



**Subnational Tax Policy and  
Administration in Developing  
Economies**

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Reprinted from *Tax Notes Int'l*, March 7, 2005, p. 919

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# Special Reports



## Subnational Tax Policy and Administration In Developing Economies

by Robert D. Ebel and Robert Taliercio

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*This paper was presented at the international symposium “Fiscal Decentralization in Asia Revisited,” held November 5 and 6, 2004, at the Hitotsubashi University in Kunitachi, Tokyo.*

### I. Introduction and Context

#### Why Local Tax Design Matters

The World Development Report *Entering the 21 Century* reaches the conclusion that two forces shape the world in which development policy will be defined and implemented: globalization (the continuing integration of countries) and localization (“self-determination and the devolution of power,” WDR, 1999-2000).<sup>1</sup> 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.<sup>2</sup> That decentralization can, and is, occurring in unitary and federal states alike.

Sorting out 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 European states that are in the transition from a command to a market economy (Dunn and Wetzell, 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 (Bosnia and Herzegovina, Indonesia, Sudan, and several other countries: Bird, 2003); and regions in which “bottom-up” participatory budgeting is taking hold (Latin America: Burki, Perry, and Dillinger, 1999; and Campbell, 2003).

The achievement of the millennium development goals (MDGs) — the gains that can be made to improve the lives of the poor by 2015 — depends in

<sup>1</sup>The report goes on to argue that these twin forces are reinforcing, and stem from the same factors as, advances of information and technology (WDR, 1999-2000, pp. 31-33).

<sup>2</sup>In this article, the terms “subnational” and “local” may be used interchangeably. They include intermediate governments (provinces, regions, states, oblasts) as well as counties, municipalities, city-states, districts, union territories, towns and villages, and special districts.

large part on the integrity, efficiency, and sustainability of decentralized governance. Nearly every one of the MDGs entails some element of intergovernmental service delivery.<sup>3</sup> The challenge is that all that decentralization can be done well or badly. Done well, it can lead to the benefits promised by a well-functioning state and local system: better services (for example, girls' education, clean water, local transportation, and picking up the garbage); national cohesion; and the creation of a potentially powerful tool for poverty alleviation. But if decentralization is done badly, it can lead to a macroeconomic mess, corruption, and the collapse of the safety net — the same things that many big central governments have delivered.

### **The decision to decentralize is political.**

The elements of a well-designed decentralized system have been adequately discussed elsewhere (<http://www.decentralization.org>). It is a design (and, some argue, a sequence) of getting right the fundamental questions:

- Who does what (expenditure assignment)?
- Who levies which revenues (revenue assignment)?
- How can the fiscal imbalances — vertical and horizontal — be resolved when, as usually happens, one finds that the case for decentralizing spending is greater than that for decentralizing revenues (a role for intergovernmental transfers)?
- How should timing of revenues be addressed (debt and the hard budget constraint)?
- What is the institutional framework required to deal with political problems and implementation challenges of decentralizing states (the mix of capacity and knowledge for facilitation)?

The decision to decentralize is political. But once the decision is made, whether gradually (as in Hungary) or with an initial big-bang reform (as in Indonesia and Pakistan), a necessary condition is to get the intergovernmental fiscal design “right.” That in turn leads to the decentralization theorem: the set of governments closest to the citizens can adjust

<sup>3</sup>Those are: (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote general equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development. *United Nations Millennium Declaration* (September 2000) and *General Assembly Road Map* (November 2002).

budgets to local preferences in a manner that best leads to the delivery of a bundle of public services responsive to community preferences. Subnational governments (SNGs) become agents that provide services to identifiable recipients until the tax price for those services reflects the benefits received.

The focus is on improving public-sector efficiency. An efficient solution 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 until 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 rule, the market-price system accomplishes that goal. When the private market fails in this objective (pure public goods, externalities, and monopoly), there is a case for public intervention — the public's commandeering of resources 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, SNGs 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.

To satisfy those conditions, subnational (local) governments must be allowed to exercise own-source taxation at the margin and be in a financial position to do so. That is the essence of decentralization. That is why subnational local tax policy design matters.

### **Structure of the Article**

This article addresses five 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 an own-source subnational revenue?
- What is the conceptual framework for assignment of revenues between and among governments, and what are the implications for a “practical” tax policy?
- What are the options for administering subnational revenues?
- Once the principles and the framework for subnational tax policy are established, what other policies should be considered for subnational tax policy design?

The final section provides conclusions.

The focus of this article is developing and transition countries. The economic range is wide, making generalizations about policy design difficult. The World Bank's clients include upper-middle-income

countries (for example, South Africa, Mexico, Slovenia, and Brazil); lower-middle-income countries (for example, Egypt, Indonesia, the Philippines, Colombia, Turkey, Poland, and Jordan); and low-income countries (for example, the Caucasus, most of sub-sub-Saharan Africa, Anglophone and Francophone, Cambodia, Laos, Vietnam, Yemen, Bangladesh, and Pakistan).<sup>4</sup> Beginning in 2002, an increasing focus has been placed on a subset of poor countries labeled low-income countries under stress (LICUS). Those are the very poor that “combine poor policy performance or low service capacity with a lack of responsiveness to their citizens.”<sup>5</sup>

Clearly, what one might conclude about the inter-governmental and 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

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 percentage 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).<sup>6</sup> 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.<sup>7</sup> Those trends carry implications for tax policy, central and local, that will differ depending on the source and type of change occurring.

<sup>4</sup>The *World Bank Atlas* ranked 208 economies using both the gross national income (GNI) per capita and purchasing power parity (PPP) approach. The most recent data are for 2002 and (some) 2001. World Bank, *World Bank Atlas*, 2002.

<sup>5</sup>States whose per-capita income falls below the International Development Association (IDA) operational cutoff of a GNI of US \$875 in 2001. World Bank, Task Force Report, World Bank Group Work in Low Income Countries Under Stress, September 2002. [Http://www.worldbank.org](http://www.worldbank.org).

