

Fiscal Federalism: Taxation in Federal States

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1. Introduction

- Fiscal federalism is a system of **transfer payments** or **grants** by which a federal government shares its **revenues** with lower levels of government.
- There are two primary types of transfers, **conditional** and **unconditional**.
- If the lower level of government is to receive this type of transfer, **it must agree to the spending instructions of the federal government**
- **The second type of grant, unconditional**, is usually a cash or tax point transfer, with no spending instructions.

- It may be noted that the ideas of **fiscal federalism are relevant for all kinds of government viz. unitary, federal and con-federal.**
- The concept of fiscal federalism is not to be associated with fiscal decentralization in officially declared federations only.
- **It is applicable even to non-federal states** (having no formal federal constitutional arrangement) in the sense that they encompass different levels of government which have *de-facto* decision making authority.
- This however does not mean that all forms of governments are 'fiscally' federal.

- **It only means that 'fiscal federalism' is a set of principles, that can be applied to all countries attempting 'fiscal decentralization'.**
- **While fiscal federalism constitutes a set of guiding principles, a guiding concept, that helps in designing financial relations between the national and sub-national levels of the government, fiscal decentralization on the other hand is a process of applying such principles.**

2. Forms of Fiscal Constitutions

(1) Unitary (148 countries) – Including China

(2) Federal (45 countries)

(a) Dual Federalism

- **Layer cake – Mexico, Malaysia, Russia**
- **Coordinate authority – Australia, Canada, India, Pakistan, and USA**

(b) Cooperative Federalism

- **Interdependent spheres – Germany, South Africa (unitary)**
- **Marble cake - e.g. Belgium (territorial -3 and linguistic-4)**
- **Independent spheres - Brazil**

(c) Competitive Federalism

(3) Con-federal : EU

(4) Asymmetric Federalism

- **Some members are more equal than others: Sabah and Sarawak in Malaysia, Quebec in Canada**
- **Choice to be unequal or more equal than others: Opting-in and Opting out options. Canada, Spanish agreements, Russia, European Union (treaty exceptions for UK and Denmark).**

3. Revenue Allocations: Problems and Issues

The process of allocating revenue and expenditure responsibilities among levels of government presents an economic and political dilemma for all countries. This creates two basic problems:

Vertical imbalance: In this context, expenditure and revenue responsibilities and amounts are unequally divided between levels of government.

Horizontal imbalance: There is inequality between local governments. Some regions have more resources than they need while others have inadequate resources.

- There are **five basic criteria** which must be considered in designing and choosing the revenue allocation options:
 - **Revenue potential**
 - **Economic efficiency**
 - **Equity**
 - **Administrative feasibility**
 - **Political acceptability**
- There is common agreement among public finance practitioners that **central governments should primarily be responsible for stabilization and distribution functions, while both central and local governments should be responsible for allocation functions.**
- Accordingly, tax base and tax power authority should be generally allocated as follows:
 - **Taxes suitable for economic stabilization should be retained at the central level, while local taxes should be cyclically stable.**
 - **Progressive taxes suitable for income redistribution should be retained at the central level.**

- **Unequally distributed tax bases should be taxed at the central level to avoid exacerbating regional disparities.**
- **Local governments should tax those revenues bases having low mobility between jurisdictions to minimize regional distortions and tax exporting.**
- **Benefit taxes and user charges should be used by both central and local government levels.**
- **These broad guidelines lead to the following indicative distribution of revenue bases by level of government:**

**Central Level Revenue Sources State & Local Level
Revenue Sources**

- | | |
|-------------------------------|------------------------|
| (a) Corporate income taxes | (a) Property taxes |
| (b) Personal income taxes | (b) Payroll tax |
| (c) International trade taxes | (c) Retail sales taxes |
| (d) Natural resource taxes | (d) Vehicle taxes |
| (e) Value added tax (VAT) | (e) Excises |
| (f) Excises | (f) User charges |
| (g) User charges | |

