



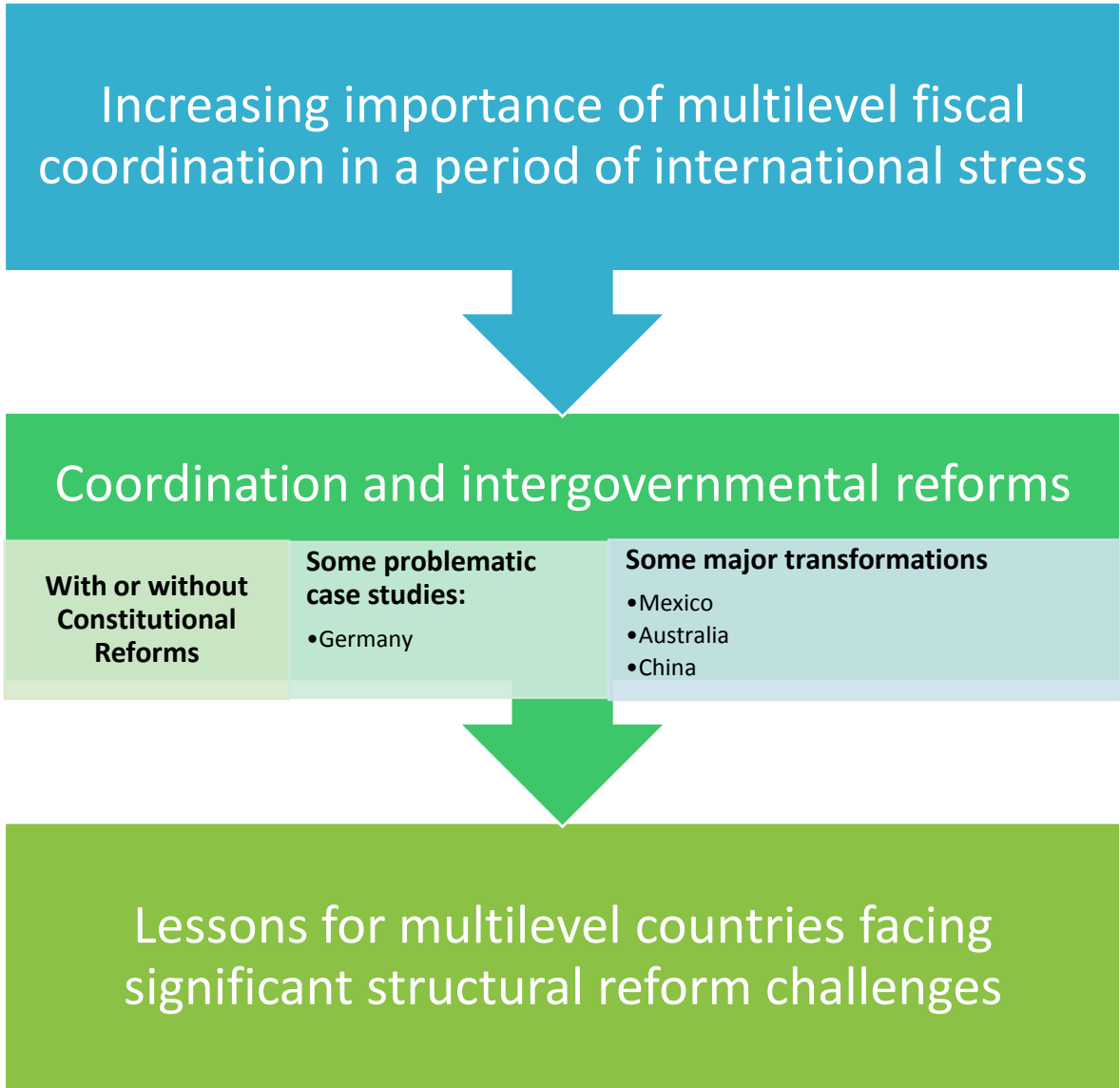
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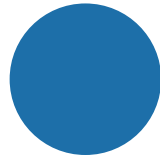
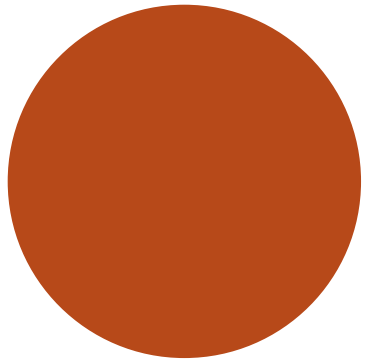
Multilevel Fiscal Coordination for Structural Change: Challenges in a period of global stress

