

Fiscal policy and tax reform

I. Introduction

A SDC COSTRA held on 30.11.2006 commissioned several short case studies on the issue of 'Development and Taxation'. In this context, the present study analyzes the extent to which the issues of fiscal policy and tax reform prevail in the policy dialogue between SDC and partner countries and to what extent they constitute priorities in partner countries¹. Also, it gathers information on the extent to which fiscal decentralization and tax reform are part of the SDC portfolio.

The first part of this study synthesizes the information given by SDC staff in the coordination offices of seven countries (Burkina Faso, Bosnia-Herzegovina, Macedonia, Mozambique, Nicaragua, Peru and Tanzania). A second part analyses the findings and concludes on possible future SDC activities regarding fiscal issues.

II. Assessment of fiscal policy and tax reform in SDC partner countries

Structure of the government (B1 – B3)

Mozambique, Peru and Tanzania dispose of a central, regional and local government level that each have an independent decision power on expenditure. In Burkina Faso, Macedonia and Nicaragua, regional governments are simply administrative delegates of the central government and do not have proper responsibility over service provision. In virtually all countries, regional governments do not have sovereignty over revenues, which makes them entirely dependant on vertical transfers by the central government².

A special situation prevails in Bosnia-Herzegovina. Here, the government structure consists of four tiers; central government, entities, cantons and municipalities. The entity governments³ are powerful and dispose of significant financial independence towards the central government. Moreover, a system with four government tiers makes the expenditure

¹ The assessment does not ignore that seco is also active in this area.

² Exceptions are: Tanzania; provincial responsibility over user fees and property tax. Nicaragua: provincial responsibility on tax on wood, fishing, etc. in Caribbean region. Bosnia-Herzegovina: provincial responsibility over property and direct taxes, user fees.

³ Federation of Bosnia-Herzegovina, Republika Srpska and Brčko district.

and revenue structure complex and necessarily leads to parallel responsibilities of different levels.

Over the last five years, the partner countries observed made important efforts to decentralize responsibilities related to the provision of public goods and services. This power shift reinforced the local and regional governments, especially in the area of infrastructure financing, local economic development and public service provision⁴. On the revenue side, the record of decentralization efforts is mixed. In some countries, the revenue capacity of the central government has been reinforced (Bosnia-Herzegovina, Peru). However, this does not necessarily mean that such a reinforcement occurs at the expense of the other government tiers. Rather, it shows an absolute increase of central government's revenues. In some countries, the revenue capacity of local governments has been strengthened, but there is no general trend visible in this direction.

Undeniably, central governments have done efforts to reform their tax systems. Namely, revenue instruments have been diversified and some countries use tax-sharing arrangements, such as piggy-backing⁵. All central governments use sophisticated instruments, such as VAT and income taxes. Especially at the local level, simpler taxation instruments prevail; property tax, excise taxes (and customs at the central level).

Openness of central government and other actors to fiscal decentralization (B4 – B6)

Most central governments are open to discuss **political and administrative decentralization**, especially in 'soft sectors' such as public utilities (e.g. water & sanitation) and education. However, there are exceptions to this trend.

The present Nicaraguan central government prefers to centralize power and is not open to support decentralization efforts. Bosnia-Herzegovina is a special case because of its complicated federal government structure. Its central level consists of the High Representative (delegate of the international community) and a multi-ethnic presidency. An objective of this central government is to reduce the power and independence of the two ethnic entities and to reinforce the multi-ethnic central institutions. This strategy naturally comes with a preference for some degree of centralization of decision power.

Unlike political and administrative decentralization, the majority of central governments does not support **fiscal decentralization** and the delegation of tax collection to local and regional governments. However, there are some exceptions from this general picture: The Macedonian government is open to decentralize taxation power and collection for VAT,

⁴ Especially so in Peru, Mozambique, Tanzania and Nicaragua.

⁵ Piggy-backing: Taxation of the same tax base by several government tiers.

income and property tax. In Tanzania, tax sovereignty is partly decentralized and separated into categories; some taxes (income tax, VAT) are levied and administered by the central government and others (toll taxes, excise tax, etc.) by local governments. However, local tax sovereignty has often been diminished in the course of the simplification process of the tax system undergone in recent years. As tax reforms often involve a limitation of the number of taxes, such a step can lead to a dry up of local revenues sources.

