Fiscal Decentralisation

Allocation of Revenue

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(I)

General Considerations on Revenue Allocation

Based on: Bahl, R and Bird, R.(2008). Subnational Taxes in Developing Countries: The way Forward.
And on: (2010). Fedelino, A. & Ter-Minassian T. Making fiscal Decentralisation Work: Cross-Country Experiences

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Expected welfare gains from fiscal decentralisation

- **More responsive governance** if functions adequately allocated, local governments have sufficient finances and administrative power, and local residents can control their governments.
- **Enhanced revenue mobilisation**: Local governments have in part better information on local tax bases, and local residents may be more willing to pay locally
- **More downward accountability** if local services financed substantially through own revenues, transparency on finances and service delivery ensured and participation enabled

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Concerns of Central Government

- Loss of **macroeconomic control**
- Loss of control over **infrastructure** policy
- Risk of increasing **regional divide** with widening local taxing power
- **Insufficient administrative skills** of local governments, especially PFM, resulting in fiscal instability and possibly disruption in local service delivery. Eventually, need for costly bail-out operations.

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Overview of Local Financing Sources

	Local control over		
	Tax base	Tax rate	Administration
1. Own revenues			
1.1 Own-source-revenues: local taxes, fees, fines	Yes	Yes	Yes/Possibly
1.2 Surcharges on central taxes (piggybacking)	No	Yes	Possibly
2. **Shared taxes**	No	No	Possibly
3. **Intergovernmental transfers**	No	No	No
3.1 Unconditional (non-earmarked))			
3.2 Conditional (earmarked)			
4. **Additional**, such as sales of goods and services, rent of assets, grants from donors, income from local enterprises	-	-	Yes, except grants

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Important Revenue Design Principles for Taxes and Fees

1. **Ability to pay principle**: Individual tax payment depends on factors such as the annual income or the wealth of an individuum and not on the fact whether this individuum has benefitted from public services or not.
   => Everybody pays for schools, not only parents with school children
   => Rich people pay more than poor people (vertical equity)
   => Individuals with a similar ability to pay contribute the same (horizontal equity)

   Refers to taxes

2. **Benefit principle:** User charges payable only when services consumed, e.g. paying for waste collection and disposal (in this case also labelled "polluter pays principle").
   => In it's pure version, each person pays the same amount for each quantity consumed.
   => Fee should cover the cost of production.

Refers to fees

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Important Revenue Assignment Principles

Principle	Meaning
Matching Principle of revenues	Finances follow functions
Fiscal equivalence principle	Beneficiaries should take decisions and cover the costs
Adequacy of revenues	Sufficient funds to provide mandatory services in an efficient and sustainable way
Local financial autonomy	Financial ability of local governments to exercise their functions independently of central government
Stability of revenues assigned	Revenues are not subject to strong fluctuations
Yielding revenues	Revenues per source are substantial. Collection and administration of the revenue does not absorb a bigger share of the revenue collected
Buoyancy of revenues assigned	Revenues follow or exceed the economic growth rate. Elasticity ≥ 1
Little mobility of taxed factor	Tax avoidance (full or partially) by moving to a low tax haven is difficult

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Ideal-Typical Features of a Local Tax

Local government
(1) decides whether to **levy tax or not**
(2) determines the **details of the tax base**
(3) determines the **tax rate**
(4) **assesses** the tax
(5) **administers** the tax
(6) **keeps all** of what is collected
And local government is accountable for this to local citizens.

Source: Bahl and Bird, Subnational Taxes in Developing Countries

Suitability criteria for local taxes

Local taxes should

- Reflect the **ability to pay** of taxpayers and be considered as fair
  Example: based on personal income, individual consumption
- **Not distort** the allocation of resources except intended
  Negative example: payroll tax; positive example: road pricing
- Be **visible** for taxpayers
- Be **easy to administer**
  Tax base easy to assess
- **Contribute substantially** the local budget
  At least the richest local governments should be able to finance its services from own revenues.
- Have **stable yield**, be **predictable** and **buoyant** over time
- Have a tax base with **little mobility**
  Tax avoidance (full or partially) by moving to a low tax haven is difficult

For discussion

Tax	Advantages/suitability as a national tax	Advantages/suitability as a local tax
Personal income tax		
Business tax/corporate income tax		
Property tax		
Value added tax		
User fee		

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Considerations on specific taxes

Property tax

– Factor mobility zero, tax visible
– Cadastres existing
– Ownership clearly defined
– Assessment of value settled and updated
– Collection functional
– Limited yield, tax rate increases face resistance, income not sufficient if local governments are responsible for functions like education, health, transportation, etc.