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Issues





An agenda for fiscal coordination

Sustainable
development for
employment
generation and high-
quality growth

Increasing importance of multilevel fiscal coordination

Greater importance of “putting house in order”

Global financial crisis 2008/10, and more recently trade disruptions

- potential disruptions in trading patterns/value chains,
- income disparities and
- pollution and congestion

National policy necessary, but not sufficient to

- Create sustainable employment “hubs”
- Create Compact, Connected and Clean Cities (CCCs): core of a “high quality growth agenda”
- Minimize cost of doing business and create a unified economic space
- Effective redistribution and addressing income inequalities

Importance of tax and social policy coordination

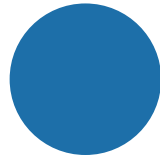
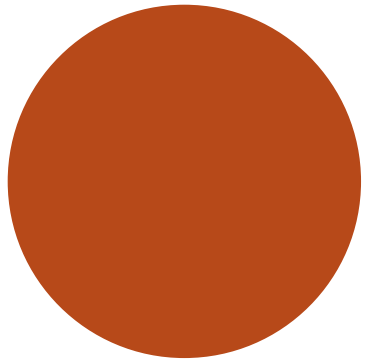
Financing of Bismarkian social programs through payroll taxes

- Can add to cost of doing business
- Encourage incentives to cheat
- “Santiago Levy’s “good intentions, bad outcomes”

Replacement of distorted by reformed VAT, also known as fiscal devaluation, e.g., in Portugal; and effective local taxes for better incentives and service delivery

Problem in getting a simple VAT in place, and a local tax system that works

- Mexico: 2013/14 reform integrated State level small taxpayers’ regime (REPECOS) with VAT; China integrated local services and national goods VAT (2015)
- Subnational tax agenda remains a problem and is a constraint to growth
- **A national tax administration does not mean less state/provincial autonomy**, but requires extensive coordination across instruments



Coordination and
intergovernmental
reforms |

Typical coordination arrangements in multi-level countries

Designed to maintain stability within an existing institutional context

- Important to reduce/eliminate earmarking and split revenue bases
- In some cases need integration of tax administration and treasury functions
- Hard to fix a single instrument in isolation

Makes it very difficult to achieve major structural changes

- Gainers and losers balance hard to achieve with only one set of instruments in isolation—e.g., specific tax reforms, such as VAT
- Need combinations of national and subnational taxes, as well as non-distorting transfer mechanism

Typical institutions

Federal states: Legislature

- Bicameral legislature, typically with upper house with equal state/provincial representation
- Designed to ensure that regional interests are properly represented

Coordination bodies:

- Constitutionally endorsed institutions, sometimes at the state/provincial level
- Institutions established by consensus or delegated powers

Constitutional bodies: Finance Commissions

Finance Commissions required under the Constitutions in some countries to

- Periodically revise revenue-sharing or transfers arrangements
- Done very professionally by an independent body in India, but unable to address major structural change (e.g., VAT integration)
- Similar constitutional provision in Pakistan
 - managed in an ad hoc fashion, with little analytical work and usually as a result of a political compromise
 - managed by the Federal Finance Minister

Ad hoc committees to reform VAT (India), cannot address other taxes or transfer design, in a “gainers and losers” assessment

Institutions by agreement: Grants Commissions

Some of these are enshrined in Constitutions

Some of the most effective are established by ordinary law, but

- with agreement of the federating units (Commonwealth Grants Commission, Australia)
- Building on Constitutional provision ***to provide similar levels of service at similar levels of tax effort***

No examples in Latin America of equalization grant systems or Commissions, or even similar function in a Finance Ministry

