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*Getting it Right:
Financing Urban Development in China*

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China is the world's most populous country. For some years, China has sustained a remarkably fast rate of economic growth. Despite the forests of construction cranes so often noted by visiting foreigners, however, China remains to a surprising extent a rural country, with only about one-third of its population living in urban areas. But China's cities are growing rapidly, and within a decade half or more of its population will be urban. In addition to urbanizing less rapidly than would normally be expected for its growth rate, the pattern of urban growth in China during its recent rapid economic expansion has also not followed that found in other countries. In particular, contrary to experience in most of the world, its largest urban centers have on the whole grown less rapidly than the urban sector as a whole. Moreover, in some critical respects the internal pattern of growth within Chinese cities has also deviated from what economic logic would suggest is sensible – although in this respect at least its experience is not too different to what has been seen elsewhere.

Nonetheless, China now has 668 cities and every indication is that the number of cities, their size, and their economic role will continue to grow. What happens in these cities will be a dominant factor in shaping the China of the future. Will the 1,000 cities that will exist within a few years flourish and lead the country as a whole onward and upward economically, or will the problems already apparent in some existing cities worsen, spread, and eventually choke that growth? The answer to this question depends in part upon whether China gets its urban finance system right.

The Problem

How China accommodates its increasingly urban population and in particular how well it manages its burgeoning metropolitan areas is critical not only directly to the well-being of an increasing number of its people but also more indirectly to its sustained economic development. Large metropolitan areas are everywhere important generators of employment, wealth, and productivity growth.¹ More than this, however, such areas increasingly seem to hold the key to the economic success of the countries in which they are located. In the emerging global 'knowledge-based economy', innovation is the key to prosperity. Firms no longer compete internationally solely on the basis of cost but also on the basis of their ability to come up with new products and to deliver them in a timely manner (OECD, 1996). Most innovation occurs in large cities and city-regions as the concentration of people and firms increases social and economic interaction and results in greater exchange of ideas among people working in different fields in the same location. Globalization and good, economically sensible urban governance and finance go hand in hand.²

In some developing countries the extreme centralization of governmental regulation, combined with marked favoritism in public sector investment towards the capital city, means that the biggest metropolitan areas are already too large from a strictly economic perspective. In China, however, past policies have both slowed urban growth and in particular slowed the growth of its largest metropolitan cities to suboptimal levels, as Au and Henderson (2002) have

¹ Some portions of the following argument draw heavily on an earlier study by Bird and Slack (2004).

² See Kaufmann, Leautier, and Mastruzzi (2004) on the importance and interconnection of good urban governance and globalization.

argued. Of course, China need not follow the paths traced by other regions. Indeed, the central argument of this paper is that China has a relatively rare chance to, as it were, ‘get it right’ by establishing the rules of the urban finance game in an economically rational way. The present urban finance system in China is clearly far from rational, as others have argued (e.g. Wong, 1999; Hong, 2003). But the systems found in other countries are also arguably far from optimal, shaped as they have been by history and chance. China may be able to steer a path between exacerbating the problems arising from its present system and falling into the problems that have distorted urban development in much of the rest of the world.

People and businesses are attracted to large metropolitan areas because they provide such benefits of close proximity (agglomeration economies) as face-to-face interaction, the availability of more and better business services, and greater accessibility to a large skilled labour force as well as to transportation and communications networks. Large metropolitan areas are thus more easily able to achieve the critical mass required to attract and support the high degrees of specialization in labour, knowledge, businesses, services, infrastructure, institutions, and media needed to attain global success in today’s world.

Up to now, however, many Chinese cities seem to have divided their efforts between attempting to keep unsuccessful businesses in operation through protectionist measures and attempting to attract new businesses by distorting land and capital markets. To attract sustainable businesses in a sounder way, cities need first to ensure access to skilled labour and adequate transportation and communications infrastructure without subsidization. Rather than attempting to keep out migrants, for example, they should provide services that will attract and retain highly trained human capital. Recent studies in developed countries suggest that the so-called ‘knowledge workers’ who are increasingly central to economic success in the modern world are attracted by such ‘quality of life’ factors as diversity, tolerance, a lively arts scene, recreational opportunities, high quality public schools, strong neighbourhoods, and safety from crime (Florida, 2002). As large segments of the skilled and educated population of countries such as China move increasingly into the same world as competing knowledge workers in other countries, similar factors are becoming increasingly important to them also.

To be globally competitive, of course, cities also need to provide a wide range of additional services to their residents in acceptable quantities and qualities -- transportation, water, sewers, garbage collection and disposal, police and fire protection, parks, recreation and culture, affordable housing, and an adequate support system of social assistance.³ To do all this, cities need access to sufficient financial resources both to build and maintain the necessary infrastructure and to deliver the services needed to make them internationally competitive. Good local governance and financial institutions have critical roles to play in enhancing economic potential in China, as elsewhere. The institutions of urban governance – including not only government policies at both local and regional levels but also central government regulations and directives with respect to such critical matters as land use, finance, and infrastructure -- shape the physical and social character of city-regions. The financial structure of a country's metropolitan areas affects the quantity and quality of urban services, the efficiency with which those services are provided, whether costs are shared throughout the region in a more (or less) fair and efficient way, and, of course, both citizen access to local government and local government accountability to citizens. Box 1 illustrates how cities elsewhere in the world often divide expenditure functions between more than one level of government in metropolitan regions.

Box 1

Who Does What in Metropolitan Regional Governments

Where there are two-tier structures of local governance, the upper tier is generally responsible for services that are region-wide in scale and scope. The Table illustrates what many would consider an ideal assignment of responsibilities, with the upper-tier responsible for area-wide services such as major infrastructure, transportation, water and sewers, waste management, broad spatial planning and economic development.

Function	Upper Tier	Lower Tier	Justification
Welfare assistance	X		Income redistribution; externalities
Child care services	X		Income redistribution; externalities
Social housing	X		Income redistribution; economies of scale; externalities
Public health	X		
Ambulance	X		Income redistribution; economies of scale; externalities
Roads and bridges	X	X	Economies of scale; externalities
Public transit	X		
Street lighting		X	Local versus regional roads

³ As has frequently been noted, however, cities cannot and should not be expected to bear all the costs of social assistance themselves. Like pensions, social welfare expenditures should predominantly be national responsibilities. In the absence of rational allocation of such expenditure functions, it will be exceptionally difficult to develop a sound urban finance system.