<sup>6</sup>For a full discussion, see 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 and Tax Policy, April 2003. [Http://www.decentralization.org](http://www.decentralization.org).

<sup>7</sup>United Nations (2001). These projections do not include the offsetting effect of the impact of HIV/AIDS. In some countries, AIDS has lowered life expectancy by as much as 15 years. See Wallace, 2003.

Even more important than demographics are the interplay between a jurisdiction’s revenue base and economic structure of output and the composition of employment that 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 — if taxpayers can be identified and registered, a tax base 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. Natural resource taxes can be very productive for some countries, but the tug-of-war (or even actual war) over ownership and tax share can create a contentious set of intergovernmental tax issues.

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Institutions matter, and not only institutions of revenue administration. Also important are the formal and informal social systems that make tax policies work, which a developed country can take for granted, but that may be weak or even nonexistent 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 by which 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 whom to tax. For example, it is axiomatic in local public finance that a “good” local tax base is immobile, with land being the classic example. But, what if, as in some postcommunist countries, there is as yet no modern tax *cadastre* because the government was the owner? Or, at the opposite end of the ownership spectrum, a traditional or indigenous people’s system whereby “everyone knows who controls the land” (and even that may vary by season or

weather conditions), but ownership is communal and the idea of land recording is not part of the culture.

**For reasons that stem from the closed vs. open economy distinction, macro policy is a central, rather than subnational, responsibility.**

Taken together, those forces define the fiscal architecture of a poor country's expenditure needs and its revenue-producing potential. 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 difficult, but not atypical, case of Sudan — a country in conflict for the last 22 years.<sup>8</sup> The country is 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 percent of gross domestic product, 1996-2000). Its macrostability performance is good, and its social and economic indicators 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, water, and sewerage (for which housing size is a proxy). Those revenues are supplemented by voluntary contributions (also used by thousands of villages), which for some communities account for as much as two-thirds of own-source revenues. Nevertheless, there is in place a system of fiscal arrangements — for example, processes for budget formulation and execution, central-to-state and state-to-local transfers, and development of a medium-term expenditure (and tax) framework.

Now we turn to the southern region, most of which has been controlled by the Sudanese People's Liberation Movement (SPLM). Recognizing the political imperative to build a cohesive "new southern Sudan" amid a diverse ethnic, language, and cultural quilt, the SPLM peace strategy is to establish a decentralized system of governance as part of an

<sup>8</sup>In January 2005, a peace agreement was signed between the northern government of Sudan and the Sudanese People's Liberation Movement.

asymmetrically decentralized national federal system. The new south will have three main levels of government: a single regional entity; an intermediate tier (3 to 10 jurisdictions); and 56 county governments. Because of the political necessity of building a system of governance that brings together many different indigenous groups, the plan is to develop budget capacity (tax and spending) in all counties. This is a region of 6 million 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 that there will be a huge external (donor country) inflow of funds for development, a challenge for the new south will be to take advantage of the external aid, but not so that the system becomes overly aid-dependent. The task — which the southern leadership understands — is to begin to develop a system of local own-source revenues that citizens can control so that they have political "buy-in" for southern governance.<sup>9</sup> That is the challenge of subnational tax policy.

Table 1 provides some simple, but real, developing-country illustrations of how the fiscal architecture, which may be national or local, frames the reality of subnational tax policy options in LICUS countries.<sup>10</sup> In reviewing 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 specialists may help for a short time. But eventually, using outsiders to do local work is not viable. That may also apply to the use of central civil servants. As some specialists concluded, in many developing countries, the local capacity to

<sup>9</sup>The Machakos Protocol is forward-looking. Subnational governments will be entitled to: (1) taxes and levies on small and medium-size enterprises; (2) land and property taxes; (3) licenses; (4) charges for government services; (5) levies on tourism; (6) stamp duties; (7) agricultural taxes; (8) a value added or gross sale tax or other retail taxes on goods and services; and (9) excise taxes. Machakos Protocol, signed by the Government of Sudan and the Sudanese People's Liberation Army/Movement, July 20, 2002 (Intergovernmental Development Authority, Nairobi, Kenya).

<sup>10</sup>The same arguments may be made in a developed-country context; see, 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 Maria Emilia Freire and Belinda Yuen, eds., *Enhancing Urban Management in East Asia*, London: Ashgate, 2004.

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

| External Reality  | Trend/Condition   | Policy Implications  |
|---|---|--|
| <b>Demographic:</b> Age distribution and family composition.            | Workforce: disproportional elderly, very young.   | Charges on consumption (fees, charges).  |
| <b>Economic:</b> Structure of output mix.                               | Home/self-employment.   | Informal economy; hard to tax other than consumption; income tax not realistic.  |
|   | Dominated by agriculture, both large and small producers.   | Limits overall tax base to property/agr.; possibly income tax; undermines broad-based real estate tax.   |
| <b>Demographic:</b> Spatial distribution of population.                 | Rural dominance.  | Broad-based land taxation often politically difficult.   |
|   | 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. |
| <b>Institutional:</b> Progress in scope and quality of social services. | Increased participation in education; use of health clinics.  | May be a willingness to pay for observable service improvements.   |
| <b>Institutional:</b> State of public records; data.                    | Many localities have no property records, or they are old (census). In some countries, land ownership is communal or nomadic. | May require presumptive taxation (which must be transparent); nomadic fee charging possible, but politically difficult; taxpayer ID system a bottleneck.   |
| <b>Institutional:</b> Communications infrastructure.                    | Transportation modes; availability of postal and mail services; IT usage by the public sector.                                | Even if assessment possible, how to collect, audit, and appeal if systems poorly developed.  |

Source: Derived from Sally Wallace.

administer a decentralized fiscal system may be as much (and sometimes even more) a central issue as a local issue (Brillantes, 2001).<sup>11</sup> The argument that if local governments lack the human capital to run a decentralized fiscal system, all they need do is farm out the task to a “higher” level of government, is often wrong.