Some Institutional Comparisons for Untied Grant Distribution

	Is there a separate agency to advise on grants distribution	What Ministry does untied grant distribution work	Is local govt involved in grant decisions	Are academics involved in a formal way	Where a separate agency operates			
					Is the agency permanent	Does it operate under the Constitution or a law	What is its range of functions	What is the size of the agency
Australia	Yes		Yes		Yes	Law	Narrow	Small
Canada		MoF	Yes					
China		MoF						
Denmark		MoF	Yes					
Ghana	Yes		No		Yes	Constitution	Narrow	Very small
Ethiopia		House of Federation and MoF	Yes	No				
India	Yes		Yes		No	Constitution	Narrow	Small
Italy		MoF and MoLG	Yes	Yes				
Japan		MoLG	Yes					
Philippines		MoF	Yes					
Sierra Leone	Yes		Yes	No	Yes	Law	Wide	Small
South Africa	Yes	MoF and MoLG	Yes		Yes	Constitution	Wide	Large
South Korea		MoLG	Yes					
Sudan	Yes	(MoF)	Yes	Yes	Yes	Constitution	Wide	Large
Uganda	Yes		Yes		Yes	Constitution	Wide	Small

Source: Bob Searle, 2010, "Revenue sharing and Intergovernmental Transfer Design," in E. Ahmad and A. Al-Faris, *Fiscal Reforms in the Middle East*, Elgar.

Policy coordination

Typically by agreement between levels of government

- Treaties ratified by national Parliaments (e.g., EU)
- Brazil FRL will require
 - **Standard information generation** and requirements
 - **Own source revenues** at the subnational level
 - But cumbersome VAT adds to cost of doing business and does not generate information on value chain needed to stop “cheating”,
 - including for income taxes and natural resources

Again, the objective is to prevent crises and also generate sustainable growth

But what if structural changes are needed?

Changing spending assignments, in keeping with “subsidiarity” principles—to get greater accountability

- Often lead to institutional changes—
 - Constitutional revisions in Italy hard to implement
 - 18th Constitutional Amendment in Pakistan, but only for spending, leading to unfunded mandates
 - Unbundling of responsibilities was easier than revenue reforms

Changing revenue assignments to ensure greater efficiency in production and competitiveness, but also critical for accountability

- e.g., consolidation of VAT bases: India (Constitutional Change was needed); Australia (agreement and delegation)

Climate Change: Both taxes and transfers needed for green growth and structural change

How might coordination mechanisms be adapted?

But
coordination
mechanisms
typically favour
the status
quo....

- Even Constitutions imposed by external powers, or reflecting colonial heritage, can be difficult to change
 - Post WWII Constitution imposed on Germany by the Allies....proved very difficult to amend
 - Case by case treatment of 15 items by Constitutional consultative Group (Föderalismus I and II, 2003/4 and 2006/7) did not get very far
 - India and Pakistan
 - Colonial heritage of Government of India Act 1935 evident in both cases
 - Despite new constitutions by independent governments
 - Key issues are overlapping responsibilities and split tax bases
- Typically requires a consultative process that involves the states and regional interests, beyond the regular consultative process (Finance and Grants Commissions and responsibility legislation)

Changing international environment

Increasing globalization and competitive pressures

- need to avoid cascading taxes that lead to inefficient production and trade barriers

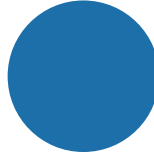
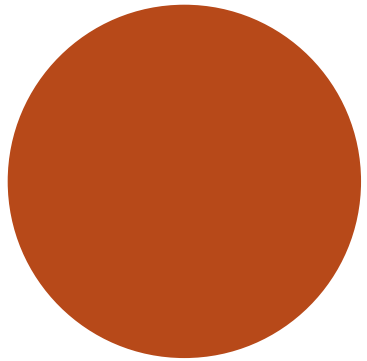
Multilevel coordination needed to address externalities from climate change

Fiscal “devaluations” as a response to the economic crisis—largely to reduce the domestic costs of doing business (Portugal)

- But Fiscal Council established under the Troika has had limited traction
- In a country like Brazil, would probably also need state representation

Coordination required on the VAT in order to create an efficient common economic space

- Shifting from taxes that add to the cost of production to an “efficient” VAT to reduce burdens on business
- ***Generate a value chain also for natural resource sector—could help to stop the cheating*** (Nigeria—Ribadu Commission)



