Call for Research Proposals

Subnational Revenue Mobilization in Latin American and Caribbean Countries

A Research Network Project

(RG-K1194)

The Inter-American Development Bank (IDB) is inviting research proposals for a proposed study of the scope for mobilizing additional revenue at the subnational level in major countries of Latin America and the Caribbean. Section 1 of this call for papers provides a brief motivation for the project. Section 2 reviews the main theoretical advantages of revenue decentralization and the economic, institutional and political economy obstacles to it. Section 3 briefly discusses historical trends in, and the current state of, subnational own revenues in the region. These topics will be analyzed in further detail in a framework paper for the study to be prepared by Teresa Ter-Minassian. Section 4 outlines the main issues to be explored in the country case studies, and Section 5 provides details on administrative arrangements for the project.

1. Purpose of the Project

As discussed in further detail below, the devolution of spending responsibilities to subnational (regional and/or local) governments (SNGs) has proceeded at a rapid pace in most Latin America and Caribbean countries in recent years, but it has not been matched by a commensurate decentralization of revenue-raising responsibilities, resulting in large vertical imbalances that adversely affect both subnational accountability and, in most countries, the overall revenue mobilization effort. A reduction of such imbalances over the medium term through own-revenue mobilization by SNGs in the region would help improve fiscal sustainability, create additional fiscal space to attend to priority spending needs, especially in socially sensitive areas and infrastructure, and increase the political accountability of SNGs to their electorate. Moreover, in a number of countries of the region, existing subnational taxes suffer from significant design flaws, and their reform would improve efficiency and equity. Finally, in most countries tax administration capacity at the intermediate (state, province or department) level—and even more so, at the local (cities and smaller municipalities) level—remains quite weak, hampering the revenue mobilization effort.

The purpose of this project is to identify, in light of both theoretical considerations and empirical evidence, the main obstacles to subnational revenue mobilization in the region, and to propose options to increase SNGs' own revenues in a manner as efficient, equitable and administratively feasible as possible.

I. What Does Theory Say about Subnational Own Revenues?

Both the normative (Musgrave, Oates, Tiebout, Brennan and Buchanan, among others) and the positive (Hettich and Winer, Weingast, and Breton, among others) theories of fiscal federalism recognize the benefits of a significant degree of autonomy for SNGs in deciding the level and composition of their revenues. These benefits include the following:

- The potential to enhance overall revenue mobilization by tapping revenue sources (such as property taxes and user fees) that would likely be neglected or administered less effectively at the central government (CG) level

- Providing greater certainty to SNGs about their resource availability, thereby facilitating the preparation of more realistic budgets and reducing volatility in the execution of spending programs
- Facilitating the alignment of tax composition and design with local preferences, and with the incidence of the benefits of subnational spending programs; and
- Making more visible to electorates the cost of subnational spending and promoting subnational fiscal responsibility, which tends to be undermined by SNGs' reliance on gap-filling transfers or other CG bailouts.

There are also, however, significant economic, distributional, institutional, and political economy obstacles to subnational own-revenue mobilization.

The main economic obstacle is the fact that typically tax bases (goods and factors of production) are more mobile within the national territory than across national borders. This increases the scope for tax evasion, and for tax competition among sub-national jurisdictions. While a degree of tax competition is desirable to promote efficiency in the use of public resources and avoid an excessive growth of government (as emphasized by public choice theories), unchecked competition can also lead to a race to the bottom, ultimately undermining SNGs' ability to finance the delivery of key public goods and services for which they are responsible.

On equity grounds, the main drawback of a strong reliance on subnational own revenues is the fact that potential subnational tax bases are generally unevenly distributed across the national territory. Thus, a full decentralization of revenue-raising powers to finance decentralized spending would result in excessive disparities in individual SNGs' ability to provide common standards of public services in key areas such as health, education and basic infrastructures. It should be noted, however, that some tax bases are more unevenly distributed than others, a fact that needs to be taken into account in the design of subnational tax systems. Moreover, differences in tax capacities (as well as in spending needs calculated at an average level of efficiency) can in principle be largely compensated for by a well-designed system of intergovernmental equalization transfers.

Institutional obstacles to subnational own revenue mobilization include the following:

- The fact that CG tax administrations are better positioned than their subnational counterparts to exploit economies of scale in the collection and enforcement of taxes. Moreover, and relatedly, they tend to be better equipped in terms of financial and human resources; and
- The fact that compliance costs for taxpayers (especially those operating in multiple sub-national jurisdictions) are magnified by the existence of (often significant) differences in national and subnational tax legislation and tax administration procedures.

