

Financing Local Jurisdictions – Guidelines and General Principles

**International Conference
„Future Megacities in Balance“
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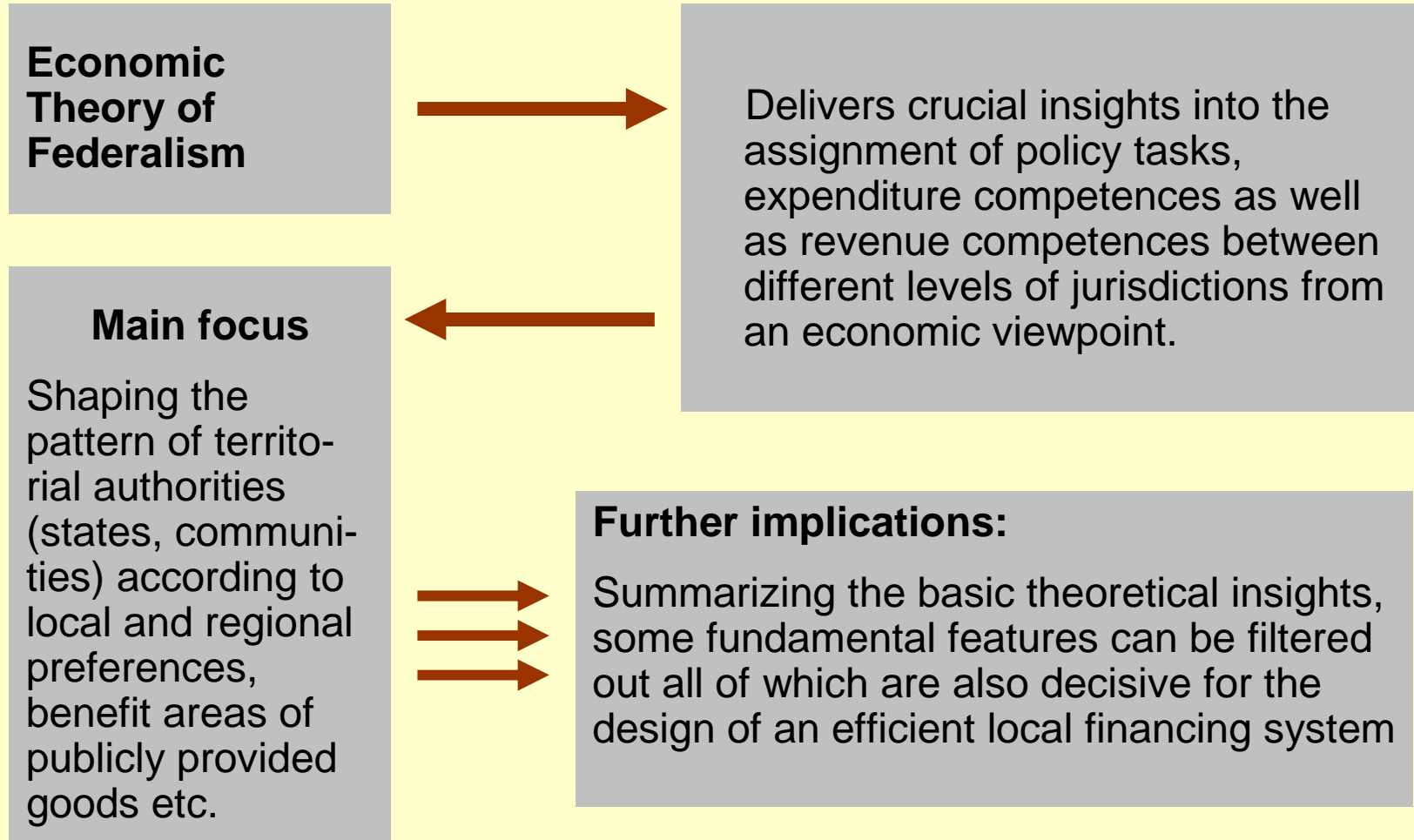
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Prof. Dr. Nils Otter**

