Chapter 4: Urban Public Finance and Taxation

In this session, we will examine: the role of city, regional and national governments in a city's economy, through public expenditure and taxation, incentives and regulation. How much of the urban economy is dependent on public investment and finance and how these finances can be mobilised and deployed? We will also examine how urban sustainability and implementing the SDGs can be financed, and the challenges that will be faced in doing this.

Cities like London and Mumbai are drivers of their regional and national economies. Greater London produces about a third of U.K.'s GDP of about 2.7 trillion dollars ; and Mumbai, 22 % of Maharashtra's economic output and about 5% of India's 2 trillion GDP. The concentration of high earning jobs and financial services in London makes it one of the world's most economically productive cities, it receives 14% of UK's public expenditure, but produces over a fifth of its revenue. As most of India's banks and a large number of large corporations are headquartered in Mumbai, it also produces more than 30% of India's income taxes.Public expenditure per head in London of course is much higher that of Mumbai showing the wide disparity in per capita expenditure levels across these cities. Yet, the bulk of urban economic activity in both these metros is in household and in the enterprise sector.

So, the question for us is: Why do we need urban public finance? The most obvious reason is to support the salaries of the public servants at the local/municipal level; at the provincial level where urban management, planning and investment decisions are taken and finally at the apex national level where national urban policies and development programs are defined and financed via the budget.

There are a range of public functions and services in urban areas, that need to be financed and delivered, with wide variation of sources of revenue and objects of expenditure which change from country to country. Some urban services are best-delivered and facilitated by governments and state agencies, for example: Law, order and justice like the Police and the Courts or Regulation of economic activity (like trade and commerce), The regulation of public property and the Commons (like land, roads, green and open spaces, which are very critical for cities), the regulation and delivery of social services (like healthcare and education for people who live in urban areas), the delivery of basic public services (typically water and sanitation and drainage), and finally, social protection and welfare entitlements which are so important to the poor and vulnerable in our cities. There are others like power, transport and telecommunications that can be delivered by multiple providers like informal enterprises; public-private partnerships; public sector enterprises or municipal and public service utilities. This is why cities are so interesting and difficult to finance. Whatever the form of ownership, delivery and regulation of these services; money is needed to manage operations and maintenance and capital to expand infrastructure. This can be done either directly through various forms of taxation or indirectly by a range of concessions, licenses and financing arrangements which work between public, cooperative and private institutions.

In most cities, a mix of public finance; PPP financing and innovative bottom-up finance arrangements are in use. This depends on national and local public policy and historical precedents.

In spite of these arrangements, state agencies and local governments, typically raise the bulk of these financial resources that are required to run and manage the city and oversee the deployment of public expenditure. Their capacity to deliver and manage these processes is therefore, crucial. What are the most important sources of public finance? Let's go through a list, rather quickly: Local, regional and national taxes, both, direct and indirect. There are many fiscal arrangements to enable taxation across countries which need to be devolved to local governments
to help implement the SDGs.

National Governments raise most of the taxes in countries and transfer them to regional and local governments. These inter-governmental fiscal transfers and grants decide who is responsible for
and who is responsive to local sustainable development challenges. This is one of the most important technical and political challenges we have. Income from rents, from public properties, user fees and charges whether it is from roads or sanitation or solid waste management services. Innovative financial mechanism such as London's traffic congestion charge is an emerging form of such income. Return and dividends from investment on Public utilities like water and from other public enterprises are also examples. And in some cities where there is considerable amount of financial distress, income from the sale and privatisation of public assets like land and public sector enterprises. And last, debt and deficit financing either through the national budget or via municipal and other forms of bonds. These bonds borrow from the market and hence from individuals, like you and me and of course from enterprises. Many of these bonds are tax-exempt for a fixed period to attract both domestic and international investment. It might be interesting for us to look at different types of bonds: The general obligation municipal bonds are usually raised to raise capital to cover local government expenses. This is backed by the state's power to tax. Revenue bonds, which are more common are often issued to fund long-term infrastructure projects, like a toll road or a metro system. Their repayments are made from the projected income from these projects and they are often placed in an escrow account to give comfort to risk-averse investors and donors. In recent times, Green and Climate bonds are used to fund projects with positive environmental and climate benefits, such as renewable energy projects, energy efficiency projects,emission reduction and waste management investments. And to address disaster risks, catastrophe bonds which transfer the risks to insurance, institutions and to investors.

Now let's come back to comparing London and Mumbai where we started from. The UK, has a unitary government, with a central role for the national government and a weak role for local bodies, except for London because of its political and economic importance. This as we can see, is reflected in London's revenue that comes from a mix of sources: In 2013-14, 54% of London's revenue came from income taxes and national insurance. 14% came from value-added taxes, 13% from corporation and business taxes and only about 6% from land taxes, stamp duties and council taxes which were all locally driven. So the bulk of London's resources come from non-local sources. India, unlike the UK has a strong and well established fiscal federal structure, divided between central and states government, and urban local bodies.

The Central Government in India has had primacy in raising revenue and then sharing it with the states increasingly through rule-based transfers. Urban development and management, is largely controlled by state governments, but cities have a weak political say in this and an even weaker revenue base. India spends only 1% of its GDP on municipal government and services which leads to a whole range of challenges that we see on the ground. Mumbai for example, in spite of it being such an important metropolitan city has limited powers to raise local taxes, with octroi being its largest source of revenue. Like other institutions, the sustainability of cities depends on the financial health of municipal and public finances. Many cities, even in high-income countries are often in trouble. Poor public financial management and debt has constrained expenditure in critical infrastructure and urban renewal; and sometimes even rich cities are unable to pay the salaries
of public servants.

Urban sustainability, is therefore closely linked to establishing principles of sustainable finance, asset and human resource management in public systems. A core principle of sustainable financing that we have to understand is that the operations and maintenance of municipal services should be paid for. They need to be paid for, either through user charges or through a mix of charges and subsidies. These subsidies,of course, should be limited to those who cannot afford commercial services and hence use these services at a basic lifeline tariff. In many locations of course, as we know, the better off have been known to benefit from the subsidies through an elite capture of services. This is a complex and contested question and is subject to considerable populist pressure across the world. Another strategic question, is how do we finance infrastructure, basic services and housing that is necessary to deliver the SDGs.

Some cities especially in China, use land markets to finance the long term capital requirements. Others, look to development assistance, banks and long-term capital (like pension funds or insurance) to part-finance these requirements. Market economies like the United States often have well-developed municipal bond and housing markets from which cities are able to raise resources to finance urban development. But even there, the 2008 economic crisis was born out of the malregulation of this sector. What would it take to finance the urban SDGs across the world? Current estimates places it between $2-3 trillion of additional investments on an annualised basis, till 2030. While additional work is done on this by national and international financial institutions, it is clear that the urban sector will require a significant proportion of the financing needs of the SDGs to address infrastructure, housing and building needs.Therefore, effective and sustainable financing, new and innovative institutional arrangements and policies to enable greater access and ensure that no one is left behind will be necessary.

So, What have we learned from this session?

Public expenditure is necessary to expand the provision of universal public services, physical and social infrastructure and regulation as well as their long-term operations and maintenance. Many of these services must be delivered by the state whereas some others can be delivered in partnership with other stakeholders like the private sector. This requires taxation and revenue-generation, though many sources, that we have discussed before. The sustainability of cities is linked to the financial health of municipal and public finances. Estimates for the financing the urban SDGs worldwide range from $2-3 trillion of additional investments annually, of which infrastructure, building and housing take the largest share.Finally while these are only estimates they tell us that creating sustainable cities will not come cheap.