In Burkina Faso, Macedonia, Mozambique and Nicaragua, the central government is open to discuss the types and volumes of **vertical transfers**, which represent a major source of local revenues. In Bosnia-Herzegovina, Peru and Tanzania, central governments are not very open to such discussions, either due to a lack of political will or insufficient capacities.

There is a general antipathy towards a system of **horizontal transfers**. Apart from Tanzania, no central government observed is supporting such mechanisms.

Obstacles to decentralization (B5 – B6)

There are different reasons why central governments are not open for decentralization plans. An often cited argument against political and administrative decentralization is the overall lack of human and financial capacities, in particular at the local level. Other impediments are the lack of know-how and missing legislation. Furthermore, some countries had difficulties to reform the centralized state structures from the colonial era. An example is Burkina Faso, which inherited extremely centralized colonial structures from the French system. Regarding fiscal decentralization, central governments additionally fear the loss of political power and the sovereignty over national revenues. The widespread disinterest and ignorance of many other actors (political parties, CSOs and the private sector) on decentralization favors the status-quo. However, the position of central governments and administrations towards decentralization is rarely uniform. Often, there are differences in opinions between ministries, depending if they would gain or not from decentralization. In addition, there can be divergences in the views of central governments and central administrations. Actors which traditionally are favoring decentralization are local governments and bilateral and multilateral agencies. The position of the private sector and of NGOs is mixed. Unlike the matter of political decentralization, NGOs are often unaware of fiscal decentralization or not interested in the subject.

Activities of local governments and other actors linked to decentralization (B7 – B12)

In the majority of the countries observed, **local governments** are active in processes of administrative and political decentralization. However, a general lack of financial and human

capacities and the lack of know-how inhibit a stronger development in this direction. In Burkina Faso, Macedonia and Nicaragua, local governments attempt to decentralize some taxes, but this does not seem to be a general trend. In addition to the lack of capacity and know-how, fiscal decentralization faces political and legal opposition from the central level. Local governments normally do not have much space for maneuver in tax issues, as tax rates are pre-determined by the central government and are not supposed to change among different municipalities or regions (Tanzania).

Besides the local governments themselves, principal drivers of change towards decentralization are the **multilateral and bilateral agencies**. Local **NGOs/CSOs** are also lobbying for decentralization. However, they are interested in the participatory process and the supply of services (political and administrative decentralization), rather than in tax issues. The **private sector** generally does not seem to be active. Either, it shows no interest in the subject⁶ or it does not have the capacities⁷.

Evolution of the performance of tax systems (C1)

Very generally speaking, recent **performance of tax systems** improved at the central but not at the local level. In all countries observed, the tax system at the central level evolved positively in terms of its ability to raise expected revenues. However, there is still space for significant improvement⁸. At the local level, the evolution of revenue raising abilities is ambiguous. Some of the countries observed collect only marginal revenues at the local level and others presently do not know local tax collection at all⁹. In some cases, the situation at the local level has worsened due to recent tax reforms, which centralized taxing power, lowered overall tax rates or abolished certain tax instruments¹⁰.

In many countries, the **compliance burden** at the central level has been lowered during the last years. However, the overall burden is still very high in many countries and there is still a long way to go. At the local level, the situation improved in Nicaragua and Tanzania but worsened in Bosnia-Herzegovina, Burkina Faso and Peru. There is no general trend visible.

The same is true for the issue of **administrative feasibility** and **economic efficiency**; the situation at the local level is ambiguous, the performance at the central level has been

⁶ Nicaragua.

⁷ Burkina Faso.

⁸ Burkina Faso for instance is still behind with its projected revenues (12% instead of the 17% defined by a UEMOA norm.

⁹ Macedonia.

¹⁰ Tanzania, Peru and Bosnia-Herzegovina.

improved. The only indicator for which tax systems overall evolved positively at the local level is the key issue of **equity implications**¹¹.

