Avoiding the Fiscal Pitfalls of Subnational Regulation

How to Optimize Local Regulatory Fees to Encourage Growth

Investment Climate Advisory Services of the World Bank Group

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ACKNOWLEDGMENTS

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Abbreviations

BC  British Columbia
BLRC  Business Licensing Reform Committee (Zambia)
CFIB  Canadian Federation of Independent Business
EBF  extra-budgetary funds
FIAS  Foreign Investment Advisory Service (now Facility for Investment Climate Advisory Services)
GDP  gross domestic product
IFC  International Finance Corporation
LGA  local government authority
MBL  mobile business license (Canada)
MFNP  Ministry of Finance and National Planning (Zambia)
MSE  micro and small enterprise
NGO  nongovernmental organization
OECD  Organisation for Economic Co-operation and Development
SBP  single business permit
SME  small and medium enterprise
TRA  Tanzania Revenue Authority
USAID  U.S. Agency for International Development
VAT  value-added tax

All dollar amounts are in current U.S. dollars unless otherwise specified.
1. Overview of Efforts and Achievements in Subnational Investment Climate Reforms

Since investment climate reforms in developing countries started gaining traction in the 1990s, most efforts have focused on issues at the national level, achieving varying degrees of success for reasons that are, by now, relatively well understood.¹ Political leadership has been shown to be a critical element. Other factors playing key roles in most successful reform efforts include supporting circumstances such as a fresh political mandate, economic crisis, and/or the imperatives of global competition (for example, pending accession to the European Union or World Trade Organization). Among the important insights derived from these efforts was the need to improve business tax regimes that focused on short-term revenue at the expense of longer-term growth objectives.

In most countries, however, important aspects of the investment climate fall under the purview of subnational governments (for example, regional or local authorities), often at multiple levels.² Procedures relating to company start-up, licensing or permits, inspections, and access to land, for example, are commonly controlled at subnational levels, even when the capacity for implementation at that level is clearly lacking. Thus comprehensive national-level reforms often still leave important issues untouched. By the early 2000s, therefore, many governments initiated business environment reforms at the subnational level, often with the support of the World Bank Group and other donors.³

Various departments across the Bank Group have developed this assistance. Investment Climate teams, for example, have supported an administrative barriers reform project in the Russian Federation, business licensing reforms in Kenya, and subnational Doing Business projects in Mexico that encouraged competition between jurisdictions to improve relevant doing business indicators. The regional Investment Climate teams have worked in a number of places, including Lima, Peru; Bogota, Colombia; at the provincial level in Indonesia; and, more recently, in Nigeria. A final example is the large portfolio of “fiscal federal” reforms undertaken by the World Bank through development policy loans and enterprise sector work in all regions over the past two decades; these have often had a strong revenue focus, as fiscal constraints at the subnational level have usually been even more acute than those at the national level.

While some investment climate reforms were officially enacted at the subnational level, follow-up projects and evaluations in most cases revealed poor reform implementation, reversals in achievements, introductions of new license or permit requirements, or disappointing impacts on sustainable business growth or private sector employment.

¹ See, for example, Kikeri et al. 2006 and IFC 2009.
² Most countries have more than one subnational level of government. The most frequent divisions include the regional level (also called the provincial or state level) and the local level (also called the municipal, metropolitan, city, town, or village level). Additional layers may also be found, such as the county or canton, falling between the regional and the local levels, or the neighborhood, falling below the local level. This report will use regional and local in a generic sense; the terminology of specific countries will be used in discussing examples and case studies.
Anecdotal evidence has suggested that in cases where license or permit fees represented a substantial portion of a subnational jurisdiction’s revenue, potential loss of this revenue created a significant barrier to meaningful reform (see Boxes 1.1 and 1.2). According to Mikesell (2007), “Such taxes rank globally as the second largest local own-source revenue source, behind the property tax.” Kelly and Devas (1999) noted that “typically in Africa, business licenses (however defined) provide between 5% and 30% of local budgets.” Even if such official fees did not contribute significantly to the local budget, where petty corruption provided an important income source for otherwise poorly paid civil servants, bureaucratic obstruction often stood in the way of sustainable reform. Under such conditions, efforts to reduce the regulatory burden at the subnational level have often failed to create sustainable reforms with meaningful impacts for the private sector.

Conversely, “fiscal-federal” reform projects (including many supported by the World Bank, such as development policy loans in India and Brazil, which show promise) faced the revenue challenge of identifying and developing appropriate income sources for subnational governments that would both yield revenue sufficient to cover a reasonable share of the costs of mandated subnational public services and provide incentives to subnational administrators to facilitate private sector growth. These efforts have often proven equally frustrating. The usual “tax handles” for subnational governments in developed countries—real estate taxes and business taxes—are often difficult to administer in low-capacity settings (for example, where cadastres are undeveloped, valuation systems are nonexistent, and small business bookkeeping practices are inadequate). The fall-back position has too often been to continue to rely on license fees (and other such “nontax revenues”) as important revenue sources for subnational jurisdictions, deterring business growth.

On the fiscal side, if one adds to the already complex local finance situation the task of designing an appropriate regulatory system—that is, one that will serve socially desirable ends and at the same time facilitate the sound expansion of business activity in the formal economy—the challenge for the jurisdiction’s policy designers becomes even more difficult. This is a task that must be faced, however, given the importance of and continued reliance on business taxes, licenses, and fees among local governments.

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4 Mikesell 2007, 58.
5 Kelly and Devas 1999, 4.
6 For further discussion of the rationale(s) for local business taxation, see Bird 2005 and 2006.

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Box 1.1. The Multiplicity of Local Taxes and Fees in the Republic of Yemen

In the Republic of Yemen, 55 types of fees and charges are used to finance local authorities. Some (such as the annual district/municipal operating fee) are subdivided into more than 500 categories of business size and activities. According to the law, a similar charge—the professional permit fee—must also be paid at the governorate (provincial) level and is subdivided into 68 different categories. Companies are also required to pay an annual registration fee to the Ministry of Trade and Industry, a membership fee to the chamber of commerce, various monthly local council support fees (such as charges on utility bills), city improvement fees (such as charges on specific common transactions), and a range of sector-specific regulatory fees. Companies are also subject to the zakat—originally a religious tax (2.5 percent on capital)—which is used as a business operation levy assigned to local authorities.

All of these payments are in addition to the standard taxes (corporate income tax, goods and services tax, property and property transfer taxes, fuel tax, and tax on insurance contracts), as well as earmarked contributions to social, transport, and development funds. In sum, a medium-sized fishing company registered in Aden, for instance, would typically have to pay up to 15 fees and charges plus standard taxes. The same is true for a hotel or construction company located in the capital city of Sana’a.

Source: FIAS desk review of Yemeni legislation; World Bank Group Investment Climate Advisory Services 2009a, 195.
Box 1.2. Proliferation of Taxes in Nigerian States

The state and local governments of Nigeria’s four major states—Kano, Kaduna, Lagos, and Cross-River—have imposed a number of taxes on businesses. According to businesses in these states, proliferation of taxes represents one of their biggest problems. Foreign Investment Advisory Service (FIAS) work in Nigeria has found that the Lagos local government levies over 126 different fees and licenses, and the local government in Kaduna state has 147 different fees and licenses, including a burial fee levied on the number of corpses.