4. Five Options for Revenue Allocations

- ▶ **Independent local taxation** (revenue base assignment) – Power granted to local governments to levy local property taxes or user charges (US).
- ▶ **Centrally-assisted local taxation** - (property tax in New Zealand and Malaysia).
- ▶ **Surcharges (piggy-backing/carry on back)** - Revenues would be administered and collected by the central government, with the surcharge amount given back to local governments. (Local governments in Scandinavia and Switzerland commonly use surcharges on the national income tax).
- ▶ **Tax sharing (transfer)** - Tax sharing is common among developing and transition countries, for example: **Russia China share a portion of VAT with the local governments; Indonesia and Dominican Republic share the property tax; Kenya shares the personal income tax; Mexico shares the payroll tax; Peru shares the sales tax; while India shares excise duties;**

- **General revenue-sharing or grants** – Sharing of collected revenues by central treasury with the local governments through a grant formula

Box 1: Merits and Demerits of Revenue Allocation Methods

| Method | Merits | Demerits |
|------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Independent local taxation | <ul style="list-style-type: none"> • Local choice of tax rate • Local choice of tax base • Local control of admin. | <ul style="list-style-type: none"> • Duplicate administration • Administrative/compliance costs • No equalization • Possible interregional distortions from differential base/rates |
| Centrally-assisted local taxation | <ul style="list-style-type: none"> • Local choice of tax rate • Local choice of tax base • Reduced admin. and compliance costs | <ul style="list-style-type: none"> • No equalization • Possible interregional distortions from differential base/rates |
| Local surcharge | <ul style="list-style-type: none"> • Local choice of tax rate • Uniform tax rate • Uniform admin. | <ul style="list-style-type: none"> • No choice of tax base • No equalization • Possible interregional distortions from differential base/rates |

| | | |
|-------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Local surcharge | <ul style="list-style-type: none"> • Local choice of tax rate • Uniform tax rate • Uniform admin. | <ul style="list-style-type: none"> • No choice of tax base • No equalization • Possible interregional distortions from differential base/rates |
| Tax sharing | <ul style="list-style-type: none"> • Uniform tax base • Unified admin. | <ul style="list-style-type: none"> • No choice of tax base • No choice of tax rates • No equalization unless distributed by formula |
| Revenue sharing grants | <ul style="list-style-type: none"> • Uniform tax base • Unified admin. • Equalization option | <ul style="list-style-type: none"> • No choice of tax base • No choice of tax rates |

Source: Charles McClure, "Revenue Assignment", 1994.

Box 2: Fiscal Federalism and Revenue Mobilization in Selected Countries (Some Examples only)

| Countries | Tax headings collected by the center | Tax headings collected by local levels | Remarks |
|---------------------|------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| PR China | VAT (75%); and all other taxes except collected by local bodies | VAT (25%) Business tax; income tax levied on corporations at local levels; personal income tax; and other small taxes | Local bodies will submit 75% of total collected VAT to the center; Local bodies can't not mobilize loans China is unitary country with total decentralization |
| South Africa | Personal income tax; corporate taxes; VAT; Excise Duties; Taxes on petro-products | Local/Regional bodies have been authorized to collect all taxes except taxes collected by the center | Federal structure; Local/regional units can levy taxes with the approval of center |
| Denmark | All taxes except collected by local bodies | Local income taxes occupies 93% of tax revenue; land tax; property tax collected by Municipality | Federal structure |
| Switzerland | VAT; Income tax (Center) and other taxes | Income tax; transfer; revenue sharing (Canton); Property tax; fees for services; | Federal structure |
| Ethiopia | 85% of total revenue is collected by center | 15% of total revenue is collected by local bodies; In addition, local bodies are mobilizing revenue through resource sharing | Ethnicity based federal structure with rights of self-determination |

5. Revenue Mobilization at Local Levels in Sri Lanka

The Local Government Revenues in Sri Lanka comprise:

- **Assessment tax:** All Municipal and Urban Local Authority areas and other “development areas” declared under the PS Act No. 15 of 1987.
- **Acreage tax:** Land tax collection by the PSs from lands over one hectare.
- **Vehicle taxes:** Annual tax levied.
- **Entertainment tax:** Entertainment Public Performances Ordinances.
- **Trade licenses:** One of the major revenue sources for all local authorities.