In almost all countries observed, the central government is active in reforming the tax system in order to **improve performance**¹². Measures in this direction include adoption of a general fiscal code, establishment of (semi-) autonomous revenue authorities (ARAs)¹³, introduction of flat tax rates, etc. Local governments are less active in the process of tax reform. Many tax issues are regulated by national legislation and therefore are perceived to fall in central government's responsibility. For instance, local governments normally do not have the authority to levy taxes on their own. In other cases, they don't have the necessary capacities or know-how. The latter is also a reason for the relative inactivity of NGOs/CSOs. Tax reform is perceived to be very technical and does not represent a top priority for many NGOs. However, there are exceptions such as private sector lobbies in Tanzania, the Union of local self-government units in Macedonia and a SECO supported association (CIFOEB) in Burkina Faso. Bilateral and multilateral agencies are very active in the tax reform process and carry out activities of technical assistance, policy dialogue, General Budget Support (GBS), Sector-Wide Approach (SWAP) and capacity building for (central and local) governments and administrations.

Interaction between government and CSO/NGOs concerning the budget (C6)

The quality of **interaction** between government and population concerning budgetary issues differs very much between countries. In Mozambique for instance, the developments in recent years were generally very positive. In Bosnia-Herzegovina instead, the situation heavily worsened.

Positive developments in most of the countries are reported regarding the central government's **commitment to transparency, accountability and scrutiny** and its openness for policy dialogue. Generally, instruments such as Middle-Term Expenditure Frameworks (MTEF) and Public Expenditure Reviews (PER) exist and are used as part of Poverty Reduction Strategy Papers (PRSP).

Regarding the **democratic process** and discussion within society regarding the budget, the situation differs a lot among countries. In Bosnia-Herzegovina and Burkina Faso, there is virtually no discussion and participation in the budgetary processes. In Macedonia and

¹¹ Exception: equity implications worsened at the local level in Tanzania.

¹² Exception is Bosnia-Herzegovina.

¹³ e.g. SUNAT in Peru and TRA in Tanzania.

Mozambique, the situation improved in recent years. In Nicaragua, Peru and Tanzania, results are mixed and differ at the central and local level.

For the indicator of the **willingness to pay taxes**, results are equally diverse among countries, but countries do score differently than on the other indicators. Positive development on this indicator normally is connected with a simplification of the tax system. In Bosnia-Herzegovina, the introduction of VAT increased the willingness to pay taxes. In Tanzania, a better compliance was assured through simplification of the tax system as well as the effective use of penalties, which gradually reduced tax avoidance and evasion. In Burkina Faso, tax compliance at the local level seems to be higher, where tax payers can monitor links between revenues and effective expenditures¹⁴.

In recent years, many actors became involved in assessing the efficiency of the national and local budgetary processes. Especially active are the central and local governments themselves (through various instruments such as MTEF, PFM, PEFA, CFAA), multi- and bilateral agencies and to a lesser extent NGOs/CSOs.

Situation prevailing at the municipal level (D)

The most common instruments to finance municipal expenditures are ODA and vertical transfers¹⁵. In some countries, municipal expenditures are supplemented by municipal revenues. However, a structural underfinancing of local governments and administrations is prevailing in many countries. Tanzania, for instance, reports that the population is accommodated with existing vertical transfers and does not establish a link between their tax payments and the local supply of services. Especially, this seems to be the case for social infrastructures (health, education, etc.). The population is more receptive regarding trade infrastructures (e.g. construction of a market).

Tanzania is the only country observed, which operates a horizontal transfer system between municipalities. However, it is too early to prove the effectiveness of this mechanism.

Incentives for tax raising and ODA (E)

ODA rather gives incentives for central and local governments to increase their tax revenues. The impact on revenue mobilization depends on aid modalities, but there are disparities of what is perceived to be conducive and what is not (mentioned are GBS, SWAP,

¹⁴ Tax (and rent) for public and communal infrastructures are better accepted as long as they are investments in the town.

¹⁵ Only Burkina Faso reports low vertical transfers.

programmatic and project aid). Two factors are mentioned to be supportive for revenue raising:

- Aid modality includes conditionality for revenue mobilization (especially GBS);
- Aid modality strengthens local ownership, which is conducive to domestic revenue mobilization (especially programmatic aid)

The impact of **vertical transfer** systems on tax raising efforts differs between countries and government levels. At the central level, the vertical transfer system is conducive to tax efforts. At the local level, the impact is differs between countries. Positive effects are reported from Burkina Faso, Mozambique and Nicaragua, negative effects from Peru and Tanzania.

