

Subnational Tax Policy Design and Fiscal Decentralization

The World Bank Course on
Practical Issues of Tax Policy in Developing Countries

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I. Introduction and Context

Why Local Tax Policy Matters

1. The World Development Report on *Entering the 21st Century* reaches the dramatic conclusion that two forces shape the world in which development policy will be defined and implemented: globalization (the continuing integration of the countries of the world) and localization (self-determination and the devolution of power". , WDR, 1999-2000).² What is labeled as *localization* elsewhere is often cited as decentralization--the division of public sector functions among multiple types of government: central and subnational.³ This decentralization can, and is, occurring in unitary and federal states alike.
2. The sorting out of fiscal power has been occurring even in "inherently centralized" countries, such as the Kingdoms of Jordan and Morocco (Ebel, Fox and Melhem, 1995; Vaillancourt, 1997; Yilmaz, Fox and Ebel, 2003), Central and Eastern Europe states that are in the transition from a command to market economy (Dunn and Wetzel, 2000; Bird, Ebel and Wallich, 1995; Wong and Martinez-Vazquez, 2002), military regimes (Shah, 1996; Pakistan NRB, 2001); countries that view decentralization as a strategy for improving local service delivery in reaction to financial crises (Thailand; Weist 2000); nation-states that are trying to avoid the centrifugal forces of separatism (Bosina & Herzegovina, Indonesia, Sudan and a host of other countries; Bird, Seoul 2003); and regions in which "bottom-up" participatory budgeting is taking hold (Latin America, Burki, Perry and Dillinger, 1999; Campbell, 2003).
3. It then follows that the achievement of the Millennium Development Goals (MDGs) -- the specific gains that can be made to improve the lives of the world's poor by 2015 -- will depend in large part on the integrity, efficiency, and sustainability of decentralized governance. Indeed, nearly every one of the MDGs entails some element of intergovernmental service delivery.⁴ The challenge is that all this decentralization can be done very well or very badly. Done well it can lead to the benefits promised by a well functioning state and local system: better services (e.g., girls education, clean water, local transportation, and picking up the garbage); national cohesion, and the creation of a

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² The report goes on to argue that these twin forces are reinforcing and stem from the same factors such as advances of information and technology (WDO, 1999-2000, pp. 31-33).

³ In this paper the terms subnational and local may be used interchangeably. The terms thus include intermediate governments (provinces, regions, states, oblasts) as well as counties, municipalities, city-states, distinct, union territories, towns/villages and special districts.

⁴ Eradicate extreme poverty and hunger; achieve universal primary education; promote general equality and empower women; reduce child mortality; improve maternal health; combat diseases; ensure environmental sustainability and develop a global partnership for development. *United Nations Millennium Declaration* (9/200) and *General Assembly Road Map* (11/2002).

potentially powerful tool for poverty alleviation. But if decentralization is done badly, it can lead to a macroeconomic mess, corruption, and collapse of the safety net -- the same things that many big central governments have delivered.

4. The elements of a well-designed decentralized system have been adequately discussed elsewhere (www.decentralization.org). To summarize, it is a design (and, some argue, a sequence) of getting “right” the fundamental questions of: Who does what (expenditure assignment)? Who levies which revenues (revenue assignment)? How can the fiscal imbalances, vertical and horizontal, be resolved when, as in nearly always the case, one finds that the case for decentralizing spending is greater than that for decentralizing revenues (a role for intergovernmental transfers)? How shall the question of that timing of revenues be addressed (debt and the hard budget constraint)? And, what is the institutional framework required to deal with political problem and implementation challenge of decentralizing states (the mix of capacity and knowledge for facilitation)?
5. The decision to decentralize is political. But once the decision is made whether gradually (Hungary) or with an initial “big-bang” reform (Indonesia, Pakistan), a necessary condition is to get the intergovernmental fiscal design “right”. This, in turn, leads to the *decentralization theorem*: that set of governments closest to the citizens can adjust budgets to local preferences in a manner that best leads to the delivery of a bundle of public services that is responsive to community preferences. Subnational governments become agents that provide services to identifiable recipients up to the point where the tax price for those services reflects the benefits received.
6. The focus is now on improving public sector efficiency. An efficient solution is one that maximizes social welfare subject to a given flow of land, labor, and capital resources. The rule for achieving an efficient allocation of resources is to supply a service up to that point where at the margin--for the last “unit” of the service supplied--the welfare benefit to society just matches its cost. In the private sector, as a general rule, the market-price system accomplishes this goal. For circumstances where the private market fails in this objective (pure public goods, externalities, monopoly), there is a case for public intervention--the public’s commandeering of resources in order to supply the activity. Once the public sector intervenes, the efficiency logic is in favor of some form of fiscal decentralization. The argument is that because of spatial considerations subnational governments become the conduit for setting up a system of budgets that best approximates the efficient solution of equating benefits and costs. In the economist’s jargon, this is the “benefit model” of local finance.
7. To satisfy these conditions, subnational (local) governments must be given the authority to exercise “own -source” taxation at the margin and be in a financial position to do so.
8. This is the essence of decentralization. And, this is why subnational local tax policy design matters.

Structure and Focus of the Paper

9. This paper proceeds to address five key questions of subnational tax policy design in an intergovernmental framework
 - What is the “fiscal architecture” that will frame, and constrain, the subnational tax policy options?

- What is subnational revenue?
- What are the principles of revenue decentralization?
- Once the principles and the accompanying normative framework for subnational tax policy are established, what other key policy considerations should one consider for subnational tax policy design?

A concluding section provides key conclusions.