Coordination for major structural reforms



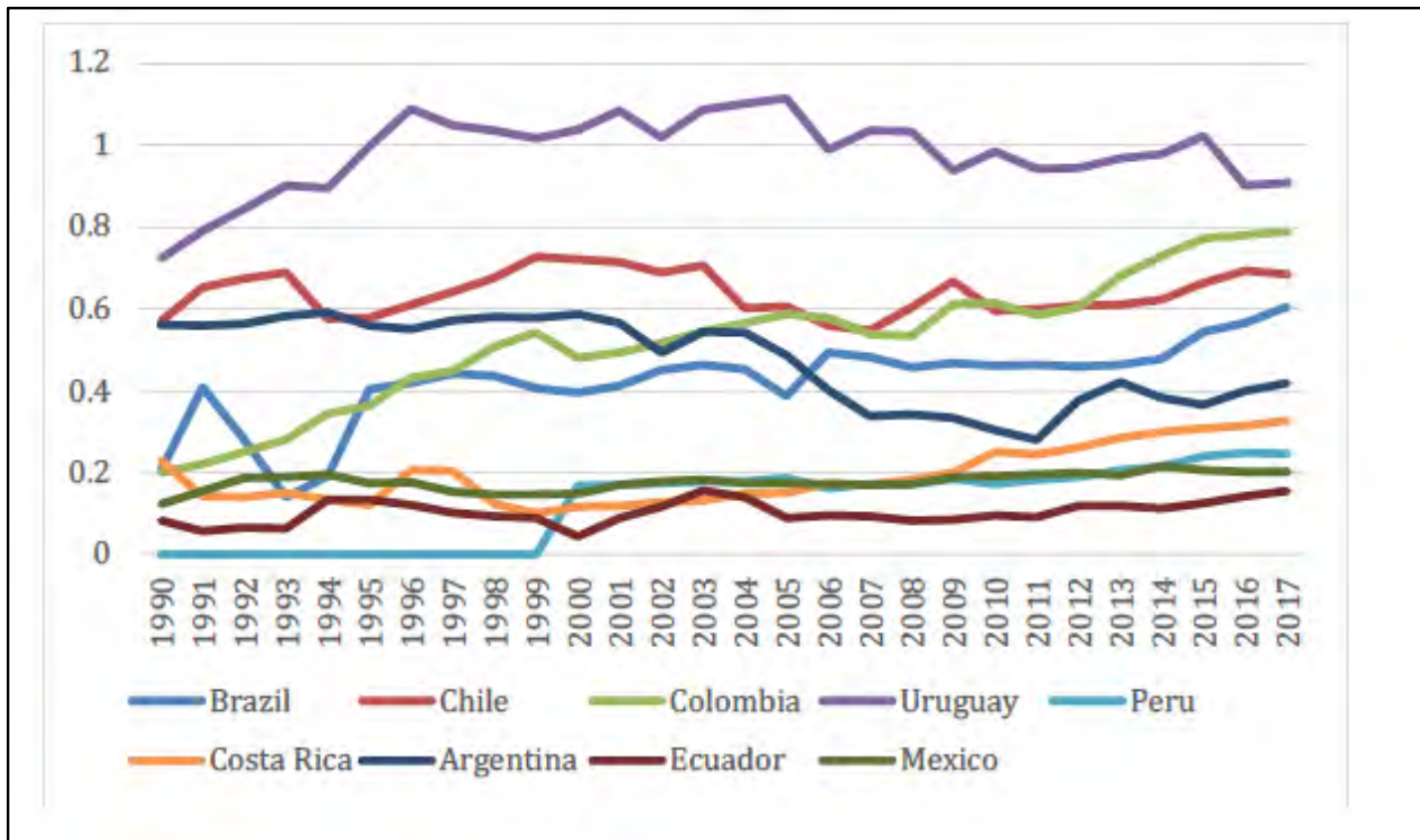
Unbundling of spending and revenue raising responsibilities

- **Who does what?**
 - Considerable overlapping in Latin American constitutions, reflecting Spanish/Portuguese legal heritage
 - Remove overlapping responsibilities for accountability
 - Address revenue assignments jointly as part of “package”
- **Centralization of social security in China to limit drag on “provincial/local” budgets**
 - Together with a centralization of tax administration
 - Sub-national tax policy agenda remains for accountability and managing local liabilities
- **Subsidiarity principle in the EU**
 - Institutional change in France, Spain and Italy
 - German unbundling of responsibilities, initiated as part of a fundamental restructuring of intergovernmental fiscal relations, but not very successful

