PSI Local and Regional Government (LRG)/ Municipal Sector

RESEARCH BRIEFING NOTE

Fiscal Contracts and Local Public Services: Bridging Tax Justice and Inclusive Cities for the New Urban Agenda

by Jerik Cruz, Researcher,
Public Services International (Local and Regional Government Sector)

Preface

Local and regional governments are increasingly asked to do more with less resources. They are at the forefront of territorial and urban policies and local economic development. They are in charge of the implementation on the ground of global frameworks such as the Sendai Protocol on Disaster Preparedness, the Decent Work Agenda, the Paris Agreement on Climate Change, the Sustainable Development Goals (SDGs), and now the New Urban Agenda. Yet, when it comes to accessing the resources to do so, austerity measures, tax avoidance, international loan conditionality, international trade and tax deals, and shrinking intergovernmental transfers increasingly strip them of the essential resources they need to finance and provide access to essential public services to urban dwellers and local communities.

How to square this circle? How can local and regional governments and their workers deliver much needed quality local public services under such constraints? Much of the discussion that led to the New Urban Agenda, the UN policy guidance for urban policy for the next 20 years has concentrated around inter-municipal tax competition, PPPs, city-based benchmarking for borrowing resources in the stock market and user-fee charges. PSI does not believe these are viable solutions that work for people, are socially just and conducive of decent employment and inclusion for all. This is why PSI consistently advocated all along for tax justice for local governments and communities as well as for progressive municipal fiscal systems.

PSI affiliates such as CUPE and the ASU have already picked up this issue and are active in developing policy for progressive municipal finance LRG/municipal unions can promote and use. This briefing note builds on these efforts and provide a set of political and practical options, recommendations and caveats for LRG/municipal unions and their members to make counter proposals and put alternative, progressive options on the table when they are told private financing, externalisation and austerity measures are the only way to finance local public services, including within the implementation of the New Urban Agenda. It is also meant to spur much needed debate PSI LRG/municipal unions members have a lot of expertise to contribute to.

We encourage PSI affiliates to contribute to the debate and email their comments on this Research Briefing Note to Jerik Cruz at **jpdcruz@ateneo.edu** *and Daria Cibrario, PSI Local and Regional Government Officer,* **daria.cibrario@world-psi.org**.

Daria Cibrario,
PSI LRG Sector Officer

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Jerik Cruz is Lecturer at the Department of Economics of the Ateneo de Manila University, the Philippines and a MSc in Development Studies from the Graduate Institute of International and Development Studies in Geneva, Switzerland. In 2016 during the course of his Master's Degree, Jerik pursued a research internship with the Local and Regional Government sector at Public Services International (PSI).

This research note summarizes the main arguments of the PSI's discussion paper "Fiscal Contracts and Local Public Services: Bridging Tax Justice and Inclusive Cities for the New Urban Agenda." The paper adopts a tax justice perspective in order to furnish a review of the various challenges and strategic responses for successfully funding the long-term attainment of fair, democratic and inclusive cities, in the light of urban development financing discussions associated with Habitat III and the New Urban Agenda.

The task of financing inclusive urban development has been one of the largest challenges facing the implementation of the New Urban Agenda (NUA)— yet Habitat III (HIII) discussions on this issue reveal an apparent dearth of concerns bearing upon tax and fiscal equity.

At no point since the 1990's have cities and urban regions been more prominent in the global governance community, but summoning the finance needed to meet the urban investment and service-delivery demands of the NUA and the Sustainable Development Goals will be no small feat. Estimated funding gaps for urban infrastructure investments alone range from an average of around $684-billion per year (as forecasted by Oxfam and Development Finance International), to $819-billion per year (by the World Bank), $867-billion per year (by the UN Sustainable Development Solutions Network), and even $1.66-trillion yearly (by UNCTAD).

Having brought together more than 40,000 people from various sectors in 167 countries, the outcomes of HIII have been particularly lauded for espousing a more comprehensive and holistic approach to the multifaceted dimensions of urbanization processes than during the 1996 Habitat II Conference, while giving historic recognition to the principle of the *"Right to the City"* for all urban dwellers at the forefront of the NUA's *"shared vision"* for urban development[1]. Yet as presently formulated, the final outcome document of the HIII falls short of addressing several of the most urgent problems affecting national and local public financing systems across the world. Examination of the evolving drafts as well as the final NUA reveals significant dilution of proposals aligning the outcome document with tax justice and fiscal equity concerns at local, national and global levels.