Finally, there are important political economy constraints to subnational own-revenue mobilization:

- CGs tend to prefer maintaining control of the main tax bases, both to facilitate the conduct of revenue-based stabilization policies and to influence subnational spending decisions
- SNGs for their part often prefer to rely on CG transfers (especially unconditional ones) to avoid the political cost of raising own revenues.

The balance between the benefits and costs of revenue decentralization varies both across countries and over time, reflecting evolving economic, institutional and political conditions. These factors shape the mix of subnational financing sources among own revenues, revenue-sharing arrangements and other intergovernmental transfers. For example, at least four different models of financing subnational spending can be identified among OECD countries, reflecting different mixes of the abovementioned sources (see OECD, 2009, for details).

The choice and design of subnational taxes are also shaped by a range of factors (Ambrosiano and Bordignon, 2006). Theoretical considerations, as well as lessons from country experiences, suggest that desirable characteristics of such taxes include:

i. Relatively low mobility of the tax base
ii. Avoidance of distortions and risks of adverse spillovers on other jurisdictions (e.g., tax exporting, or predatory tax competition)
iii. Relatively even distribution of the tax base across the national territory
iv. Significant revenue-raising potential
v. Low sensitivity to cyclical fluctuations and other exogenous shocks
vi. Relative ease of administration and
vii. Low compliance costs

The matrix below scores (as high, medium, or low) the conformity of each potential sub-national tax handle (personal or corporate income taxes; surcharges on national income taxes; retail sales tax; VAT; a subtraction VAT-type business tax; excises; property taxes; and royalties from natural resources) with the criteria above (with the caveat that specific economic or institutional circumstances may affect that scoring in individual countries). The reasons for such scoring will be explained in detail in the framework paper for the study.

	Revenue potential	Mobility of tax base	Potential efficiency costs	Sensitivity to cycle	Even distribution of tax base	Costs of admin.	Compliance costs
PIT	**M/H**	**L**	**L**	**M/H**	**L/M**	**H**	**M/H**
CIT	**M**	**H**	**H**	**H**	**L**	**H**	**M/H**
PIT surcharge	**M/H**	**L**	**L**	**M/H**	**L**	**L**	**L**
RST	**M**	**L**	**L**	**M/H**	**L**	**H**	**L/M**
VAT	**H**	**M**	**H**	**M/H**	**L**	**H**	**H**
Business VAT	**M**	**M/H**	**M/H**	**M/H**	**L**	**M**	**M**
Excises	**M**	**M**	**M/H**	**M**	**L**	**M**	**L**
Property taxes	**M**	**L**	**L**	**L**	**L/M**	**H**	**M**
Royalties	**H**	**L**	**L**	**H**	**L**	**M/H**	**M**
User fees	**M**	**L/M**	**L**	**L**	**M**	**M**	**M**

The matrix suggests that all potential subnational tax handles fall short (to varying degrees) of one or more of the desirable criteria, and that tradeoffs need to be made among them. For example, high revenue potential is often accompanied by high sensitivity to cyclical fluctuations (since both reflect a high income elasticity of the tax). Taxes with high revenue potential, such as a subnational VAT, are often difficult to administer (especially if destination-based) and can give rise to serious distortions (especially if origin-based). Most subnational taxes involve significant administration costs. These and compliance costs can be minimized by reliance on piggybacking mechanisms (such as surcharges on national income taxes). Surcharges, however, provide a more limited degree of subnational control over own revenues than alternative tax handles. These tradeoffs are influenced by a range of country-specific factors. An important purpose of the project will be to identify these factors in the country case studies and recommend appropriate policy choices accordingly.

2. Overview of Main Trends in Subnational Taxation in Latin America and the Caribbean

As in the rest of the world, most countries in Latin America and the Caribbean have experienced a clear trend towards increasing decentralization of spending responsibilities in recent decades. As a result, subnational spending rose sharply between 1985 and 2008 (both as a ratio to GDP and as a share of overall public sector spending) in most countries of the region (especially Argentina, Bolivia, Colombia, Ecuador and Mexico).

The rapid devolution of spending responsibilities was not mirrored, however, on the revenue side. With the exception of Brazil and, to a much lesser extent, Argentina, Bolivia and Colombia, subnational own revenues in Latin America and the Caribbean account for small, and broadly constant over time, shares of total tax revenues, and for less than 2 percent of GDP, giving rise to large vertical imbalances.