10. The focus of this paper is on developing and transition countries. And here one must be alerted that the economic range is wide, thereby making difficult generalizations about policy design. The World Bank's clients include Upper Middle Income (e.g., S. Africa, Mexico, Slovenia, and Brazil); Lower Middle Income (e.g., Egypt, Indonesia, Philippines, Colombia, Turkey, Poland, and Jordan); and Low Income Countries (e.g., the Caucasus, most of Sub-Saharan Africa, Anglophone and Francophone; Cambodia, Laos, Vietnam, Yemen, Bangladesh, Pakistan).⁵ And, beginning in 2002, an increasing focus has been placed on a subset of poor countries labeled Low Income Countries Under Stress (LICUS). These are the very poor that "combine poor policy performance or low service capacity with a lack of responsiveness to their citizens".⁶
11. Clearly what one might conclude about the of intergovernmental/local revenue policy options of, say, Sudan vs. Slovenia (and, even more dramatically, of developed Korea vs. developing Kenya) may be quite different.

II. Fiscal Architecture

12. Demographic, economic, and institutional changes frame subnational tax policy. The concentration of world population has moved from the developed to the developing economies, the distribution of income in most countries has become increasingly disparate, and some countries are witnessing unprecedented increases in the percent of elderly—others in the young. The natural growth rate in population is 1.4 percent per year worldwide; but developing countries populations are growing much more quickly than the populations of developed countries (1.7 percent versus 0.1 percent).⁷ It is projected that developing countries will increase their share of the world's population from 82 percent in 2000 to 86 percent in 2050.⁸ These trends carry with them implications for tax policy, central and local that will differ depending on the source and type of change occurring.
13. Even more important than demographics is the interplay between a jurisdiction's revenues base and economic structure of output and the composition of employment that

⁵ The World Bank *Atlas* ranked 208 economies using both the GNI Per Capita and Purchasing Power Parity approach. The most recent data are for 2002 and (some) 2001. World Bank, *World Bank Atlas*, 2002.

⁶ States whose per-capita income fall below the International Development Association (IDA) operational cutoff of a GNI of \$875 in 2001. World Bank, Task Force Report, World Bank Group Work in Low Income Countries Under Stress, September 2002. www.worldbank.org

⁷ For a full discussion: Sally Wallace, *Fiscal Architecture: A Framework for Analysis of Public Expenditure Needs and Revenue Capacity*, a Paper Prepared for the World Bank Thematic Group on Taxation & Tax Policy, April 2003. www.decentralization.org

⁸ United Nations (2001). These projections do include the offsetting effect of the impact of HIV/AIDS. In some countries, the presence of AIDS has lowered life expectancy by as much as 15 years (UN, 2001). See Wallace, 2003.

goes along with production. Thus, property taxes make sense as a sustainable revenue source for non-service oriented economies; business receipts sales and excises will become increasingly important for communities that experience a shift to services, a sector that is characterized by hard to tax small businesses, the self employed, and underground activities; agricultural taxes are obviously attractive in land intensive areas—that is, if taxpayers can be identified and registered, a tax base can be measured, and collection procedures initiated; value added taxes may be more or less important depending on the importance of export in a country's economy, but even if productive nationally, they are difficult to apply and administer locally; and natural resource taxes can be hugely productive for some countries, but then the tug-of-war (or, indeed, actual war) over ownership and tax share can create a very contentious set of intergovernmental tax issues.

14. And, institutions matter. Here one is not only talking about institutions of revenue administration, but also the many social systems that make tax polices work and which, a developed country can take for granted, but that that may be very weak or even non-existent in a developing country: For example: a system of postal addresses for tax billing and collection; computerization for tracking tax payments, and, when necessary, recording and monitoring tax liens; a telephone or web site where one can download tax forms and instructions and have questions answered. And, a judicial system for tax appeal and quality assurance. Then there is the cultural question of what and who to tax. For example, it is axiomatic in local public finance that a “good” local tax base is one that is immobile—with land being the classic example. But, what if, as in some post-communist countries, there is as yet no modern tax cadastre because, of course, the government was the owner? Or, at the opposite end of the ownership spectrum, a traditional/indigenous peoples system whereby “everyone knows who controls the land” (and even this may vary by season and/or weather conditions), but ownership is communal and the idea of land recording is just not part of the culture.
15. When taken together, these forces define the "fiscal architecture" of a poor country's expenditure needs and its revenue-producing potential. As such, they establish the framework for developing policies that make "fiscal sense" in defining a society's practical options for policy design and implementation. Take the very difficult, but not atypical, case of Sudan. This is a country that has been in conflict since 1983; though a peace-treaty is in sight. The country is very diverse geographically, culturally, ethnically and economically. The fiscal base of the more developed northern region of the Government of Sudan (GoS) is dominated by the Khartoum /Al-Gezira economy, which accounts for about three quarters of total value added tax, receipts. A unitary and highly centralized system, the GoS revenue effort is low (9.4. % of GDP, 1996-2000). Its macro-stability performance is good, and its social and economic indications are dismal (literacy, school enrollment, tropical diseases, access to safe water). The own-source revenue authority for the GoS's 16 northern states is greatly restricted to low rate rental value tax, business licenses, per head taxes on camels, cattle and sheep, and fees for services such as solid waste collection, automobile licensing, and water and sewerage (for which housing size is a proxy). These various revenues are supplemented by voluntary contributions (also used by thousand of villages) which for some communities account for as much as 2/3 of own-source revenues. Nevertheless, there is in place a system of fiscal arrangements: e.g., sound and conventional budget formulation and execution, central-to-state as well as state-to-local transfers, and work on developing a medium term expenditure (and tax) framework.

