Conference on Revenue Mobilization and Development

Taxation and Decentralization
Some Instruments

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Introduction

- Expenditure decentralization has been a trend for a long time
- Revenue decentralization has been a challenge for a long time too
- Prof. Chambas' presentation provides an excellent view of
  - The advantages of financing local expenditures with own revenues
  - The difficulties involved in designing suitable taxes for local governments in Sub-Saharan Africa

Objective of this Short Presentation

- To supplement Prof. Chambas' presentation with a bird's-eye view of some tax instruments for revenue mobilization in subcentral units of government
- In relation to prof. Chambas' presentation, scope is extended to:
  - Developing countries in general (not only Africa)
  - Subcentral governments (not only local)
- Principles, findings, and orientations provided in Prof. Chambas' analysis of Africa apply, with few nuances, to most developing countries

Alternative Schemes of Tax Financing

1. Own taxes – tax base is exclusive to one level of government
2. Base sharing – same tax base or similar bases used simultaneously by two or more levels
3. Tax sharing – lower level government entitled to a share of the tax collected within its jurisdiction by the higher level government or to a fraction of the nationwide collection, defined by a pre-established rule or formula

- Prof. Chambas' RLPE includes (1) and (2); his RLP also includes (3)

1. Own Taxes

- Highest degree of autonomy for subcentral units
- Some advantages
  - Predictability of revenues makes easier to plan expenditures
  - Strong link between local public service and level of local revenues may stimulate participation of citizens in the budget process, enhanced accountability and fiscal responsibility
- Some disadvantages
  - Higher compliance costs than one tier taxation
  - Duplication of tax administration (unless tax collection service provided by central government)
  - Potential predatory tax competition
  - Unequal distribution of the tax base among units

2. Base Sharing

- Subcentral government loses some degree of autonomy as it cannot define the base
- Some advantages
  - Predictability of revenues
  - Strong link between local public service and level of local revenues
  - Administratively simpler than similar own tax
  - Tax competition through base erosion is prevented
- Some disadvantages
  - May give rise to horizontal fiscal disparities as well as tax competition through rate differentiation
  - May give rise to vertical tax competition

3. Tax Sharing

- Limited fiscal autonomy: subcentral unit able to decide how to spend but not how much
- Some advantages
  - Lower compliance costs
  - Single tax administration
  - No tax competition
- Some disadvantages
  - Decisions of the central government affect the revenue of the lower level unit
  - Weak link or absence of link between local public service and level of local revenues

Tax Arrangements

- Most common tax arrangement in developing country is (1) + (3)
- (2) is used in some developed countries, especially to finance central and state/provincial governments in big federations (e.g. income tax in USA, dual value-added tax in Canada), but:
  - India is preparing the introduction of a dual VAT, now scheduled for April 1, 2012
  - Brazil has been discussing the adoption of a dual VAT since 1995

Possible Subcentral Taxes

- Own taxes
  - Property taxes (land, buildings, vehicles, transfer of property)
  - Retail sales tax
  - Excise tax
  - Service tax
  - Value added tax
  - Turnover tax
  - Subcentral business tax
- Base sharing with central government
  - Personal income tax
  - Dual value-added tax

Taxes that Deserve More Attention from Policymakers

- Dual value-added tax shared by central and and state/provincial governments for federations and unitary countries with high degree of decentralization
- Subcentral business tax as own tax for state/provincial or local governments or yet for base sharing

Dual Value Added Tax

- VAT is the most important tax in many developing countries, usually assigned to the highest level of government
- Major exceptions are Brazil and India, where VAT is assigned to states but are good examples of bad taxation
- As the decentralization process deepens, implying need for highly productive and buoyant own revenue for lower tiers of government, dual VAT is a promising possibility

Subcentral Business Tax

- Property tax has been the only broad-based tax suitable to local units
- Inappropriate broad-based taxes have been adopted by local units in some countries (e.g., turnover tax in Colombia, service tax in Brazil) and also by intermediate level units (e.g., turnover tax in Argentina and interstate export tax in India)
- An origin principle, subtraction method VAT with limited rate ranges, that has been in place in Italy (IRAP) and Hungary and has been proposed in Canada (Bird & Mintz) and Mexico (but finally adopted as a central minimum income tax – IETU), deserves consideration as a substitute for inappropriate taxes or as a supplementary tax for subcentral units of government

Thank You