### III. Own-Source Taxation

The discussion in much of the development literature and in many comparative country reports can be surprisingly unclear about the fundamental question of what constitutes a subnational (local) tax. And the question may not arise only in client country reports. Thus, the Government Finance Statistics (GFS) of the Intentional 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 nontax revenues (fees, charges). This is not to single out for criticism the GFS, which is still the only global source of consistent international fiscal comparisons, but to point out that for even the current best set of international comparisons, tax definition and measurement is problematic.<sup>12</sup>

Thus, if the determination is not made early in the reform process as to what constitutes local tax, and the proper authority of local taxation is not

<sup>11</sup>Alex Brillantes, *The Japanese Model for Achieving Inter-governmental Reform*, A Government of Japan and the World Bank Institute Symposium, Chulalongkorn University, Bangkok, Thailand, June 2001. [Http://www.decentralization.org](http://www.decentralization.org).

<sup>12</sup>The OECD’s revenue statistics for its member countries also take this approach. However, for 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 No. 7 (Paris: Organization for Economic Cooperation and Development, 2002).

**Table 2.**  
**Classification of Local Taxes by Degree of Central or Local Control**

|                          |  |   |
|--------------------------|--|---|
| High Revenue<br>Autonomy | SNG sets tax rate and base.  | Highest degree of own-source revenues. Most often concerns fees and charges; refer to Tables 3 and 4.   |
|                          | SNG sets tax rate only.  | Necessary and sufficient condition for categorization as own revenue (piggybacking, tax base harmonization, and conformity permitted).                                |
|                          | SNG sets tax rate, but only within centrally permissible ranges.                                 | A typical practice is to cap the top rate.  |
| No Local Autonomy        | Tax sharing whereby central and local revenue split can be changed only with the consent of SNG. | Can result when a local authority collects the tax and remits to the center (for example, China (Jin and Zou, 2003)).   |
|                          | Revenue sharing, with share determined unilaterally by central authority.                        | 100 percent 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). |
|                          | Central government sets rate and base of SNG revenue.  | May accompany political decentralization.   |

Source: Adapted from OECD, report 7, 2002.

granted, it is likely 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. And the use of the wrong data as the independent decentralization variable for analytical purposes will lead to false conclusions on the interplay of decentralization, macroeconomic stability, and public-sector size (Ebel and Yilmaz, 2003).

Taxes of SNGs may be divided into categories of decreasing local autonomy (Table 2). If SNGs 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 sub-national (local) tax. If the SNG has no control over the base and rate of a tax — for example, when the central government determines how to split revenues (tax sharing) — it is not a local tax.

Using those definitions, Table 3 reveals the significant variation in the degree of tax autonomy for SNGs in developed and developing countries. SNGs in developing countries get much of their tax revenues from tax sharing, whereas SNGs in developed countries have control over tax rate and base or must approve any changes in the revenue split of shared taxes.

Selected East Asian countries are placed in perspective in Table 4. The data show that, except for the Philippines, East Asian countries exhibit a low level of local own-source revenue autonomy. That

may reflect any of three considerations: a misunderstanding on the part of central and local officials on what constitutes own-source revenue (this was the case in many Eastern and Central European countries in the early 1990s, where there was a tendency to confuse revenue sharing with own-source revenue autonomy);<sup>13</sup> a reluctance of central authorities to grant much fiscal autonomy (for example, central government maintains legal control over conventional local taxes such as the property tax); or local government reluctance to take advantage of the legal authority assigned to it.

Again, the measurement and extent of revenue autonomy matters (tables 3, 4). Analysis suggests that when the decentralization variable is identified as the degree of revenue autonomy, a case can be made that moving from political to fiscal decentralization enhances macroeconomic growth and stability (Brennan and Buchanan, 1980, Ehadie, 1994; Ebel and Yilmaz, 2003).

#### IV. Framework for Revenue Decentralization

It is established that the decentralization of expenditure responsibilities brings with it the need to decentralize revenue-raising responsibilities, and,

<sup>13</sup>Richard Bird, Robert Ebel, and Christine Wallich, *Decentralization of the Socialist State* (Washington: World Bank, 1995), chapter 1.

**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> |
| <b>Developing/Transition Countries*</b> |                                   |                               |                               |   |   |   |  |
| Bulgaria (1998)                         | 0                                 | 0                             | 0                             | 0   | 41  | 59  | 0  |
| Czech Rep. (1995)*                      | 2.0                               | 5.0                           | 3.0                           | 0   | 90.0  | 0   | 0  |
| Hungary (1995)*                         | 0                                 | 30                            | 0                             | 0   | 0   | 0   | 70   |
| Poland (1995)*                          | 0                                 | 45.0                          | 1.0                           | 0   | 54.0  | 0   | 0  |
| Estonia (1997)                          | 0                                 | 9.8                           | 0                             | 0   | 90.2  | 0   | 0  |
| Latvia (1997)                           | 0                                 | 0                             | 0                             | 0   | 0   | 0   | 100  |
| Lithuania (1997)                        | 0                                 | 0                             | 0                             | 0   | 0   | 0   | 100  |
| Romania (1998)                          | 0                                 | 8.6                           | 4.6                           | 0   | 0   | 66.9  | 19.9   |
| Slovenia (1999)                         | 16.85                             | 0.6                           | 0.26                          | 0   | 82.29   | 0   | 0  |
| Slovak Rep. (1998)                      | 7.4                               | 28.2                          | 0                             | 0   | 0   | 64.4  | 0  |
| <b>Developed Countries</b>              |                                   |                               |                               |   |   |   |  |
| Austria (1995)                          | 5.9                               | 6.0                           | 0                             | 88.1  | 0   | 0   | 0  |
| Belgium (1995)                          | 5.1                               | 49.1                          | 0                             | 45.3  | 0.4   | 0.2   | 0  |
| Denmark (1995)                          | 0                                 | 95.2                          | 0                             | 0   | 2.7   | 0   | 2.1  |
| Finland (1995)                          | 0.01                              | 88.6                          | 0                             | 0   | 11.4  | 0   | 0  |
| Germany (1995)                          | 0.3                               | 13.2                          | 0                             | 86.5  | 0   | 0   | 0  |
| Iceland (1995)                          | 8.0                               | 92.0                          | 0                             | 0   | 0   | 0   | 0  |
| Japan (1995)                            | 0.1                               | 89.8                          | 0                             | 0   | 0   | 0   | 10.1   |
| Mexico (1995)                           | 0                                 | 0                             | 0                             | 74.6  | 18.8  | 0   | 6.6  |
| Netherlands (1995)                      | 0                                 | 100                           | 0                             | 0   | 0   | 0   | 0  |
| New Zealand (1995)                      | 98.0                              | 0                             | 0                             | 0   | 0   | 0   | 2.0  |
| Norway (1995)                           | 0                                 | 3.7                           | 0                             | 0   | 0.6   | 95.7  | 0  |
| Portugal (1995)                         | 30.1                              | 8.6                           | 0                             | 0   | 0   | 0   | 61.3   |
| Spain (1995)                            | 26.7                              | 35.4                          | 0                             | 37.9  | 0   | 0   | 0  |
| Sweden (1995)                           | 0.3                               | 99.7                          | 0                             | 0   | 0   | 0   | 0  |
| Switzerland (1995)                      | 51.8                              | 40.8                          | 0                             | 3.2   | 4.2   | 0   | 0  |
| U.K. (1995)                             | 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 and 2002).

