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Research Report

The mobilisation of sub-national revenues is a decisive factor in the realisation of the 2030 Agenda

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The Mobilisation of Sub-National Revenues Is a Decisive Factor in the Realisation of the 2030 Agenda.

Summary

In 2015 the global community committed itself to an ambitious programme of reform. Achieving the Sustainable Development Goals and implementing the resolutions of the Paris climate conference require that great efforts are made – including those of a financial nature. Many states will have to ensure that untapped or barely used sources of income are developed.

Sub-national units such as provinces, departments, districts, and cities will play an increasing role in the mobilisation of public revenues. They are also in the forefront with regard to realisation of the global reform agenda, as many of the objectives concern classic areas of activity of local government: schools, basic medical care, local road construction, public transport, construction of social housing, the supply of drinking water and disposal of waste water, refuse collection etc. These services are already the responsibility or co-responsibility of sub-national units.

The mobilisation of revenues at sub-national level is therefore not only a financial necessity, it is also prudent from a development policy perspective: if the users and funders of a good match, there is a greater likelihood that the preferences of citizens will be observed and the use of funds monitored. In addition, local taxes and levies are often paid by a broad circle of citizens and companies. This serves to strengthen the relationship between governments and the governed.

One thing should be clear in this: although many countries will exploit the scope for collecting local taxes and levies in the future, this potential is nevertheless limited. Many sub-national units will remain dependent on transfer payments from the central state. Cities, districts and the middle tier cannot solve the funding problem of the states on their own. However, they can help to place the provision of public services on a broader foundation of legitimacy and, in co-operation with the national level – for example via the exchange of information – improve fiscal policy as a whole. Consequently, they also contribute to overcoming problems of fragile statehood.

Fiscal decentralisation and local taxation are eminently political topics

Although fiscal decentralisation is in many respects a technical issue, it is common knowledge that the issue is also equally a political one. Political determinants are decisive for the legal design of fiscal decentralisation, but also for the actual functioning of the system. This discussion is often conducted under the heading of “political economy of fiscal decentralisation”. However, the subject comprises two different dimensions, both of which need to be considered if fiscal decentralisation is to succeed in practice.

- On the one hand, it is necessary to balance the interests of the central government, which often strives to retain as much authority as possible, and sub-national governments, which demand the transfer of these competencies. This dimension typically attracts great attention.
- On the other hand, there is the question of what incentives sub-national governments have to actually exploit the freedom of action assigned to them. This is far less present in the academic and political debate. It is often overlooked that local politicians and administrative bodies may have reasons not to raise taxes. Social policy considerations may play a role here, together with power consolidation issues or the inadequate design of the transfer systems, rendering local tax collection efforts superfluous.

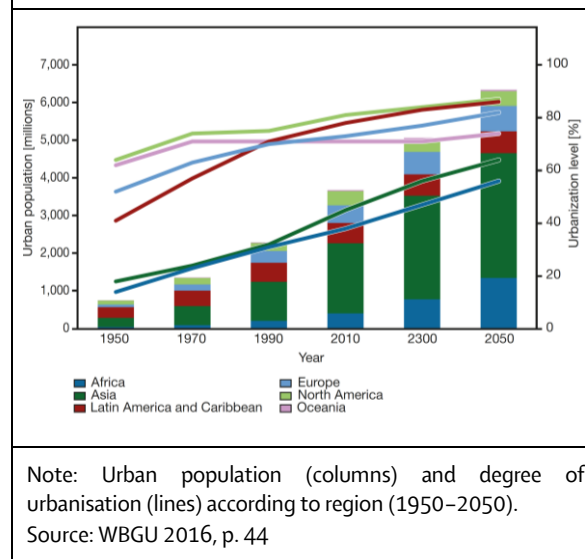
Empirical research has not yet produced conclusive answers to the question whether or not the decentralisation of taxes and levies actually has a positive effect on the quality of services and the utilisation of existing tax potential. At the centre of this discussion is the question of under which prerequisites municipalities use fiscal autonomy to negotiate a broad “fiscal contract” with their citizens. Frequently the political prerequisites for common good-oriented policies are as lacking at local level as they are at the national one. In some cases, sub-national tax authorities are subject to the influence of powerful interest groups who systematically thwart local taxation efforts or abuse them for their own clientelistic purposes. Such conduct is less easy where state monitoring institutions and civic organisations ensure transparency and accountability. In this respect, fiscal decentralisation should be addressed in the scope of an integrated approach that views the public finance system as a central component of good governance.