The problem of tax proliferation arose primarily because: (i) state and local governments had limited resources to fund their public spending; (ii) vague definitions within the primary law gave them the power to tax different tax bases; (iii) innovative taxes were created primarily by private tax collectors, also known as “consultants”; and (iv) taxes were used by corrupt officials as a guise to extort from individuals and business.

Nigeria has a federal structure of government, and tax bases are assigned to the various levels of government. Corporate taxes and value-added taxes (VAT) are collected and retained by the federal government, and while the personal income tax base is under the federal government, it is collected and retained by the state government. Oil revenue goes directly to the federal government. While federal taxes are reallocated to the different states, the limited tax bases reduced their capacity to raise revenues. This motivates them to look for new tax bases.

The taxing power of the states depends on the authority given to them by the federal law called Decree 21. FIAS found that imprecise definitions for the different tax bases implied that state and local governments could “invent” new taxes that had only an indirect connection to the intention of the decree. For example, while property taxes have been given to the local governments, and are intended to tax immovable property, this right has been used by them to tax all kind of property, including household property.

These kinds of innovative taxes have, in many cases, resulted in multiple taxation of the same tax base, prohibited by the constitution, which allocates the tax base exclusively to the different levels of government. For example, while cellular phone installations, especially cell phone towers (and the requisite regulations), fall under federal jurisdictions, states have used their regulatory laws to impose a fee on the installation of telecom towers, claiming that they had the power to do so to ensure safety of the citizens. Similarly, states are now planning to impose a sales tax even while a federal VAT is already in force.

The limited funds to run their respective governments is also leading state and local governments to tax through regulations. A number of regulations have been created with the primary aim of collecting revenue—not regulating. The example above of cellular telephone towers is a prime example. Federal government regulations should, in fact, ensure that towers are installed safely; however, state governments have used this ground to charge a fee to ensure safety. Interesting examples of such fees include those on the erection of tombstones, on mobile advertisements, and on musicians. Fees for mobile advertisements are one of the most despised levies and are charged on any vehicle, even those that do not carry mobile advertisement. The grounds for this are that the person driving the car is a mobile advertisement for the company he represents.

The multiplicity of taxes sometimes borders on extortion and is levied on dubious grounds with limited legitimacy. The state and local governments depend on private tax collectors called consultants. While the use of consultants for tax collections has been banned, and their role limited, ostensibly, to information gathering, in practice, they are used widely by taxing authorities. As a result, there is a strong lobby whose goal is to widen the tax base and “invent” new taxes to keep itself in business. The budgeting of these taxes is very nontransparent and it is unclear if the taxes collected actually reach the treasury or are being pocketed by unscrupulous government officials.

One lesson to learn from Nigeria is that subnational taxes can become a major issue for business when state and local governments under financial strain create multiple taxes to sustain their delivery of public goods. The limited transparency of these taxes can induce corrupt government officials to create new taxes with the goal of pocketing them. Another lesson is that the reliance on the private sector for tax collection could lead
Thus, while investment climate projects at the subnational level often disappoint because of bureaucratic resistance rooted in revenue loss or rent-seeking, fiscal-federal projects, too—especially those focused on short-term revenue needs—often yield disappointing results due to lack of incentives for subnational governments to encourage private sector growth in the medium to long term.

Since most subnational jurisdictions in developing and transitional countries face interrelated fiscal and regulatory problems, both should be considered in an integrated fashion when addressing the underlying problems and developing sustainable solutions. National governments, too, must work more constructively on these issues with subnational governments (for example, by developing clear frameworks describing the mandates for subnational services and the parameters for subnational revenue sources). A final consideration in planning reforms is to ensure that short-term revenue needs at the subnational level do not hinder efforts to ensure the healthy broadening of the tax base associated with sustainable growth led by the private sector.

The rest of this handbook\(^7\) is organized as follows. Chapter 2 reviews a number of countries’ experiences with subnational reforms, noting both success stories and disappointments and pointing toward lessons learned. Chapter 3 sets out the basic principles of subnational revenue (including business taxation). Chapter 4 describes sound licensing practices for subnational governments (including establishing licensing fees). Chapter 5 provides recommendations for subnational reform projects where both the regulatory authority and taxation require attention (which is, in fact, the most common situation). Finally, the Appendix offers nine case studies—the basis of the information and experience gathered here—covering subnational reform efforts in the following countries:

- Canada (British Columbia)
- The Russian Federation
- China
- Kenya
- Tanzania
- Peru (Lima)
- The Balkans (Serbia and Bosnia and Herzegovina)
- Tajikistan
- Zambia

2. Success Stories and Disappointments

Outside of OECD (Organisation for Economic Co-operation and Development) countries, examples of sustainable fiscal and regulatory systems for subnational governments are hard to find (and several OECD countries might also be considered relatively poor examples). Fiscal reforms and regulatory reforms are usually designed in “silos,” without much consideration for the interactions between the two. In developing countries, because of difficulties in finding short- or even medium-term solutions to developing own-tax resources, fiscal reforms at the subnational level often fall back on revenues from fees. At the same time, regulatory reforms that would substantially reduce subnational-level fees are rarely attempted (or, if enacted, are often reversed), due to the need for revenue. The failure to solve this conundrum creates a stagnating investment climate full of unresolved problems affecting small businesses, in particular, and seriously impeding their growth potential. National governments often neglect fiscal problems at the subnational level; they may even exacerbate them with “un-funded mandates” for social services.

After several months of research, the only robust success stories found were in developed countries (for example, municipal-level permit reforms in the province of British Columbia in Canada). In these cases, already sound fiscal bases permitted regulatory reforms reducing costs for businesses (including fees) without threatening the fiscal health of the municipalities that enacted them.

In the developing countries investigated, on the other hand, regulatory reforms to substantially reduce fees were rarely even recommended; those recommended were still more rarely enacted; and those enacted were often reversed. The burdens on businesses were thus only significantly eased by reforms reducing financial costs within the private sector (for example, eliminating requirements for notarization of documents) or alleviating demands on staff time within businesses completing administrative procedures. Such reforms are beneficial, but their effects are quite limited. In Kenya, for example, International Finance Corporation (IFC) study determined that “the license fees constitute the most costly element of the licensing cost–67% pre-reform [and] 64% post-reform.”

Perhaps the most striking finding of this review of cases was the near-universal failure even to assess the fiscal framework or the role of fee revenues as sources of funds for the relevant jurisdictions. Conversely, fiscal reforms aimed at the subnational level tended to focus on immediate revenue needs and to assume that revenues from license fees were a sufficient solution to that problem, without considering the negative effect that reliance on such sources may have on business creation, investment, and growth.

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9 One recent exception has been the Zambia licensing reform project, which undertook just such an assessment. As of 2011, the findings had been used to define constraints to regulatory reform (fiscal neutrality), but they had not yet been used to develop alternative sources of revenue to help expand the potential for regulatory reforms.
2.1. SUMMARY OF FINDINGS FROM PAST REFORMS

A review of reforms dating back more than five years reveals little evidence of major subnational-level reforms that achieved substantial, measurable impact on the investment climate in the absence of broader national-level reforms, in particular those that improved the fiscal framework for subnational jurisdictions.