\*Data are for 1995. The Czech Republic (1995), Hungary (1996), and Poland (1996) are OECD member countries and have graduated beyond the transition label.



**Table 4.**  
**Revenue and Tax Autonomy for Selected European and East Asian Countries**

| Country (Year)               | Estimated Own-Source Revenues as Percentage of Total Subnational Revenue | Country (Year)                             | Estimated Own-Source Revenues as Percentage of Total Subnational Revenue |
|------------------------------|--|--|--|
| Belgium*                     | 97.100   | Lithuania (1999)                           | 4.8  |
| Bulgaria*                    | 13.4   | Romania (1999)                             | 21.0   |
| <b>Cambodia (2003)</b>       | <b>&lt; 5</b>  | Slovenia (1999)                            | 28.1   |
| <b>China (P.R.C.) (2002)</b> | <b>&lt; 5</b>  | Slovakia (1999)                            | 42.1   |
| Czech Republic (1999)        | 40.2   | Spain (regions, local)*                    | 22.0, 84.0   |
| Denmark (1999)*              | 96.0   | Switzerland (cantons, communities) (1999)* | 89.0, 87.0   |
| Estonia (1999)               | 15.4   | <b>Philippines (2000)</b>                  | <b>30.0</b>  |
| Germany (1999)*              | 53.0   | <b>Thailand (2002)</b>                     | <b>10.9</b>  |
| Hungary (1999)               | 33.3   | Poland (1999)                              | 35.2   |
| <b>Indonesia (2002)</b>      | <b>15.5</b>  | <b>Vietnam (2003)</b>                      | <b>&lt; 5</b>  |
| Latvia (1999)*               | 14.1   | Romania (1999)                             | 21.0   |

*Source and notes:* European data are from OECD, *Fiscal Design Surveys Across Levels of Government*, Tax Policy Study No. 7, Paris, 2002. "Own source" refers to total taxes, revenues for which the SNG sets the tax base plus taxes when the SNG sets only the rate. Revenues include taxes plus nontax sources levied by the local government (for example, fees and charges). The range for Belgium reflects local municipalities (97 percent) and regional governments (100 percent). The asterisk denotes a tax (not revenue) autonomy ratio. East Asian data are provided by Robert Talierno, "Own Source Revenue Policy and Administration" in *East Asian Decentralization* (Washington: World Bank, coming 2005).

without own revenue sources, SNGs would be fully dependent on funding from the center (or other external sources, such as international donor aid). Thus, the benefits of decentralized decisionmaking will not be achieved. On top of those two points, we have also imposed the framework of the fiscal architecture.

The next task is to begin sorting out revenues among governments, in three steps. The first step is to narrow the discussion of subnational tax options by imposing the theory of the public budget on the fiscal system. The conclusion of this section is that, for fundamental reasons of open vs. closed economies, central and SNGs have different fiscal functions. That gives the central authority the first claim on crucial tax handles, notably broad-based consumption and income taxes and taxes on natural resource production.

The second step is to add in two broad normative principles for guiding subnational revenue policy: the benefit approach, in which the decision rules are similar to those of the private sector quid pro quo of payment for services; and revenue mobilization, whereby, from an efficiency (and in some cases, an expediency) perspective, local governments are well positioned to use some taxes and fees.

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.

#### **Context: The Theory of the Public Budget**

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.

For reasons that stem from the closed vs. open economy distinction, macro policy is a central, rather than subnational, responsibility (Musgrave, 1959; McLure, 1999). There are three aspects to this. Each has implications for revenue assignment.

- *Stabilization.* The traditional argument for central responsibility stabilization policy is straightforward because of the general economic openness of SNGs, subnational units are ineffective in dealing with unemployment or inflation because markets are so interrelated that leakages result.<sup>14</sup> That leads to two policy

<sup>14</sup>This is also becoming true across nations, thus calling for international coordination of macro policies.

realities. The central government must have access to debt and revenue instruments that serve as effective tools for fiscal policy. For tax assignment, that 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).<sup>15</sup>

- *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 is that, as part of the central authority's role in managing the flow of external trade (and of foreign exchange reserves), it must be assigned monetary policy. It follows that the center must 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 of evening out income variations that result from regional or exogenous shocks.<sup>16</sup> To perform that risk management role, the central authority must have fiscal and monetary tools that include access to broad-based consumption and income taxes. It follows that the center is best suited to assume the risks of volatile revenue sources in particular, taxes on petroleum and mineral resources and the notoriously capricious business (for example, corporate) income and profits tax.

For distribution responsibility, the central vs. subnational division becomes less clear-cut. For most of 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 a largely central responsibility. In the open subnational economy, people and firms' freedom to move among localities frustrates any single subnational jurisdiction's attempt to significantly change the income profile of its residents through fiscal policies. The only "successful" outcome of a SNG's attempt to significantly redistribute income is that

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

<sup>16</sup>Seok-Kyun Hur, *Intergovernmental Allocation of Tax Bases in Korea*, Seoul, 2003.