16. Now turn to the southern region, most of which is controlled by the Southern Peoples Liberation Movement (SPLM). Recognizing the political imperative to build a cohesive “new southern Sudan” in midst of a very diverse ethnic , language and cultural quilt, the SPLM peace strategy is to establish a decentralized system of governance as part of an asymmetrically- decentralized national federal system. The new south will have three main “levels” of government: a single regional entity, an intermediate tier (somewhere between 3 to 10 jurisdictions), and 56 county governments. Because of the political necessity to build a system of governance that brings together many different indigenous groups, the plan is to aggressively develop budget capacity (tax and spending) in all counties. This is a region of 6 to 10 million (no recent census) that has few paved roads, scattered health clinics and primary schools, and, in the rural areas, various “bore holes” for water distribution. Recognizing the there will be a huge external (donor country) in flow of funds for development, a challenge for the new south will be to take advantage of the external aid, but not to such an extent the system becomes overly aid-dependent. Accordingly the task – and the southern leadership understand this—is to begin now to develop a system of local own source revenues that citizens can understand and control so that they have political “buy-in” for southern governance.⁹ This is the challenge of subnational tax policy.
17. Table 1 provides some simple but very real developing country illustrations of how the fiscal architecture, which may be national and/or local, frame the reality of subnational tax policy options in LICUS countries.¹⁰ In the review of the table, a further practical point should be kept in mind: once one has identified the tax policy options as initially constrained by a subnational jurisdiction’s fiscal architecture, tax policy design will be influenced (and probably limited) by availability of trained practitioners who can implement and administer that policy. Turning to external experts may help for a short time; but in the not very long run, using outsiders to do local work is not a viable solution. And that warning —to not rely on outsiders – may also apply to the use of central civil servants. Indeed, as some experts concluded, the reality is that in many developing countries the local capacity to administer a decentralized fiscal system may be as much (and, in some circumstances, even more) a central than local cause (Brillantes, 2001)¹¹. The argument that if local governments lack the human capital to run a decentralized fiscal system all they need to do is farm-out the task to a “higher” level of government is fallacious.

⁹ The Machakos Protocol is quite forward-looking. Subnational governments will be entitled to: taxes and levies on small and medium enterprises, land and property taxes, licenses, charges for government services, levies on tourism, stamp duties, agricultural taxes, a value added or gross sale tax or other retail taxes on goods and services, and excise taxes. Machakos Protocol, Signed by the Government of Sudan and the Southern Peoples Liberation Army/Movement, July 20, 2002 (Intergovernmental Development Authority, Nairobi Kenya)

¹⁰ The same arguments may be made in a developed country context. E.g., Lisa A. Roden, “Cyclical Change in the Minnesota Economy” in Robert Ebel and Therese McGuire, eds. The Final Report of the Minnesota Tax Study Commission: Staff Papers (London and St. Paul, Butterworths, 1986), pp. 3-23; and Robert Ebel and Francois Vaillancourt, “Revenue Sources of Local Governments: Nature and Determinants” in *Enhancing Urban Management in East Asia*, Maria Emilia Freire and Belinda Yuen, eds. (London: Ashgate, forthcoming 2003).

¹¹ Alex Brillantes, *The Japanese Model for Achieving Intergovernmental Reform*, A Government of Japan and the World Bank Institute Symposium, Chulalongkorn University, Bangkok, Thailand, June 2001. www.decentralization.org

Table 1. Illustration of Local Fiscal Architecture of LICUS Developing Economies

External Realty	Trend /Condition	Policy Implications
<u>Demographic</u> : Age distribution and family composition	Workforce: disproportional elderly, very young	Charges on consumption (fees, charges).
<u>Economic</u> : Structure of output mix	Home/self employment	Inform economy; hard to tax other than consumption; income tax not realistic
	Dominated by agriculture, both large and small producers	(i) Limits overall tax base to property/agr; possibly income tax; (ii) undermines broad based real estate tax
<u>Demographic</u> : Spatial distribution of population	Rural dominance	Broad based land taxation difficult (not impossible; depends on ownership structure)
	Urban dominance	Real estate (commercial & residential taxation feasible; growing problem of informal economy (but localities may be better attuned than the center to capture fees). Low rate business receipt taxes enforceable.
<u>Institutional</u> Progress in scope and quality of social services	Increase participation in education; us of health clinics	May be a willingness-to- pay for observable service improvements
<u>Institutional</u> : state of public records; data	Many localities have no property records; or, they are very old (census). In some countries, land ownership is communal and/or nomadic	May require presumptive taxation (which must be transparent); nomadic fee charging possible, but politically difficult; taxpayer IDs system a bottleneck.
<u>Institutional</u> . Communications infrastructure;	Transportation modes; existence of postal/mail services	Even if assessment possible; how to collect, audit & appeal if systems poorly developed

II. Tax Definition

18. The discussion in much of the development literature and in many comparative country reports can be surprisingly unclear about fundamental question of what constitutes a subnational (local) tax. And, it is not only in client country reports where the question may arise. Thus, the Government Finance Statistics (GFS) of the International Monetary Fund are reported in a manner that lumps together as a subnational or local revenue both subnational receipts from tax sharing of central collections and "own" taxes and non-tax revenues (fees, charges). This comment is not to single out for criticism the GFS, which is still the only global source of consistent international fiscal comparisons, but rather to point out that for even the present best set of international comparisons, the question of tax definition and measurement is problematic.¹²

¹² The OECD's Revenue Statistics for its member countries also takes this approach. However in the case of comparisons of the OECD countries, the distribution between what is a true local vs. centrally determined revenue is small. As a rule fiscal systems in developed countries have correctly sorted out the distinction between what is central vs. own- subnational revenue source. *Fiscal Design Surveys Across Levels of Government*, Tax Policy Studies # 7 (Paris: Organization for Economic Cooperation & Development, 2002).

19. Thus, if the determination is not made early on in the reform process as to what constitutes “local tax” and, thus, the proper authority of local taxation is not granted, a likely outcome is that political decentralization will be taken to be the same as fiscal decentralization. The result will be to obfuscate the debate over the policy changes that are required to allow a jurisdiction to realize the efficiency benefits promised by the decentralization reform itself. Moreover, the use of the wrong data as the independent decentralization variable for analytical purposes will lead to drawing false conclusions with respect to the interplay of decentralization, macroeconomic stability and public sector size (Ebel and Yilmaz, 2003).
20. Taxes of subnational governments (SNGs) may be divided into categories of decreasing local autonomy (Table 2).¹³ If subnational governments have total or significant control over a tax, fee or charge as demonstrated by “own” political control over tax rate (necessary and sufficient) or base, it is a subnational (*local*) tax. If, in contrast, the subnational government has no control over the base and rate of a tax, as, for example when the central government determines how to split revenues (“tax sharing”), it is not a local tax.