Instances of such neglect or dilution include:

- ***Intergovernmental fiscal relations***. Compared to the original May 6 zero draft, which explicitly committed to *"increased local government autonomy over taxes"* (paragraph 131) as well as a minimum 20% share of the national government budget dedicated to central-local fiscal transfers (paragraph 130)[2], the final draft of the NUA instead adopted considerably more generic language of supporting *"appropriate policies and capacities that enable sub-national and local governments to register and expand their revenue base"* (paragraph 134) and promoting "sound and transparent systems of financial transfers" (paragraph 135).
- ***Institutional constraints on tax capacity.*** While HIII discussions recognized various governance challenges hounding local fiscal systems in the Global South, such institutional constraints on tax capacity as well as corresponding measures to address them have not been reflected in statements and outcome documents related to the HIII process. By comparison, during the 2015 International Conference on Financing for Development at Addis Ababa, considerations of the importance of *"political will", "high-level political support", "broad-based dialogue,"* and *"building coalitions for reform"* made appearance in the Addis Tax Initiative, a parallel effort by 30 countries and international organizations to promote stronger domestic tax systems[3].
- ***Tax competition.*** If the original zero draft of the NUA demonstrated an understanding that the *"standardization and publication of permitting, registration and taxation processes is a crucial first step, along with labor and environmental standards* [of creating an enabling and fair business environment]*,"* (paragraph 60) such clauses have been stricken from subsequent versions of the Habitat III outcome document. This stands in contrast to the 2015 Addis Ababa Action Agenda, which acknowledged the need to address *"excessive tax incentives"* and similar *"harmful tax practices,"* not only but particularly in the extractive industries (paragraphs 26, 27).
- ***Global tax avoidance and evasion.*** While the original zero draft of the NUA expressly stated that, *"Tax avoidance should also be addressed along with considering the insertion of anti-abuse clauses and transparency mechanisms"* (paragraph 137), any such mention of the challenges wrought by global tax avoidance and evasion on

urban financing (whether directly upon local tax takes or the availability of central-local transfers) has been removed in subsequent drafts of the agenda. From one form of global tax avoidance alone (i.e. transfer mispricing), losses to developing country governments in 2015 have been estimated by UNCTAD to be on the order of roughly *one-third* of total corporate income tax obligations (i.e. $100-billion)[4].

- ***Diminished policy space from investment agreements:*** Despite growing threats to states' policy space resulting from the expansion of Investor-State Dispute Settlement (ISDS) mechanisms in *"next generation"* investment agreements, such policy space curbs, and their potentially disruptive effects on public financing efforts, have continued to be neglected throughout the HIII process. This is in the midst of growing numbers of tax-related cases lodged through such ISDS tribunals, which as of 2016 affected at least 24 countries in over 40 separate lawsuits[5]. Local and regional governments are no less threatened by ISDS arbitration: indeed, more than 50% of ISDS claims thus far have resulted from measures adopted by subnational governments and specialized regulatory agencies[6].

- ***Fiscal austerity:*** Even before the wave of fiscal adjustment following the Global Financial Crisis of 2007-2008, local and municipal governments across the developed and developing world have been both victims as well as early adopters of austerity measures, whether through retrenching local public services, increasing regressive taxes, and privatizing public assets and services, all amidst substantial cuts in central-local transfers[7]. Strikingly, in March 2016, the Mexico Declaration for Habitat III acknowledged the role of fiscal austerity measures in, *"leading to underinvestments in the necessary infrastructure for urban development.*[8]*"* But despite this, the threat posed by fiscal austerity to financing inclusive cities has not been featured nor addressed in the NUA itself.

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While there are no silver bullets for strengthening local and municipal revenue-raising systems, local governments that have been empowered by effective fiscal decentralization, can avail of several local tax options which can contribute significantly to their prospects for publicly financing inclusive cities.

In fact, several of these options have already received widespread attention throughout the 2015 UN FfD Conference and the 2016 HIII process— including effective fiscal decentralization, registering and expanding local revenue bases via multipurpose cadasters, local taxes, land value capture mechanisms, and so on[9]. Yet in particular, deepening the support of national governments, international organizations like the IMF and OECD, bilateral aid agencies, and the global community of tax practitioners, for the following measures can reap major dividends for widening the fiscal space of local governments, especially in the developing world:

- ***Property taxation:*** Widely considered as the *"ideal local tax,"* property taxes are almost, without exception, delegated to local government control, and yet remain chronically under-used in developing countries[10]. But if politically difficult to implement, both renewed national and international commitment to municipal financing issues because of HIII, and the administrative impacts of numerous technological innovations (e.g. GIS, digitalization, etc.), have appreciably increased the prospects for heightening property tax takes in lower-income nations[11].