Weekly fair fees from pola: Premier revenue source for PS.

Rented market fees.

Fees from rented houses under housing schemes.

All fines Under the Excise Ordinance Opium; Poisons and Dangerous Drug Ordinance; Food act; Pawn and Brokers Ordinance; Local Authorities Election Ordinance.

- **All Stamp Duties under the Boat Ordinance; Butchers Ordinance; Vehicle Ordinance; Public Performance Ordinance.**
- **Stamp Duties under Land transactions.**
- **Fees for registration.**
- **Selling of various firms and applications.**
- **Fees from land sales.**
- **Fees from advertisements, banners, and boards.**
- **Parking fees.**
- **Interest on loan.**
- **Professional taxes.**
- **Revenue grants.**

6. Alternative Methods to Resource Mobilization in Developing Countries

- (1) Revenue sharing with Provincial Council and the Central Government.**
- (2) Mobilizing resources through “Matching Fund” at the support and guarantee of Central Government.**
- (3) Introducing “Equalization Fund Scheme” especially to attain same level of services in backward areas as compared to advanced areas in PS**

- (4) Allocating **block grant** to PSs by Central Government in its annual budget approved by the Parliament.
- (5) **Mobilizing savings from households receiving remittances** especially in the context of income generating activities and poverty alleviation.
- (6) **Developing economically viable projects under public-private partnership with investment loan from commercial banks and lending agencies including foreign funding agencies.**
- (7) Setting up of a **“Local Development Fund”**.

7. Decentralization Experience in five South Asian countries

Bangladesh

- The 1972 Constitution provided the basis for the devolution of powers to local government bodies which were entrusted with local administration and development responsibilities.
- Women have been given "equal rights with men in all spheres of the State and public life"
- However, local governments lack adequate financial resources for the development of basic rural infrastructure.

- **There is a need to improve the resource base of local government institutions through sharing of tax and non-tax revenue, and provision of grants and other development assistance by the central government.**
- **Local government bodies also need support for building their management capacities.**
- **Public-private partnerships have to be promoted for local development**

India

- **The 73rd Amendment of the Indian Constitution installed village-based *Panchayati Raj* institutions as the country's third level of governance after the central and state governments.**
- **About three million councilors, nearly a third of them women, have been elected to over 260,000 *Gram Panchayats* at village level, 6,500 *Panchayat Samitis* at sub-district level and 500 *Zilla Parishads* at the apex district level.**

- ***Panchayat*** elections have disproved the myth that rural women are uninterested in public life.
- Significantly, about 40 percent of women *panchayat* members belong to marginalized groups.
- *Panchayats* face impediments to discharging their responsibilities, the primary being an inadequate resource base.
- *Panchayati Raj* representatives and nearly a million local government officials assigned or closely connected with the *panchayat* bodies also need capacity-building training.

Nepal

- **The Local Self-Governance Act (LSGA), 1999 and Local Self-Governance Regulations (LSGR), 2000 provide the framework for decentralization.**
- Policies and legislation are in place to encourage local participation through local government institutions, NGOs, self-help groups such as users' committees, community organizations and women's groups.
- Local bodies are becoming increasingly involved in local service provision and users' groups in the management of local resources and services.