Sidewalks		X	Externalities; economies of scale
Water system	X		No externalities
Sewer system	X		No externalities
Garbage collection	X		Economies of scale
Garbage disposal	X		Economies of scale
Police protection	X		Economies of scale; externalities
Fire suppression		X	Economies of scale; externalities
Fire prevention/training	X		Externalities; economies of scale
Local land use planning		X	Local responsiveness; scale economies for specialized services
Regional land use planning	X		Economies of scale
Economic development	X		
Parks and recreation		X	Local access, responsiveness
Libraries		X	Externalities
			Externalities
			Local responsiveness
			Local responsiveness

Source: Bird and Slack (2004)

While there is considerable dispute in the literature (e.g. Klink, 2002; Divay and Wolfe, 2002; Lefèvre, 2003; Kaufmann, Leautier, and Mastruzzi, 2004) as to exactly how, and how much, the design of governing institutions matters in affecting outcomes, it is indisputable that money matters: who has it, where does it come from, and under what conditions it can be spent and by whom? How public expenditures are financed directly affects the feasibility of any developmental proposal or service provision goal and is thus always a key issue in any city or metropolitan area strategy (World Bank, 2002). In particular, international experience suggests strongly that the ability to ‘self-finance’ – that is, to be free to at least some extent from the whims and wishes of higher-level governments – is a critical factor in determining which metropolitan cities will live and thrive in a globally competitive environment and which will fade away, in endless bickering between contending financial and political sources of support.

How large cities are governed and financed thus matters a lot, and not just to their inhabitants but to the country as a whole. How China chooses to finance the enormous urban development task that lies before it will shape the nature of its future growth to a considerable extent. There are therefore few more important tasks facing China in the next few years than getting the right urban finance strategy into place. But just what does this mean?

The ‘market-based development’ that has been discussed in deliberations on the current plan strikes the right note. Sound ‘market-based’ urban development, however, does *not* mean that Chinese cities should plunge even more deeply into the murky waters of ‘public-private relationships’ than they already have, driven in part at least by their pressing need to secure more revenue through obscure and ‘extra-budgetary’ means by exploiting their regulatory powers and asset holdings (especially land) in ever more obscure ways. Rather, what sound market-based urban policy means is that China should try to seize the opportunity it now has to avoid either worsening its present urban problems or falling into some of the traps other cities around the world have stumbled into with urban growth patterns being driven more by inappropriately priced urban space than by any ‘market’ logic.

China may have thus a rare chance to ‘get it right’ by establishing the rules of the urban finance game in an economically rational way before it becomes so locked into a distorted urban price system that change may become almost as politically impossible as now appears to be the case in many developed countries. Of course, if China is really to get it right with respect to urban finance, much more careful and detailed analysis is needed to set the prescriptions for ‘good’ urban finance policy suggested here in the necessary detail, and many important aspects that cannot even be mentioned here need to be considered carefully. What follows is thus no more than a brief and preliminary essay into an enormous and, it seems, as yet largely unexplored territory.

Approaching Urban Finance

The basic approach to financing urban development in China suggested here is simple. From an economic perspective, cities -- and for the reasons mentioned earlier large metropolitan cities in particular -- should be thought of as in effect ‘enterprises’ that provide services of various sorts both to urban residents and to the country as whole.⁴ As with any enterprise operating in a (globally as well as nationally) competitive environment, success depends on both

⁴Of course, there are many other possible approaches to urban finance – for example, the aim of reducing urban poverty through using local finance for redistributive purposes. As discussed elsewhere, however (e.g. Bird, 2001), the ‘benefit’ approach taken here not only provides a sounder analytical structure within which to consider urban finance issues but is also not necessarily inconsistent with poverty-alleviation concerns. For an interesting alternative approach to the ‘benefit’ model with a Chinese twist, see Deng (2003).

obtaining sufficient resources and using them in the right combinations to produce goods and services that potential customers are willing to pay for. Moreover, if the ‘success’ of any enterprise – whether a private firm or a metropolitan government – is also to mean an improvement in society’s welfare, the prices that all relevant decision makers face must be ‘right’ in the sense of correctly representing social opportunity costs.

The main condition that needs to be satisfied to get urban development right is thus simply that decision-makers must both face correct input prices and charge correct prices for their outputs. This is easy to say, but experience demonstrates that it is not at all easy to achieve in the real world of urban finance. A recent article in *The Economist* (May 15, 2004), for example, starts with the assertion that “Beijing traffic jams get worse by the day as ever more people own cars.” The title of this article --“Time to Hit the Brakes”- seems at least as relevant for urban finance as it may be for the macroeconomic policy that was the main concern of the article. If China is not to replicate the experience of too many cities in other countries and end up with what a famous early paper on this subject in the United States provocatively – and accurately -- called “The City as a Distorted Price System” (Thompson, 1968), the time to get urban prices right is as soon as possible. From a developmental perspective, this is surely one of the main challenges facing Chinese urban finance right now. Many key urban ‘prices’ in this sense seem clearly wrong now, and urban growth is already being distorted as a result, as evidenced by the vacant luxury buildings and wildly distorted land prices found in some areas.⁵

Those who are responsible for making urban development decisions in China’s burgeoning cities need to face the right prices for the use of such critical inputs as land and capital. They also need to charge the right prices for the services they provide. To be more specific:

- Both public and private decision-makers should face correct prices for land. This requires both an appropriate regulatory structure and, importantly, an appropriate land tax

⁵ For some evidence, see *China Economic Quarterly*, Q1 2004, pp. 31-34.

system so that the best use is made of scarce urban space.⁶ Excessive decentralization, for instance, already appears to be occurring in some cities. Rapid rises in land prices frequently signal large shifts in land use which in turn sometimes reflect underlying fiscal regulatory distortions.

- Both public and private decision-makers should also face correct prices for capital. This requires that there be a ‘hard budget constraint’ facing local governments as well as developers and that no one has access to unduly cheap (subsidized) capital.⁷ Unless factor prices are correct, factor choices will be distorted and economic well-being consequently lower than it otherwise would be.
- Those who use urban transportation systems, especially roads, should also face the full economic costs of their use decisions. This requires an integrated regulatory/tax approach to roads, vehicles, and public transit systems.
- Users of other public services should also face ‘correct’ prices, both to ensure that such services are appropriately used and, importantly, to send the correct signals with respect to urban investment decisions to both public and private decision-makers.
- Finally, to ensure that the right signals arrive to the right people at the right time, not only do intergovernmental finance systems have to be properly designed to ensure accountability ‘upwards’ when relevant – a goal which Chinese national authorities seem already motivated to achieve -- but in addition attention needs to be paid to developing and implementing administrative and political systems to provide both adequate accountability ‘downwards’ and also the resilient ‘error-correction mechanism’ of citizen feedback that is an essential component of any sustainable political-economic system. As Wong (1999) has emphasized, in this and many other ways transparency is the key both to good government and to good economic decisions.

6 See Bahl and Zhang (1989) for a prescient early recognition of the importance of this point for China’s sound urban growth, and Hong (2003) for a more recent appraisal.