Structure

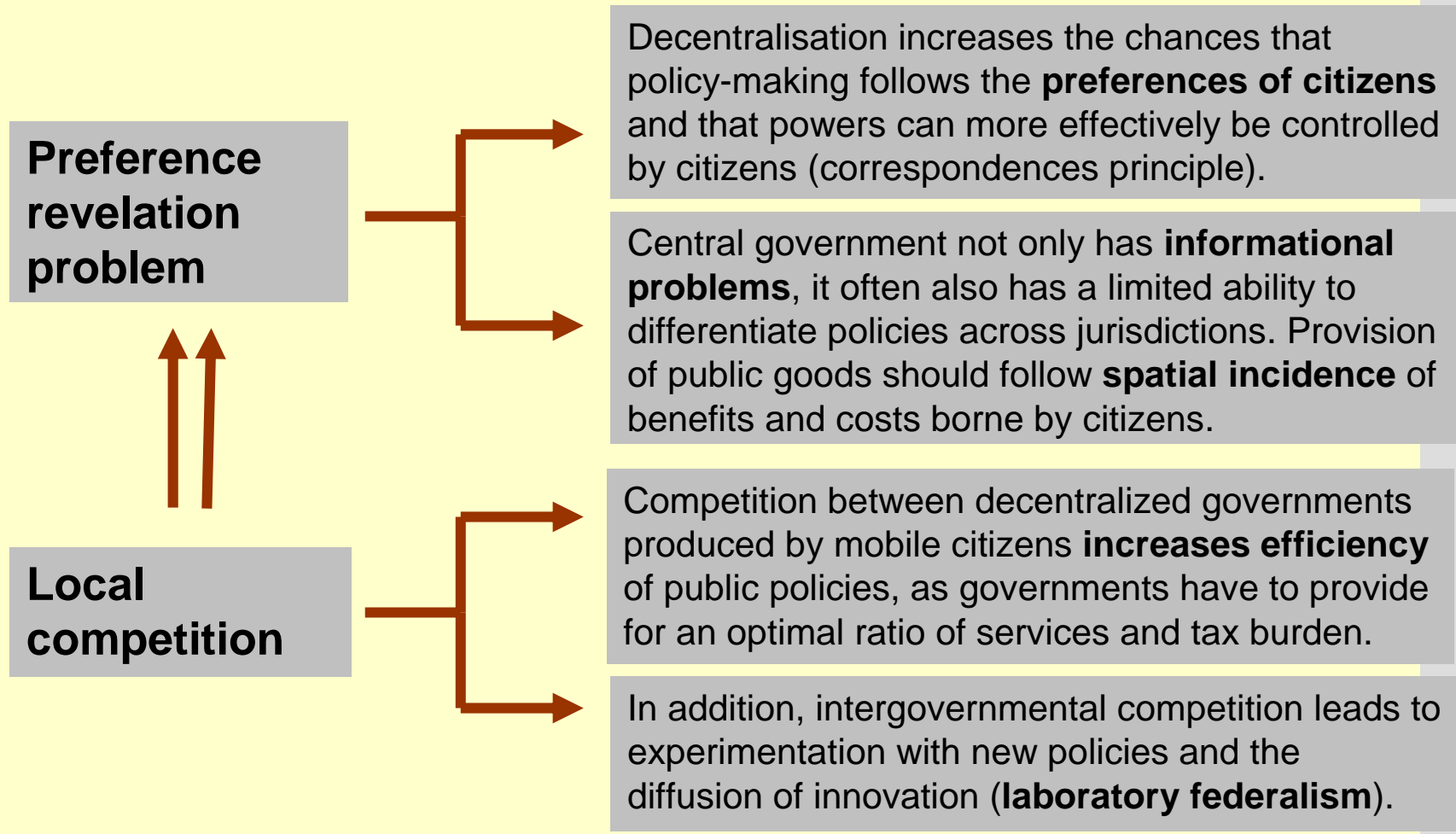
- I. Introduction: The theory of fiscal federalism
- II. Guidelines: General tax assignments and grants-in-aid
- III. Principles: Unique requirements concerning local taxes
- IV. Conclusion: Consequences for urban financing

I. Introduction: The Theory of Fiscal Federalism

Theoretical Features I: Overall aspects

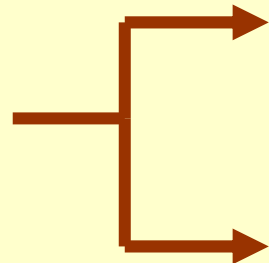


Theoretical Features II: Pro Decentralisation



Theoretical Features III: Pro Decentralisation

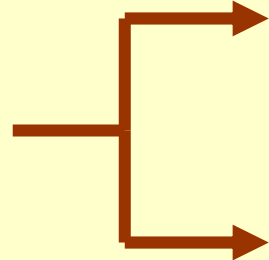
Leviathan restraint hypothesis



If the assumption of a **benevolent government** is relaxed then governments may also pursue their own ends, which will not always coincide with those of society (=> exploitation of tax resources).