- **Thousands of user groups have been given authority to manage local forests.**
- **Decentralized governance has produced positive impacts in terms of people's participation in governance, poverty reduction, empowerment of women and weaker social groups, and involvement of non-governmental organizations and the private sector in delivery of social and production services.**
- **Local people have been able to solve individual as well as community problems on their own.**
- **The number of women in leadership roles in community-based activities is increasing.**
- **The provision for representation of women in local governance has made about 40,000 women local government representatives**
- **Although the LSGA has devolved authority to local bodies, central line agencies are reluctant to put this in practice.**
- **Local bodies continue to be treated as subordinate agents of local development rather than autonomous units of local self-governance.**

Pakistan

- **In 2001, a three-tier federated local government system was set up in every district of the country as an integral part of provincial governments.**
- **The local government system integrates rural with urban local governments and the bureaucracy with the local governments so that the district administration and police are answerable to the elected head of the district government.**
- **Women, peasants, workers and minorities have been given representation at each level of local government.**
- **Citizen Community Boards provide a mechanism for motivating and involving the local community in local development. The local government system has been implemented in all the four provinces of Pakistan and direct elections have been held to fill more than 120,000 Union Council seats**

- **Decentralization has made the district and *tehsil* (sub-district) the hub of all development and service delivery activities.**
- **The head of the district government is an elected representative and not a bureaucrat. While the new system provides for more responsiveness and accountability, the process of establishing supporting institutions is slow which is affecting service delivery.**
- **Yet, local revenue mobilization is insufficient for the sustainability of the local government bodies and comprehensive capacity-building is required for local government institutions.**

Sri Lanka

- **Major devolution legislation was enacted in 1987 in the form of the 13th Amendment to the Constitution and the Provincial Councils Act No. 42.**
- **Recent studies of the devolution process in Sri Lanka have found shortcomings in the structure and working of decentralized governance in the country.**
- **Social and economic indicators strongly suggest that decentralization has not been effective in reducing inter-regional income and social development disparities.**

- The main reason is the lack of sufficient political will at the center and an inadequately developed legal framework which have made the system unwieldy and ineffective with high "transaction costs".
- This is reflected in the insufficient delegation of powers from the center to the provinces and from the provinces to local authorities.
- There is also insufficient utilization of existing technical and management capacities.

8. Fiscal Decentralization in Nepal:

Theory and Practice

Understanding of Decentralization

- Transfer of authority and responsibility for public functions from central to local levels.
- Devolution of decision making process to the sub-units of government.

Forms of Decentralization

Political Decentralization: Provides local citizens and their representatives more power for decision making (Devolution).

Administrative Decentralization:

Redistribution of Authority, Responsibility and Resources among different levels of government (Demonstration and Delegation).

Fiscal Decentralization: Transfer of power for fiscal decision making and management responsibilities to the lower level. Authority to raise revenues and access to transfer and making decisions on current and capital expenditures.

Why Decentralize?

Economic Development

Elected government

Inefficient centralization

Uniformity not acceptable

Local governments have grown up

Autonomy vs. Dissolution

Arguments for Decentralization

Moves government closer to the people –

Better services

Willingness to pay

Nation building

Table 1**Nepal: Contribution of Government Expenditure to Local Bodies (After LSGA, 1999)**

Rs.in Billion

| FY | GDP Rs. in billion | Total govt. exp | In % of GDP | Total govt. rev. | In % of GDP | Total govt. exp. to local levels | In % of GDP | In % of total govt. exp. | In % of total govt. rev. |
|-----------------|---------------------------|------------------------|--------------------|-------------------------|--------------------|-----------------------------------------|--------------------|---------------------------------|---------------------------------|
| 1998/99 | 261.5 | 59.6 | 22.8 | 37.2 | 14.2 | 2.7 | 1.0 | 4.6 | 7.4 |
| 2004/05 | 533.5 | 102.6 | 19.2 | 70.1 | 13.1 | 2.8 | 0.5 | 2.7 | 3.9 |
| *2009/10 | 960.0 | 285.9 | 29.8 | 176.5 | 18.3 | **22.0 | 2.3 | 7.7 | 12.5 |

Source: World Bank * Estimated data from Budget Speech. ** Recurrent expenditure at District level.