7 There is a huge literature on these points: see, for example, Rodden, Litvack, and Eskeland (2003).

Although the sources of revenue available to and used by local governments of all sizes are often similar in principle, in reality both expenditure and revenue needs and patterns tend to be different in large metropolitan regions, reflecting both the different nature and level of services they provide and their greater ability to levy taxes (Bird and Slack, 2004). The present discussion is concerned primarily with the larger cities, because that is where most of the action is, and where it is likely to continue to be. Both experience and theory suggest that large metropolitan areas can and should have greater fiscal autonomy than other urban or rural areas, where “autonomy” means *both* greater responsibility for local services *and* greater ability (and responsibility) to levy their own taxes and collect their own revenues.

Implications for Urban Finance in China

Obviously, it is not possible in this short paper to develop even the few points mentioned above in detail, let alone to treat this whole complex area. Instead, all that is done in the remainder of the paper is to mention briefly some implications of this approach for several important aspects of urban finance: user charges, land taxes, vehicle taxes, intergovernmental fiscal transfers, and infrastructure finance. The basic argument is essentially that unless cities are given sufficient ‘good’ fiscal instruments to finance their expansion, they are likely to continue, as in the past, to cope with the problems facing them by recourse to ‘bad’ ones such as extra-budgetary funds (Wong, 1999), arbitrary and illogical fees (see Box 2), and distorted ‘public-private’ schemes (see Box 6).

Box 2

Real Estate Development in Shanghai

In general in China, to obtain a land lease (certificate for land use right), a private entity has to pay an initial lump-sum lease payment (conveyance fee), all conversion costs, all expenditures on servicing land, and other land fees and taxes. At least 28 different fees were imposed on various aspects of real estate development in Shanghai in 2001. The following partial list gives the flavour:

- 0.15% of construction ‘workload’ as administrative fee for construction industry
- 0.1% of contract amount for enterprises from outside entering city to carry out works
- 25 yuan/person/month to administrative fund for employing persons from other provinces
- 0.02% of tender bid for planning tender for national enterprises; for international US\$100-US\$4000 depending on size of investment capital
- 300-3500 yuan/square meter of greenery for occupying greenery
- 50-90 yuan/square meter as deposit for provision of greenery in urban districts
- 0.07% of construction ‘workload’ plus 0.15% of product sales revenue as fee for supervising quality of construction works

- up to 0.1% of construction costs for tendering stage plus decreasing rate (from 2.5% to 0.5%) of construction costs depending on level of costs and 35,000-50,000 yuan/person involved in management/year as fee for managing construction works.
- Up to 0.05-0.1% of construction workload as administrative fee for drawing up construction quota
- 0.1% of total costs of civil and utility works up to 90 million yuan, and 0.05% above that level as license fee for construction works plus a “license processing fee” of 50% of license fee.
- 0.2% decreasing with value to 0.02% of price of registered realty as initial registration fee

Source: Hong (2003)

User Charges

Although the apparently widespread and generally deplorable misuse of ‘fees’ in China in recent years has perhaps obscured the case for good user charges, the simple fact is that the efficient provision of goods and services *requires* local governments to charge directly for services wherever possible (Bird 2001a). Such charges should be levied on those who directly receive the benefits from services – whether residents, non-residents, or business enterprises -- whenever those beneficiaries can be identified (unless subsidized provision is considered absolutely essential to achieve some critical policy objective). User fees allow residents and businesses to know how much they are paying for the services that they are receiving from local governments. Moreover, when proper prices are charged, governments can make more efficient decisions about how much to produce and citizens can make more efficient decisions about how much to consume.⁸ User charges are especially appropriate for services such as water and public transit where benefits are confined largely to individual consumers but the principal is more extensive in application, covering, for example, both the use of urban land and access to urban streets and roads.

Imposing appropriate user charges is important not only because they result in efficient use of services but also because they encourage more efficient land use. If marginal cost pricing is used as the basis for charging for services, for instance, higher fees are charged to consumers who are far away from existing services and hence costly to serve, and lower fees are charged to consumers who are closer. If consumers are charged average cost, however, as is often done in the mistaken name of fairness, those in outlying areas (where costs are relatively higher) pay less than

⁸ In a recent rigorous empirical study, for example, Borge and Rattso (2003) show that sound user charge financing of sewer service by Norwegian local governments has significantly reduced the cost of providing such service.

the marginal cost of the service. They are subsidized. Urban sprawl is encouraged, and often in an unfair way as people in the central, high-density area pay more than the marginal cost of the service, subsidizing the use of services by those further out (Slack, 2002). Uniform pricing of urban services, while politically appealing, is inherently economically inefficient. Studies in Chile, for instance, demonstrate clearly that under-pricing and distortions in water and sewer pricing have resulted in severe locational distortions (Daniere and Gomez-Ibañez, 2002).

User charges are often condemned as unfairly increasing the relative fiscal burden on the poor. As many studies have shown, however, almost the opposite is true in large urban areas: those who benefit most from under-priced services are those who make the most use of them (Bird and Miller, 1989). The poor – who have neither automobiles nor luxury houses with many bathrooms - - are not well-represented in this group. Relatively simple pricing systems such as low initial ‘life-line’ charges for the first block of service use can deal adequately with any undesirable inequity as a result of introducing more adequate pricing systems.⁹ Finally, an additional important benefit of more appropriate pricing of urban services is to reduce pressure on urban finances indirectly by reducing the apparent need for still more investment in under-priced infrastructure. If a service costs users little or nothing they will, unsurprisingly, generally want more of it. This does not mean that they should get it, especially not at the expense of eminently more rational uses of scarce fiscal resources for urban growth.

Land Taxes

Where user charges cannot be used because the benefits of a particular service are not confined to individual consumers, taxes that are borne by local residents are an appropriate means of finance when the benefit area of the service is largely coterminous with the municipal boundary.

⁹ Interestingly, Singapore is currently proposing to *increase* the progressivity of its revenue system by imposing higher levies and charges for a number of government services.

A truly local tax might be defined as one that is assessed by local governments, at rates decided by local governments, and collected by local governments.¹⁰ The most critical features of a good local tax are two: (1) local governments should be able to set tax rates; but (2) the tax bases on which those rates are imposed should not lend themselves to ‘tax exporting’ (shifting the tax burden to non-residents). Rate flexibility is essential if a tax is to be adequately responsive to local needs and decisions, while remaining politically accountable. Restrictions on local ability to shift taxes to non-residents are critical to ensure that local budgetary decisions are both efficient and accountable. Apart from user charges, the only major revenue sources that pass most of these tests appear to be taxes on land and property and on vehicles. Unfortunately, as a recent survey shows, few such property taxes exist in most developing countries (Bird and Slack, 2002). Nor do they by any means now exist in China, where, as Hong (2003) shows in detail, even the basis on which to build a decent land tax system seems some distance away.¹¹

Nonetheless, taxes on land and real estate have an important potential role to play in funding urban needs for two key reasons. First, real property is immovable: it cannot move away when it is taxed. Second, there is a connection between the types of services funded at the local level and the benefit to property values. To the extent the property tax approximates the benefits received from local services it is like a benefit tax. Residential property taxes are thus especially appropriate to fund local governments because they are essentially borne by local residents.¹² Those who enjoy the benefits of local services should pay for them.

