May require technical assistance from higher levels (PPP offices) and international agencies

Conclusions: need for coordinated actions

Conclusions

- Papers present a departure from conventional instrument by instrument approaches
- Tax and investment/SDG decisions must be taken together in a systemic framework
  - Political economy of subnational operations
  - Institutional arrangements for arms length operations—do not need local organizational structures, especially with new technological advances
- National resources will continue to be critical, but the desired envelope will not be feasible without sub-national agreements in most cases
- Private financing will need to be leveraged in a sustainable manner