Table 2**Status of Grants from Central Government to Local Bodies in Selected Countries:
International Comparison****Source: Kaiser, 2006.**

| Countries | Grants from central government to local bodies as % of GDP FY 2004/05 | Grants from central government to local bodies as % of national income FY 2004/05 |
|---------------------|----------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------|
| Nepal | 0.52 | 2.68 |
| Pakistan | 6.30 | 34.20 |
| India | 10.80 | 49.20 |
| Ethiopia | 9.50 | 35.90 |
| Nigeria | 13.60 | 38.0 |
| South Africa | 18.90 | 56.50 |
| Argentina | 12.40 | 44.40 |
| Brazil | 15.30 | 41.70 |
| Mexico | 7.40 | 41.0 |
| Russia | 12.70 | 38.50 |
| Malaysia | 2.40 | 11.0 |

Revenues to DDCs through Revenue Sharing

- ▶ **5-90% of revenue collected from house and land registration**
- ▶ **50% of royalties received from mines**
- ▶ **40% of fees collected from tourists**
- ▶ **10% of royalties received from forest products**
- ▶ **50% of royalties received from hydropower. Of which DDC located at hydro-plant area will receive 12% of the amount received by DDC, and other districts within the development region where hydro-plant is located will receive 38%.**
- ▶ **25% of Malpot collected by VDCs and Municipalities**
- ▶ **45-50% of total collection of DDCs from the sale of sand, stone, slate, and *gitti* etc should be provided to concerned VDCs and Municipalities**

Table 3: Status of Internal Revenues in Local Bodies

| Countries | Internal revenues as % of income FY 2004/05 | Internal Revenues as % of GDP FY 2004/05 |
|--------------|------------------------------------------------|---------------------------------------------|
| Nepal | *5.0 **2.8 | 0.7 |
| Pakistan | 7.0 | 0.9 |
| India | 33.8 | 6.1 |
| Ethiopia | 18.7 | 3.0 |
| Nigeria | 10.7 | 3.2 |
| South Africa | 18.9 | 6.1 |
| Argentina | 44.20 | 8.4 |
| Brazil | 39.0 | 10.5 |
| Mexico | 25.5 | 4.5 |
| Russia | 32.4 | 13.0 |
| Malaysia | 9.10 | 2.4 |

Source; Kaiser, 2006. * Including revenue sharing and local development tax. ** Net internal revenues only.

9. Current Status of Fiscal Decentralization in Nepal

Revenue Assignment as of LSGA, 1999

- ▶ **Inter-government fiscal transfer and amount received from revenue sharing (Unconditional grants to DDCs: HDI 505; Area 105; Population 205; and Cost index 205)**
- ▶ **Internal revenue received from tax and non-tax sources**
- ▶ **Internal and external borrowings**
- ▶ **Miscellaneous sources including the programs supported by donors.**

Revenues to Municipalities

- **Grants from the government**
- **Grants from DDCs**
- **Grants from TDF**
- **Internal sources**
- **Local development tax (75-80% of total revenue including all grants).**

LDT is collected at Customs points at the rate of 1.5% of import duties.

Structure of Income in VDCs

- **Grants from the government**
- **Grants from DDCs**
- **Other grants**
- **Internal sources**

10 . Nepal and its Uniqueness

- ▶ **Large diversity** – ethnicity, linguistics, geographic, income;
- ▶ **Unitary country** – which means a strong central government; did attempt to decentralize, an attempt to address issue of disparity, economic efficiency etc.
- ▶ An attempt to address the disparity question on the debate again (Is federalism the answer?)