2.1.1. In-Depth Case Studies of Subnational Reforms

Appendices 1 through 9 of this handbook present case studies for the subnational reforms considered. (These are also described in more detail in Section 2.2.) A summary of these efforts and their results follows:

- **Canada (British Columbia)** – The mobile business license: positive success story
- **The Russian Federation** – National reforms to remove power from subnational governments regarding business registration, licensing, and inspections: patchy implementation
- **China** – Improved subnational fiscal powers: results insufficient to curb abuse
- **Kenya** – Single business permit, designed to replace most other subnational licenses and permits: not enacted as envisioned
- **Tanzania** – Subnational level fiscal reforms: several different uncoordinated efforts, none successful
- **Serbia and Bosnia** – Streamlining of municipal-level procedures for licenses and permits: mostly avoided reducing fees, with one notable exception
- **Peru** – Municipal operating licenses streamlined: good initial response in terms of new business registration, but evidence shows most informal firms remain deterred by fees and other investment climate issues
- **Tajikistan** – “Super patent” for small businesses: a relatively recent reform
- **Zambia** – Explicit effort to assess fiscal impact of subnational regulatory reform: not yet enacted

2.1.2. Subnational Doing Business

The publication of subnational Doing Business reports has paved the way for reforms in a growing number of countries, starting with Mexico in 2005. Countries that have gone through at least two rounds of subnational Doing Business reports (that is, a baseline report with recommendations and a follow-up report documenting improvements since the baseline) include Mexico, Colombia, India, Pakistan, and Nigeria. The reports contain many recommendations for simplifying procedures and for reducing unnecessary steps, the time required to complete procedures, and costs.

However, the pattern of reforms clearly shows that fee reduction is the least popular type of reform. In Mexico, for example, states and cities lack own-source revenues and rely heavily on transfers from the national level. Among the reforms enacted by 28 municipal jurisdictions participating in the subnational Doing Business for starting a business, 45 involved simplifying and streamlining procedures or reducing the number of steps or days required, but only four reforms reduced fees.10 For registering property, 12 municipalities made 14 reforms to reduce the number of steps or days needed to complete the procedure, but only two reduced tariffs.11

In Colombia, among 13 municipalities, the subnational Doing Business report records 24 reforms to streamline or simplify procedures for business start-ups, but only one to reduce costs. (One “negative reform” actually increased costs.) For registering property, five cities streamlined procedures, but only two reduced tariffs or fees, one by simplifying procedures, the other by reducing tax certificate fees.12

In India, among 17 municipalities participating in subnational Doing Business, start-up reforms included eight to reduce numbers of procedures or time required, while only two reduced fees, in one case quite substantially.13

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10 World Bank and IFC 2009a, 14.
11 Ibid., 23.
12 World Bank and IFC 2010, 16.
13 World Bank and IFC 2009, 16.
Regarding construction permits, 28 reforms simplified and streamlined procedures but none reduced fees, which ranged widely (from about $450 to $15,900). Fees for property registration showed a higher rate of reform, with six to simplify procedures and five to reduce fees (four cities reduced the stamp duty and one reduced other administrative fees). In fact, it was noted that “registering property costs 10.6 of the property value” in India, which is relatively high by world comparison, and also exhibits a wide range, from 5.4 percent to 25.4 percent. In most cases, the largest cost category is the stamp duty, which ranges from 4 percent to 12.5 percent.

Pakistan introduced a national e-service for registration, through which applicants registering for incorporation online paid only half the fee paid by those registering in other ways. Similar fee reductions were available for using other e-services, such as name verification, although applicants could face additional fees for validation of digital signatures. Overall, the report noted that “the cities with a high use of online registration services have lower overall costs to start a business.”

For construction permits in Pakistan, no fee reductions were noted except for telephone connection costs. For property registration, the capital value tax rate increased at the national level, but no reforms were reported regarding subnational-level fee reductions.

In the Philippines, 16 reforms were recorded in 18 cities between 2008 and 2010. The great majority of the cost savings—an average of $875—resulted from increased competition among notaries. Two procedures were eliminated, leading to savings of only $21 on average.

In Nigeria, a national-level reform was enacted to reduce stamp duties for incorporation from 1.5 percent to 0.75 percent of share of capital. The subnational Doing Business report notes, however, that “this reduction has not been properly communicated to the public in all states, and incorporation lawyers in places like Delta and Bayelsa still charge the old rate in practice.” Business premises registration fees are set locally and range from about $15 to $150; no proposals to reduce these fees have been put forward. The only reduction in building permit costs has been due to the online publication of the Lagos Building Permit Approval Handbook, for a cost savings to users of about $375.

For property registration, five reforms among eight cities simplified or streamlined procedures, but only two reduced or eliminated fees; four “negative reforms” increased fees. Costs are relatively high, ranging from 5.2 percent of property value to 33.6 percent.

The clear pattern is one of reliance on reforms to procedures in preference to reforms that reduce official fees. The likely reason is that the jurisdictions are reluctant to reduce their revenues from fees, even though the fees are often an unwarranted cost on businesses and usually represent a much larger burden than the cost of business staff time saved through procedural reforms.

2.1.3. Other Subnational Reform Projects

While the subnational Doing Business projects mainly focused on benchmarking and competition between subnational jurisdictions, many other reform projects provided explicit advisory assistance in the reform process (or involved extensive reforms without significant external assistance, as in China in the 1990s); but these alternative approaches were not necessarily more successful. The paragraphs below elaborate on these projects, which are also presented in more detail in the appendixes.

The case of British Columbia, Canada, offers a mostly positive example. A sound investment climate is, of course, relatively easier to maintain in a high-capacity, high-income country with well-established institutions. Still, it is

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14 Ibid., 21.
15 Ibid., 26.
16 World Bank and IFC 2010b, 15.
17 World Bank and IFC 2010c, 8.
18 World Bank and IFC 2010a, 15.
19 Ibid., 21.
20 Ibid., 24.
useful to focus on the key features of successful reforms (and their underpinnings), at both the provincial and the municipal levels. This case also illustrates the problems arising from the tension between regulatory reforms and the municipalities’ need for revenue from license fees.

Fiscal federal reforms in Russia were criticized for failing to give local governments enough “own revenues” to provide most subnational jurisdictions with the incentive needed to promote investment climate reforms to encourage private sector growth, such as deregulation or constraints on unnecessary government inspections. A rigorous panel study found that subnational jurisdictions that did not rely on transfers from the national government (a quite small minority, including those with large markets, such as Moscow and St. Petersburg, and a small number of regional governments with natural resources) were more likely to ensure sound implementation of national regulatory reforms designed to improve the investment climate. Most other subnational jurisdictions dragged their feet on implementing such reforms.

By contrast, China’s fiscal federalism usually ensured a much stronger base of own-source revenue for subnational governments, which in turn provided a stronger incentive for such jurisdictions to implement investment climate reforms. China’s efforts in this direction were sometimes reversed, however (for example, mandated cuts in subnational own-source revenues after 1994), only patchily implemented, or, according to empirical evidence, selectively implemented to favor large businesses at the expense of small ones. Abuse of revenue-producing resources continued at the local level as well (for example, in control of access to land).

In Kenya, where well over one thousand licenses and permit requirements could be imposed on private businesses (the majority of which were levied at the subnational level), the national government developed a new single business permit, to be implemented by local authorities, to replace the majority of other local business licenses. Unfortunately, many municipalities failed to repeal all the other licenses, so that some businesses ended up paying for those and for the new permit. The single business permit included eight different categories for different sectors, and subcategories within those covered various sizes of businesses. Annual fees ranged from about K Sh 200 (in 2011, about $2.30) for a shoe shiner in a small town that had chosen the lowest rate bands to K Sh 120,000 ($1,382) for a large transport company in a city that had chosen the highest rate bands.21 Definitions were based on what were meant to be objective criteria, such as floor space or numbers of employees or vehicles, but often arguments arose over whether businesses were “hiding” workers or vehicles or claiming floor space for household rather than business use. Such disagreements created an incentive for “negotiation” and hence for bribery.