  Concrete experiences suggest that successful property tax improvements are more likely to occur when (a) property taxes are explicitly framed as a benefit tax, establishing visible links between higher tax rates/collection and increased public services and infrastructure provision, (b) they are embedded within broader programs of accountability-enhancing public sector management reforms, (c) tax reforms are implemented in a comprehensive and strategic manner, giving particular priority to the quality of tax administration, and (d) both sustained political commitment and technical capacity are manifested among key local leaders and stakeholders[12].

- ***Local business taxes:*** While understandably seen by economists as inefficient and distortive, local business taxes are likely to remain a popular complement to the property tax due to their greater responsiveness to economic growth, their political expediency as well as their tendency to be seen as a local benefit tax for business actors. Moreover, in recent years, leading tax scholars have paid more attention to proposed Business-Value Taxes (BVT)— business levies similar to value-added taxes, but imposed on production instead of consumption, on origins (i.e. exports) rather than destination (i.e. imports), and based on annual accounts of the factors of production employed by businesses rather than on transactions and invoices[13]. However, to forestall excessive tax competition and exporting, it may be advisable for central governments to impose both business tax rate floors and ceilings across subnational jurisdictions and municipalities[14].
- ***Local income surtaxes:*** While locally-administered income taxes are infrequent, the application of local surtaxes or flat-rate, locally-determined *"piggyback taxes"* to higher-level income taxes represents an increasingly-viable revenue option in large developing-country urban areas. Importantly, such a flat-rate tax would not conflict with the promotion of progressivity in central personal income taxes, and due to their visibility, could also fulfill the function of an accountability-promoting subnational benefit tax between local officials and their resident-taxpayers[15].
- ***Local excise and health/ environmental taxes:*** When formulated as a benefit tax for public infrastructure development, excise taxes represent a revenue option that can yet be harnessed to a greater degree in developing countries. On one hand, if subnational governments have been assigned with public transport infrastructure responsibilities (e.g. road construction/ maintenance), the adoption of vehicle-related excise taxes (e.g. vehicle licensing fees, fuel taxes) has potential as an easily-administered, growth-responsive subnational revenue stream. Similarly, imposing excise taxes on *"sin"* products such as alcohol and tobacco has also received increasing attention as another potential benefit levy, particularly for generating revenue for health and education spending[16].

  Even beyond these, subnational governments may be able to implement or may be able to share more significantly in the returns from direct product taxes (e.g. levies on oil/ gas products), subsidies (e.g. moving subsidies from coal-based to renewable energy), and taxes on harmful substances and activities (e.g. carbon taxes, air pollution fees) for advancing health and environmental objectives while raising additional revenues for their own expenditure needs[17].
- ***Land value capture mechanisms:*** Throughout HIII, few local revenue-raising instruments have gained as much attention as land value capture financing. The common idea undergirding such mechanisms is that local and municipal governments can and should *"capture"* (whether by taxes or fees), the incremental and unearned increases in land values that result from public investments and/or infrastructural enhancements, which would otherwise accrue to private landowners[18].

  If harnessed, not just for revenue-raising purposes, but also as a means for curbing gentrification processes, value-capture instruments are an important addition to local governments' portfolio of instruments for financing inclusive and sustainable urban development. Yet in practice, the tasks of (a) determining land values in themselves, (b) isolating the land value impacts of public investments from all other factors, (c) projecting land value appreciation from investments, (d) assembling the requisite political, institutional and technical capacities, and (e) preventing the factors which may lead land value declines instead of appreciations (e.g. from congestion, noise, and other infrastructure effects), have all remained difficult to implement on the ground, potentially inhibiting the immediate applicability of such measures in developing countries[19].

- ***User charges and fees:*** Viewed in some quarters, along with property taxes, as *"the most appropriate revenue for local governments,*[20]*"* attempts to raise user charges and fees for public services and infrastructure can threaten to deny access to such services to poorer and lower-income demographics, and can easily conflict with the *"Right to the City"* approach of the NUA.