Table 2: Classification of Local Taxes By Degree of Central/Local Control

High Revenue Autonomy	SNG sets tax rate and base	Highest degree of own - source revenues. Most often pertains to fees and charges
	SNG sets tax rate only	Necessary and sufficient condition for categorization as “own revenue” (piggybacking, tax base harmonization/conformity permitted)
	SNG sets tax rate, but only within centrally permissible ranges	The typical practice is to cap the top rate
	Tax sharing whereby central/local revenue split can be only changed with consent of SNG	Can result when a local authority collects the tax and remits to the center. (E.g., China, Jin and Zou, 2003).
	Revenue sharing with share determined unilaterally by central authority.	100% control by center; this category is a source of much misspecification of what is a central vs. local revenue (GFS includes this category as a local tax)
No Local Autonomy	Central government sets rate and base of “SNG revenue”	May accompany political decentralization

Source: Adapted from OECD, Report 7, 2002

21. Using these definitions, Table 3 reveals the significant variation in the degree of tax autonomy for subnational governments in developed and developing countries. Subnational governments in developing countries get a significant portion of their tax revenues from tax sharing, whereas subnational governments in developed countries either have control over tax rate and base and/or must approve any changes in the revenue split of shared taxes. Some analysis suggests that there is a lesson here: countries that pay attention if the “correct” tax decentralization variable are likely to be in a

¹³ Administrative considerations are not considered here. For a discussion, refer to Bird, 2003 and Mikesell, 2003.

position to facilitate macroeconomic growth and stability and place a downward pressure on the size of the public sector. (Brennan and Buchanan, 1980, Ehadie, 1994).

III. Framework For Revenue Decentralization

22. It is now established that (i) the decentralization of expenditure responsibilities brings with it the need to decentralize revenue-raising responsibilities, and (ii) without own revenue sources, subnational governments would be fully dependent on funding from the center (or other “external” source such as international donor aid), and, thus, the benefits of decentralized decision-making will not be achieved. On top of these two points, we have also imposed the framework the fiscal architecture matrix.
23. The next task is to begin the sorting-out of revenues among governments. This is approached in three steps. The first is to further narrow the discussion of subnational tax options by imposing upon the fiscal system the theory of the public budget. The conclusion of this section is that for fundamental reasons of open vs. closed economies, central and subnational governments have different fiscal functions, and that this gives the central authority the first claim on key tax handles, notably broad based consumption and income taxes and taxes on natural resource production.
24. The second step is to add in broad normative principles for guiding subnational revenue policy. There are two: (i) the benefit approach, in which the decision rules are similar to that of the private sector *quid-pro-quo* of payment-for-services; and (ii) revenue mobilization, whereby from an efficiency (and income cases, an expediency) perspective local governments are particularly well positioned to utilize certain taxes and fees.
25. The third step is to take the tax choices that result from the first two steps and test them against a set of the criteria judging what constitutes a “good” local revenue system.

Table 3: Subnational Government Taxes As Percentage of Total Tax Revenue

	Tax Autonomy: Own Source Taxation			Limited Autonomy	No Autonomy: Revenue Sharing		
	<i>SNG Sets Tax Rate and Base</i>	<i>SNG Sets Tax Rate Only</i>	<i>SNG Sets Tax Base Only</i>	<i>Revenue Split May be Changed with Consent of SNG</i>	<i>Revenue Split Fixed in Legislation (May be Changed Unilaterally by the Central Government)</i>	<i>Revenue Split Determined by the Central Government</i>	<i>Central Authority Sets Rate and Base of SNG Tax</i>
<i>Developing/Transition Countries</i>							
Bulgaria (1998)	0	0	0	0	41	59	0
Czech Rep. (95)	2.0	5.0	3.0	0	90.0	0	0
Hungary (95)	0	30	0	0	0	0	70
Poland (95)	0	45.0	1.0	0	54.0	0	0
Estonia (97)	0	9.8	0	0	90.2	0	0
Latvia (97)	0	0	0	0	0	0	100
Lithuania (97)	0	0	0	0	0	0	100
Romania (98)	0	8.6	4.6	0	0	66.9	19.9
Slovenia (99)	16.85	0.6	0.26	0	82.29	0	0
Slovak Rep. (98)	7.4	28.2	0	0	0	64.4	0
<i>Developed Countries</i>							
Austria (95)	5.9	6.0	0	88.1	0	0	0
Belgium (95)	5.1	49.1	0	45.3	0.4	0.2	0
Denmark (95)	0	95.2	0	0	2.7	0	2.1
Finland (95)	0.01	88.6	0	0	11.4	0	0
Germany (95)	0.3	13.2	0	86.5	0	0	0
Iceland (95)	8.0	92.0	0	0	0	0	0
Japan (95)	0.1	89.8	0	0	0	0	10.1
Mexico (95)	0	0	0	74.6	18.8	0	6.6
Netherlands (95)	0	100	0	0	0	0	0
N. Zealand (95)	98.0	0	0	0	0	0	2.0
Norway (95)	0	3.7	0	0	0.6	95.7	0
Portugal (95)	30.1	8.6	0	0	0	0	61.3
Spain (95)	26.7	35.4	0	37.9	0	0	0
Sweden (95)	0.3	99.7	0	0	0	0	0
Switzerland (95)	51.8	40.8	0	3.2	4.2	0	0
U. K. (95)	0	100	0	0	0	0	0

Sources: OECD, Taxing Powers of State and Local Government (Paris, 1999); OECD, Fiscal Design Surveys Across Levels of Government (Paris, 2001 & 2002).