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Considerations on specific taxes (continued)

Business tax

- Popular with local governments and citizens
- Local governments can better identify (new) small local businesses than central government, therefore tax potential better exploited
- Yielding and buoying
- Minimum tax rate recommended to prevent from excessive tax competition as tax base is relatively mobile and rich locations could lower taxes and attract more and more businesses

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Considerations on specific taxes (continued)

Personal income tax

- In line with “ability to pay principle”
- High yield, buoying
- Usually prerogative of central state
- Piggybacking recommended (surcharge for local governments)
- Advantage of flat surcharge rates: more easy to administer, less tax evasion and inequalities, easier to increase rate
- Advantage of locally determined surcharge rate: more local accountability

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Considerations on specific taxes (continued)

VAT

- In line with "ability to pay principle"
- High yield, buoying
- Usually prerogative of central state
- Widespread opinion that not applicable locally as pre-tax deduction for tax on value added from extraterritorial areas creates high administrative burdens
- Possibly for revenue sharing between central and local governments and distribution to local governments based on indicators

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Considerations on specific taxes (continued)

Vehicle-related taxes as an example of excises

- **Regional fuel tax** would lead to tax evasion if tax rate not uniform
- **Road pricing**: possible for regional level for financing regional road infrastructure or managing road use, collection costs outside motorways high
- **Parking fee**: collection costs low, evasion difficult if illegal parking is addressed and parking space is scarce

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Purposes of non-earmarked transfers

- Ensure fiscal autonomy
- Financing of own functions, co-financing of shared functions
- Allocative efficiency
- Fiscal equalization

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Predictability and Buoyancy of Unearmarked Transfers

(Example)

Article 24 on the unconditional transfer of the "Law on Local Self-Government Finance" of Albania from 2017 states:

- The annual size of the unconditional grant to be allocated to local self-government units shall be **no less than 1% of the Gross Domestic Product**, ...
- In every case the size of the unconditional transfer **cannot be smaller than the sum allocated the previous budget year**.

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Earmarking transfers – yes or no?

- Local autonomy?
- Financing of shared and delegated functions (principle of fiscal equivalence)
- Monitoring and oversight by higher level
- Fungibility of money

Borrowing at sub-national level -1

Purposes of borrowing:

(1) Short-term: Bridging of liquidity shortages
(2) Medium- to long-term: Financing of capital investments as long as useful life of infrastructure is longer than amortization of loan
(3) Never for financing of current expenditure except in highly exceptional situations like extreme disasters

Restrictions:

(1) Legal restrictions frequent
(2) Even when legally no objection, local governments might not be allowed to borrow when central government is already to highly indebted
(3) Administrative requirements, e.g. well functioning local PFM, local fiscal household / financial key control figures in order

Payment arrears are de facto debts; PPP's may result in indirect borrowing

Borrowing at sub-national level -2

Fiscal risks from borrowing

(1) In case of (implicit) bail outs for central government

(2) In case of hard budget constraints for local government, local citizens and businesses, and staff

Transparency important for local and central government, tax payer, lender

- Debt stock and composition of debt
- Arrears
- PPPs
- Fiscal risks from borrowing mechanisms
- Amortisation plans

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(II)

Sub-National Revenue from Natural Resources

Based on: Natural Resource Governance Institute (2016) Natural Resource Revenue Sharing

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Possible Modalities of Natural Resource Revenue Sharing

1. **Pooling with all other fiscal revenues** centrally as part of intergovernmental transfer system	Algeria, Chile, Myanmar, Norway
2. **Separate system** for (some) revenues from natural resources	
2.1 **Derivation-based**	
2.2.1 As local taxes, collected locally	Argentina, *Canada*, *India*, United Arab Emirates, United States
or	
2.2.2 Transfers by national government to local governments based on location of extraction	Angola, Bolivia, Brazil, Cameroon, *Canada* (some regions), Chad, China, Colombia, DRC, *Ecuador*, Ethiopia, Ghana, Guinea, *India*, Indonesia, Iraq, Italy, Kyrgyzstan, Madagascar, *Mexico*, *Mongolia*, Niger, Nigeria, Papua New Guinea, Peru, Philippines, South Sudan, *Uganda*, United States, Venezuela
2.2 **Non-derivation-based** - Natural resource revenue transfers mechanism - Indicator-based: population, poverty level, remoteness, etc.	*Ecuador*, *Mongolia*, *Mexico*, *Uganda*