Multilevel issues on revenue reassignments

- **Multilevel constraints**
 - Germany: unified tax policy at Federal level, but administration at Länder level generates inefficiencies
 - India and Pakistan: split bases for the VAT, multiple administrations—given colonial heritage
 - generates complexity and inefficiencies; coordination of tax bases with multiple administrations in India did not yield desired benefits (as in Germany)
- Intergovernmental theory suggests **that some control over rates at the margin needed** for subnational accountability (Ambrosanio and Bordignon 2015)
 - But the VAT is a bad choice for sub-national assignment (Bird, 2015)
 - And the US-style property tax does not work in Latin America
- **So what are the alternatives?**

Property taxes in Latin America: a dismal story



Source: Ahmad, Brosio, Jimenéz, 2019, CEPAL/IADB Jornadas Mexico City.
Potential tax estimate: 3.6% of GDP.

Political economy of coordinating fiscal reforms: German lessons

- **Joint decision trap:** groups of Länder can
 - block national policies in the upper House (Bundesrat), but
 - Lacked legislative powers over spending or tax policy
 - And controlled tax administration (post WWII condition)
 - Coordination costs, especially for the private sector, plus revenue leakages especially for the VAT
- **2003 Federal Reform Commission** (PMs of Länder, plus representatives of political parties in Bundestag)
 - Did not achieve much in the first round
 - Tried again with a National Coalition Government (2006/7), but again not very effective
- **Main difficulty: different issues treated separately**
 - E.g., disentangling spending responsibilities from sub-national tax powers and transfer design;
 - or subnational tax admin separately from tax policy autonomy
 - Different coalitions of gainers and losers for each major reform able to block reforms that may have been feasible as a “package”

Consequences of Instrument by Instrument focus

Disentangling spending assignments easiest

- Some progress with devolving responsibility for education from the Federation to the Länder, but
 - Weakened the commitment to uniform standards across Länder
 - Need for greater Federal support for day-care and pre-school?
- Achieved autonomy to regulate store working hours—but
- immediately offset by national agreement that replicated national standard

Failure to address structural reforms in either Commission, in relation to:

- Tax policy assignments,
- Tax administration consolidation, or
- Transfer design simplification.

Difficulty with disentangling revenue assignments--Germany

Gainers and losers between the advanced Western and less developed Eastern Länder

- West stands to gain from tax policy autonomy, but the East does not and can block proposals
- No progress possible without a joint consideration of tax assignments as well as transfer design
- Similar issues arise with tax policy and administration
- Unable to get integrated tax administration (huge loss on VAT despite unified policy—same problem in India)

Separate focus on taxation in both Reform Commissions was not successful

Typology for local taxation and policy

		1a	1b	2a	2b	3a	3b
Key Factors	Central Tax	Shared taxes		Own-revenue/ Surcharge		Local Tax	
		Central Admin	Joint-Admin	Joint-	Central	Joint-Admin	Local Admin
Rate/base	CG	CG	CG	LG	LG	LG	LG
Revenue	CG	CG/LG	CG/LG	LG	LG	LG	LG
Administration							
Registration	CG	CG	CG	CG	CG	LG	LG
Valuation	CG	CG	CG	CG	CG	LG	LG
Assessment	CG	CG	CG	CG	CG	LG	LG
Bill Delivery	CG	CG	CG/LG	CG/LG	CG	LG	LG
Collection	CG	CG	CG	CG	CG	LG	LG
Enforcement	CG	CG	CG	CG	CG	LG	LG
Services	CG	CG	CG/LG	CG/LG	CG	LG	LG

Central Control
Local Autonomy

But not necessary to have administration to control a tax

- Source: Ahmad (2015), "Governance and Institutions", in Ahmad and Brosio, *Handbook of Multilevel Finance*.
- Note: enforcement would include both (1) the maintenance of a common data base on transactions and assets, using tax and third party information, and (2) audit.