Context: The Theory of the Public Budget

26. The traditional analysis of public finance lays out a way of looking at the function of governments as divided into three “branches” or competencies: macroeconomic management, redistribution of income, and resource allocation.
27. For reasons that stem from the close vs. open economy distinction, macro policy is a central rather than subnational responsibility (Musgrave, 1959; McLure, 1999). There are three aspects to this. Each of which have implications for revenue assignment:
- Stabilization. The traditional arguments for central responsibility stabilization policy is straightforward: because of the general economic openness of subnational governments, subnational units will be ineffective in dealing with unemployment or inflation because markets are so interrelated that leakages will result.¹⁴ This leads to two policy realities. The central government must have access to debt and revenue tools that serve as effective tools for fiscal policy. With respect to tax assignment, this clearly argues for central assignment of broad based taxes on consumption (value added tax) and income (personal income taxes, broad based business receipts and profits levies).¹⁵
 - International Trade Policy. The second practicality is that control over the money supply must be made through a single central authority (Central Bank). One tax-related aspect of this is that as part of its role in managing and monitoring the flow of external trade (and of foreign exchange reserves), it is necessary to assign monetary policy to a central authority. It follows that the center must therefore have control over international trade taxes. Thus, customs levies are clearly central.
 - Insurance. Central fiscal policy is tantamount to an insurance contract whereby the central authority agrees to the task to even out income variations that result from regional and/or exogenous shocks.¹⁶ To perform this risk management role, the central authority must have arsenal of fiscal and monetary tools. Included among the tools are access to broad based consumption and income taxes. It also follows that the center is best suited to assume the risks of highly volatile revenue sources, in particular taxes on petroleum and mineral resources and the notoriously capricious business (e.g., corporate) income /profits tax.

¹⁴This is also becoming the case across nations, thus calling for international coordination of macro policies.

¹⁵Here there are two different stabilization issues: (i) whether the aggregate fiscal position (taxes and spending) of the subnational sector influences the overall national economy; and (ii) whether subnational fiscal changes during economic recessions or expansions might contribute to (procyclical), or dampen the macro economy. U.S. studies demonstrate that state/local policies tend to be countering cyclical. In economic expansions subnational governments tend to build up reserves thereby dampening effective demand. In recessions they tend to spend from reserves, thereby minimizing the dampening effect.

¹⁶ Seok-Kyun Hur, *Intergovernmental Allocation of Tax Bases In Korea*, Seoul 2003

28. With respect to the responsibility for the distribution, the central vs. subnational division becomes a bit less clear-cut; for largely the same reasons of the open nature of subnational economies, securing equity in the overall distribution of income among a nation's residents is also as a largely central responsibility. In the open subnational economy, people and business firms are free to move from one locality to another will frustrate any single subnational jurisdiction's attempt to significantly change the income profile of its residents through fiscal policies. The only "successful" outcome of an SNG's attempt to significantly re-distribute income is that everyone will be poor. The implication for tax policy is for assignment to the center revenues that have the potential for redistribution, *viz.*, taxes on personal income and wealth
29. What makes the distribution competency a bit less clear is the more intergovernmental nature for carrying out a successful (and national) distribution policy is that distribution has a "place" as well as "people" dimension. The proximity of subnational governments to the poor and familiarity with and understanding of the varying institutional situations and hostile environs in which the poor inhabit in different regions and communities provide distinct advantages to the well-decentralized governmental units in designing and implementing anti-poverty policies (Rao, 2002). One important implication of this fact is that in the developing country context, the central government will have to find much (but, not all) of the fiscal resources for poverty alleviation programs, whereas local governments will undertake program design and implementation (and, as localities become established, own-financing at the margin). Again: to the central unit must be assigned the large revenue producers.
30. This leads one to the allocation competency as the traditional *raison d'être* for the subnational role in revenue mobilization. This is about commandeering resources from the private sector to pay for SNG (local) public goods. Within this context, there are two guidelines for tax assignment: Benefits Received and Revenue Mobilization.

Benefits Received

31. As noted above, the benefits framework serves as a foundation for the efficiency gains that a well-designed decentralized system can provide. Here the logic argues that subnational revenue policy be such that it is the beneficiaries of a flow of services who should be asked to pay for those services. The approach is both equitable and efficient. In its most strict interpretation, the benefits argument dictates a reliance on user charges and fees. Note, however, that application of the benefits principle does not necessarily require (i) full cost recovery or (ii) restriction of the levying the tax/fee on only residents of the taxing jurisdiction. Moreover, the beneficiaries of a the *net* fiscal benefits of a given flow of subnational public services may or may not reside in the tax/fee levying jurisdiction (e.g., visitors, non-resident factor suppliers of a subnational based entity); and/or, even if they do, the benefits may be either specific to the direct user or generalized to a broader community.¹⁷
32. Specific Benefits. On the matter of the conceptual nature of the benefits criterion for its relevance for local governments, a conceptual debate emerges on just how general or

¹⁷ The term *net* is stressed to indicate that these spillover flows (externalities) may be positive or negative. In the case of the negative externality (the most obvious case is pollution), a tax or fee may be levied with the purpose of reducing the net costs through reducing consumption or production.

specific a benefit need to be to qualify as a tool for subnational taxation. Specific charges/fees include those for:

- Direct use of a facility or consumption of a service. Examples include residential care for the elderly, utility consumption, trash and garbage collection, sewer services, school meals, parking, road and canal tolls, entry fees to facilities such as museums, sports facilities, and parks; airline landing/slotting, and road use (which may be structured as a tax—as for example on motor fuel or other vehicle characteristic)
 - License fees paid for the privilege of an activity (business establishment, driving permits, vehicle use; registration fees to defray the cost of public monitoring of an activity such as land transfer and titling); and
 - Betterment levies to pay of local infrastructure (measured by increases in land values consequent upon the granting of planning decisions; special assessments to cover costs such as for sidewalk construction and repair, and developer fees to finance both on-site and off-site infrastructure.)¹⁸
33. The rationale for the use of specific charges, even in cases where they may be mandatory, is, straightforward since there is (or ought to be) an identifiable *quid-pro-quo* between the activity for which there is a charge and the beneficiary of that activity. And, because there is an identifiable link between service provide and user, there are other merits to the advice that “whenever possible charge”. Thus, the *quid-pro-quo* eases the job of revenue administration (identification, assessment, and collection). Plus, there is an educative merit of informing the citizen that prices (costs) can be public as well as private.
34. What is not at all straightforward are the twin matters of the design and level of a charge. There are several design options, and the choice of method will depend on both the nature of the activity for which there is a charge and administrative considerations. Design options include marginal cost pricing (for the economist, conceptually obvious; but hard to define and measure); average cost pricing (easier to calculate if, as with other design approaches, only financial costs are considered); multi-part tariffs (in the simplest form a fixed asset charge such as a connection fee combined with additional fee for use of a system); going-rate charges (or, perhaps more aptly, fiscal expedient whereby the degree of user demand elasticity is captured)
35. Generalized Benefits. More conceptually problematic, but easier to implement (administratively, if not politically), are the “generalized benefits” that can be related in a logical way to service received. Thus, there is a rationale for local broad based taxation of the business enterprise on income or receipts: employing the business enterprise as a tax collecting intermediary serves a conduit for taxing individuals, wherever they may reside (including non-resident factor suppliers such as shareholders) for the benefit of local services accruing initially to the business enterprise. In this view, the services of local government are being treated, as a factor of production similar to land labor and capital and their costs should be incorporated into the pricing structure.

¹⁸ Onsite infrastructure, some of which may be part of the developer’s own-private responsibility, includes public facilities constructed on or adjacent to an area being developed (roads, pavements, water and sewage distribution networks). Off-site: development related arterial roads, schools, fire, police stations, parks and museums, whether or not built on the developed area.

36. The generalized case also arises with respect to broad based personal taxation if it can be determined that the generalized benefits of local government spending are related to one's improvement in production (income earned) and/or the ability to consume (income spent). That governments create such taxable benefits can be applicable for a central government (there is little controversy here) or a subnational entity (for example, think of a state like Andhra Pradesh or an employment generating agglomeration center such as Amman or Budapest). In either case, unless there is some other reason to believe that benefits change more or less rapidly than income or consumption, it is reasonable to rely on flat-rate taxes for the finance of generalized services. (McLure, 1999).
37. For the central entity, either a production (origin) taxes such as that on personal income or payroll or a destination approach is acceptable (consumption value added tax). For the subnational government, however, an additional inquiry is necessary since people may not work where they live. If the benefits are most closely linked to the production/earning of income, then the jurisdiction should opt for a production-base tax such as a tax on payroll levied where the employment occurs. If, however, the situation were such that the benefits from tax payment local spending are more likely to be service - consumption based, then the policy design argues for resident based income taxation or single stage retail sales tax. Which is the stronger case? *A priori*, "basic" local services (e.g., schools, health clinics, neighborhood libraries, maintenance of local roads and sidewalks and street lighting) are consumed by (benefit) those who live in rather than work in a jurisdiction. This suggests that subnational governments should stick to resident based taxes on personal income.
38. Using this generalized benefits argument, could an SNG end up with generalized benefits taxation on both production and consumption? Yes. The production rationale follows from the business enterprise rationale. The consumption from the tax-financed services to residents. Individuals have several roles as taxpayers: factor suppliers, income earners, consumers, and wealth holders; and each role provides a tax handle.

Revenue Mobilization

39. Well functioning subnational governments are able to access some tax bases more readily than a central government (e.g., certain user charges, rudimentary sales taxes, and real property taxes).¹⁹ The SNG list includes revenues that not only tend to satisfy the benefits rule, but that also have the merit of being levied on activities and tax bases that are (i) relatively immobile (real property, land and, to a lesser extent, buildings); payroll, depending on the degree of resident/worker mobility; and (ii) for which the benefits of subnational services (expenditure assignment) can be identified. A range of specialized taxes (excises and narrow based consumption levies) and fees and charges (road user and property improvement) fit this criterion.
40. While recognizing the merits of the revenue mobilization objective, one must be candid that this search for local revenues may have a fiscal expediency character. A good example is the octroi, a special type of sales tax on all goods crossing an internal (e.g., village, city, regional) boundary.²⁰ The base is on the value, weight, or number of items

¹⁹Taxes on other forms of property (e.g., an intangibles or wealth tax) are not well suited to open economy jurisdictions.

²⁰ Roy W. Bahl and Johannes F. Linn, *Urban Public Finance In Developing Counties* (Oxford: Oxford University Press, 1992), pp 226-228.

entering a local jurisdiction by road, rail, sea, or air. The rate structure is likely to be varied and complicated. Collection points may be located at various terminals (the octroi is sometimes referred to as a form of terminal taxation) or checkpoints on highways or at railway stations, airports and docks. A potentially prodigious local revenue producer the tax is also often associated with bribery and other forms of corruption. Despite its being condemned regularly by government finance commissions, academics, and World Bank sector reports, the octroi continues to be an important revenue source, particularly in some Indian and Pakistani jurisdiction where tradition has made the octroi more politically acceptable than user charges (e.g., on average it accounts for 50% of own source revenues of large municipal corporations in Maharashtra). Such reliance is likely to continue: in the absence of fundamental intergovernmental fiscal reform and building capacity in local revenue institutions, there is no good alternative.