Source: Natural Resource Governance Institute, 2016

Italic: mixed systems

Examples of mixed systems I

- **Uganda**: six percent of petroleum royalties shared among the local governments located within the petroleum exploration and production areas (derivation-based).
  - Half of this amount is allocated between local governments based on the level of production or area affected, defined by where production takes place or where oil is uploaded onto any transport platform.
  - The remaining half will be apportioned on the basis of “population size, geographic area and terrain”.
  - An additional one percent royalty will be allocated to a “gazette cultural or traditional institution”.

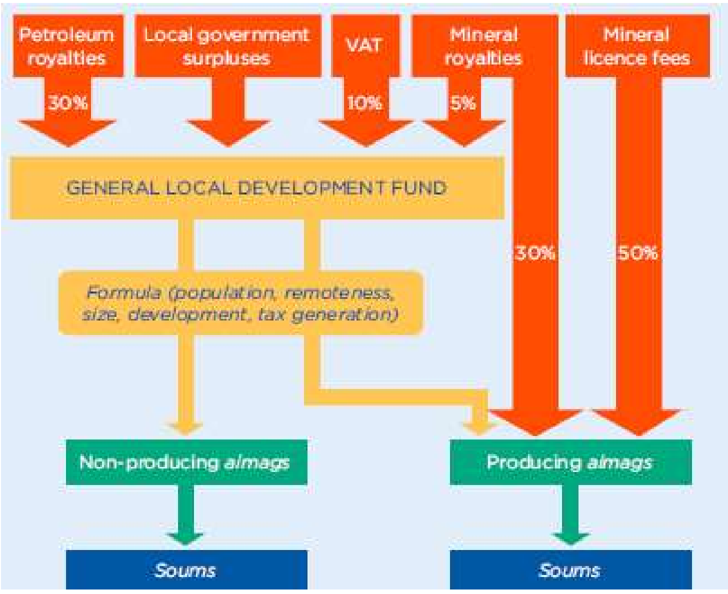
Source: Natural Resource Governance Institute, 2016

Examples of mixed systems II

- **Mongolia**:
  - Five percent of mining royalties and 30 percent of petroleum royalties are allocated according to a number of indicators (non-derivation-based).
  - An additional 30 percent of mining royalties go directly to *aimags* (provinces) where mineral production is located (derivation-based).
  - 50 percent of license fees goes directly to the mining *aimags*' local development funds (derivation-based, earmarked).

Source: Natural Resource Governance Institute, 2016

Mongolia's Resource Revenue Sharing System



Mineral Tax Collection by Levelel of Government

Property tax:
Mostly sub-national

Royalties:
Sometimes sub-national, more often national

Corporate income tax:
Mostly national

COUNTRY	GOVERNMENT STRUCTURE	CORPORATE INCOME TAX		ROYALTIES		PROPERTY/ LAND TAXES	
		N	S	N	S	N	S
Argentina	Federal	X			X		X
Australia	Federal	X		X[a]	X	X[a]	X
Brazil	Federal	X		X		X	
Canada	Federal	X	X	X[a]	X	X[a]	X
Chile	Unitary	X				X	
China	Unitary	X			X		X
Democratic Republic of the Congo (DRC)	Unitary	X		X			X
Ghana	Unitary	X		X			X
India	Federal	X			X		X
Indonesia	Regionalized unitary	X		X		X	X
Kazakhstan	Unitary	X		X			X
Kyrgyzstan	Unitary	X		X	X[b]		X
Malaysia	Federal	X	X		X		X
Mexico	Federal	X		X		X	
Mongolia	Unitary	X		X			X
Myanmar	Unitary	X		X		X	X
Peru	Unitary	X		X			X
Philippines	Regionalized unitary	X	X	X	X[c]		X
Russia	Federal	X	X	X			X
South Africa	Unitary	X		X			X
Tanzania	Regionalized unitary	X		X			X
United Arab Emirates	Federal		X		X		X
United Kingdom	Regionalized unitary	X					
United States	Federal	X	X	X[a]	X		X

Source: Natural Resource Governance Institute, 2016

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Possible Objectives of Natural Resource Revenue Sharing