Option for states/ provinces: Piggy-back on income taxes and revamped transfers

Move to less distortive structure of taxation (replace payroll taxes for state level finance)—Mexico options

- Setting of rates at margin by provinces/states for a major tax base with National Tax administration
- Piggy-back on Income Taxes (US model)
- Consolidate state nomína for social benefits centrally in IMSS (Mexico)

Substantial additional revenues for states, especially with an expansion of the PIT base

Potential expansion of Federal PIT with state level asset information

Revamp transfer mechanisms

- to strengthen equalization aspects: revenue capacities and needs
- Use hold harmless for political economy
- Limit access to discretionary transfers


Fiscal rules, as “compromise solutions” often do not work, despite coordination efforts

In order to salvage “success” German Commission II introduced a “debt brake” in the Constitution based on the Swiss model, to come into operation in 2019

- But Swiss cantons have access to own-source revenues, whereas German Länder do not
- Potentially disastrous consequences for German federalism and long-term investment
 - See Milbradt, 2017, in Ahmad, Brosio and Bordignon, *The Crisis in Europe and Multilevel Finance*, 2017.

Fiscal rules require

- Adequate “own-source” revenues, as well as
- Transparency of operations (GFSM2014 compatible) sub-national balance sheets, including liabilities for PPPs



Some political economy examples

Mexico and China

Mexico: National and subnational tax reforms for CCCs

- Political economy is difficult, and **important to balance gainers and losers**: key to the 2013 Mexican reforms
 - Gainers and losers—addressed in 2013 with multiple instruments
 - Fixing the overall revenue requirements led to a curtailment of sub-national own-source revenues in both China and Mexico
 - Did not address the overlapping taxation of labor (payroll taxation at the national and state levels)
- **Incentive structures to adopt appropriate policies depend on interface with transfers**
 - 2010 *tenencia* to states failed given the reliance on ‘gap-filling’ transfers (Piñeda et al., 2015)
- **Property taxes to anchor local services and infrastructure for CCCs?**
 - Mexico property taxation virtually non-existent (0.3% of GDP), mostly collected from Mexico City,
 - Potential in Mexico >3% of GDP (see below)

2013/14 Mexican reforms: VAT integration, carbon tax and excises key to the reforms—raising the tax/GDP ratio by over 4% of GDP

Tax policy, all the main taxes that were impossible to touch previously

- **Eliminated the special provisions in the VAT**, dropped the threshold and integrated state level taxes
- **Rationalized the CIT**, but
- **Did not address the state level *nomína***, a major cause of informality (Levy, 2008, and 2018 IADB)
- **Excises on “bads”**

Carbon tax could be a model for others

- Set petroleum price at world prices,
- But State-level piggy-back desirable (see Ahmad and Stern, 2010, Ahmad, 2018)

Subnational financing/taxation remains to be addressed

- Piggy-back on income tax and petroleum tax
- Fix local property tax (current research program)

2013 reforms turned the whole of Mexico into a Free Trade Zone...though problems in the Southern States



New clean “hubs” for backward states and sustainable development

Mexico abolished the famous CCT: “Oportunidades” in 2018 as it did not prevent increase in poverty (e.g., in Chiapas) and reduced work incentives

Better connectivity for lagging southern provinces facing “poverty trap”?

But sustainable new urban hubs require **state and local investment in services and smaller investments** to link to national grids

State and local incentives and financing remain a problem for the new “hubs”

Mexico: Beneficial property tax also influences financing of basic services, activity and migration, as well as income distribution