In Tanzania, reforms focused more on the fiscal side and went through several iterations of overreliance on “fees” and on insufficient transfers from the national level to cover required public services. An attempt to build up property taxes was stymied by local elites. Efforts to develop new business taxes were poorly designed.

In the more recent case of Zambia, efforts to undertake regulatory reforms and reduce license fees (through elimination of certain licenses and reducing fee rates for others) were required to include measures to ensure “revenue neutrality,” as many municipal administrations depended on such revenues for up to 15 percent of their budgets.

On the other hand, similar reforms in Nigeria faced resistance not because of official fees (which were usually quite low and therefore represented only about one percent of budgets) but because many civil servants relied on the income they received from rent-seeking when processing businesses’ applications for licenses. In some countries where revenues are scarce, governments keep official salaries extremely low in part to avoid deficits. In such cases, civil servants either resort to rent-seeking or look for a “second income.” If that second income is from entrepreneurial activity, they may make deals with colleagues to ensure that private sector competitors to their own business face significant bureaucratic obstacles. Over time, the habits of entrenched rent-seeking may create local “elites” who benefit more from the status quo than they would from a more open investment climate with healthy levels of competition.

In the case of Lima, IFC worked at the subnational level to enact reforms to reduce barriers to entry that the business community had identified as its highest priority for change. IFC helped districts in Lima streamline local

21 Currency unit: Kenya shilling (K Sh); K Sh 86.8 = $1 (2011).
business licenses and then took the laudable step of trying to assess the impact of the reforms. Initial results looked quite positive: an immediate jump was seen in the numbers of new business registrations. About a year later, however, in the effort to carry out “tracer studies” of businesses that formalized after the reforms were enacted, researchers noted a high degree of reluctance to register among informal businesses, despite the reformed procedures and even when registration fees were paid for them. Other aspects of the investment climate (for example, onerous tax burdens or inspections) were clearly deterring formalization, even more so than had the cumbersome registration procedures.

Subnational reforms in Serbia and in Bosnia and Herzegovina streamlined many procedures, but they were mostly unable to reduce official fees. One municipality, largely due to strong competition between municipalities and advice from World Bank Group project, did successfully enact a set of recommendations to reduce high fees for location permits (see Box 2.1 for more information).

In Tajikistan, 2008 amendments to the tax code simplified the patent (similar to the Kenyan small business permit) and introduced an alternative tax certificate, based on firm turnover, as opposed to the original certificate based on profits. Revenues accrue to local governments. Early indications show improvements both in revenue performance and entrepreneurs’ satisfaction with the tax structure; a more definitive evaluation remains to be undertaken in the future.

Box 2.1. Successful Regulatory Reforms in Goražde

Investment Climate teams of the World Bank Group have been continuously engaged in Bosnia and Herzegovina from immediately following the civil war. It was not until the mid-2000s that the focus shifted to include the subnational level: the municipal and entity levels in the Republika Srpska and the municipal, cantonal, and entity levels in Bosnia and Herzegovina’s remaining section, the Federation.

The most impressive reform efforts were displayed by the municipalities. One of the most successful was Goražde, in South East Bosnia, a Federation town of about 20,000 largely surrounded by Republika Srpska towns. While trying to outdo its neighbors and attract donors’ attention, its leaders worked to improve the business-enabling environment for smaller entrepreneurs. With its young, enthusiastic new mayor, the head of a new administration, the town got behind the reform effort.

The area of concentration chosen for focus was regulation of building construction and legalization, well within the scope of local legislators and, according to local entrepreneurs, one that represented a significant impediment to doing business in Goražde. Together with the authorities, the municipality analyzed the fee structure for these permits and decided, rather than alter the fee directly, to adjust the base (price per m²) for its calculation, from 1,073 KM/m² to 600 KM/m², effectively lowering the fee costs.

<table>
<thead>
<tr>
<th>Savings for Urban Permit:</th>
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<td>Citizens</td>
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<td>Average saving (according to the frequency for businesses and citizens)</td>
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<td>Annual savings for business and civil sector</td>
<td>1,600,890 KM</td>
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<tr>
<th>Savings for Building Legalization:</th>
<th>Fee and stamp-duty</th>
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<tbody>
<tr>
<td>Businesses</td>
<td>34,994 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>2,627 KM</td>
</tr>
<tr>
<td>Average saving (according to the frequency for businesses and citizens)</td>
<td>3,436 KM</td>
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<tr>
<td>Annual savings for business and civil sector</td>
<td>274,880 KM</td>
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(continued next page)
Many reform programs at the subnational level have simplified regulations and reduced the time burden of compliance, often representing significant improvements over the pre-reform situation, but relatively few of these have produced major reductions in official fees paid by businesses or a substantial shift from “fee revenue” to “tax revenue” in subnational jurisdiction budgets.

2.2. Common Features of Success

Reform efforts to substantially reduce fees are relatively rare outside the developed world. As shown in the case of British Columbia, Canada, a clear framework for regulatory and fiscal mandates for subnational governments (with expenditure requirements roughly matched with available and appropriate resources) seems to be a key ingredient. Many success stories feature a degree of competition for recognition and greater investment among subnational jurisdictions within a country, a strategy used by the subnational Doing Business projects. Other keys to success include enlightened leadership at the subnational level (for example, a governor or mayor who appreciates the benefits to the tax base of attracting new investment through a sound, sustainable investment climate), ongoing capacity building for subnational administrations, and the positive example of successful reformers.

In a number of cases reduced fees have lowered the costs of entering business, apparently encouraging entrepreneurs to open more businesses or to apply for the cheaper licenses. To encourage fee reduction, Doing Business cites the example of Egypt:

Egypt successfully implemented a reduction in property-registration fees. In 2006, registering a property in Cairo cost 5.9% of the property value. Ninety percent of properties were either not registered or undervalued. The Egyptian government reduced registration fees from 3% of the property value to a low fixed fee and abolished other fees. It cost merely 1% of the property value to transfer property in 2008. The reform paid off: property registrations, and concomitant revenues, rose in the 6 months following the reforms.

However, subnational government leaders often fear, with reason, that not all such fee reductions will necessarily lead to increased revenue or that any resulting revenue growth will not prove sustainable. The same logic seen in the “Laffer curve” for taxes can easily apply to fees and gives rise to the same questions: What is the elasticity of demand for businesses to undertake an activity subject to a fee of a certain rate? Even if a fee

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Box 2.1. (continued)

After the reform, the number of permit applications increased significantly for the first time in the postwar years. In 2009, a total of 236 applications were made: 80 for legalization permits, 102 for urban permits, and 54 for building-use permits. In 2010, applications totaled 278—an increase of 16 percent—including legalization: 112 legalization permits, 98 urban permits, and 68 building-use permits. These numbers would likely have been even higher if not for the extensive area flooding in the summer of 2010, and the early figures for 2011 show a continuing rising trend.

The example of Goražde demonstrates how investment and construction activity can benefit from regulatory changes. Even though the fees were lower, because the number of applications rose the municipality did not lose revenue. The business and civil sector savings, however, totaled approximately KM 1.97 million. In addition, the far more transparent regulation of construction and new construction and the general increase in investment into Goražde in turn reflected positively on private sector growth.
reduction substantially increased transactions and net revenue in the short run (for example, because applicants aware of the impending fee reduction had waited to register until it had taken effect), will the increases be sustained over the long run? If not, how can revenue shortfalls be made up?