On the other hand, the non-residential portion of the property tax – generally the most important part of the tax in developing countries – is inherently less appropriate for financing local government expenditures. Taxes on business may be partially exported to residents of other jurisdictions who are consumers of the products or services produced in those properties or who own the business. Such tax exporting reduces accountability because those bearing the

¹⁰ Although in principle whether a tax is actually administered locally or not is not of primary importance, in practice experience suggests that local administration definitely increases local control (Mikesell, 2003).

¹¹ Deng (2003) makes an interesting argument to the effect that to at least some extent the land leasing, land user fees, and even the murky ‘public-private’ arrangements characterizing most land use decisions in Chinese cities may approximate the effects of a decent land tax, but he also concludes that at most the present system may constitute a transitory stage on the way to the necessary improved land tax system.

¹² Like most short statements about tax incidence, the text statement is too simple to be fully accurate: for a more detailed discussion, see Bird and Slack (1993).

burden of the tax are not the same as those enjoying the benefits. The ‘virtuous circle,’ in which those who decide, those who pay, and those who benefit are identical, is thus broken. Local residents may demand greater expenditures than they otherwise would because they know much of the cost will be paid out of ‘other people’s money.’ Some restriction on the use of non-residential property taxes through such measures as a maximum rate or at least requiring a uniform rate on residential and non-residential property may thus be desirable. Large metropolitan areas tend to have relatively more commercial and industrial property than smaller urban areas. A larger commercial/industrial tax base permits local governments to make greater expenditures than smaller municipalities for the reasons noted above. To the extent such taxes exceed the benefits received by business from local government activities and are exported, some restrictions on the ability of local governments to tax business may be especially needed in metropolitan areas.¹³

Quite apart from its potential revenue importance, a good property tax is also critical in terms of its influence on urban land use patterns. To the extent that property tax differentials are matched by differentials in expenditures on public services, they do not distort choice on location or land use. Where such matching does not occur, however, the result is a pattern of positive and negative subsidies that will influence urban development patterns, often in a way that worsens it. Unfortunately, in reality taxes on land and property are seldom matched by service benefits. For example, non-residential properties are often over-taxed relative to benefits received compared to residential properties; tax competition among municipalities often does not reflect differential service benefits; and favorable tax treatment of farm properties in urban areas creates further distortions. Such misallocations are potentially very costly in the case of rapidly urbanizing countries such as China.

Increases in property tax should be expected to result in a reduction in density (other things being equal). Where the tax is levied on the assessed value of property (land and improvements), any investment that increases the value of the property will increase the assessed

¹³ For further discussion of the extent to which local taxes on business are justified and the way in which such taxes might best be imposed, see below.

value and make the property subject to a higher tax.¹⁴ Higher property taxes thus provide an incentive for less densely developed projects – for example, scattered single-family houses rather than apartment buildings. On the other hand, a tax on land only provides an incentive for greater density relative to a tax on both land and improvements. The choice of highest and best use as the tax base (rather than current use) is also likely to result in higher densities. These and many other important policy issues related to land and property need to be sorted out and considered carefully in the context of China's urban system if the 'highest and best use' from the perspective of both urban financial needs and urban development more generally is to be made of scarce urban land.¹⁵

Many policy choices with respect to the structure of land and property taxes may have an impact on urban land use: what is included and excluded from the tax base, how property value is defined for different classes of property (for example, residential, farm, commercial, and industrial properties), what percentage of the value is taxable, and how effective tax rates vary within and between classes of property. Unfortunately, the information available on most of these aspects in China is inadequate to permit analysis of the effects of the existing – almost certainly non-optimal – tax systems on land use. Given the apparently low effective tax rates currently applied, the resulting distortions may not be too high. Nonetheless, in view of both the great need for urban development expenditures in the future and the likelihood that the role of land and property taxation as a source of local finance will increase over time, it is important to ensure that the future development of urban land and property tax systems in China's major metropolitan areas takes into account not only the need to be politically acceptable and administratively feasible but also the desirability of designing such taxes properly from an economic perspective. Fiscal gadgets such as land value increment taxes and progressive land taxes, while always popular with theorists, seem unlikely to play much of a role owing to the

¹⁴ This assumes that an increase in the value of the property is reflected in the value assessed for taxation purposes, which of course requires a good valuation system – something not easy to achieve in the rapidly changing conditions of developing countries and particularly difficult in a country like China in which property rights in land are not clear and the existing system is far removed from a value-based tax (Li, 1995). For discussion of alternative approaches to taxing property, see Bird and Slack (2002).

¹⁵ The present land tax system in China is described in Xu and Wang (2004), and evaluated in more detail in Hong, (2003).

high and perhaps insuperable political and administrative costs of applying them correctly.¹⁶ As a rule, it is more important to develop simple, uniform local property taxes, with the only differentiation perhaps being somewhat heavier taxation of land than of improvements.

Taxing 'Automobility'

One essential element of a sound urban finance strategy is to tax immobile real estate properly. Another is to tax highly mobile motor vehicles properly (Wong, 1999). If city growth is not to be 'driven' by cars, cars and their use must be properly taxed. The most important tax on automobiles from a revenue perspective is the fuel tax, which is also the simplest and cheapest form of automotive taxation from an administrative perspective. Although fuel taxes are seldom levied at the urban level, they could be, with the refiner or wholesaler acting as the collection agent for urban governments and remitting taxes in accordance with fuel shipments. Indeed, different regions could impose taxes at different rates if they chose to do so subject to the constraint that they would probably not be able to differ much from the rates imposed by their neighbours, given the mobility of the tax base.¹⁷

However imposed, user charges on road users reflecting the marginal social cost of road use would result in more efficient allocation of scarce public sector resources. Of course, a city fuel tax is not the same as a direct user charge in the sense that it does not reflect the marginal social cost of vehicle use, but it may still be broadly considered to be a benefits-based tax. Such a municipal fuel tax would likely be most appropriate for large metropolitan areas that have transit systems that would benefit from a dedicated source of revenue. So long as roads are under-priced, there is a strong 'second-best' case for subsidizing urban transit, and well-designed road charges can deal with both sides of this problem at once. Kain and Liu (2002), for example, provide an interesting recent empirical study of these issues in Chile.

¹⁶ For an interesting discussion of the extent to which its unusually heavy land-related taxes have helped alleviate excesses in land speculation in Taiwan, however, see Jenkins, Kuo and Sun (2003).

¹⁷ For example, a recent study of the limits on fuel taxes imposed by regional competition in Europe is Evers et al. (2004). Local fuel taxes are levied in many U.S. jurisdictions and in a few larger Canadian municipalities. The revenues generated from these taxes are often earmarked for local roads and transit services. Those cities that levy a fuel tax generally piggyback onto state/provincial fuel taxes, principally because the administrative costs of levying their own taxes would be prohibitive.