Vertical transfers to local governments could play an analogous role as ODA does for the central government. Similar to mechanisms playing between ODA and the central government, these transfers should comprise incentives for local revenue mobilization.

Emphasis of SDC action at central or local government levels (F1)

In Bosnia-Herzegovina, Burkina Faso and Peru, the emphasis of SDC policy dialogue at the **central** level lies increasingly on revenue mobilization. In the other cases analyzed, policy dialogue focuses on the expenditure side.

At the **local** level, SDC action is generally focused on expenditures. One exception is the COOF in Burkina Faso, which is working on revenue relevant issues in three different municipalities.

SDC relevance of tax and budgetary issues at central and local levels (F2)

COOF activities in the area of policy dialogue (in particular when it is involved in General Budget Support or in a SWAP) and capacity building are perceived to have a very positive impact on budgetary and tax issues, independently from the level of interaction (local and central). Capacity building at the central level scores best in all countries observed¹⁶. Another successful activity is to increase administrative feasibility, especially at the central level. Activities which are perceived to fail the most or deemed irrelevant are the reduction of compliance burden (especially at the local level) and the reform of the horizontal transfer system (which simply does not exist). Activities to foster equity were not successful in most

¹⁶ Only in Peru is the COOF reporting less success on this indicator.

of the countries. Increase of economic efficiency at the local level was not successful either, apart from activities in Peru.

SDC results regarding tax reform and fiscal decentralization (F3 – F6)

Several COOFs put forward the issues of revenue mobilization and fiscal decentralization in their **policy dialogue**. However, outside the frameworks offered by GBS and SWAT there are not many opportunities for policy dialogue by COOFs regarding taxation.

Several COOFs are successfully carrying out **capacity building** activities for the fiscal administration. For instance, the COOF Burkina Faso contributed to increased administrative feasibility by supplying software and computers to the fiscal administration at the central level. At the local level, capacity building activities regarding tax issues are often integrated in broader decentralization programs; e.g. the 'Etat local' strategy in Burkina Faso.

In general, it is important to note that taxation does not at all represent a 'mainstream' activity field of SDC. Several of the COOFs analyzed are active in this area, but others are totally absent.

COOFs mention different reasons for their inactivity in the field of fiscal policy and tax reform. There seems to be a lack of awareness and know-how inside of SDC, because the topic is relatively new on the development agenda. Furthermore, external factors sometimes make a focus on tax issues difficult. COOFs report that the insufficient progress in other areas (public service reform) renders stronger emphasis on revenues ineffective. In some countries, there also seems to be little interest of the (central and local) governments to tackle taxation issues.

SDC collaboration on fiscal decentralization and tax reform with other donors (F7)

- Multilateral donors; Worldbank, IMF, EC
- Bilateral donors; GTZ (seems to be the most active), USAID, DFID
- Governments; Belgium, Germany, France, Netherlands, Norway, Ireland, Sweden, Denmark, Finland, Ireland

Does the COOF consider activities in the field of fiscal policy in the future? (F8)

Most COOFs are planning future activities in the areas of tax reform and fiscal decentralization. The COOF:

- **Burkina Faso** is working on revenue issues and reports that its 'Etat local' strategy will address tax mobilization: The COOF is active in three municipalities (Ouahigouya,

Koudougou and Fada) through the AGECE. Also, general budget support at the central level targets local resource mobilization. Moreover, the technical support for tax collection given to the central government (with SECO support) could be extended to local governments;

- **Mozambique** is already working on tax issues. Inter alia, it commissioned a study on intergovernmental fiscal relations in Mozambique;
- **Nicaragua** sees some potential in technical assistance for tax administration and local governments, possibly with SECO support;
- **Peru** is working on a decentralization project (APODER), which includes an element of fiscal decentralization in its next stage;
- **Macedonia** is not planning to work on taxation issues, but reports that there are other donors active in the area;
- **Bosnia-Herzegovina** and **Tanzania** are not necessarily planning activities related to tax issues;

III. Conclusions and possible future SDC actions

In recent years, many SDC partner countries worked on the decentralization of their public service system. There is a general trend in the direction of more political and administrative decentralization. The performance of tax systems at the central level generally has been improved in the course of comprehensive reforms by many partner countries. SDC is very active in the process of political and administrative reforms regarding expenditures, e.g. budget planning and controlling, along with participatory budgets.