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.

What makes the distribution competency less clear is that distribution has a "place" as well as a "people" dimension. The proximity of SNGs to the poor, and familiarity with and understanding of the institutional situations and hostile environs the poor inhabit in different regions and communities, provide advantages to the well-decentralized governmental units in designing and implementing antipoverty policies (Rao, 2002). One implication is that, in the developing-country context, the central government will have to find many 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, the large revenue producers must be assigned to the central unit.

That leads 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. In this context, there are two guidelines for tax assignment: benefits received and revenue mobilization.

### Benefits Received

As noted above, the benefits framework serves as a foundation for the efficiency gains that a well-designed decentralized system can provide. The logic argues that subnational revenue policy should be designed so that it is the beneficiaries of a flow of services who are 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 that application of the benefits principle does not necessarily require full cost recovery or the restriction of levying the tax or fee on only residents of the taxing jurisdiction. Also, the beneficiaries of the net fiscal benefits of a flow of subnational public services may or may not reside in the tax or fee levying jurisdiction (for example, visitors or nonresident factor suppliers of a subnational based entity); even if they do, the benefits may be either specific to the direct user or generalized to a broader community.<sup>17</sup>

*Specific benefits.* For the nature of the benefits criterion in its relevance for local governments, a

<sup>17</sup>The term "net" is stressed to indicate that those spillover flows (externalities) may be positive or negative. For the negative externality (the most obvious case is pollution), a tax or fee may be levied to reduce the net costs through reducing consumption or production.

conceptual debate emerges on how specific a benefit must be to qualify as a tool for subnational taxation. Charges and fees include those for the following:

- Direct use of a facility or consumption of a service. Examples include (1) residential care for the elderly, (2) utility consumption, (3) trash and garbage collection, (4) sewer services, (5) school meals, (6) parking, (7) road and canal tolls, (8) entry fees to facilities such as museums, sports facilities, and parks, (9) airline landing and slotting, and (10) road use (which may be structured as a tax for example, on motor fuel or other vehicle characteristics).
- License fees paid for the privilege of an activity (business establishment, driving permits, vehicle use, and registration fees to defray the cost of public monitoring of an activity such as land transfer and titling).
- Betterment levies to pay for local infrastructure (measured by increases in land values consequent on the granting of planning decisions, special assessments to cover costs for things such as sidewalk construction and repair, and developer fees to finance both on-site and off-site infrastructure).<sup>18</sup>

The rationale for the use of specific charges, even when mandatory, is straightforward, because 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. Also, 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 identification aspect of revenue administration. There is also an educational merit of informing the citizen that prices (costs) can be public as well as private.

What is not straightforward are the design and level of a charge. There are several design options. The choice of method depends 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); multipart tariffs (in the simplest form, fixed asset charges, such as a connection fee combined

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

with an additional fee for use of a system); and going-rate charges (or, perhaps more aptly, fiscal expedient whereby the degree of user demand elasticity is captured).

*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 services received. Thus, there is a rationale for local broad-based taxation of the business enterprise on income or receipts. Using the business enterprise as a tax collecting intermediary serves as a conduit for taxing individuals wherever they may reside (including nonresident factor suppliers, such as shareholders) for the benefit of local services accruing initially to the business enterprise. In that view, the services of local government are treated as a factor of production similar to land, labor, and capital, and their costs should be incorporated into the pricing structure.

The generalized case also arises for 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) or the ability to consume (income spent). That governments create those 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 financing generalized services. (McLure, 1999).

For the central entity, either a production (origin) tax, such as those on personal income or payroll, or a destination approach is acceptable (consumption value added tax). For the SNG, however, an additional inquiry is necessary, because people may not work where they live. If the benefits are most closely linked to the production or earning of income, the jurisdiction should opt for a production-base tax, such as a tax on payroll levied where the employment occurs. If the benefits from tax payment local spending are more likely to be service-consumption-based, 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 (for example, 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 SNGs should stick to resident-based taxes on personal income.

Using that generalized benefits argument, could a 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. Each role provides a tax handle.

### Revenue Mobilization

Well-functioning SNGs are able to access some tax bases more readily than can a central government (for example, some user charges, rudimentary sales taxes, and real property taxes).<sup>19</sup> The SNG list includes revenues that not only tend to satisfy the benefits rule, but also have the merit of being levied on activities, and tax bases that are relatively immobile (real property and, depending on the degree of resident or worker mobility, payroll); and 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 that criterion.

While recognizing the merits of the revenue mobilization objective, one must be candid that the 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 (for example, village, city, or regional) boundary.<sup>20</sup> The base is on the value, weight, or number of items 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 jurisdictions where tradition has made the *octroi* more politically acceptable than user charges (for example, on average it accounts for 50 percent of own-source revenues of large municipal corporations in Maharashtra). That 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.

<sup>19</sup>Taxes on other forms of property (for example, an intangibles or wealth tax) are not well suited to open economy jurisdictions.

<sup>20</sup>Roy W. Bahl and Johannes F. Linn, *Urban Public Finance in Developing Countries* (Oxford: Oxford University Press, 1992), pp. 226-228.

## V. Local Revenue Administration: Models and Options From East Asia

According to Vehorn and Ahmad (1997:109), there are four traditional models for tax administration in decentralized polities: (1) central government tax administration with sharing of revenues; (2) central government tax administration with assignment of taxing powers to different levels of government; (3) multilevel administration with revenue sharing; and (4) self-administration by each level of government. A fifth model, which is not mutually exclusive to the others, is contracting out to the private sector (also known as “tax farming”). Mikesell (2002:3) stresses another dimension, the extent to which the national and subnational authorities cooperate or operate independently.

This section provides an in-depth look at local revenue administration in the East Asian region, while highlighting the issues and trade-offs in terms of autonomy and efficiency. Table 5 shows that, on the administrative side, there is much diversity in East Asia, with the transition economies closer to the centralized pole and the Philippines, Indonesia, and Thailand closer to the decentralized pole. It could be argued that all of the major administrative models are featured in this sample of East Asian countries.