To the extent that automotive taxation is designed, as it should be, not simply to produce revenue but to price the use of publicly provided services or externalities, fuel taxes are of course a crude instrument. Toll roads and an appropriate set of annual automobile and driver license fees can in principle be much better benefit taxes. For example, vehicle fees might be based on such features as age and engine size (older and larger cars generally contribute more to pollution), location of the vehicle (cars in cities add more to pollution and to congestion), and axle weight (heavier vehicles do exponentially more damage to roads and require roads that are more costly to build). Similarly, drivers' license fees might take into account driving records (20 percent of drivers are responsible for 80 percent of accidents). These and many other issues appear to deserve considerably more attention than they have received to date in China. Singapore's combined vehicle tax/regulatory structure and in particular its experience with road pricing (see Box 3), for example, appears to offer very useful lessons for Chinese cities that seem increasingly to be wrestling with the all too familiar consequences of under-priced access to urban roads. On the other hand, ill-fated experiences with toll roads in Malaysia and elsewhere may equally suggest lessons to be avoided.

Box 3 Road Pricing in Singapore

Singapore has had long experience with pricing access to its roads. The first road pricing scheme was the Area Licensing Scheme (ALS) which was introduced in the central area – the Restricted Zone (RZ) – in 1975. The ALS was a simple manual system. There were 34 entry points to the RZ and anyone entering the RZ during normal working hours had to display an area license (available in monthly or daily forms). Licenses could be purchased from post offices, petrol stations, and special booths. Initially, only cars and taxis were affected and only during peak hours. Subsequently, however, the scheme was extended to cover all types of vehicles for the whole day, with different types of vehicles being charged different prices and prices also varying by time of day. Enforcement was by police who manned the entry points, but vehicles without licenses were not stopped. Instead, their owners received a notice to pay a fine. The system was considered successful in keeping transportation problems in the central city within reasonable limits. Twenty years later, in the mid-1990s, much the same concept was extended to several expressways during peak hours under the name of the Road Pricing Scheme (RPS).

By that time, however, considerable work had already been done on introducing a system of Electronic Road Pricing (ERP), and in 1998 Singapore finally introduced its current ERP system. ERP is based on the 'pay-as-you-use' principle and is designed to be a fair system charging motorists for use of roads at peak hours. Traffic conditions on roads where ERP is in operation are reviewed regularly and the price charged adjusted to minimize congestion as necessary. Rates are set based on traffic congestion levels at pricing points (as measured by taxis in the traffic stream, all of which are fitted with GPS devices). In 2003, a graduated rate was introduced in the first five minutes of a new higher-priced time slot to discourage motorists from altering their speed in an attempt to avoid higher charges. Essentially, the system works by using a dedicated short-range radio system to deduct charges from CashCards purchased by motorists and installed in a so-called "In-vehicle Unit" or IU. The cards are available in various amounts from convenience stores, automatic teller machines, and petrol stations. IUS were issued free to all

registered vehicles at the beginning of the program and installed (free) by approved workshops. IUs are different for different types of vehicles (since different types pay different prices) and are glued on windows of vehicles. (There is a special type for motorcycles.)

When a vehicle approaches a zone subject to ERP, its IU is electronically queried (in order to check its type and determine the applicable price), and the correct amount deducted from its CashCard, with the amount remaining being displayed to the driver. Violations – entry without paying (no IU, no CashCard, insufficient money to pay left on card) – are detected electronically and photographs are taken of the rear license plate of the vehicle, and the owners fined accordingly. The reported rate of violations, however, is only 0.25%.

Interestingly, revenue received from ERP is considerably less than that under the earlier schemes, in part because prices are lower. As this indicates, Singapore views road pricing not as a way to raise revenues but primarily as a means of managing traffic.

Source: Menon and Keong (1998)

Local Business Taxes

Many countries, including China, impose local business taxes in various forms.¹⁸ However, most local business taxes, while they often produce substantial revenue, do not score highly on most other criteria. Few such taxes are equitable. Almost none are neutral. Most accentuate rather than reduce disparities between localities, giving most to those who have most -- though this may of course make such taxes especially attractive to metropolitan areas. Most lend themselves to tax exporting, thereby violating the principle that those who pay should be those who benefit. All too many are costly to administer, especially taking into account the cost of compliance and the facility with which such taxes tend to become essentially discretionary in operation and hence the basis for corrupt transactions.

Despite such criticisms, local governments always want to impose taxes on local business. Such taxes are popular with officials and citizens alike for several reasons. First, they often produce substantial revenue, and in particular they also tend to provide a much more elastic source of revenue than, for example, property taxes. Second, since no one is quite sure of the incidence of such taxes, assuming or asserting that they are paid by someone other than local residents is easy. Third, in many countries, local governments have much more discretion over the rate, base, and application of such taxes than of any other form of taxation. For this reason, local business ‘taxes’ (including various forms of direct government involvement in business, as

¹⁸ See Bird (2003). The business tax in China is discussed in e.g. Wong (2003) and Hong (2003).

in China) often constitutes the most readily available source for cities to finance urgent expenditure needs.¹⁹

Moreover, there is a good economic case for at least some local business taxation as a form of generalized benefit tax. Specific public services benefiting specific business enterprises should of course be paid for by appropriate user charges (and to some extent land taxes), as argued earlier, but where recouping the marginal cost of cost-reducing public sector outlays through user charges is not feasible, some form of broadly-based, general levy on business activity may well be warranted. This argument, however, lends little support to local taxes on any one business input, whether labour (payroll tax) or capital (corporate income tax or property tax). Instead, what this line of reasoning suggests is that a broadly based levy neutral to factor mix, such as a tax on value added, should be imposed. In particular, the most appropriate form of VAT for this purpose is one levied on the basis of income (production, origin) rather than on consumption (destination). Compared with a conventional VAT, such a tax – sometimes called a business value tax (BVT) -- has three important distinguishing features. First, it is levied on income, not on consumption, that is, it is imposed on the sum of profits and wages or, to put it another way, on investment as well as on consumption. Second, it is imposed on production, not on consumption, that is, it is imposed on an origin not a destination basis, and hence, as is appropriate for a benefit tax, taxes exports and not imports. Third, it is assessed by the subtraction (or addition) method on the basis of annual accounts rather than on a transaction or invoice credit method (and can thus be enforced at least in part on the basis of a higher-level enterprise profits tax).²⁰ While a great many technical issues obviously need further thought and discussion, moving toward a local business tax of the BVT type as, for example, Italy did recently (Bordignon, Gianni, and Panteghini 2001), followed to some extent by Japan in 2004 (see Box 4) is one avenue that China may wish to explore further.²¹

¹⁹ Although this point cannot be discussed in detail here, it is assumed here that the ‘business of government is not business but government’ and that city governments facing tasks of the magnitude of those facing in China should not be dissipating their efforts and resources by trying to run factories and shops.