From the point of view of a city administration, such reforms may appear risky. Pilot programs may help provide evidence of the fiscal effects of regulatory reforms, tipping the balance either in favor of or against the reforms. As noted, most examples of successful reforms to reduce fees have occurred in developed countries, where the fiscal base of local governments is sufficiently robust that revenues from fees are not necessary to supplement the budget. This framework may then be reinforced through well-designed transfer systems that can stabilize income for subnational governments without encouraging profligacy or reckless behavior, as in the Canadian case. Developing countries, however, rarely have that luxury at the national, let alone the subnational level.

In countries where competition among subnational governments to attract investment is limited (for example, by cultural or linguistic barriers to the mobility of entrepreneurs), it can be beneficial for the national government to actively encourage (or even require) subnational governments to relinquish regulatory powers vulnerable to exploitation and abuse by local politicians. While Russia is rarely held up as a positive example in terms of investment climate, national-level reforms implemented between 2000 and 2002 stripped subnational governments of their authority to impose their own requirements on businesses for registration, licensing, or inspections. This framework functioned well in regions that implemented the reforms comprehensively, but improvement in other regions (specifically, those still dependent on transfers from the federal level) tended to lag.

In this regard, China’s framework, which especially in the early 1990s allowed for much more own-tax revenue at the subnational level, was likely a contributing factor to the encouragement by subnational governments of private sector business growth. When the central government reduced subnational own-tax revenues, these governments resorted to opaque “off-budget” revenues, including license fees. The central government in turn applied pressure to curb these abuses, which helped mitigate, but not eliminate, the problem.

A common theme is thus the need for active coordination between the national and subnational levels of government in improving the investment climate, covering both regulations (including license fees) and taxes in an integrated manner and considering both short-term constraints and medium-term opportunities.

Desirable features of a central-government framework for subnational investment climate reform (elaborated further in chapter 5) include the following:

- Clear mandates for subnational governments on both business regulation and taxation (including license fees)
- Fiscal transfer policies that realistically match subnational expenditure mandates with available resources
- Resources for capacity building at the subnational level to improve management of business regulation and taxation mandates
- Accountability extending from the base (that is, the citizens) through subnational governments to national governments (including national agencies operating at the subnational level)

2.2.2. Common Features of Disappointments and Reversals

Limited scope and medium-term backtracking or reversal have, unfortunately, been common outcomes of subnational reform projects. While streamlining regulations is almost always helpful, the impact of reforms (especially in terms of sustained higher levels of new business formation, investment, and employment) is often restricted or unsustainable.

Subnational regulatory reforms have often failed to reduce businesses’ costs sufficiently to affect their decisions regarding business formation and investment. The subnational administrations cannot afford to eliminate licenses carrying fees providing needed revenue, nor can they substantially reduce those fees. National governments often neglect such problems at the subnational level and may even exacerbate them by imposing unfunded mandates for public services. Fiscal-federal reform programs often put short-term budget needs first,
falling back on business licensing as a ready revenue source, even though the medium and long-term effects of that policy are usually to deter business growth and the resulting increase in the tax base.

Reforms that appear to deliver positive results in the short run often lead to disappointment in the medium term. For example, while a “spike” of new business registration often follows regulatory reforms, subsequent investigations have shown that many of the new businesses fail at higher than usual rates and that those that have “formalized” do not make the expected new investments or hire more staff, as occurred in Lima.24

Hernando De Soto25 famously reported on earlier reforms in Peru that were reversed within two to three years of their enactment. Vested interests in the local administration had always resisted reforms. After the reforms were enacted, a few workplace fires and accidents occurred, giving these resistors an excuse to reverse many of them and to reinstate ex-ante licensing and inspection requirements.

Russia presents a classic case in which most subnational governments are overly reliant on transfers from the federal government. These transfers create problems when, on the one hand, they are inadequate to cover necessary expenditures, and on the other hand, they are negotiated and thus fail to provide a “hard budget constraint” that would encourage sound prioritization. In this setting, many subnational administrations have found it expedient to continue to cut deals with local so-called oligarchs, including uneven enforcement of regulations, allowing these regulations to fall most heavily on the oligarchs’ potential competitors among local small and medium enterprises.

Kenya’s single business permit was explicitly designed to provide revenues for local authorities while reducing compliance costs for businesses and increasing transparency. While the situation improved relative to the proliferation of licenses that had occurred in the past, most local authorities opted for the highest levels of fees allowed by the central government, yet nevertheless have faced increasing deficits. While “ex-ante” inspections associated with business licenses have apparently been reduced from past levels, “ex-post” inspections still involve intimidation and threats of shut-downs or even imprisonment, which in turn lead to bribes.

Bird (2010) notes that (aside from “the few like Brazil and India that have effective federal constitutions”26), taxes allowed for subnational governments are usually assigned at the discretion of higher level governments, and tend to fall into one of three categories:

- Taxes (and user-fees) that are too small to bother with – the minor nuisance taxes on … billboards, and the like that are so often found at the local level;
- Taxes difficult or costly for central governments to administer, especially if they are potentially politically challenging – such as the property tax;
- Taxes that may slip between the cracks – such as the technically rather bad local business taxes found in a number of countries.27

Another challenge at the subnational level is the lack of capacity for sound implementation of regulations and taxation. Small towns, in particular, may suffer from a real lack of civil servants qualified to undertake meaningful sanitary or fire-safety inspections, to license pharmacies or building contractors, or to enforce environmental regulations. If such regulations cannot be meaningfully enforced at the local level, or if taxes cannot be collected, mandating local governments to administer them will be pointless.

In terms of reforms, too, local governments may be more prone to capture by local elites, and systems of checks and balances (for example, a free press and independent judiciary) are often lacking to control the activities of local politicians, bureaucrats, and their “cronies.”

24 IFC 2010.
26 Bird 2010, 147.
27 Ibid., 149.
Prud’homme (1995), for example, speculated that corruption may increase with decentralization, as local elites find it easier to “capture” local bureaucrats. On the other hand, Gurgur and Shah (2005), using empirical data from both developed and developing countries, found that decentralization more often tends to reduce corruption by improving accountability. The effect is stronger in countries (and probably subnational jurisdictions, which may differ in these regards even within a single country) with a well-functioning democracy and an active civil society.

2.2.3. The Policy Dilemma

The desire to improve the investment climate calls for the removal of unnecessary regulations, the streamlining of the remaining regulations, and the elimination of any license fees that are higher than necessary to cover the relevant costs (for example, user fees, or pollution permits). Yet in developing and transition countries, many subnational governments depend on the revenues from license fees for a significant portion of their budgets. If these entities should not get revenues from licenses, what can they do to meet their spending needs?

