

# Fiscal decentralisation and inter-governmental transfers

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# Outline

1. Rationale for decentralisation
2. Revenue assignment
3. Fiscal transfers
4. Are the theory and practice in sync?  
→ Next sessions

# Why decentralise?

Two main theoretical arguments:

- Economic argument
  - Allocative efficiency
  - Principle of subsidiarity
- Political argument
  - Accountability and democratic development
  - Distributive justice

These theoretical benefit, or “promises”, are not necessarily realised in practice (see Smoke, 2013):

- Missing premises: functioning electoral systems, democratic participation, dialogue between citizens and elites (Uganda)
- Administrative capacity (Peru) and quality of public services (Brazil)
- Accountable to whom? Centre (fiscal transfers) or citizens (taxes)

# What to decentralise?

- Deconcentration, delegation, devolution
- Expenditure assignment
  - Equity and redistribution
  - Stabilisation
  - Efficiency in the allocation of resources
- Revenue assignment: what taxes to assign at which level and what functions for each tax
  - Ex 1: Property tax rate and assessments
  - Ex 2: Commuters
  - Ex 3: Mobile tax bases (consumption)
- Other considerations: national unity, ethnic diversity, subjective preferences on power sharing, ...

# Principles of revenue assignment

What is a good local tax?

1. Adequacy
2. Buoyancy
3. Stability
4. Efficiency
5. Equity
6. Autonomy
7. Administrative feasibility
8. Political feasibility
9. Integration / consistency

# What taxes to decentralise?

Principles for the “revenue assignment” problem:

- **Adequacy**
- Buoyancy
- **Stability**
- **Efficiency**
- **Equity**
- **Autonomy**
- **Administrative feasibility**
- Political feasibility
- Integration / consistency



## Local taxes:

- **Property tax**
- Licenses, fees and user charges
- Some indirect taxes

## National taxes:

- Income taxes
- Most consumption taxes (VAT)
- Trade taxes

# Tax compliance

- Complying with tax laws VS Evasion & Avoidance
- Determinants of compliance:
  - Deterrence: probability of audit, sanctions, enforcement
  - “Tax morale”: 5 mechanisms
  - Practical constraints / measures to facilitate compliance
    - Taxpayer education, segmentation of RA, risk management and audits, ...
- Compliance varies by context and tax type
- Challenges to increase compliance
  - Costs and benefits of enforcement
    - Is it desirable to aim for 100% compliance?
    - Is 100% compliance even feasible?
  - Very low audit rates throughout the world
  - Capacity constraints
  - Low level and quality of public service delivery
  - Quasi-voluntary compliance
  - High-resistance local taxes: property tax

# Sub-national financing mix

- Property tax is a good tax, but it is underused
  - 40% of local taxes, but 10% of local expenditure
- Gap between revenues and expenditures
- Fiscal transfers are often the main source of revenue
  - How to design a good transfer?
  - What are the effects of transfers in practice?
  - Do transfers crowd out taxes? (‘earned’ VS ‘unearned’)
- Other revenues: aid, natural resources



# How to design a good transfer?

# Transfers design

Two main dimensions in transfer design:

- Vertical imbalances: how much of the centrally collected revenue should be redistributed at the sub-national level
  - Spending responsibilities must be proportionate to available revenues
  - With low tax revenues, transfers are essential
- Horizontal imbalances: how are these resources distributed across regions
  - Equity in the distribution of resources at the same level of government

# Intergovernmental relations

- Design: approach to the distribution of power
- Implementation: influence of central government (positive or negative)
- Multiple levels of sub-national governments
- Multitude of actors involved:
  - Local government oversight ministries (Ministry of Local Government, Home Affairs, Interior, etc.)
  - Coordinating ministries with a broad mandate to oversee an aspect of public sector operations (Ministry of Finance, Planning, Civil Service, etc.)
  - Special purpose ministries (Ministry of Rural Development, Urban Development, Special Areas, etc.)
  - Ministries involved in service delivery (education, health, transport, etc.)

# Revenue sharing formulas

- Whole tax pot, or specific tax types.
- Conditionality on service delivery
  - National objectives + political preferences
  - Is it feasible? Poor regions performing poorly
- Matching grants
  - Variable matching rates:
    - Higher for higher central interest
    - Higher for lower local enthusiasm and ability to pay
- Block grants
  - Amount decided ex ante with a formula based on:
    - Expenditure needs and fiscal capacity
    - Measures difficult to manipulate (ex.: population)
  - Incentive problems or “soft budget constraint”
  - Information problems: small tax base or low enforcement?