However, SDC is not very active yet in tax reform and fiscal decentralization. Considering the information given by the seven COOFs, it seems that the most effective actions of SDC regarding tax issues lie in the area of **policy dialogue** and **capacity building** at the central and local levels.

Regarding **fiscal decentralization**, SDC should carefully analyze the possible benefits and downsides. Fiscal decentralization is not the universal panacea for revenue mobilization in partner countries, and its success depends on political, geographic, social and economic **conditions**. The answers of the COOFs show that countries, which are open for political and administrative decentralization also think more positively about fiscal decentralization. Therefore, countries with existing and functioning **decentralized political and administrative structures** will be more promising candidates for fiscal decentralization than

centralized states. In addition, an appropriate **sequencing** of decentralizing activities is absolutely crucial and must take into account the specific national context. As local discretion always entails a **potential for corruption**, activities of fiscal decentralization should **safeguard** against this peril. **SDC should generally integrate fiscal aspects in its decentralization programs** and highlight the importance of local representation in the budgetary process, if lasting change is to be achieved in the area of decentralization.

Based on the seven COOFs interviewed, the following points identify some potential activities for SDC regarding tax reform and fiscal decentralization:

- Most actors in partner countries (local authorities, population, private sector) do not give high priority to fiscal issues and there is little awareness on possible benefits of broader representation in the revenue process. Therefore, SDC should **raise awareness** on these issues and feed the **debate** among central and local authorities, civil society and the private sector. In particular, SDC should contribute to move the tax policy debate **from the technical to the political sphere**;
- **Policy-dialogue with other bilateral and multilateral aid agencies** should highlight the importance of national revenue mobilization and local representation. Activities in this area must be **coordinated** and **harmonized** among all actors concerned;
- Considering that openness for broader representation in revenue processes is still low, **policy-dialogue at the central level** is necessary in order to collaborate with central governments and parliaments to enact respective **legislation** and to implement it;
- Fiscal policy design must be **coordinated** among different levels of government, which are concerned with reform. This is especially true for activities in the area of fiscal decentralization;
- Once legislation has been enacted, the authorities concerned must tackle its implementation. COOFs reported insufficient capacity and know-how as a major impediment for implementation, especially at the local level. Therefore, **financial assistance** and **capacity building** for local administrations could be a promising area for SDC action. Given the technical complexity of taxation, **cooperation** on

technical assistance could be envisaged with experienced bilateral and multilateral **development agencies** (e.g. SECO, GTZ and WB);

- **Climate change** is getting an ever more prominent position on the global development agenda. Fiscal instruments to change incentives will play a key role in climate change in the near future and SDC has an opportunity to enter this crucial new area. Fiscal instruments of climate change have a potential triple bottom-line: environmental (by containing emissions) economic (by generating revenues) and social (by spending those revenues on development).

Glossary of abbreviations

ARA	Autonomous Revenue Authority
AGEC	Appui à la Gestion Communale
APODER	Apoyo a la Descentralización en Espacios Rurales
CIFOEB	Centre d'Information de Formation et d'Etudes sur le Budget
CFAA	Country Financial Accountability Assessment
COOF	Coordination Office
COSTRA	Strategic Committee of the SDC directorate
CSO	Civil Society Organization
DFID	UK Department for International Development
EC	European Commission
GBS	General Budget Support
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IMF	International Monetary Fund
MTEF	Middle Term Expenditure Framework
NGO	Non-governmental Organization
ODA	Official Development Assistance
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Reviews
PFM	Public Financial Management

PRSP	Poverty Reduction Strategy Paper
SWAP	Sector-Wide Approach
SDC	Swiss Development Co-operation
SECO	State Secretariat for Economic Affairs
SUNAT	Superintendencia Nacional de Administración Tributaria
TRA	Tanzanian Revenue Authority
UEMOA	Union Economique et Monétaire Ouest Africaine
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	Worldbank

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