The Philippines, for example, is highly decentralized for tax administration. The Bureau of Internal Revenue (BIR) administers national taxes, while each local government administers its own-source revenues according to the local government code and local revenue codes. There is little formal cooperation provided for by law. The BIR operates independently of local tax administrations, and the national government provides little support to local governments. Local tax administrations, for the most part, operate independently of one another.

At the other extreme is Vietnam, in which all tax administration is centralized. Vietnam’s central General Taxation Department (GTD), under the Ministry of Finance, is responsible for collecting all internal revenue with offices at the provincial and district levels. Local governments have no responsibility for tax administration. However, tax administrators are responsible to their ministerial management as well as to representatives of local governments.<sup>21</sup> Thus, there are some tensions built into the administrative system. On the one hand, local governments have little formal responsibility for tax administration, and on this count the system

<sup>21</sup>However, the GTD is responsible for appointment, promotion, and transfer of departmental staff. It is unknown to what extent local government officials have input into these processes.

**Table 5.**  
**Administrative Models Used in Selected East Asian Countries, 2003**

| Models   | Countries                          | Observations   |
|--|------------------------------------|--|
| Central administration with tax sharing (I)          | Vietnam                            | Highly centralized, but dual subordination of tax administrators gives SNGs some control at the margin.                      |
| Central administration with local tax autonomy (II)  | Cambodia (at the provincial level) | Relatively minor taxes and fees assigned to the provincial level.  |
| Multilevel administration with tax sharing (III)     | China (P.R.C.)                     | Formally separate administrations for national and provincial levels, though dual subordination in practice.                 |
|  | Indonesia                          | Formally separate administration, though some cooperation between NG and SNG tax agencies, including on the property tax.    |
|  | Thailand                           | Formally separate administration at the national, municipal/city, and subdistrict levels.                                    |
| Self-administration by each level of government (IV) | Philippines                        | Separate provincial, municipal/city, and barangay administrative levels; little cooperation between NG and SNG tax agencies. |

Source: Robert Taliencio, "Own Source Revenue Policy and Administration" in *East Asian Decentralization* (Washington: World Bank, coming 2005).

is highly centralized. Such administrative centralization may reduce incentives for revenue collection because central tax administrators will either have fewer incentives to collect local revenues over central revenues or local administrators would have greater incentives to collect more local revenues. However, Martinez-Vazquez (2003) also notes that provincial authorities have been known to pay bonuses to tax administrators who improve their collection performance. In this sense, at the margin, SNGs have some administrative control. The system is also designed to promote local incentives to raise revenues through a mechanism that allows SNGs to retain all collections above target, though, as might be expected, that has led to strategic behavior and gaming of the system (World Bank, 2000).<sup>22</sup> A further aspect of the Vietnamese system is the apparent administrative control at the margin that results from the payment of bonuses to tax administrators by local governments.

In Indonesia and the People's Republic of China, the central governments administer all taxes that are shared, while the local governments administer revenues assigned to them. In Indonesia, local revenue agencies administer the taxes for which they are responsible, with little support from the central

government. As in the Philippines, that results in disparate administrative quality across the country (for example, collection costs in Indonesia vary widely by locality). China's tax sharing system reforms of 1994 created two separate tax administrations — one central to administer national and shared revenues, and a provincial tax administration tasked with all subnational government revenues. According to the World Bank (2002:71), there is still a problem of de facto dual subordination of central tax administrators to local governments, because of old allegiances and local governments providing bonuses and penalties to stimulate collection performance, thus creating potential conflicts of interest. There is another concern in that the interests of subprovincial governments, principally counties and prefectures, are not necessarily given the same consideration as those of the provinces in terms of tax administration. It may be that provincial tax administrations sometimes afford a lower priority to collections that do not benefit the provinces as much.

#### **Autonomy and Efficiency in Administrative Design**

Guidance from the literature on good practice in tax administration in decentralized contexts is less clear. There is no consensus on the principles of devolved administration. Rubinfeld (1983) argues that collection authority should be devolved to the government with the lowest collection and enforcement costs. That recommendation, however, would

<sup>22</sup>To the extent that SNGs have marginal control over collections in excess of the targets, these marginal revenues may be considered own-source revenues.

usually mean no devolution at all in many developing countries. Mikesell (2002:20) also argues that overall administrative and compliance costs for the entire national and subnational system should be considered when designing the level of administrative devolution.

The efficiency criterion would argue for reducing total administrative and compliance costs by taking advantage of economies of scale and scope. In the Philippines, for example, there are hundreds of small-scale tax administrations collecting revenues throughout the country. Their ability to attract and retain qualified staff is limited, as is their access to appropriate information technology. That limited capacity also has direct consequences for taxpayers through higher compliance costs. Variations in local administrative capacity also mean taxpayers do not receive uniform treatment throughout the country.

The question is whether it is possible to centralize some administrative functions to reduce administrative costs without reducing local government autonomy. Or, to what extent is local tax administration a *sine qua non* of autonomous local governance? Revisiting the definition of own-source revenues (in which it is argued that, for a local revenue to be an own-source revenue, it must be subject to control by the taxing jurisdiction at the margin), one could make the case at the extreme that, because there are functions of tax administration that effectively control marginal revenues, control over some aspects of tax administration must be part of the definition of an own-source revenue.

Looking at administration as a bundled set of functions rather than a homogeneous process allows one to think about differential treatment of administrative functions and their relation to autonomy. For example, the level of enforcement activity chosen will have a direct bearing on the level of tax arrears collections. Thus, a SNG that had control over enforcement activities would be able to increase revenues at the margin. The same holds true for administration of taxpayer registries, which can be managed more or less aggressively, and the provision of taxpayer services. It is less true for other functions, such as property valuation if market methods are used, there is not much scope for differences in implementation. Administration as well as policy levers can be used to affect marginal revenues (though some administrative effects in practice might be quite small).