A fragmented system (due to local competition) will serve for a stricter **budget discipline** in terms of a strengthened link between expenditures and revenues: thus a reduction of the size of the public sector can be expected.

Augmentation of Democracy

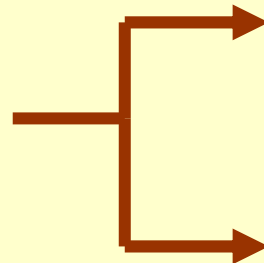


On the one hand, better consideration of local preferences and inter-jurisdictional competition within a highly decentralised federal system can lead to **democracy improvements**.

On the other hand, federalism increases political information for citizens and transparency in public transactions, which reinforces the **proper functioning of democracy**.

Theoretical Features IV: Pro Centralisation

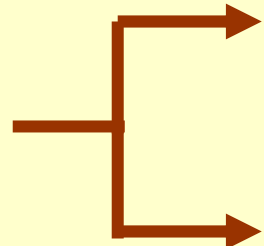
Spillover and economies of scale



The policies of one region may have (negative or positive) effects on other regions (**geographical externalities**), only central government can take account of these interactions.

For several policies, decentralised **governmental units are too small** for effective governance and intergovernmental coordination causes considerable costs. Hence, centralisation is justified, if common goods exploit economies of scale.

Additional arguments



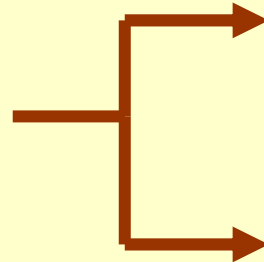
Income redistribution is difficult to achieve at the local or regional level because the rich would tend to migrate to low tax jurisdictions (the poor might migrate to high benefit localities), which in turn could aggravate social disparities.

Macroeconomic stabilisation requires a central government because – due to the openness of regional economies – fiscal policy would strongly affect other jurisdictions, but only benefit the decentral community to a small extent.

II. Guidelines: General tax assignments and grants-in- aid

Guidelines for the analysis of fiscal relationships I: investigation steps

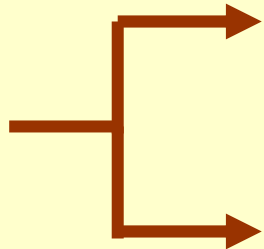
Step 1+2: “passive” assignment



Responsibility assignment: As a starting point, subnational expenditures and revenues have to be designed in correspondence to the allocated public tasks

Expenditure assignment: Expenditures follow the assignment of responsibilities. According to the so-called “principle of connection”, one can link expenditures to the legal decision or to the administrative execution.

Step 3+4: “active” assignment

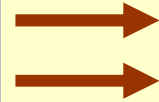


Tax (revenue) assignment: Revenues follow the assignment of expenditures. Ideally, at each layer of government own source revenues should be sufficient to cover the respective level of expenditures.

Fiscal equalization scheme: Massive (fiscal) distortions between either different levels of government or between jurisdictions of the same level can (should) be corrected by a system of fiscal equalization.

Guidelines for the analysis of fiscal relationships II: autonomy of revenues

In descending order of local autonomy



1. Fees and user charges
2. Tax power (tax source, tax base, tax rate)
3. Tax surcharge
4. Tax sharing
5. General grants
6. Ear-marked grants
7. Refunds