The megatrend of urbanisation

The described mechanisms of political economy already constitute a major challenge under comparatively static conditions. However, they are now also subject to enormous changes. The global progression of urbanisa-

tion is particularly responsible for this. By 2050 around two thirds of the world population will live in towns and cities (see Figure 1). This means that practically the entire growth in the global population will be absorbed by urban areas. Many observers point out that the success or failure of the 2030 Agenda will be decided in the towns and cities.

Fig. 1: Urbanisation on the global scale



There is no doubt that this presents major challenges for all towns and cities, regardless of their size. In the majority of developing and emerging countries the sub-national levels are scarcely prepared for this. There is often an excessive delay in tailoring territorial responsibilities to the rapid growth of urban areas, strengthening the financial independence of the towns and cities and enabling greater political autonomy in the fulfilment of their administrative and service functions. Sub-national governments require freedom of manoeuvre for budgeting and local spending. Instead, in many places their hands are tied due to earmarked funding and other bureaucratic rules emanating from central government.

Greater leeway on the spending side needs to be combined with more own responsibility for revenues. In many countries this includes the decentralisation of further tax competencies, but above all the responsibility for using already existing competencies to a greater extent. Those taxes that in theory are best collected at local level are often only utilised to a lesser extent. Therefore, in many cases it makes sense to combine greater spending autonomy with increased responsibility for self-financing. This creates incentives for sub-national governments to generate more resources and spend these more efficiently and effectively. The prerequisites for taking out loans at local level are also improved as a consequence – important for the financing of infrastructure.

Local taxation of real property – the example of Indonesia

In many developing and emerging countries, the taxation of real property is regarded as a source of income with a particularly high potential. This is primarily due to the fact that the fast pace of urban growth is leading to an enormous rise in property values in many areas. Property tax is often referred to as a typical local tax, as it is closely linked to services that are provided locally (e.g. infrastructure, utilities) and information available locally is required for its effective collection.

In most countries municipal governments nonetheless find it difficult to fully exploit the potential that property tax offers. One example is Indonesia. Here parts of the property tax were transferred to the municipalities between 2011 and 2014. However, with the exception of the capital, Jakarta, scarcely any municipalities used the new competencies to effectively increase revenue from this tax. This is evident, for example, in the fact that practically all cities and districts have retained the old tax rate of a maximum of 0.2 percent of the property value, although an increase to up to 0.3 percent is legally possible.

What is clear is that in the poorer and rural districts of the country there is no favourable relationship between the revenue from this tax and the administrative effort involved in collecting it. There is often little interest here in an effective raising of the tax. However, in the richer, more densely populated areas it can clearly be seen that there is often a wide gap between the expectations and reality of property tax in particular.

Naturally, capacity issues play a role here. Property tax may be a typical local tax, but its administration is decidedly complex. The valuation of buildings and land, the keeping of the land register, the processing of claims and the enforcement of payments cannot be achieved without trained staff and appropriate infrastructure. However, a number of Indonesian cities have shown that these obstacles can be overcome.

A more decisive aspect is that many Indonesian municipal governments shy from the effective collection of property tax due to political considerations. Its visibility means that property tax is not especially popular anywhere. In addition, politically-influential sectors of society – large companies and wealthy individuals – usually bear the main burden of taxation. Some local governments therefore prefer to waive revenues, as they estimate the political cost of collection as higher than the financial benefit.

Multi-level governance

Local revenues contribute to the financing of state services, but they are also a key element in the effective interaction of state levels. In poorer countries, too, the sub-national levels are now assigned more and more public tasks due to decentralisation reforms. In this, the flow of information between the state levels has a decisive influence on the quality of services and the efficiency of the public administration.

Where sub-national governments are (co-) responsible for taxes and levies, they are also involved in collecting information from taxpayers and keeping corresponding registers. In many cases significant gains in efficiency can be achieved here from the co-operation between the levels. For example, municipalities can be assigned responsibility for collecting tax-relevant information within the scope of public tasks commissioned to them by higher levels of government. Other tasks require more extensive or better-equipped administrative systems and can therefore be transferred from local to mid or central state level. The digitalisation of public administration opens up further opportunities for interlinking the levels in this respect.