Choice Among Local Taxes

41. Debate on revenue policy seldom makes clear the basis for selecting/assigning one revenue source over another. Several factors may be at work to discourage explicit statements, for example, lack of data as to the economic effects of a tax, uncertainty as to who will bear the burden, and the complexity and multiplicity of outcomes due to the interplay of different taxes. Nevertheless, when a subnational government makes the political decision to tax, a set of criteria is needed to make choices. Table 4 present five generally-agreed-upon criteria that are accompanied by a checklist which revenue sources do or do not satisfy the objectives laid out. As one reviews the table, three points will become apparent. First, in selecting or modifying one tax or set of taxes, it is inevitable that tradeoffs will have to be made among the criteria. No one revenue meets all the objectives of a “good” tax, and some taxes may satisfy one criterion and violate another.
42. Second, for a subnational revenue *system* to work well, it is highly desirable to utilize a mix of taxes. All revenue sources have inherent structural inequalities, and if any one is used too intensively, those defects will become intolerable. This argues utilizing a mix of taxes (for a given yield, lower rates), as well as for fostering broad based sources of taxation (of which some are available to local governments).

IV. Beyond Assignment: Further Design Issues

43. Before summarizing the assignment discussion, five design /design-related issues merit attention.

Mandates. If a SGN is to have incentives to maintain the hard budget constraint, it must not be overloaded with unfunded central (or, in some cases, intermediate to local) mandates for service delivery. The reason is clear: local officials will balk at taking on political risk of raising revenues at the margin unless they can demonstrate to the citizens some service delivery quid-pro-quo. A policymaker loaded with unfunded mandates cannot provide that service-tax cost link.

Table 4. Criteria for Making Subnational Tax Choices

Criteria/Objective	Comment	Taxes that Satisfy Objective	...And Those That Fail
Accountability: Local policymakers responsive to citizen preferences	Local officials have power to determine “own” tax rates; tax burdens borne locally; transparency	Local Personal Income Taxes (may conform to higher level” tax base with rate set locally) User Charges	General Business taxes Visitor (tourist) taxes Natural resource taxes (petroleum, minerals)
Revenue Productivity: Taxes that promote “adequacy” in order to finance an agreed flow of public services.	As a system, recognizes a balance between a bases responsive to changes in economic conditions growth (elasticity or buoyancy) and stability (certainty)	<i>Ad valorem</i> property tax (distinguish between land and improvements) Area-base property tax Proportional rate personal income Business receipts Single stage sales taxes Terminal taxes (e. g., octroi)	Corporate profits Many user charges Low-effort property taxation
Benefits-Received: - To extent possible taxes should function as a “price” for flow of services that accrue to the taxpayer/citizen	Taxes perform tax price <i>quid-pro-quo</i> and may be tailored to local and regional variations and benefit areas. Service spillovers (+ or -) may call for (i) special districts; (inter-local cooperation; (ii) middle tier governments.	Whenever possible charge Visitor Taxes Business taxes (generalized benefits)	Non-resident based income tax
Non-Distortion: - taxes should not unintentionally interfere with private decisions consumers, factor suppliers and producers; they should be “neutral”	Variability in tax rates possible; Immobile tax bases rate high as do taxes with relatively high price inelasticity of demand; case for uniform tax bases; certainty in taxation	Taxes on immoveable property Land value tax plus charges User Charges Resident based Personal Income Sumptuary Taxes Taxation of “bads” Poll Taxes	Non-resident based income tax Gross receipts taxes Severance Taxes (if high rate) Octroi
Tax Equity: Tax burden should be reasonable and fair	Vertical equity (differential treatment unequal as usually measured by income or wealth—“gressivity”); Horizontal (equal treatment of those in equal circumstances (as measured by income, consumption, or wealth)	Progressive Resident Personal Income Taxes Ad valorem property taxes Some local sales taxes; excises	Poll taxes (e.g. communal tax) Area-based property taxes Gross receipts taxes
Simplicity: administration & compliance	Citizens should be able to understand and control the system; cash flow preferable to accruals; standardized tax bases	Piggyback Personal income Single stage sales taxes; excises Wage taxes Turnover taxes Some user charges	Multi-rate taxes Potentially broad based taxes narrowed by exemptions, deductions & tax preferences Property tax

Fiscal Balance There is no *a priori* reason to expect the financial yields of a well designed system of revenue assignment to match the financial requirements resulting from (an also well designed) regime of intergovernmental expenditure assignments. Indeed, except for a very wealthy/ high-income producing area there will be imbalances. These imbalances may be vertical (central-subnational mis-match between expenditure need and resources) or horizontal (horizontal as disparities between an SGN's own-revenue generating capacity and its spending needs. This is, of course, where the imperative for a well designed system of intergovernmental transfers from "higher" to lower" levels of governments can achieve important objectives.²¹ This also serves to reinforce the principle that subnational tax policy design is only one component of a *system* of intergovernmental finance. For most jurisdictions, a "well designed" revenue system will not --nor should it be expected to-- solve the revenue adequacy challenge.

Revenue Administration. One will never have well designed subnational tax policy in the absence of a sound set of institutional arrangements for revenue administration. But now the question arises as to whether these institutions need to be subnational. The rule that as long as the SNG has the authority to set the tax rate at the margin would seem to suggest that it is quite ok for a "higher" level of government (e.g., provincial for municipal, central for intermediate and local) to take on the tax administration tasks. And, indeed, except for miscellaneous user charge and fees, this is how it operates in many developing countries. Recognizing the merits of this simplicity, it is nevertheless important and desirable that subnational governments develop a capacity to administer that part of their own-source revenue mix that is not part of a shared (e.g., conforming) tax base. The case for local administration of solely local taxes is straightforward: when a government has a direct stake in the outcome (e.g. collection) of good revenue administration, it will have the incentive to assess, collect and audit in an effective and timely manner.