Local governments need not, in theory, have direct control over all tax administration functions as long as local governments are in control of how those functions are administered. Tax administrators, as bureaucrats, are the agents of political principals; tax bureaucrats are supposed to do as their political principals say, according to the law. One definition of a good tax administration is one that simply follows

the law namely, the tax code leaving aside whether the law is good tax policy. It is possible to imagine a situation in which bureaucratic agents are located outside the local government, yet are still responsible to the local chief executive. Tax administrators may not need to be local government employees to ensure accountability to local governments. Devolved responsibility does not necessarily imply devolved administration, especially in the context of weak local capacity.

***The services of local government are treated as a factor of production similar to land, labor, and capital.***

Several options exist that would guarantee local autonomy while improving efficiency. Those options need not be considered as universal for all SNGs in a given country. Options could be considered, as appropriate, on a SNG-by-SNG basis, which would imply asymmetrical treatment of SNG administrative systems. Depending on local conditions, asymmetry might make sense and would likely generate useful experiences that could be considered as pilots for more comprehensive reforms.

One option, though more common in OECD countries, would be to contract out appropriate functions to the private sector, including collection and assessment.<sup>23</sup> Though that is prohibited in some countries (for example, the Philippines), it is an option. If there are proper monitoring and anticorruption procedures (and this may be a big if), 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 town council levies a series of fees and business receipts taxes and puts out a request for proposals (RFP) for the tax collection process. The winning bidder is contracted to collect as the tax law allows and to 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 the *tehsil* to make policy (for example, tax rate) changes as needed and monitor its revenue flows. The central authority retains the responsibility for audit through its office of auditor general. Every third year, the RFP is reissued for the bidders to respond with amounts they will guarantee to collect for the local treasury. If the market works and other

<sup>23</sup>Byrne (1995) provides an overview of tax administration functions appropriate for privatization, from printing and collections by banks to prosecutions of cases.

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 taxpayer payments and collections to the local treasury.

**Despite its being condemned regularly, the octroi continues to be an important revenue source.**

A similar, but less comprehensive, approach to tax farming occurs in some Lebanese municipalities where 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.

A similar approach is to contract out, but to other public sector agencies. Local governments with greater capacity might perform some functions for local governments with less capacity for a fee. That is the case with Lima's Tax Administration Service, which collects property taxes for two other Peruvian municipalities (Ate and La Victoria) for a 25 percent commission. The issue is whether SNGs would have control over administration at the margin.

Another option would be to establish a local government tax agency that would assist local governments on a case-by-case basis for a fee with core tax administration functions such as registration, collections, and compliance. A subnational tax agency would allow economies of scale and scope that could result in lower administrative and compliance costs. There are no known examples of that approach.

And yet another approach is for the national government to take responsibility functions, such as property assessment, or to assist local governments with core functions. In many countries, from Colombia, where the central government maintains the property register and updates property valuations (Vehorn and Ahmad, 1997), to Cyprus, Estonia, Jamaica, Pakistan, and Malawi, where the central government is responsible for property tax assessment and collection (McCluskey and Williams, 1999, cited in Mikesell), though property taxes are assigned to local governments, national governments assist with core functions.<sup>24</sup> To add a dynamic element to that approach, one could envision local governments taking over more functions as they developed capacity in those areas. That would not necessarily mean all local governments would perform all tax administration functions, because some

make more sense carried out centrally; but it would allow for functions to be systematically transferred — perhaps slowly — to capable SNGs.

This approach has been tried in the region, but with limited success. In several countries, ministries of finance (and sometimes, specific departments, such as the Bureau of Local Government Finance in the Philippines) are responsible for assisting local governments with own-source revenue administration. However, that seems to work poorly in practice because, first, this is not a core business activity of finance ministries, and it gets relegated to low priority status. Second, resources are often inadequate, which results in differential assistance to SNGs, but usually seems to leave many SNGs underserved a problem particularly in Indonesia and the Philippines.

Some East Asian countries have already taken advantage of SNG economies of scale and scope at the SNG level. Responsibilities for administration vary among subnational types of government, with higher jurisdictional levels having some responsibility for collections for lower jurisdictions in many countries in the region. In Indonesia and the Philippines, provinces collect and transfer some revenues to local governments. Though that raises questions about provincial incentives to collect, it may be that economies of scale are achieved in administration. Under these arrangements, provincial governments are responsible for most, if not all, administrative functions for those shared taxes. What has not been tried is a model in which the provinces assumed only partial responsibility for some functions, while local governments assumed responsibility for others. That option is worth exploring as a means to rationalize administrative arrangements both between national and subnational governments and among subnational governments themselves.

Recent work in East Asia shows that local government administrative capacity is often weak. That weak administration is the binding constraint on improving revenue performance (*E. Asian Decentralization*, World Bank, 2005). The principal problems identified include: (1) the prevalence of stop filers, nonfilers, and late filers because of the low capacity to perform the taxpayer registration function, which results in delinquent payments and the accumulation of arrears (especially in the Philippines); (2) infrequent exercise of audit and enforcement (temporary closures and property auctions) authority, resulting in low compliance (a problem in both the Philippines and Indonesia); (3) the limited availability of taxpayer services (though there are some important examples of good practice in individual local governments in the Philippines and Indonesia); (4) the low professional qualifications of

<sup>24</sup>See also Mikesell (2002) on intergovernmental tax administration compacts in the United States.

staff; and (5) inadequate support from, and coordination with, national government.

Problems of weak local administration are not unique to East Asia. The governance support systems that one takes for granted in most countries may sometimes be so insufficient as to thwart tax autonomy. That is often true in low-income or post-conflict situations. Consider the difficulties in enforcement of tax payment (collection) of postwar Lebanon, where there is no reliable nationwide postal service, a lack of computerization, and an ineffective bank-deposit mechanism for making tax payments.