Clearly, there are no silver bullets. Experiences in developed countries (see in particular the British Columbia case study, Appendix 1), have provided some general characteristics of a good (or “as good as possible”) tax regulatory regime. The relevant objective functions are messy (that is, multiple, competing objectives are at stake), requiring that priorities be set. The consensus in principle holds that local governments should be given incentives to foster investment as well as efficiency in public-service delivery. Thus sound subnational reforms must integrate both regulatory and fiscal authority. This necessarily joint effort between the relevant national and subnational authorities must take into account both short-term constraints and sustainable, medium- to long-term growth strategies.
3. Revenue Reforms for Subnational Governments in Developing Countries

Countries around the world (both developed and developing) exhibit a wide range of solutions for dividing responsibilities among national and subnational levels of government, depending on capacity, economies of scale, desired levels of accountability, and other political, historical, cultural, and ethnic considerations. These divisions are often described in each country's constitution. Generally speaking, most developing countries tend to be more centralized than most developed countries. This handbook takes each country's fundamental decisions about the division of responsibilities as "given" and focuses on the narrower revenue and regulatory responsibilities that follow from those broader divisions.

3.1. TAXES APPROPRIATE FOR LOCAL GOVERNMENTS

Since the 1950s, researchers in public finance have noted that taxpayers who were mobile across subnational jurisdictions could "vote with their feet," moving to jurisdictions that provided them with their preferred mix of local public services and local taxes. This situation helped promote efficiency, as no jurisdiction could keep taxpayers by providing poor services and high taxes (relative to other jurisdictions to which taxpayers could move), and borrowing constraints would keep jurisdictions from trying to offer generous public services but low taxes. Thus the main choices for mobile taxpayers (including businesses) would be between jurisdictions with relatively good services and high taxes and those with relatively poor services and low taxes.

The broader theory of "fiscal federalism" pointed out the efficiency of allowing the quantity and quality of many public services to be decided by local communities (especially in relatively large or heterogeneous countries), based on local preferences, priorities, and circumstances.

A so-called "second generation" of fiscal federalism has put more emphasis on the relationship between decentralization (especially own-source revenue for which subnational jurisdictions maintain control of the effective rate of taxes and therefore marginal tax revenues) and the incentive for subnational governments not only to improve efficiency in provision of public services but also to expand the tax base by (among other things) improving the investment climate.

In the relatively more centralized developing and transition countries, central governments tend to keep control of the most productive tax instruments, and the availability of appropriate tax bases for subnational governments, which are often of lower capacity than the central government, has often been problematic. They therefore become dependent on fiscal transfers, which in turn are quite often inadequate to cover the costs of mandated services.

30 This term encompasses both relevant base control and, more importantly, rate control, and it also states what really matters: local governments can affect the real rate at the margin.
31 See, for example, Bahl and Linn 1992; Shah 2004; Bahl and Bird 2008.
The lack of fiscal autonomy at the subnational level may also retard the development of public sector accountability by depriving citizens of their most realistic opportunity to have a meaningful influence on public sector decision-making. The argument has been presented in slightly different ways in the fiscal sociology literature, which emphasizes the importance of taxation as a determinant of state capacity (for example, see Campbell 1993). More recent work further explores the way taxation shapes state-society interactions (for example, Brautigam et al. 2008).

Bahl and Bird (2008) articulated several criteria by which one may judge whether a tax is “local”:

- Local governments can decide whether to levy the tax or not.
- They can also determine the precise base of the tax.
- They can decide the tax rate.
- In the case of “direct” taxes, they assess the tax imposed on any particular taxpayer.
- They administer the tax.
- They get to keep all they collect.

The authors go on to note: “In the real world, however, many taxes may possess only one or two of these characteristics and the ‘ownership’ of the levy may be unclear.”32 Perhaps the least important criteria is administration. Central governments may be more efficient at administering many taxes. On the other hand, Mikesell (2007) makes the following point:

While centralized administration promises quality service at reasonable cost, it may dull accountability and slow the revenue flow. Also, central administration may devote less attention to collecting these taxes than for its own. Self-administration brings administration closer to taxpayers and assures representation of jurisdictional interests in revenue apportionment disputes. However, subnational governments may lack technical capacity. That is the dilemma: while the central administration may be indifferent to rigorous collection of subnational taxes, subnational governments may lack capacity for self-administration.33

Essentially, if the subnational government can control its revenues at the margin (usually by controlling rates, at least within a range), such revenues are usually considered “own source.”

Bahl and Bird suggest four basic principles for assigning revenues to subnational governments:

- First, subnational taxes should not unduly distort the allocation of resources.
- Second, to the extent possible, governments at all levels should bear significant responsibility at the margin for financing the expenditures for which they are politically responsible.
- Third, ideally own-source revenue should be sufficient to enable at least the richest subnational governments to finance from their own resources all locally provided services that primarily benefit local residents.
- Fourth, to the extent possible, subnational revenues should burden only local residents, preferably in relation to the perceived benefits they receive from local services.34

In almost all cases, subnational governments require a number of different revenue instruments (and transfers) to cover their spending needs, and since not all local governments are the same, the best mix of taxes “is likely to differ not only between regional and local governments but also between governments of different sizes and complexities.”35

33 Mikesell 2007, 41.
34 Bahl and Bird 2008, 8.
Since central governments usually insist on full control over the most productive tax bases (for example, income taxes and VAT), subnational governments must usually rely on a mix of property taxes, excise taxes, sales taxes, and business taxes.

On the positive side, Bird (2010) notes that “at least in some situations, subnational governments may have the potential—and, provided the intergovernmental system is properly designed, the incentive—to try to reach [the informal sector] in ways that the central government cannot.”36

The policy matrix in Table 3.1 summarizes some of the key points in the ensuing discussion.

As the top row of Table 3.1 suggests, a wide range of possible local revenue sources other than intergovernmental transfers has been considered, ranging from user charges and property taxes—the traditional local revenues almost everywhere—to less common sources, such as payroll and income taxes, excises taxes, and sales taxes. For the most part, nontraditional revenue sources are considered suitable only for larger regional (or metropolitan) governments, as indicated by the $R$ in the top row, and may also include a simple surcharge on the central personal income tax. Note, however, that some types of business taxes, as described in more detail below, can be and indeed are used both by smaller local and larger metropolitan and regional governments.

The left-hand column of Table 3.1 lists several criteria used to assess the relative desirability and/or feasibility of each of the revenue sources shown. As is common in policy analysis, this table illustrates the usual difficulty of finding good numbers or clear and uncontroversial qualitative judgments for each cell. Inevitably, therefore, just as the particular instruments and objectives shown in the table reflect subjective views—albeit informed to the extent possible by experience—so do the illustrative entries in the individual cells.37 Nonetheless, composing such a matrix can be an interesting and useful exercise for anyone thinking about local finances in any country. Among the inevitable realizations will be that (1) cell content will likely vary for each variation in type of subnational government: local, regional; urban, rural; big, small; rich, poor; and (2) different decision makers in the policy process (local mayors, central ministers of finance, citizens, businesses) would also likely weight the various criteria differently.

In short, one of the main lessons to be learned from Table 3.1 is that, while many local revenue packages are conceivable, the “best” package for any particular country or local government is likely to be both very context-specific (and, in all likelihood, path-dependent) and sensitive to the prevailing balance of political forces and interests. The appropriate answer to the question of subnational taxation lies at the heart of the complex and often conflicting political, social, administrative, and economic issues underlying any resolutions to both the taxation and the decentralization puzzles: it is thus not something that may be quickly or easily discerned, let alone resolved, in any country. However, as Bird has noted, “subnational business taxation is likely to distort the allocation of resources to some extent unless offset by corresponding benefits to business.”38 In most cases, business taxes paid in developing countries usually exceed the benefits to the businesses, but the methods and management of business taxes could also be significantly improved.

Another consideration is the possible interaction between national and subnational taxes. Are they on the same base or on different bases? Can one be deducted from the other?