However, co-operation between state institutions regularly fails due to technological hurdles, unclear competency distinctions and a lack of structures for jointly removing existing obstacles. In the area of tax policy and administration in particular, where the advantages of interlinking are especially evident, there is seldom willingness to co-operate with other regional authorities. The onus here is upon the central state level to create incentives for improved co-operation, for example via the joint financing of infrastructure.

Heterogeneity: transfer systems remain necessary

In the discussion of fiscal decentralisation, the focus is often placed on cities. In this it is easy to overlook how significant the socio-economic differences can be at sub-national level. It is a fact that many poorer or rural municipalities or regions can never be wholly independent from a fiscal viewpoint. Their potential for generating their own revenue is simply too small, and this will not alter with the transfer of new tax competencies.

In this respect, state transfer mechanisms should ensure that economically weaker towns and municipalities are capable of providing public services at an acceptable level. To reconcile this goal with the strive for increased fiscal autonomy and responsibility for sub-national governments the regular, systematic monitoring of transfer systems is of particular relevance. Transfer mechanisms should not establish negative incentives for the utilisation of tax potential. Transfer regulations that "punish" municipalities for raising their own taxes are not helpful.

It is also important to have a degree of flexibility in the tax administration models. Whilst it can certainly be worthwhile for larger cities to establish a strong, independent tax administration system, the situation in smaller towns and municipalities is a different one. A lack of capacity in tax administration at sub-national level is often stated as a key argument against the decentralisation of further tax competencies. In this, the fact that own revenues do not necessarily require the establishment of an independent tax administration is sometimes

ignored. It is by all means possible for local governments to decide autonomously about tax base and tax rates, but for tax administration tasks to be carried out by authorities at mid or central state level. Models such as this enable autonomy to be strengthened without overburdening weaker municipalities. However, in practice such a distribution of tasks scarcely occurs in developing countries.

Fragility as a central challenge

The collection of taxes and levies is considered a central characteristic of statehood. A functioning tax system represents a key pillar of the "fiscal contract" between state and society – with claims and obligations on both sides. However, many developing countries are characterised by fragile statehood.

The term refers to the ability of the state to provide public services (capacity), enforce the monopoly of the use of physical force (authority) and gain the acceptance of public institutions in the eyes of the population (legitimacy). Depending on the extent to which these three dimensions are manifested, very different types of fragile statehood can be identified – culminating in cases where deep-lying deficits exist in all three dimensions, such as in Afghanistan or South Sudan.

The relationships between low state capacity and insufficient tax collection are generally known and are the focus of development policy intervention, although as yet not especially frequently at sub-national levels. It is also apparent that the state monopoly of the use of

physical force is a central prerequisite for effective tax collection. Where this is not the case, extortion and other forms of informal taxation are common practice. New research also indicates that a state whose claim to legitimacy meets with broad acceptance is more capable of organising collective action and mobilising the resources required for this.

However, the reverse also applies: the ability to raise taxes and spend these in a sensible development policy manner is of central importance in the overcoming of fragile statehood. The interrelation between payments and public services for citizens is particularly visible at local level, which is why this level plays such an important role in overcoming fragile statehood and political conflict situations. A functioning tax system at local level promotes strong local identities. These can act as an anchor for political stability by ensuring that statehood is not exclusively perceived as a product of – possibly weak – centralised power.

Ideas for flexible solutions are required to a greater degree than theoretically-reasoned blueprints if account is to be taken of the heterogeneity of the development levels and political power constellations. In this respect, the goals of decentralisation are not merely fiscal in nature: instead the objective is to establish the prerequisites for a "fiscal contract" at local level, which can have positive fiscal, but also political effects at national level. For this reason, sub-national taxation is also a theme for development co-operation with poorer and fragile countries.

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Note: This paper addresses theses and recommendations discussed in the scope of the 5th International Workshop on Domestic Revenue Mobilisation (13-14 September 2016) at the German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE) in Bonn. The subject of this workshop was the role of sub-national taxation in the implementation of the 2030 agenda. Programme and papers of the event can be viewed at the following website: <http://www.die-gdi.de/veranstaltungen/implementing-the-2030-agenda-the-role-of-subnational-taxation/>.

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