The East Asian experience suggests that the multilevel administration model (with tax sharing) holds promise. The advantage of that model is that different functions could be assigned to different levels of administration and assistance to SNGs could be facilitated. Assigning complex tasks characterized by economies of scale (for example, property valuation) to either a central government agency or an agency dedicated to local tax administration support would reduce administrative costs and likely improve service quality. The idea of a local administrative support agency, funded by local governments and under their collective control, holds promise and should be explored further. Other solutions, such as contracting out to other SNGs or contracting out to the private sector and the national government by piggybacking on its taxes, are also worth consideration.

## VI. Choice Among Taxes: Assignment

Debate on revenue policy seldom makes clear the basis for selecting or assigning one revenue over another. Several factors may be at work to discourage explicit statements for example, lack of data on the economic effects of a tax, uncertainty on who will bear the burden, and the complexity and multiplicity of outcomes because of the interplay of different taxes. Nevertheless, when a SNG makes the political decision to tax, a set of criteria is needed to make choices. Table 6 presents five generally agreed-on criteria that are accompanied by a checklist of which revenue sources satisfy the objectives laid out. Two points are apparent. First, in selecting or modifying one tax or set of taxes, it is inevitable that trade-offs must 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. Second, for a subnational revenue system to work well, it is desirable to use a mix of taxes. All revenue sources have inherent structural inequalities, and if any one is used too intensively, those defects become intolerable. That calls for using 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).

## VII. Beyond Assignment: Further Design Issues

Before summarizing the assignment discussion, three other design issues merit attention.

*Mandates.* If a SNG has 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 the 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.

**A subnational tax agency would allow economies of scale and scope that could result in lower administrative and compliance costs.**

*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. Except for a very wealthy, high-income producing area, there will be imbalances. Those imbalances may be vertical (central-subnational mismatch between expenditure need and resources) or horizontal (horizontal as disparities between a SNG’s own-revenue generating capacity and its spending needs). That is, of course, when the imperative for a well-designed system of intergovernmental transfers from higher to lower levels of governments can achieve important objectives.<sup>25</sup> It also reinforces 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.

*Overlapping assignments and harmonization.* The discussion of assigning revenues to different governments does not imply that each type of tax should be assigned to only one government. There is good reason to assign the same tax or revenue to

<sup>25</sup>See Serdar Yilmaz, *Intergovernmental Transfers: Concepts and Policy Issues*, Seoul, 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, University Tokyo, February 2001.



**Table 6.**  
**Criteria for Making Subnational Tax Choices**

| Criteria/Objective   | Comment   | Taxes That Satisfy the Objective   | ... And Those That Fail   |
|--|---|--|---|
| Accountability: Local policymakers responsive to citizen preferences. Those taxed have political redress.  | Local officials 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); natural resource taxes (petroleum, minerals).  |
| Revenue productivity: Taxes that promote "adequacy" to finance an agreed flow of public services.  | As a system, recognizes a balance between bases responsive to changes in economic conditions growth (elasticity or buoyancy) and stability (certainty).   | Ad valorem property tax (distinguish between land and improvements) or area-based property tax; personal income tax; general broad-based business tax (e.g., gross receipts/turnover); single stage sales taxes; some terminal taxes (e.g., <i>octroi</i> ). | Corporate profits; many user charges; low-effort property taxation.   |
| Benefits received: Taxes should function as a "price" for flow of services that accrue to the taxpayer or citizen.                                       | Taxes perform tax price quid pro quo and may be tailored to local and regional variations and benefit areas. Service spillovers (+ or -) may call for (i) special districts (interlocal cooperation) or (ii) middle-tier governments. | Whenever possible, charge visitor taxes, business taxes (generalized benefits, e.g., value added).   | Nonresident-based income tax (assumes nonresidents are subject to alternative taxes for services received, e.g., user charges, sales taxes, visitor taxes, and general business tax). |
| Nondistortion: Taxes should not unintentionally interfere with private decisions of 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 immovable property; land value tax plus charges; resident-based personal income; sumptuary taxes; taxation of net negative externalities; poll taxes.   | Nonresident-based income tax; gross receipts taxes; severance taxes (if high rate); <i>octroi</i> .   |
| 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 (for example, communal tax); area-based property taxes; gross receipts taxes.  |
| Simplicity: Administration and 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/receipts taxes; some user charges.  | Multirate taxes; potentially broad-based taxes narrowed by exemptions, deductions and tax preferences; property tax.  |

multiple units as long as it does not create unacceptable administrative complexities, inequities, and distortions. 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, particularly for broad bases that are shared. For example, the central government could levy a nationally uniform personal income tax base and give the SNGs the authority to add their own tax rate (piggybacking) to the central rate. The central authority then has the incentive for good revenue administration across the entire range taxpayer identification, assessment, collection, appeal,

and audit. The resulting possible fiscal disparities among local jurisdictions (because the derivation principle favors the high-income-producing jurisdiction) is a matter to be addressed elsewhere (in the design of the transfer system).

### VIII. Concluding Comments

Recognizing that, for developing countries, generalizations about subnational tax policy design are difficult, some observations can be made in this new era of a global trend toward localization.

- Getting the design challenge of fiscal decentralization "right" is important because a well-designed intergovernmental system is essential

to increasing the quality of life, as now formally expressed in the millennium development goals. Although fiscal decentralization has many facets, a necessary condition must be satisfied. Local governments must be given, and then exercise, the authority for own-source taxation. That does not mean own-source taxation will lead to revenue adequacy. Except in special circumstances of rich communities with a wide degree of revenue autonomy, this will not be true. But for rich and poor and urban and rural communities alike, subnational tax policy design matters.

- The decision to decentralize is always political. But once that decision is taken, the technical issues of tax policy become paramount so that a community can efficiently pay for poverty reduction, safe drinking water, improved maternal health, and literacy programs. That will not be easy: As one moves from the developed to developing economies, the job becomes much more difficult as the tax policy options are narrowed not only by considerations as broad as the fiscal architecture of nations, but as narrow as whether there is a paved road or a list of potential tax bases and taxpayers.
- Despite the challenges, the payoff of doing decentralization and decentralized tax policy well is enormous. The evidence is that the rich countries of the world are those that have decentralized; a key to that strategy has been attention to good subnational tax design.

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