11 . Federal Structure in Nepal as of Constitution 2015

There are 7 provinces

- ▶ **Pradesh 1:** Taplejung, Panchthar, Illam, Sankhuwasabha, Trhthum, Dhankuta, Bhojpur, Khotang, Solukhambu, Okhaldhunga, Udayapur, Jhpa, Morang, and Sunsari (14).
- ▶ **Pradesh 2:** Saptari, siraha, Dhanusha, Mahottari, Sarlahi, Rauthat, Bara, and Parsa (8).
- ▶ **Pradesh 3:** Dolakha, Ramechhap, Sindhuli, Kavrepalanchok, Sindhupalchowk, Rasuwa, Nuwakot, Dhading, Chitwan, Makwanpur, Bhaktapur, Lalitpur, and Kathmandu (13).
- ▶ **Pradesh 4:** Gorakha, Lamjung, Tanahu, Kaski, Manag, Mustang, Parbat, Syangja, Myagdi, Baglung, and Nawalparashi (East of Bardhaghat Susta) (11).
- ▶ **Pradesh 5:** Nawalparasi (West of Bardhaghat Susta), Rupandehi, Kapilvastu, Palpa, Arghakhanchi, Gulmi, Rukum (East), Rolpa, Pyuthan, Dang, Banke, and Bardiya (12).

- ▶ **Pradesh 6: Rukum (Westen part), salyan, Dolpa, Jumla, Mugu, Humla, Kalikot, Jajarkot, Dalikh, and Surkhet (10).**
- ▶ **Pradesh 7: Bajura, Bajhang, Doti, Achham, darchula, Baitadi, Dadeldhura, Kanchanpur, and Kailali (9). Total: $75+2=77$.**

12. As of Constitution of Nepal 2072 Part 26 Article 250 a Natural Resources and Finance Commission will be constituted, which will recommend the criteria for sharing of resources among local, provincial and central government.

- a. Federal Government Tax provisions: Customs, Excise, VAT, Income tax, Passport and visa fee, Fee from tourists, Fee from services, and Fines and penalties.**

b. Provincial government tax provisions: House and land registration fee; Vehicle tax; Entertainment tax; Advertisement tax; Tax from tourists; Tax on income from agriculture; Fees from services; and Fines and penalties.

c. Local government tax provisions: Local taxes (Property tax; House rent tax; house and land registration fee; Vehicle tax); Fees from services; services; Fees from tourists; Advertisement tax; Tax on profession; Land tax (Malpot); Entertainment tax; and Fees and fines.

Finally, tax should be levied on surplus not on subsistence.

7 Provinces: HDI, Agriculture Productivity, Population and Territory

| Heading | P 1 | P 2 | P 3 | P 4 | P 5 | P 6 | P 7 |
|--------------------------|-------|-------|-------|-------|-------|-------|-------|
| HDI | 0.500 | 0.422 | 0.506 | 0.506 | 0.455 | 0.409 | 0.416 |
| Agriculture Productivity | 0.216 | 0.259 | 0.297 | 0.146 | 0.247 | 0.077 | 0.135 |
| Population In percent | 17.12 | 20.40 | 20.87 | 11.90 | 15.26 | 4.82 | 9.63 |
| Territory In percent | 17.60 | 6.56 | 13.79 | 17.13 | 16.95 | 19.68 | 13.28 |

Summary
Fiscal Transfer from the Center to Local Bodies
FY 2017/18 (2074/75 BS)* Rs. in Billions

| Classification | Fiscal equalization Grant | Conditional Grant | Total |
|----------------------------|---------------------------|-------------------|--------------|
| Pradesh (7) | 7.1 | - | 7.1 |
| Local Bodies (744) | 148.6 | 76.4 | 225.0 |
| Metropolitan City (4) | 3.7 | 2.2 | 5.9 |
| Sub-Metropolitan City (13) | 6.6 | 2.8 | 9.4 |
| Municipality (246) | 60.7 | 32.0 | 92.7 |
| VDCs (Gaun Palika) (481) | 77.6 | 39.3 | 117.0 |
| TOTAL (744) | 155.7 | 76.4 | 232.1 |

Source: Ministry of Finance, Government of Nepal, 2017/18. * Estimated.
Note: The estimated budget for FY 2017/18 is Rs. 1,278.99 billions and the proposed amount of fiscal transfer is Rs. 232.1 billions, which is 18.1 percent.