All the major Latin American and Caribbean countries include real estate and other types of real property (in particular, automotive vehicles) among their subnational tax bases; a few (mainly Brazil, Argentina, and Colombia) include sales, or the consumption of specific (generally non-merit) goods or services; and even fewer include incomes or wages (Mexico). With the exception of Chile, most countries that are natural resource producers allow some form of participation by the originating regions or localities in the revenues (royalties or taxes) generated by such resources. Albeit understandable on political economy grounds, and as a compensation for possible local environmental costs of the resource exploitation, this assignment tends to exacerbate regional disparities and to increase the volatility of subnational own revenues.

The vertical gaps created by the asymmetry in the decentralization of expenditures and revenues are filled by intergovernmental transfers. These have shown a rising trend in Latin America and the Caribbean in recent years, especially in Argentina, Bolivia and Mexico, at least through 2007. They also vary widely in magnitude across the region, ranging from over 8 percent of GDP in Argentina to under 1 percent in more centralized countries like Chile, Costa Rica, and Ecuador. The most important type of inter-governmental transfers is revenue-sharing, which is generally formula-based, as a percent of total national revenues or of a subset of such revenues.

3. Main Issues to Be Analyzed in the Case Studies

Each country case study should analyze the following main questions:

a. How large is the current vertical imbalance (the gap between own revenues and spending responsibilities) at the local and, where appropriate, the intermediate (state, province, department, etc.) levels of government? How is this gap typically filled (by revenue sharing; other forms of transfers, including ex post gap-filling transfers; subnational borrowing)?

b. What are the implications of these arrangements for:
   i. Overall revenue mobilization; fiscal balances; and medium-term public debt sustainability?
   ii. The capacity of SNGs to provide common standards of public services?

c. What are the current subnational taxes? How do they fare in relation to each of the criteria outlined above and why?

d. What are the political economy factors that underlie the current arrangements and outcomes, and how likely are they to hamper future reform efforts?

e. Which should be the main priorities for reform of subnational taxation in the country in question:
   i. Revenue mobilization?
   ii. If so, which tax handles could be better exploited, and why? What is a realistic range of additional revenue that could be targeted, over what time horizon, and what policy and institutional reforms (including in the intergovernmental transfer system) would be required for it?
   iii. Less sensitivity to cyclical fluctuations and other exogenous shocks?
   iv. Would this require politically difficult changes in the assignment of certain revenues (e.g., from natural resources)? If so, which other reforms (notably in the inter-governmental transfer system) may make such changes politically viable?
   v. Reduction of distortions and efficiency costs?
   vi. Which specifically? What reforms would be required for this purpose? Which would be the main winners and losers from such reforms?
   vii. Reduction of regional inequalities?
   viii. Why? Could this be better achieved through changes in the intergovernmental transfer system?
   ix. Improvements in subnational tax administration?
   x. What are the main current weaknesses? How much do they vary across different states and local governments? To what extent would these weaknesses make it advisable to re-centralize the administration of particular taxes (or certain aspects thereof, e.g., valuation of properties; audit of large taxpayers)? How much scope is there to strengthen vertical and horizontal cooperation among tax administrations (including through common taxpayer registries; joint audits; exchange of information, etc.)?
   xi. Reduction of compliance costs for taxpayers?
   xii. What would be effective steps towards this objective? Greater use of piggybacking mechanisms? Greater harmonization of national and sub-national tax and tax administration legislations? Greater use of electronic invoices (where relevant) and of e-government at the sub-national level?

f. What are the legal and/or political constraints to asymmetric approaches to the reform effort, to better tailor such reforms to varying economic circumstances and capacity levels among the country's SNGs?

g. What role could technical assistance and multilateral financing play in building national and subnational governments' consensus and capacity to carry out the desired reforms?

Based on the analysis of the above questions, the case studies should provide well-articulated and prioritized recommendations for policy and institutional reforms, taking into account the country's historical legacies, legal framework and political economy context.

The methods of analysis of such questions are likely to vary across the sample countries, reflecting in particular availability of the relevant data. Each research proposal should outline in detail the methodologies and databases it proposes to utilize in analyzing the questions above. The soundness of the proposed methods of analysis will be an important criterion guiding the selection of the proposals for the project. In general, the case studies will be expected to include simulations of the revenue impact of alternative reform proposals, and as detailed assessments as feasible with available data on the impact of such reforms on the regional distribution of revenues (as a proxy—albeit an imperfect one—for regional capacity to deliver a standard level of public services). The studies should also include estimates of the elasticities of subnational taxes to relevant cyclical variables, such as output gaps and changes in commodity prices. Finally, they should report available aggregate indicators of efficiency in subnational tax collections and compliance costs.