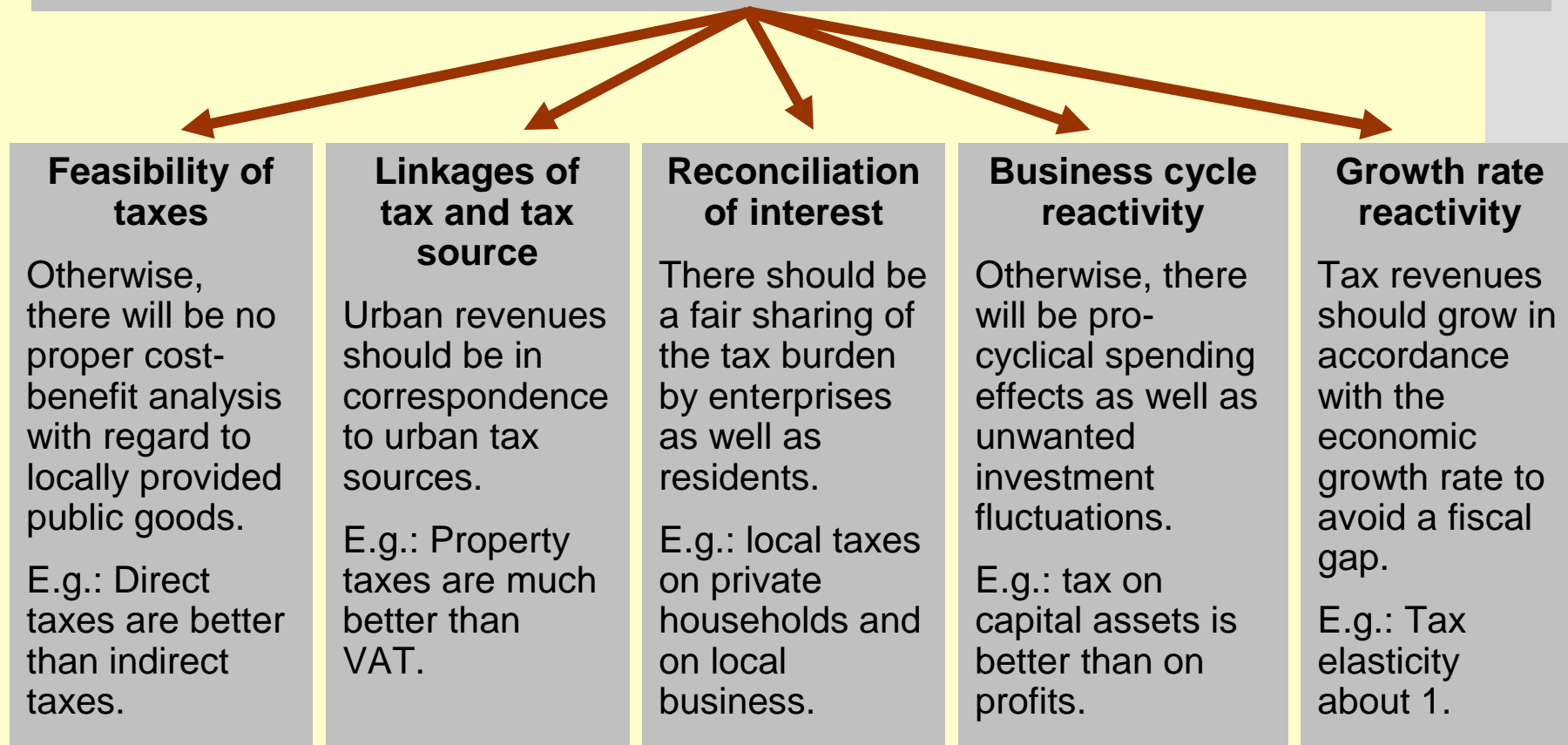
Measured by effectiveness of:

- Principle of fiscal equivalence
- Principle of subsidiarity

III. Principles: Unique requirements concerning local taxes

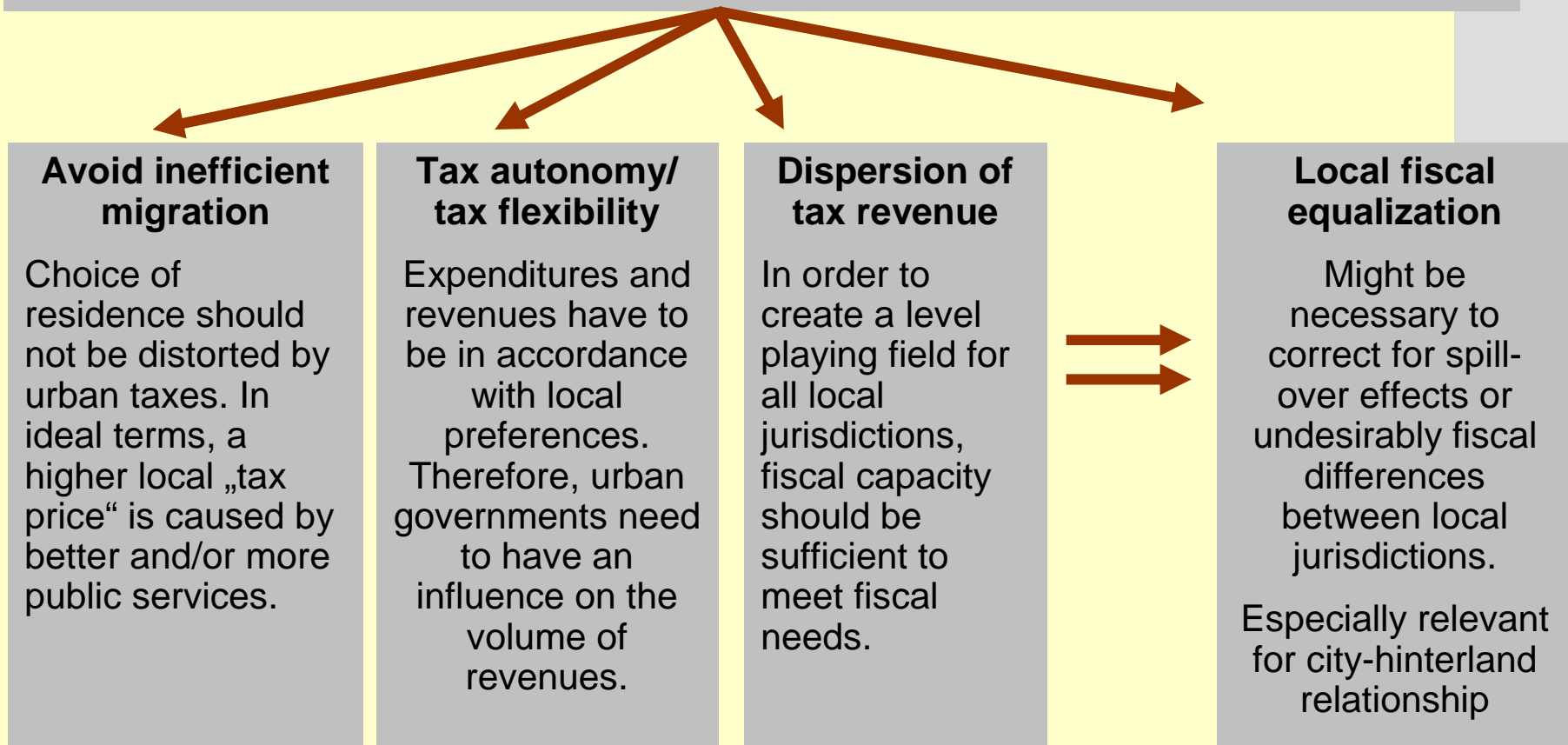
III. Principles: vertical tax criteria

vertical perspective: local jurisdictions as entities of a federal state



III. Principles: horizontal tax criteria

horizontal perspective: interrelationship between local jurisdictions



IV. Conclusion: Consequences for urban financing

From the normative approach to a complex real world...

Sustainable urban financing...

...can be defined in terms of **sufficient own-source revenues**.

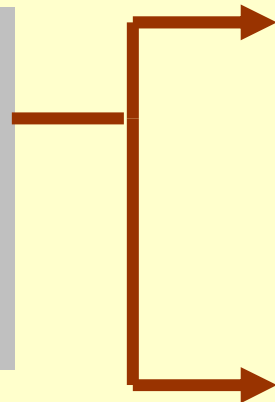
In concrete terms this means that at least

- the richest urban governments are able to finance from their own resources **all locally provided services**; or
- significant parts of the urban budget can be financed by revenue instruments for which the urban government is **politically responsible**.

...recommends **user fees and residents-based taxation** for residential services, and **user fees and business-based land-value taxes** for business services.

...right back to efficient urban finances from an economic perspective:

No matter which revenue instrument is used...



...it should be guided by the simple dictum that **financing follows function**. If big expenditure responsibilities are to be carried out (social security, health, education), urban governments need access to significant revenues for which they are politically responsible.

...it requires that subnational governments are able to affect the volume of revenues **at the margin** through their own policy choices. If urban governments are expected to act responsible they must be able to increase (or decrease) their revenues by means that make them publicly responsible of their action.

Seen from the perspective of
a city treasurer...



...getting the basics right...



Thanks for your attention.
Comments are welcome!

...will change his mood!