General advice from the World Bank includes the following:

Two points are apparent [regarding criteria for suitability of local taxes]. 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

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36 Bird 2010, 18.
37 For a more detailed discussion of the subnational revenues and criteria listed in Table 3.1, see Bird 2006.
38 Bird 2010, 40.
Table 3.1. A Preliminary Evaluation of Common Sources of Local Revenues

<table>
<thead>
<tr>
<th>CRITERION</th>
<th>USER CHARGES (L, R)</th>
<th>PROPERTY TAX (L)</th>
<th>SALES TAX (R)</th>
<th>BUSINESS TAXES (L, R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue adequacy*</td>
<td>OK for some activities; not in general</td>
<td>OK for general local government</td>
<td>Yes</td>
<td>Often</td>
</tr>
<tr>
<td>Revenue buoyancy**</td>
<td>No</td>
<td>Not much</td>
<td>Yes</td>
<td>Often</td>
</tr>
<tr>
<td>Correspondence of payers and beneficiaries</td>
<td>Excellent, if well designed</td>
<td>Fair, if properly done</td>
<td>Depends on mobility</td>
<td>Depends on design</td>
</tr>
<tr>
<td>Local accountability</td>
<td>Excellent</td>
<td>Theoretically high, but in practice can often be low</td>
<td>Can be OK</td>
<td>Usually low</td>
</tr>
<tr>
<td>Administrative cost (public sector)</td>
<td>Sometimes high</td>
<td>If well designed can be low, but in practice often high</td>
<td>Moderate</td>
<td>Sometimes high</td>
</tr>
<tr>
<td>Compliance costs (private sector)</td>
<td>Irrelevant, in principle</td>
<td>Depends, but not high</td>
<td>Moderate</td>
<td>Often high</td>
</tr>
<tr>
<td>Latitude for corruption</td>
<td>Relatively low</td>
<td>Moderate to high</td>
<td>Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Political acceptability</td>
<td>Apparently not very high in most countries</td>
<td>Moderate</td>
<td>Perhaps</td>
<td>High</td>
</tr>
<tr>
<td>Distortionary impact</td>
<td>None, if properly designed</td>
<td>Moderate</td>
<td>May be OK</td>
<td>Usually high</td>
</tr>
<tr>
<td>Progressivity***</td>
<td>Irrelevant?</td>
<td>Possibly</td>
<td>No</td>
<td>Usually unknown</td>
</tr>
<tr>
<td>Effect on regional disparities</td>
<td>May reduce to some extent</td>
<td>No change</td>
<td>No change</td>
<td>No change</td>
</tr>
</tbody>
</table>

Source: Bird 2006, 192.

*An assessment of the importance of the revenue source relative to the expenditures of a local government.

**A measure of how well revenues keep up with general economic growth and inflation.

***An indication of whether the tax increases with the wealth or income of the individual taxpayer, such that it is not more of a proportional burden for poor taxpayers than for rich ones.
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).  

The sections below describe in more detail some of the most relevant options for subnational governments in developing and transition countries, including property taxes (in general), business taxes (including differential property taxes on businesses), and business license fees that function primarily as taxes. For more detailed discussion about “user fees” (for example, for water and sewerage services, which benefit households as well as businesses), see Bird (2001) or Coolidge et al. (1993). For more detailed discussion about improving developing countries’ tax administration at the local level (for example, identifying missing taxpayers, improving valuation, developing better collection techniques, and so on), see Blore et al. (2004, chapter 4) and Mikesell (2007).

### 3.2. PROPERTY AND LAND TAXES

The property tax is one of those good ideas that has not yet caught on. It has great revenue potential, its burden rests with middle- and upper-income families, and it distorts business and consumer economic decisions less than do other taxes. It is a mainstay of the local government finance system in many countries — central governments usually do not want to bother with it — and it could be an important part of a national fiscal decentralization strategy. Yet, the property tax has failed to become a significant revenue producer, raising only an amount equivalent to about 0.6 percent of gross domestic product (GDP), on average, in developing and transition countries.

This section draws from experience in designing and implementing property tax reforms around the world. The goal is to draw lessons and provide guidance that will help developing and transition countries overcome obstacles to successful property tax reform, and introduce a viable, modern property tax that delivers on all its promise.

### Box 3.1. Property Tax Reform – Recent USAID Experience

- Bosnia and Herzegovina: 2005–ongoing
- Jordan: 2009–ongoing
- Kosovo: 2001–ongoing
- Vietnam: 2009–ongoing

### 3.2.1. Why Property Tax Has Not Lived Up to Its Hype

The property tax has not been more revenue productive in low-income and transition countries for a number of reasons. Typically, the tax base is significantly eroded by a combination of legal exemptions, undervaluation,

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39 Ebel and Taliercio 2009, 22.
40 The text in this section was prepared by Roy Bahl for the USAID publication, *Best Practices in Fiscal Reform and Economic Governance: Implementing Property Tax Reform* (December 2009).

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and a failure to include all properties in the tax base. In many countries, less than one-half of property value is taxed. This is compounded by low collection rates. Voters, local governments, and the central government all contribute to this weak performance. Voters resist increases in the tax, often strongly, even though effective tax rates are already quite low. Perhaps to avoid such resistance, local governments are often unwilling to implement the necessary policy and administrative changes that would remove preferential treatments and broaden the tax base. Moreover, in many cases the central government provides enough revenue in intergovernmental transfers that elected local officials are spared the political pain of increasing local taxes.

Transition economies have faced additional obstacles to effective property tax development. Under the socialist system, all policy decisions concerning property and other taxes were centralized and the local authorities were considered merely as implementing agents. To complicate matters, property markets were undeveloped, limiting options for establishing a viable tax base. However, in recent years, decentralization of government and democratization have led to adoption of strategies to increase the dependence of local authorities on own source financing and heighten the accountability of local officials to voters. Hence the growing importance of property tax reform, particularly in these countries.

### 3.2.2. Some Pointers in Guiding Property Tax Reform

Property-tax proponents have long advocated to redefine the property tax so that it might come closer to realizing its potential. Many have identified specific best practices, including administrative and policy reforms that have been broadly successful. But the setting, the culture, and the politics are different from one country to the next, and so what “works” in Argentina may not work at all in Pakistan. Though specific practices may not be easily transferable, some generic rules for good property tax practice can serve as a road map for property tax reform.

<table>
<thead>
<tr>
<th>Box 3.2. A Primer on the Property Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>The property tax is an annual tax on real estate, that is, land and permanent structures and improvements on the land. For present purposes, property taxes are distinct from one-off taxes on property transfers or on capital gains from such transfers, and from other levies with related bases, such as annual wealth taxes. The tax is usually, but not always, a local tax, and it is most commonly an ad valorem tax, founded on the concept of market value, although area-based property taxes are still seen in some transition countries of Central and Eastern Europe and Vietnam. The tax base may be the land only, land and buildings, or various permutations of these factors. If designed and applied correctly, the property tax can be a transparent, equitable, and stable source of revenues for local government. Voters are aware of the amount they pay each year, and can equate this with the benefits they receive from local services that they know to be financed by the property tax. Tax assessments are in the public domain and, therefore, the public can observe how the tax is applied to all properties and their owners. There is also generally a good correlation between assessed values and the ability of property owners to pay. Moreover, revenue from a market value property tax is generally predictable and buoyant, rising steadily with growth in the economy.</td>
</tr>
</tbody>
</table>

Those who might be in a position to design a reform package based on the international experience might consider the following:

- **Understand the existing conditions.** Do a thorough diagnostic, specifically addressing what is working and what is not. This is a good way for government to get focused on what it most wants to accomplish with the property tax, whether it is revenue mobilization, fiscal decentralization, land use control, or something else. Several useful models for such a diagnostic are available, including models for countries as disparate as Pakistan, Montenegro, the Philippines, and Jamaica.