4. Selection Criteria

Research institutions only may present proposals for this project. The final number of proposals accepted will depend on the quality and the proposed budget of the proposals received. Each approved research proposal will receive financial support from the IDB of up to **US$40,000**. Proposed budgets will be evaluated taking into account the scope of work proposed. Projects that seek extra funding to complement financing by other institutions are strongly encouraged.

Proposals should include a detailed background section and literature review, data templates (in Excel format) to be used in the study, with a preliminary assessment of data availability, and a detailed description of the methodologies and empirical strategies to be used for each section or area that will be covered. The bibliography of this call for proposals lists several references for the empirical strategies used in the literature.

Final papers will be considered for dissemination as IDB working papers and may be included in a book or a special journal issue on **Subnational Revenue Mobilization in LAC**. For studies with only IDB funding, other forms of dissemination or publication should be explicitly approved by the coordinators until the journal issue option has been fully defined. Proposals may include suggestions for further dissemination of the final version of the paper and its policy implications.

5. Proposal Submission

Research institutions interested in submitting a proposal should pre-register before **October 8, 2010** by **clicking here**. If unable to pre-register before the due date for proposals, please send an email to red@iadb.org. Proposals are due **Wednesday, October 27, 2010**.

Proposals should be submitted using the **Web Submission Form**. **Please note that there are two options within the submission form: one for institutions and another for teams of individual researchers. Please make sure to choose the institutional form.**

The following information will be required for submitting your proposal:

- The proposal with all the technical aspects involved in the development of the study, based on the Terms of Reference outlined in this Call for Proposals.

  A budget indicating the time and resources that will be used within the context of the research work plan. **The proposal and corresponding budget must be sent in separate files.** The budget proposed should disaggregate items financed by the IDB contribution and those financed by the research institution or by the team of individual researchers. The budget should distinguish among amounts assigned to professional honoraria, "overhead" and other major categories of research expenditures.

- The name and Curricula vitae (three pages maximum per researcher) of the research leader and other researchers involved. The research team should demonstrate its ability to meet the objectives of the project, including relevant experience. Please note that for proposals submitted by institutions, subsequent substitutions for researchers originally specified in the proposal may be made with prior approval from the project coordinators, but the research leader (of each subject) should lead the entire project until its full completion. Conditions regarding the substitution of researchers apply only to contracts with institutions and not to contracts with individual researchers.

- Institutions must provide the name and contact information of its legal representative, with authority to sign contracts with the IDB, if selected to conduct the study

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Note: ALL proposals and research papers should be submitted in English.

6. Coordination and Schedule

The project will be administered by the Research Department (RES), in close coordination with the Institutional Capacity and Finance Sector (ICF) of the IDB. Mrs. Teresa Ter-Minassian, former Director of the IMF's Fiscal Affairs Department, will act as technical coordinator for the project, with the support of Eduardo Lora (General Manager of RES and Chief Economist a.i.) and Ernesto Stein, Lead Researcher at RES.

The tentative schedule of activities is as follows:

- **October 8, 2010:** Due date for **pre-registration**.
- **October 27, 2010: Due date for receiving proposals**. Institutions and researchers should ensure that complete documentation is submitted through the **Web Submission Form**.
- **November 10, 2010:** Announcement of selected research proposals.
- **December 2-3, 2010: First Discussion Seminar** in Washington, DC.
- **February 16, 2011:** Due date for receiving a **first draft** of research papers.
- **March 7-8, 2011: Second Discussion Seminar (location to be determined).**
- **April 27, 2011:** Due date for receiving a **second draft** of research papers.
- **June 29, 2011:** Deadline for a **final version of the research papers,** including a summary that discusses policy lessons and delivery of the datasets utilized by the study to the IDB.
- **July 20, 2011:** Deadline for receiving an **edited version** of the research papers, following the guidelines of the Bank's Publications Protocol, for publication as a Working Paper.

7. Financial Aspects

The IDB will contribute up to **US$40,000** for each study, depending on the scope of the work proposed.

The payment schedule is as follows:

- 35 percent within 30 days of signing the formal agreement between the IDB and the respective research center or researchers.
- 15 percent upon participation in the first discussion seminar of the project.
- 25 percent within 30 days of presenting and approving the second draft of the research paper.
- 25 percent upon approval by the Bank of the final research paper and upon delivery of the datasets utilized by the study to the IDB.

8. Bibliography

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