There is an institutional option, and that is for the local jurisdiction to contract out the tax administration function. Indeed, if there are proper monitoring and anti-corruption procedures (and this may be a big "if",) such "tax farming" can work. Thus, in several of the newly created Pakistani Tehsils (towns), Nazims (Mayors) have contracted out the tax administration process to a private firm. The process: the town council levies a series of fees and business receipts taxes, and then puts out a Request for Proposals (RFP) for the tax collection process. The winning bidder is then contracted to collect as the tax law allows, and then remit a guaranteed flow of funds to the tehsil. The amount of revenue collected in excess of the guaranteed flow becomes the collection agent's fee. As structured the process allows for the tehsil to make policy (e.g., tax rate) changes as needed and to monitor its revenue flows. The central authority retains the responsibility for audit through its office of Auditor General. Every third year the RFP is re-issued for the bidders to respond with amounts they will guarantee to collect for the local treasury. If the market works, if other competitor-bidders see an opportunity to capture excess profits (fees) the RFP response should reveal an opportunity for the tehsil to reduce the wedge between tax payer payments and collections to the local treasury.

²¹ See Serdar Yilmaz, *Intergovernmental Transfers: Concepts and Policy Issues*, Seoul Korea, July 2003; and Richard M. Bird and Michael Smart, *Intergovernmental Fiscal Transfers: Some Lessons from International Experience*, Symposium in Intergovernmental Transfer in Asian countries, Hitotsubashi, Tokyo, February 2001.

A similar, but less comprehensive approach to tax farming occurs in some Lebanese municipalities whereby the property tax collector (who goes door-to-door) receives a percentage of the taxes collected. The total yield is recorded and the remittance to the municipality is net of the fee.

Lack of Governance Support Systems In some situations, the governance support systems that one takes for granted in a most countries may be so insufficient as to thwart tax autonomy. Indeed, this is often the case in LICUS and/or post-conflict situations. Consider the difficulties in enforcement of tax payment (collection) of post-war Lebanon where there is no reliable nationwide postal service, lack of computerization, and no effective bank-deposit mechanism for making a tax payment. Now what does go about administering a property tax? In Tripoli, the process is to hand-deliver the tax bill to each taxpayer on-site. If the taxpayer is not home (or at the place of business), a notice of tax due is left at the site. It is then the taxpayer's responsibility to make payment. Some taxpayers may pay; others may not. For those who do pay, it requires a trip to a municipal office. As for tax scofflaws...they may get away with it unless they can be identified as tax delinquents when at some point they must go to the municipal center for a construction permit or telephone hook-up (under the law Tripoli could initiate a tax lien, but in practice it has no institutional capacity to do so). Other possible collection devices: attach the tax bill to payment of the electric bill (common in many less developed countries); privatize collection and give collectors a tax collection incentive pay system;²² and/or require proof of property tax payment for automobile registration, which can be well monitored.

Overlapping assignments and Harmonization. The discussion of assigning revenues to different governments should not be taken to imply that each type of tax should be assigned to only one government. Rather, there is good reason to assigning the same tax/revenue to multiple units as long as it does not create unacceptable administrative complexities, inequities and distortions. In fact, the opposite may be true—that overlapping uses of the same tax bases may simplify administration and reduce costs for tax administrators and taxpayers alike (McLure, 1983). If there is a policy of overlapping tax bases, the case for tax base harmonization is strong. This is particularly true for broad bases that are shared. Thus, for example, the central government could levy a nationally uniform personal income tax base and concurrently give the SNGs the authority to add their own tax rate (“piggybacking”) to the central rate. Now the central authority has the incentive for good revenue administration across the entire range--taxpayer identification, assessment, collection, appeal and audit. That this practice may create fiscal disparities among local jurisdiction (since the resulting derivation principle favors the high-income producing jurisdiction vis-à-vis low income areas) is a matter to be addressed elsewhere (in the design of the transfer system).

²² A collection—incentive system did exist in some parts (e.g., Tripoli) of pre-war Lebanon. Under these arrangements, the tax collector could give the taxpayer a discount for on-the spot tax payment up to a fixed percentage to the nominal tax due. The collector and taxpayer then would negotiate the share of the discount to be granted to the taxpayer and that (the remainder) to be “paid” to the collector for his services. For example, if the municipality offered a 10% discount for immediate payment, the discount could be split in some negotiated proportion (such as 5% to the taxpayer in the form of reduced tax liability and 5% pocketed by the collector as incentive pay). The tax liability net of the discount would then be remitted to the municipal treasury.

V. Concluding Comments and The Revenue Assignment Matrix

44. Recognizing that for developing countries generalizations about subnational tax policy design are difficult, some general lessons can be drawn about in this new era of a global trend toward localization:
- The reason that getting “right” the design challenge of fiscal decentralization is so important is that a well designed intergovernmental system key to the accomplishment of increasing the quality of life as now formally expressed in the Millennium Development Goals. And whereas fiscal decentralization as many facets, there is a necessary condition that must be satisfied. Local governments must be given, and then exercise, the authority for own - source taxation. This does not mean that own source taxation will lead to revenue adequacy. Indeed, except in very special circumstances of rich communities with a wide degree of revenue autonomy, this will not be the case. But, for rich and poor and urban and rural communities alike, subnational tax policy design matters.
 - In every case, the decision to decentralize is political. But once that decision is taken, the technical issues of tax policy become paramount so that a community can efficiently and effectively pay for poverty reduction, safe drinking water, improved maternal health, literacy programs. This will not be an easy task; indeed, as one moves from the developed to developing economies, the job becomes much more difficult as the tax policy options are narrowed by not only considerations as broad as the fiscal architecture of nations, but also as narrow as to the matter whether there is a paved road or a list of potential tax bases and taxpayers.
 - Despite all the challenges, the payoff of doing decentralization and decentralized tax policy well is enormous. The evidence is that the rich counties of the world are those who have decentralized; and a key to that strategy has been attention to good subnational tax design.