  This is not to say, however, that incremental increases in user charges have no place in subnational fiscal strategies, especially as a means of promoting more sustainable resource consumption. Based on local fiscal reform experiences, however, initiatives to impose such increases would work best if adopted in gradual fashion, are preceded by pilots and sufficient evaluation before wider adoption, are formulated through accountable and collaborative arrangements between local governments, users and taxpayers (e.g. via the establishment of user committees), and feature fine-tuned pricing arrangements for preventing low-income and vulnerable populations from being excluded from the enjoyment of services[21].

Whether any such local tax measures will be adopted or even deliberated will fundamentally depend upon whether sufficient revenue-raising powers will be devolved to subnational governments as part of long-delayed or uneven fiscal decentralization processes[22]. Though increasing local governments' share of the national public budget beyond current levels is imperative (i.e. with the 5th Congress of the United Cities and Local Government recommending allocating at least 20% of total public budgets to local governments[23]), it is equally crucial to upgrade local tax authority and fiscal autonomy to levels significantly above the present dispensation. Granting local governments such heightened capacity to finance inclusive development from their own-source revenues will be decisive to allaying the perennial problem of *"unfunded mandates"* left over from administrative decentralization processes.

Yet even beyond local and national levels, maximizing public revenue streams for financing inclusive cities will necessitate not only the adoption of individual revenue-raising measures, but multi-level reform to harmonize the alignment of global and local tax-related systems. Confronted with the global-level fiscal issues enumerated in the previous section, reform of the global regimes for corporate taxation, investment protection, tax cooperation and international public financing comprise no less decisive factors for generating an integrated enabling environment for national and local domestic resource mobilization.

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Pursuing each of these revenue options will prove demanding and protracted processes— yet linking increases in national and local tax measures to the establishment of *"fiscal social contracts"* between governments and taxpayers, can serve to spur long-term enhancements in public finance systems, fiscal stability, accountable governance, and pro-poor service delivery.

Against technically-oriented approaches to tax reform, tax regimes should be seen as fundamentally *relational, institutional* and *negotiated* phenomena between state authorities and taxpayers. In this regard, governments' entering into fiscal contracts with citizens— defined as mutually-beneficial arrangements where *"citizens accept and comply with taxes in exchange for government providing effective services, the rule of law and accountability"*[24] — has often represented one most reliable means to strengthening domestic taxation systems over the long term[25]. Indeed, several observers have argued that such fiscal contracting dynamics have been at play in advances towards increased revenues, more redistributive tax burdens, and increased pro-poor public spending regimes across Latin American countries from the 1990's until the late-2000's[26]. More recently, research on Mexican municipalities has also attested to the possibility of subnational fiscal bargaining processes, with attempts to raise local taxes typically being preceded or accompanied by improvements in accountability and services in order to secure increased citizen trust, satisfaction, and tax compliance[27].

The bargaining processes through which such fiscal social contracts are established can unfold in both direct (e.g. formal fiscal dialogues and negotiations, lobbying) as well as indirect (e.g. protests, strategic signaling) fashion; and can also be crystallized via formal (e.g. earmarking) or informal (e.g. political pledging) means[28]. Yet most importantly, the adoption of proactive measures by governments to foster transparency, trust, informed participation, and constructive bargaining over revenue measures, public spending, and overall fiscal governance has usually been found to catalyze the formation of fiscal contracts and long-term *"virtuous circles"* of heightened taxation, improved governance and better public services[29].

Experiences with governance-focused efforts with fiscal reform offer a number of lessons that can help government officials, civil society organizations and trade unions ensure that local and national public financing systems are anchored upon the cultivation and upkeep of fiscal contracts between government officials and citizen-taxpayers. The following are especially noteworthy[30]:

- Encouraging ***open, inclusive and participatory negotiations*** over national/local revenue-raising and spending policies that are responsive to citizens' demands can be a major catalyst for initiating constructive bargaining processes between state officials and taxpayers. Without such negotiations, local revenue-raising efforts are far more likely to be bogged down by unneeded resistance from taxpayers as well as unwillingness to comply with tax obligations.
- Promoting ***transparency and accountability*** in fiscal governance is critical to strengthening the legitimacy and credibility of local governments in dealings with taxpayers and citizens. Oftentimes, adopting advance transparency and accountability measures by local governments (or alternatively, visible public service improvements) can serve as a useful first move for shoring up a modicum of trust between public officials and taxpayers.
- More directly ***linking taxation to improved public services*** and an ***agenda/ vision for shared prosperity*** has been documented to be a strong motivating factor among taxpayers for complying with higher taxes as well as their general willingness to pay taxes. Especially at the local and regional level, formulating revenue measures as benefit taxes and making judicious use of revenue earmarking— when implemented effectively and honestly — can prove highly beneficial as strategies to secure public acceptance for tax measures.
- Increasing the ***visibility and directness*** of the proposed tax measures is critical to ensuring that both taxpayers and local governments are sufficiently incentivized to engage in tax bargaining. Oftentimes, citizens are unmotivated to negotiate simply because they are unaware of how much taxes they are actually paying (e.g. with consumption taxes), which, in turn, fails to compel governments to link increased taxation to better governance and service provision. Fostering reliance on direct taxes (e.g. income, property) thus makes it far more likely that fiscal bargaining take places, which can be reinforced by measures to make the burdens of indirect taxes more publicly visible (e.g. adding sales taxes to prices at the point-of-sale).
- Ensuring that tax measures and enforcement practices address citizen-taxpayers' ***perceptions of fairness and equity*** as well as other social norms can be highly significant in orienting citizens to building a culture of tax compliance both within and between groups of different taxpayers. The legitimacy of the tax system is heavily undermined by existence of perceived free-riders, and addressing such behavior is crucial in two respects: both with the informal business sector (vs. formal businesses), but even more so with regards to elites (vs. non-elite taxpayers).
- Fostering ***citizens' awareness, capacity and organization*** in tax matters can help democratize public discourse on technical tax debates as well as enabling taxpayers and their representatives in civil

society, parliament and trade unions to competently and collectively bargain around tax-related matters. Given the relative neglect of tax issues in civic discussions, capacity-building by organizations in the trade union and civil society sectors, as well as the formation of taxpayers' associations and community-oriented tax clinics, can do much heighten the robustness of informed engagement on fiscal concerns and to ensure that such engagement takes upon a collective, rather than individualistic, character.

None of these lessons and their implications on processes for local revenue-raising will result in reform headway if no political coalitions are present at key institutional arenas[31]. Though more often touted for its seminal participatory budgeting scheme, the public finance experience of Porto Alegre, Brazil since the late 1980's, reveals the centrality of effective, cross-class coalitions in driving local *"fiscal revolutions"* combining progressive revenue-raising burdens, pro-poor patterns of public spending, and accountable, democratic, and competent governance[32]. Winning the mayoralty of a fiscally-incapacitated Porto Alegre government in 1988, members of Brazil's Workers' Party (PT) initially deepened links with grassroots community movements via neighborhood meetings to promote greater public participation in annual municipal budgeting decision-making and overseeing local public spending procedures. This engagement was expanded to a broader set of local governance issues starting in 1993— such as but not limited to economic development and tax systems, and city organization and urban development—, which established organizations (e.g. unions, business associations) and middle-class professionals could also engage in.

Throughout this entire process, the administrative apparatus of the Porto Alegre government was reorganized, with critical municipal units such as the Cabinet of Planning and the Community Relations Coordination being reconsolidated under the Mayor's office to circumvent clientelist networks and to institutionalize participatory processes in a new bureaucratic structure. Parallel to this, the fiscal space of the municipal government increased by an astounding 338% from 1988 to 2004, particularly due to massive boosts in property tax (416%) and services tax (172%) collections as well as significant growth in fiscal transfers over the same period. In paving way for fiscal expansion, participatory budgeting mechanisms proved indispensable as venue for marshalling public support for local tax reform, for aligning spending patterns to pro-poor objectives, and for demonstrating transparency, accountability and responsiveness to the demands of constituents[33].

Akin to the PT's success in consolidating a new local fiscal contract in Porto Alegre, and ushering a subsequent local revolution in public finance, left-of-center political parties, trade unions, civil society organizations and community movements will have vital roles as public-interest brokers between the broader concerns of tax justice, local democratic accountability, the need to finance and govern cities in an increasingly-urbanized world, and the poor, working and middle-class populations all at risk of being denied their fair share of the wealth and opportunities in the cities of the future. Though there are no quick fixes for financing inclusive urban development, a variety of revenue-raising options nonetheless lie within reach, which if undergirded by equitable fiscal contracts, can make substantial progress towards improving local fiscal space, governance, and pro-poor public services. In the years to come, it will be efforts to facilitate such contracts that will be at the heart of turning the promise of sustainable, inclusive and fair urban development for all the world's cities into reality.

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PUBLIC SERVICES INTERNATIONAL

For more information and resources:

Public Services International (PSI)
45, avenue Voltaire
01210 Ferney-Voltaire - FRANCE
Tel: +33 4 50 40 11 66

lrg-municipal@world-psi.org

www.world-psi.org