1. **Compensation of negative impacts of resource extraction**, such as
   - Environmental damage
   - Local price increases
   - Congestion / enhanced immigration
2. **Fostering local economic development**
   - Especially where territories are poorer than country average
3. **Responding to local claims** for ownership of extracted resources
   - Compensation for gradual depletion of resources
4. **Pacification**
   - Resource revenue in exchange for peace and security which is essential for local territory or entire country and for safeguarding a productive business environment

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Warnings of false expectations

- **Fostering of economic development**
  - Locally higher prices and costs for non-extractive sectors, Dutch disease
  - Corruption and efficiency losses
  - Aggravated boom-bust cycles with local pro-cyclical effects, i.e. overspending in boom times and social brake marks in case of downturns
- **Pacification**
  - Correlation between natural resource wealth and civil war
  - Capturing of state by local elites
  - Prolongation of conflicts by misusing natural resource money for financing of pre-existing armed disputes

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How to design a resource sharing system?

Considerations on four issues

1. Vertical distribution
2. Horizontal distribution
3. Derivation vs. indicator-based approaches
4. Dealing with management challenges

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Design issue 1: Vertical distribution

1. **Finance follows function principle**: resources allocated at local level should be in line with local expenditure assignments.

2. **Direct local resource tax collection** provides more fiscal authority to local governments than transfers. However, the extent of local tax collection should depend on the

   - **Tax administration capacities** of local level to assess, collect and manage taxes
   - **Trust** in national government's ability and willingness to collect and distribute taxes in accordance with agreed formula
   - **Financial management capacity** of local governments to deal with revenue volatility and absorb large windfalls

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Design issue 2: Horizontal distribution

- Distribution formula should be in line with agreed objectives of transfer system.

- Distribution formula could consider:
  - Fiscal equalization objectives, such as revenue inequalities and/or higher than average cost burdens of individual local governments
  - Local economic development objectives
  - Local claims on natural resources; pacification
  - Compensations for negative impacts of extractions

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Design Issue 3: Derivation- vs. Indicator-Based

Derivation based

+ Less statistical data required

+/- Makes producing regions wealthier
 + beneficial for regions left behind, - new inequalities
 - efficiency losses as marginal benefit of additional spending is higher in poorer areas

- Stronger pro-cyclical effect, with local tendency for over-spending in boom cycles and painful cuts in bust periods

- Definitional challenges, e.g. if location of production matters and mine or oil field crosses border

+ Supports pacification arrangements

Indicator-based

+ More effective at addressing poverty, regional divide, negative impacts of extraction, etc.

- More data and statistical research needed

+ Less politicized , more technocratic revenue sharing debate

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Design issue 5: Dealing with Management Challenges

Possibly **overwhelming magnitude of resource revenues** for local governments

Parking part of revenue in foreign assets until absorptive capacity of local governments is developed and risk of misuse, waste, local inflation does not exist anymore

Local **revenue volatility** leading to poorly designed and executed local projects in boost periods and unsustainable borrowing or drastic expenditure cuts with disruptions in the execution of already started capital investment projects, neglected maintenance of physical assets or non-delivery of public services, lay-off of local staff and pro-cyclical multiplier effects on the local private sector

Allow local governments to make savings in times of revenue windfalls and use savings when revenues decline (**stabilization fund**) or allow **local borrowing** in difficult times However, stabilization funds can be misused for patronage and corruption if these are not managed transparently, and local borrowing may result in default especially if central government provides an (implicit) guarantee.
In addition, central government can smooth transfers if the basis is defined as a **moving average of multi-year resource revenue data**.

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Design issue 5: Dealing with Management Challenges (continued)

Additional local revenue is **not used for strategic development purposes**

Earmarking of resource revenue, e.g. in Mongolia through Local Development Fund. However, fungibility of money exists.

Transparency on natural resource revenue and the related spending is often weak

Under derivation-based systems: project-by-project and stream-by stream payments are basic; under indicator-based systems: information needed depends on formula. As the complexity of the needed information is high, information should be verified by qualified and independent auditors.

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Group Work on Natural Resource Revenue Sharing

Study the case of one country's Natural Resource Sharing System, using the descriptions of the Natural Resource Governance Institute, discuss it in your group and prepare a poster on the following issues:

(1) System of resource revenue sharing

(2) Objectives of the system (explicit or implicit)

(3) Pros and cons of the system

(4) Special features (if any)

One participant per group will present. Presentation time 5 minutes.

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