²⁰ For a (correct) argument that profits taxes should be imposed only by higher-level governments, see e.g. Wong and Martinez (2002)

²¹ An alternative approach might be simply to rationalize the existing set of (often presumptive) levies imposed on business, but this path seems most suitable for smaller local authorities (Kelly and Devas, 2001).

Box 4**Local Business Taxation in Japan**

Until 2004, Japan's regional governments (prefectures) impose an Enterprise Tax on most non-agricultural businesses, generally on the basis of income as computed for the national Corporation Tax, although a gross receipts basis was used for electricity, gas, and insurance companies and prefectures could use other bases such as the number of employees or the amount of capital if they wished to do so. The base attributable to the prefectures in which any taxpayer had places of operation was determined by prorating the total tax base (e.g. as reported for national Corporation Tax) generally on the basis of the number of employees. The standard tax rate was set nationally and ranged from 4% to 9.6% on taxable income over 10 million yen (or 1.3% for those levied on the basis of gross receipts). However, prefectures could impose higher rates up to the limit of 110% of the standard rates. The tax was collected by the prefectural governments.

In part because of Japan's prolonged recent recession, many companies reported losses and hence paid no Enterprise Tax, thus decreasing local revenue. In response, a new form of local business tax was introduced this year to change the tax base (though only for corporations with capital greater than 100 million yen) to one less sensitive to economic fluctuations. The key element in the new tax base is the sum of salaries, net interest, net rent, and gross income --- which is equivalent to the base of (an addition-type) value-added tax. This tax base is subject to a flat tax of 0.48%. In addition, a new Capital Tax is levied on paid-up capital (amounts invested and capital surplus) at a rate of 0.20%. The previous Enterprise Tax continues to be applied but at lower rates, ranging up to 7.2%, with prefectures now being permitted to impose rates up to 120% of the standard rates.

Of course, any tax on business, no matter how well designed, may undesirably weaken the link between taxpayers and those who benefit and consequently induce confusion about who is paying for what. To reduce such ill effects, as was mentioned earlier with respect to non-residential property taxes, it may thus be advisable to set limits on the rates of such taxes to prevent both excessive tax exporting (e.g. by setting a ceiling rate) and tax base shifting or "beggar-my-neighbour" policies (e.g. by setting a minimum rate).

Intergovernmental Transfers

Even the largest cities may need fiscal transfers from higher-level governments when local public services spill over municipal boundaries so that local decision-makers will take appropriately into account benefits that accrue to non-residents. Such a grant should be conditional to ensure the funds are spent on the service that generates the externality and be matching -- that is, with some local government contribution -- to reflect the extent of the externality. Some externalities may be internalized within an urban jurisdiction if boundaries are extended to include all of the users of the service. As noted earlier, however, in some respects the benefits of an internationally competitive metropolitan area extend beyond its boundaries to the

whole country. Some transfers from central governments may thus be justified for local functions that contribute to international competitiveness.

In principle, the only other kind of intergovernmental transfer that large metropolitan areas should receive may be in the form of some kind of “capitation payment” for such nationally important services as education, health, and social security and assistance if these are provided in whole or in part at the local level. Large metropolitan areas generally have much larger (per capita) tax bases than smaller urban or rural areas because of their high level of economic activity and higher densities of residential, commercial, and industrial development. Although the costs of services and the need for services may be higher than elsewhere also, in both principle and practice transfers are likely to be considerably less important for large metropolitan areas than for other local governments. Indeed, in countries with wide regional economic disparities, there seems to be no reason why the wealthiest regions (including large metropolitan areas) should not be able to raise and spend most of their budgets themselves – although even they seem likely to remain to some extent transfer-dependent if they are charged with financing extensive social services. As always, any transfers that they do receive should be carefully designed to ensure both that local decision-makers remain subject to a hard budget constraint and to foster accountability.

Financing Infrastructure

In many ways the key urban finance problem confronting many Chinese cities right now is how to finance infrastructure (Wong, 2003). In many developing countries it has long been common to finance large metropolitan capital works essentially from central funds. As a recent detailed study of the effect of central government financing of the metro in Santiago, Chile (Kain and Liu, 2002) demonstrates, however, this practice may result in both increased regional inequality and distorted metropolitan growth. In general, metropolitan infrastructure should be financed locally, and often by borrowing, as discussed below. In a number of countries, however, in part because of restrictions on local borrowing (and on local revenues in general) municipalities are increasingly turning to the private sector to finance infrastructure costs in new developments as well as to improve existing infrastructure in areas already developed. Development charges and public-private partnerships are two ways that the private sector has

become involved in infrastructure financing. Both methods are used more widely in large metropolitan areas, where infrastructure costs tend to be particularly high. While some Chinese cities have had sometimes considerable experience with variants of some of the approaches sketched in this section, this discussion focuses not on the specifics of those experiences but rather on some important general points – notably that, contrary to what many seem to think, there really is no such thing as a ‘free lunch’ when it comes to financing infrastructure. Someone always pays, and it is critical to ensure that the right people pay the right amounts if the right infrastructure is to be built in the right places at the right times.

Borrowing.

In many countries, local governments are not permitted to borrow to meet operating expenditure requirements. They are, however, sometimes permitted to borrow to make capital expenditures. Where the benefits of a capital investment (for example, the construction of a water treatment plant) are enjoyed over a long period of time, say 25 years, it is both fair and efficient to pay for the project at least in part by borrowing so that the stream of benefits matches the stream of costs through the payment of debt charges. Nonetheless, local access to capital markets is often heavily restricted in developing countries.

In countries in which local governments can borrow directly from a functioning capital market (as opposed to ‘captive’ public-sector institutions), a municipality’s bond rating largely dictates the rate of interest (and other features) necessary to make its bonds marketable. Such ratings involve detailed assessments of municipal capacity to bear debt and to raise revenue even in depressed economic circumstances. On the whole, the size of a municipality is negatively correlated with the interest rate attached to the debt instrument, so that smaller local governments generally pay higher servicing costs than larger ones.²² For this and other reasons, large metropolitan areas tend to have more access to bond markets than smaller municipalities.

Provided there is no central subsidization of such borrowing (e.g. through guarantees, explicit or implicit), financing capital investment in this way is a good idea in principle. In

²² Smaller municipalities, for example, may only be able to borrow through a financing authority or state/provincial body, in part to reduce borrowing costs by pooling the borrowing requirements of different municipalities.

practice, however, many developing countries have run into substantial difficulties as a result of subnational borrowing and have thus imposed tight restrictions on it. While in the long run, as Rodden, Litvack, and Eskeland (2003) show, such restrictions should be loosened, in the case of China where many forms of ‘borrowing’ appear to have been widely and not always wisely used in the past (Wong and Martinez, 2002), it seems unlikely that this will or should happen in the immediate future. In part for this reason, cities all over the world have been increasingly turning to more innovative methods of infrastructure finance, as they have to some extent in China also.

Development Charges.