Province No. 7

Province No. 6

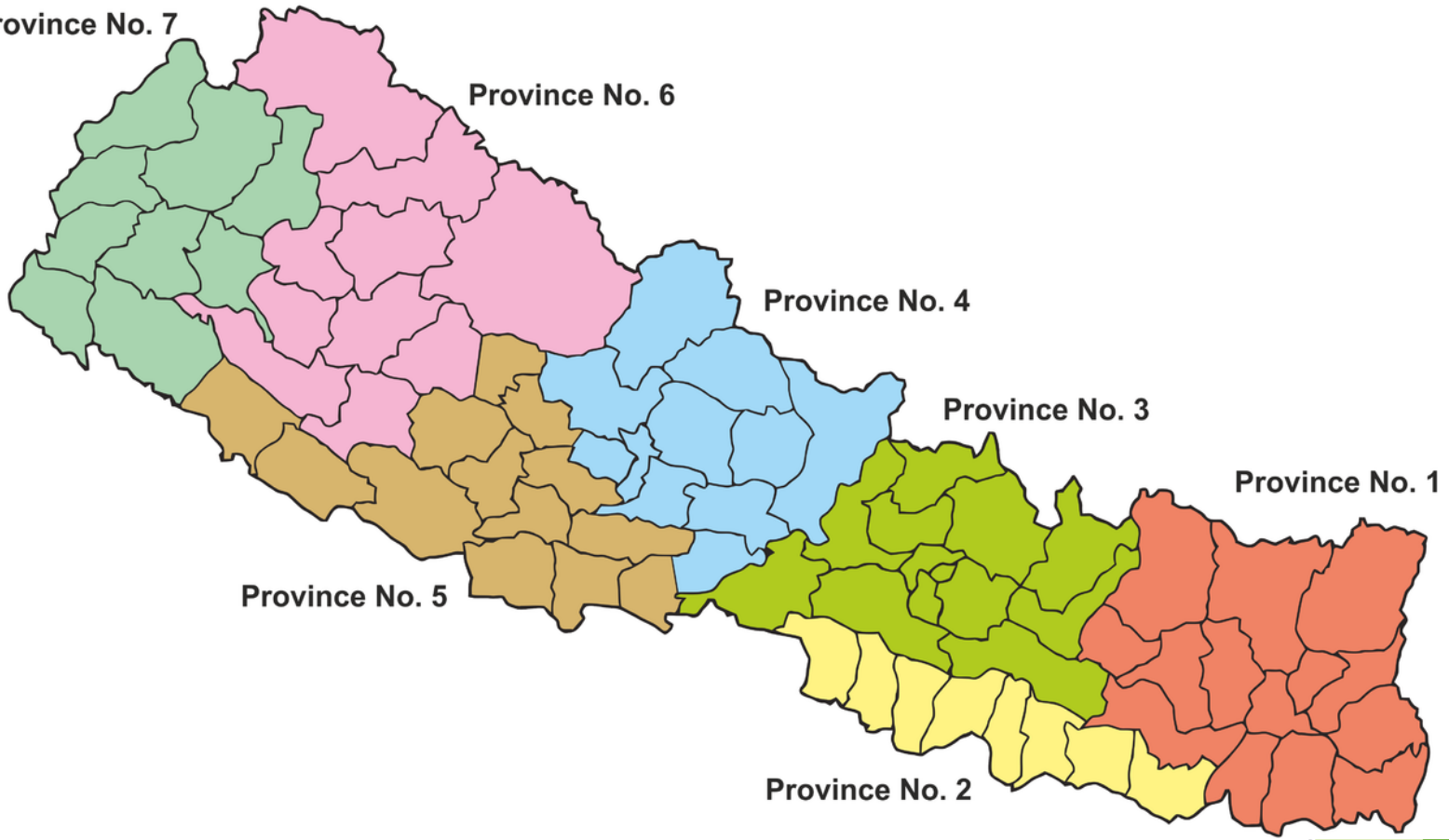
Province No. 4

Province No. 3

Province No. 1

Province No. 5

Province No. 2



THANK YOU

The background features abstract, overlapping geometric shapes in various shades of green, ranging from light lime to dark forest green. These shapes are primarily located on the right side of the frame, creating a modern, layered effect against the white background.