States	Tamaño de hogar promedio (m2)	PIB 2015 (millions of pesos)	Ingresos esperados a 1,5% del PIB	Espacio residencial total (m ²)	Espacio residencial per cápita	Impuesto por m ²
AgCal	95,3	198.175	2.973	16.447.684	12,5	180,73
Baja Calif.	83,5	505.938	7.589	37.672.301	11,4	201,45
Baja Calif. S	72,8	130.097	1.951	7.942.069	11,2	245,71
Campeche	75,3	126.938	1.904	10.001.384	11,1	190,38
Coahuila	98,2	573.850	8.608	40.956.711	13,9	210,17
Colima	88,6	95.358	1.430	7.674.290	10,8	186,38
Chiapas	64,5	290.464	4.357	49.575.736	9,5	87,88
Chihuahua	102,2	515.188	7.728	40.663.270	11,4	190,04
CDMX	92,2	2.836.540	42.548	97.170.469	10,9	437,87
Durango	96,6	194.989	2.925	23.938.138	13,6	122,18
Guanajuato	96,2	661.221	9.918	73.584.035	12,6	134,79
Guerrero	61,9	232.024	3.480	31.752.177	9,0	109,61
Hidalgo	80,3	253.582	3.804	35.157.000	12,3	108,19
Jalisco	99,6	1.107.682	16.615	92.963.038	11,9	178,73
Mexico	77,8	1.438.522	21.578	186.895.533	11,5	115,45
Michoacan	77,7	391.667	5.875	48.104.674	10,5	122,13
Morelos	79,3	186.472	2.797	19.733.271	10,4	141,74
Nayarit	89,1	114.884	1.723	15.617.576	13,2	110,34
Nuevo L.	93,1	1.219.287	18.289	69.213.036	13,5	264,25
Oaxaca	64,8	260.508	3.908	39.632.417	10,0	98,60
Puebla	77,9	539.447	8.092	65.527.444	10,6	123,49
Queretaro	88,8	369.836	5.548	26.272.177	12,9	211,16
Quintana R	69,6	245.512	3.683	14.387.702	9,6	255,96
Potosí	94,6	330.163	4.952	39.179.995	14,4	126,40
Sinaloa	72,0	361.904	5.429	33.521.878	11,3	161,94
Sonora	85,4	537.498	8.062	37.442.657	13,1	215,33
Tabasco	76,9	262.359	3.935	28.477.713	11,9	138,19
Tamaulipas	82,3	490.613	7.359	32.320.914	9,4	227,69
Tlaxcala	79,3	96.609	1.449	14.839.503	11,7	97,65
Veracruz	72,4	803.983	12.060	86.400.461	10,7	139,58
Yucatan	73,5	232.221	3.483	22.855.479	10,9	152,41
Zacatecas	93,1	159.227	2.388	17.833.788	11,3	133,93

- Raising 1.5% of GDP in each state puts a higher tax rate/m² in the richer states, providing price signals for spatial convergence
- Linkage with basic services, e.g., education subsidy improves income distribution

Source: Ahmad and Viscarra (forthcoming)

**Campeche and Tabasco GDP is without oil production.

China—political economy masterpiece in 1993/4

Revenue-sharing (VAT and income tax) with national (State) administration replacing myriad provincial taxes



But political economy considerations:

Hold harmless clause: lump-sum to ensure that no province would lose funds


Origin-based revenue shares

Equalization system to ensure that poorer provinces would have the capacity to provide public services

Investment funds for “Sustainable hubs” to ensure continued growth

Australia—cutting the Gordian knot


Australia faced the difficulty of the British colonial split bases—with provincial sales taxes



Proposal to create a national administration in late 1990s without changing the constitution



Agreement to have the VAT administered nationally, but monies redistributed fully to provinces through the equalization system (Independent Grants Commission)



Political economy required a joint consideration of tax policy, administration and transfer options, although the Australian model might not work everywhere



Some lessons for Brazil

Tax Reforms in a Multilevel Context

- **VAT value chain important in reducing cost of doing business**, as well as “stopping the cheating” including with natural resources
- Will require **more effective sub-national taxes**, piggy-backs and beneficial property taxes
- **Case for a single national tax administration**
 - If single rate, little point in multiple administrations
 - Simpler to establish a national tax administration to serve all levels of government—linkage between sales tax and income tax administration
 - Functional structures essential for integration
 - Simplify and reduce the costs of doing business
 - Makes it easier to use state level third party information for the income tax
- **If parallel administrations**, coordination needed to ensure uniformity of processes and procedures, and
 - Importance of information generation and exchange
 - Huge coordination task to minimise burdens on businesses

Extensions

How to address externalities, such as the “green growth agenda”?

- National carbon tax with state level piggy-backs?
- Needed to prevent race to the bottom and tax wars (Ahmad and Stern, 2011)

Local tax agenda critical

- National or regional cadaster
- Collection of information on property transactions
- Linkage between local rate setting and quality of public services
- Local rate setting and access to credit

Increasing importance of arms' length tax administrations

Finally....

Coordination needed to ensure that tax on tax interactions are properly managed

- Especially generation of information to stop the cheating

Major structural change may not be politically feasible without joint consideration of taxes, spending assignments and intergovernmental transfers:

- Coordination in Brazil also needed to:
 - Reduce overlapping spending responsibilities at different levels of government, while also
 - Replacing many earmarked transfers by an equalization framework