For instance, development charges (also known as lot levies or exactions) are widely used by municipalities in Canada and the US to pay for infrastructure (see Box 5). A development charge is a one-time levy imposed on developers to finance growth-related capital costs associated with new development (or, in some cases, redevelopment). These charges are levied for works constructed by the municipality, and the funds collected are used to pay for the infrastructure made necessary by the development. The rationale for charging developers for such costs is that ‘growth should pay for itself’ and not be a burden on existing taxpayers.

Box 5

An Example of Development Charges

Development charges are employed (under different names) by many local governments in Canada and the United States to pay for infrastructure associated with new development. Charges are imposed for works made necessary by the development – e.g. expanded roads or new schools – when those works are constructed by the local government. Development charges are imposed in addition to other requirements imposed on developers such as requiring some of the land to be set aside for parks (or a cash-in-lieu payment instead).

While the precise pattern of charges varies considerably from city to city, the following charges were imposed in August 2004 in Mississauga, a city of 600,000 adjacent to Toronto. Actually, five different local government bodies impose development charges in Mississauga:

With respect to non-residential development, the city imposes charges of over \$46,373/hectare for storm water management and for other services charges of \$33.31/sq.mtr. for industrial development and \$41.00/sq.mtr. for non-industrial development. At the same time, the Region of Peel (the upper-tier local government within which the City is located) imposed charges of \$28.34/sq.mtr. on industrial and \$39.30/sq.mtr. on non-industrial, and the two local school boards – Peel District Board and Dufferin Peel Catholic Board – impose additional charges of \$1.72/sq.mtr. and \$3.44/sq.mtr. respectively.

The charge imposed on residential development by the city for storm water management is the same as that on non-residential development but the charge for other services varies with the type of development -- \$3,333.53/unit for ‘small apartments’, \$6,410.65/unit for apartments, and \$8,974.90/unit for other residential (mainly single-family houses). Peel Region similarly varies its charges, imposing \$7,062.55/unit on other residential and lower amounts

on apartment units. In contrast, the two school boards impose uniform charges on all types of residential units of \$855 for the Catholic Board and \$1281 for the Public Board. Finally, GO Transit, a regional public transportation agency, imposes charges that again vary by type of property, up to a high of \$337.95/unit for other residential.

Other levies on developers that are sometimes imposed include land dedications that require the developer to set aside land for roadways, other public works, school sites, or for environmental reasons; parkland dedications that require a portion of the land used for development to be set aside for parkland or a cash payment in lieu of parkland be made; density bonusing, under which developers are granted higher densities in return for meeting conditions such as providing day care, preserving an historic building etc.; connection fees to permit developers to buy into existing capacity of water and sewer facilities; and over-sizing provisions (sometimes called front-end financing) that require developers to provide more infrastructure than is strictly required for their development. In some cases, local governments agree to recover part of the costs on behalf of the developer from future owners.

Studies that have investigated who ultimately pays development charges generally conclude that who bears the ultimate burden of such charges – the purchasers, developers, or pre-development landowners – depends largely upon the demand and supply conditions in the market for new housing (Slack and Bird, 1991). Over the long term, however, it seems likely that most charges imposed for new housing or industrial developments are borne by the new owners. This is presumably true even when such charges are as many and as heavy as is reportedly true in cities such as Shanghai. If properly implemented, such development charges can act, in effect, as a form of marginal cost pricing and hence induce more efficient development patterns and discourage urban sprawl. To do so, charges have to be differentiated by location to reflect the different infrastructure costs. Unfortunately, few instances of such appropriately differentiated charges can be found in practice: for instance, the Shanghai system set out in Hong (2003) would not pass this test.

Public-Private Partnership.

Shanghai also offers many examples of Chinese variants of ‘public-private partnerships’ as they have come to be called. Under this approach the private sector is even more directly involved in the provision and financing of public sector services through an explicit (or in the

Chinese case apparently sometimes an implicit) partnership agreement. Such partnerships involve the direct participation of one sector in a venture controlled by the other sector. Both partners contribute funds or services in exchange for the enjoyment of certain rights or future income. Unfortunately, in many cases in China it is not at all easy to tell who or what is 'private' or 'public' in such arrangements, let alone to work out if risks and rewards are being appropriately allocated (see Box 6).

Box 6
Some Problems with 'Public-Private' Development Schemes

In some cities, extensive use has been made in recent years of quasi-public companies as vehicles for investment in public infrastructure and real estate development. The results have not always been as expected. In Guangzhou, for example, while substantial investment in a subway and the roadway system has alleviated traffic congestion, equally substantial investment in real estate development has resulted in high vacancy rates. In October 2002, for instance, the reported vacancy rate of residential housing in Guangzhou was over 20 percent and for the province of Guangdong as a whole, over half the vacant units had been vacant for over a year. Most of the investment in both infrastructure and housing was financed by bank loans, in many cases with repayment capacity estimated on the basis of expected sales of appreciated land leases. In Guizhou province, where the situation is similar, many such loans appear to be in difficulty.

For a number of years many local governments in a number of provinces have been dependent on the sale of such leases for a considerable fraction of their revenues and have at the same time been increasingly involved in land and real estate development. Local government's role is critical to the acquisition of land for development, especially when the conversion of farmland is involved. A lot of money can be made in these activities, and governments have not been slow to move into not only developing serviced land but even building shopping complexes and housing developments. Unfortunately, exactly what has been done, by whom, and who bears how much risk is almost completely unknown, since all these activities are conducted through companies and corporations in which various governments are involved but in ways that are murky and completely hidden from public scrutiny.

Despite the obvious risks in such involvement, arguably local governments in expanding urban areas have had little choice but to take the gamble, because they are responsible for financing infrastructure but have neither the tax resources to do so nor the authority to borrow. In 1986, Shanghai was authorized to borrow abroad for infrastructure investment. To make such borrowing feasible given the lack of local fiscal resources, the city was allowed to create the Shanghai Jiushu Company (SJC) as an independent economic entity to bundle together profit-making projects with public works, financing the works through borrowed funds to be repaid by the profits. The SJC's investments in hotels, factories, and so on were considered successful and many similar quasi-public companies were subsequently set up not only in Shanghai but in many other cities. Such activities are now one of the major components of the increasingly important 'off-budget' financing of urban growth in China, although no one has a clear idea of either their importance or their nature. Some of these companies seem intended mainly to provide employment or supplementary income for officials, but others may well be used to exploit government's monopoly of land acquisition and information about development plans, not necessarily for the benefit of the public.

While this system has certainly facilitated the provision of urban infrastructure in some Chinese cities, it has three major drawbacks. First, it exacerbates the already considerable lack of transparency in local fiscal matters, reducing the effectiveness of budgetary procedures and creating considerable opportunities for both waste and corruption. Second, by creating a strong incentive for government to engage actively in business, it both distracts government officials from their primary task of providing public services and also hinders market reform. Third, because what works in Shanghai or other growing coastal cities is much less likely to work in many inland cities, their attempts to follow the 'Shanghai model' are all too likely to end up saddling them with the debts of failed development corporations.

Source: Wong (2003)

Partnerships may involve private participation in public works or public participation in private ventures. Public equity in private undertakings is one form of partnership. Under such an arrangement, a local government becomes a partner in a private profit-making project in return for its assistance in establishing the project. For example, the government might provide property (usually land) or services in return for a share of the revenues. The private sector clearly gains from such an arrangement because its repayment to the public sector depends on the profitability of the venture: that is, the government shares the risk. On the other hand, the resulting uncertainty of the revenue stream to the local government is one reason such ventures are not common.

Perhaps the most common form of involvement of the private sector in the provision of public services around the world is one in which a private firm contributes part of the initial capital cost of a facility and operates it under the city's guidance for some years, ultimately transferring the facility to the municipality. Under this arrangement, the developer finances the facility and then recovers its investment through operating revenues. The government avoids the initial capital costs and gives up any profits associated with the operation but gets the facility in the end.

Another common arrangement is contracting out for services such as water and sewers, waste management, recreational facilities, and transportation. Empirical studies of such arrangements suggest that services are usually provided at a lower per unit cost (Kitchen 2002). Opponents of contracting out have argued that in some instances private-sector delivery is of lower quality and requires significant monitoring by the local government. Nonetheless, on the whole most evidence suggests that contracting-out – up to and perhaps including the extreme of privatization – is economically efficient. Efficiency, however, depends more on the existence of actual or potential competitive suppliers than on who owns the right (or obligation) to provide the service. Replacing a public monopoly with a private monopoly, for example, is unlikely to make things better and may make them worse. Competitive tendering promotes a competitive environment in which contractors are forced to be efficient.

In general, a principal advantage of public-private partnerships is that by relieving cities of the financial responsibility for up-front capital costs they enable needed infrastructure to be built even at times when government funding is constrained (Tassonyi, 1997). Partnerships let cities get facilities built without incurring explicit debt. The operation of facilities and programs by private or not-for-profit operators also reduces municipal operating expenditures and may perhaps enable additional revenue to be collected. Moreover, such operations permit the public sector to draw on private sector expertise.

Offsetting these potential gains, however, are several potential risks associated with public-private partnerships. For the private sector, for instance, there are risks that the regulatory framework could change and cause delays in the project. For the public sector, there is the risk that the public services provided may not be what the public wants or that the private sector may not be able to carry out its expected role. There is also a non-negligible risk in many cases that the long-run cost of private sector financing may turn out to be greater than the cost of public sector financing would have been (Slack and Bird, 1991).

Of course there are many more types of public-private partnership arrangements than described here. The precise details of how such arrangements are structured and how risks are shared will determine whether or not they will be successful from a public policy perspective. Based on experience in developed countries (e.g. with sports arenas) metropolitan governments must be especially careful if they enter into such arrangements not to end up assuming the ‘downside’ risk of projects while allowing their private partners to reap any ‘upside’ gains. As Glaeser and Meyer (2002a) show, we still have much to learn in the urban context about how best to privatize – or to put the point more generally, how to let the market into public service delivery in a relevant and useful way.

Conclusion

The key question is not *how much* government activity has to be financed but rather *what kind* of government activity has to be financed and who should and can finance it. An earlier survey of many of these issues (Bird and Slack, 2004) suggests that there is really no “best

practice” way to improve metropolitan governance and service delivery – neither any one system that fits all circumstances nor any necessary or inevitable progression in any direction. The points mentioned above at most constitute only a modest a first step on the long path toward working out the best answer to this question for any particular urban region. Nonetheless, a few general conclusions may be tentatively suggested;

- One important element, for example, appears to be a government structure that adequately encompasses the economically relevant metropolitan region, although the precise nature of the best structure for any particular region remains highly context-dependent in both theory and in practice.
- Another ingredient, as suggested earlier, is that metropolitan regions should be essentially self-financing. In the long run, viable solutions to the problems of metropolitan areas can be attained only by those who live there: they must, in the end, make the critical decisions, pay for them, and live with the consequences. Only thus – not by waving some magic central planning wand – can the right decisions ever be made, albeit probably slowly and painfully.²³
- Finally, and by no means least importantly, an appropriate fiscal structure is necessary both between the region and the rest of the country and within the region. Care should be taken both to avoid unduly subsidizing (or taxing) large urban areas and to price scarce resources – in particular the use of space and public services – properly.

Such conclusions may not seem very exciting or novel. But taking them seriously, and attempting to implement them appropriately, would actually be not only novel but almost revolutionary.

²³ As Meyer and Glaeser (2002, p.10) correctly say “...proper public policies will not persist (or will not be implemented adequately) unless the political institutions are designed to provide politicians with the right incentives to implement those policies.”

If China ‘gets urban finance right’ in these terms, it will avoid some serious potential problems its growth will otherwise generate and hence achieve a better life for its people, whether they live in metropolitan areas or elsewhere. While it may be particularly difficult to think through these issues in the Chinese context, because the formal system of governmental finance constitutes only part, and not necessarily the most important part, of the reality facing urban officials, the main message of the above discussion – that getting urban public sector prices is an important determinant of city size, city structure, city growth, regional economic dynamics, public service delivery, environmental degradation, and even national well-being – is so important that it is surely worth taking these issues seriously. The sooner this is done, the better for China.

It was argued earlier that urban success is increasingly likely to be critical to Chinese economic success in the modern world. This does not mean, however, that the national government should try to regulate the details of what cities do or how they do it. On the contrary, the national government should, first, focus on things that it can and should do to facilitate sound urban development – a more adequate interurban transportation system comes to mind – and, second, set the rules so that the decisions cities make will be not only in their own interests but also those of the nation as a whole. In particular, cities will, first, have to be given access to some good fiscal bases such as property and vehicle taxes and a better local business tax. Secondly, they will also have to have the freedom to use these resources in the way that they, and the citizens to whom they should increasingly become transparently accountable, see fit, provided those who make the decisions are also those who bear the consequences of mistakes. Thirdly, to make all this work, as many have argued earlier, an adequate and revised system of formal and transparent intergovernmental fiscal transfers will be needed. None of this will be easy to achieve, given where China is today.

But perhaps one may be modestly optimistic: China is a large, diverse and complex country with many cities which have had many different experiences. If there were ever a case in which it appears to make sense to ‘learn from below’, it is surely with respect to urban development and finance in China. If some of the basic ‘rules of the game’ shaping urban finance decisions can be changed, so that cities can express their obvious dynamism in more

constructive ways than devising new extra-budgetary schemes or ever more convoluted and obscure ‘partnership’ arrangements, some cities will undoubtedly come up with more creative and sustainable solutions to their problems that can then be emulated, with appropriate adjustments by others. The road to success, both urban and national, may well be to “let a thousand cities bloom!”

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