- **Adopt a “policy first” stance.** Unless the tax structure is simple enough to be efficiently administered, and fair enough to gain the confidence of the population, administrative reform by itself will not succeed. Administrative reform comes second, but of course is essential to the success of any reform.
Determine which tax base is best. These include several ad valorem, or value-based, approaches, including rental value, capital value of land and improvements, and land value, as well as the physical area approach (see Table 3.1). Though the international trend seems to be toward capital value of land and improvements, the fact is that any of the four can work effectively. The right choice needs to be determined by the specifics of the country. For instance, area-based systems are popular and relevant in countries where there is no formal land market, and little comparative sales data on which to base value estimates (such as in some of the transition countries of Eastern and Southeastern Europe). By contrast, the capital value approach is favored in countries where there is a longer tradition of land markets (such as in Latin America). Still a different approach might be taken where most property is held in leasehold (favoring rental value), or where the country has some large cities but is still heavily agrarian (favoring an ad valorem system for urban zones, and an area-based system for rural areas).

Restrict exemptions to those properties that meet certain criteria. These might include properties that are protected from domestic taxation by international treaty, properties used for “merit” purposes (for example, schools and churches), and perhaps properties of low value. Other exemptions tend to be politically driven, erode the tax base substantially, and introduce unfairness to the system. Arguably the most problematic of the preferential treatments is that given to owner-occupiers, and to government properties. These issues are too sensitive to warrant a blanket recommendation to discontinue them, but best practice might dictate the following actions:

- Place a “sunset clause” on all exemptions. Make renewal dependent upon a successful evaluation. At a minimum, institute a periodic review of property tax exemption policy with the goal of determining whether exemptions continue to serve their intended purpose.
- Adopt the practice of valuing all property, whether taxable or exempt, and publish an annual tax expenditure note for the property tax quantifying the revenues foregone from exemptions and other reliefs.
- Charge a “payment in lieu” for government properties and for relevant nonprofit uses of property. Payments can be set to approximate the costs of delivering local services to these properties and thereby compensate the government, at least in part, for providing such services. Many countries, including India, Kenya, and Canada, apply some form of payment in lieu.
- Decide on treatment of poor households. There is some rough justice and probably little revenue loss in exempting low-valued properties. On the other hand, the case for providing preferential treatment for pensioners or for larger family sizes would seem less easily justified.

Build the requisite property tax administration capacity. Best practice shows that all four steps in property tax administration (identification of properties, valuation, recordkeeping, and collections) must be part of any administrative reform program. To leave out even one of the basic pillars of administration may jeopardize the success of a property tax reform, whether in terms of revenue mobilization or any other objectives the reform was designed to achieve.

### Table 3.2. Choosing the Right Base

<table>
<thead>
<tr>
<th>APPROACH</th>
<th>TAX BASE</th>
<th>CONSIDERATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Value of Land and Improvements</td>
<td>Market value of the property, that is, the amount that the land and improvements would sell for in an open market</td>
<td>Works best when there is some objective evidence of sales values, though notional assessment is feasible</td>
</tr>
<tr>
<td>Rental Value</td>
<td>Annual value of the rent that can be reasonably expected in a fair market transaction</td>
<td>Best when rental is the main form of housing tenure, and when there are no rent controls</td>
</tr>
<tr>
<td>Land Value</td>
<td>Market value of land, inclusive of improvements made to the land, such as clearing, grading, and installation of utilities</td>
<td>Works best when there is ample vacant land on which to base value estimates; can be used to encourage more intensive development of land, and avoids the need to value improvements</td>
</tr>
<tr>
<td>Physical Area</td>
<td>Each parcel taxed at a specific rate, per area unit of land and structures, irrespective of value</td>
<td>Best when there is no formal land market and little comparative sales data on which to base value estimates; has the advantage of simplicity, and is a good first step toward a transition to a value-based system</td>
</tr>
</tbody>
</table>

Source: Author.
Bring all properties on to the tax roll. A comprehensive land register, or cadastre, records details including the location, dimensions, tenure, ownership, and value of each individual parcel of land. (The cadastre is often maintained in conjunction with other records, such as a register of titles or deeds.) Yet partial coverage of properties is a major problem in many developing and transition countries. There are two ways to move toward the goal of full coverage: (i) institute a geographical information system and tax mapping system for identifying properties; and (ii) adopt a unique parcel ID numbering system in order to link the various land, building, and property tax records.

Concentrate administrative resources on improving the ratio of assessed to market value of property. In some cases, this will require strengthening a weak staff and revamping antiquated procedures. In other cases, it will require overcoming the lack of political will in government—for example, when the government resists or delays efforts to revalue properties as required by law. Reformers should proceed slowly until the local government shows its resolve to remove such constraints.

Eliminate or reduce the incentive to underdeclare the value of property transactions. This type of fraud typically results from the imposition of a property transfer tax, where such a tax exists. One way to minimize the risk of underdeclaration is to reduce the transfer tax rate to a low level and put in place a workable system to challenge and overturn underdeclarations of sales values. Another is to abolish the transfer tax in favor of a capital gains tax on land transfers.

Adopt aggressive measures to raise the collection rate. This is especially important in low income and transition countries where collection rates tend to be miserably low. A more horizontally equitable tax structure can contribute to this by removing preferential treatments. This will give taxpayers a sense that the property tax is fair, and might even increase property owners’ willingness to pay. Furthermore, reducing compliance costs—for instance, by establishing collection points at banks or neighborhood offices—can also go a long way to increasing compliance and, ultimately, collection rates. But still, the major route to increasing the collection rate is for the local government to enforce the tax according to the provisions given in the law. Again, it is a question of the will of the government to establish a strong, sustainable property tax.

Establish monitoring systems and capacity. The local (or central) government should establish a monitoring activity that will help with tracking the success of a reformed property tax. The following are some of the important components of such diagnostics:

• Carry out an annual sales ratio study of properties in order to track the disparity between the sales value of property and the actual market value.
• Do an annual analysis of the collection rate.
• Prepare an annual tax expenditure note for the property tax in order to track the cost of exemptions.
• Track the activities of the property transfer tax office in terms of declared vs. actual values of property, and the per-cent of unchallenged declarations.
• Do an annual breakdown of revenue collections by subcategories, for example, by zone, use (residential, commercial, rental), and so on.
• Prepare an annual delinquent list, classified by status (collectible or bad debt).  
  
• *Phase property tax reform.* With the above guidance in mind, analysts should recognize that developing and transition countries cannot move immediately to the level of practice in industrialized countries. A better route would be to define a long-term plan for improved property taxation, and to implement the reform program over a period of years. A planned transition, one that both allows the administration to catch up and allows taxpayers to get used to the new system, is the best route to success.

---

**Box 3.4. Five Steps to Preparing a Property Tax Reform**

**Step 1:** Do a diagnostic of the present system and prepare a policy paper that outlines the structural and administrative reform program.

**Step 2:** Reform the tax structure. Concentrate on the choice of a tax base, on rate structure, and on exemption policy.

**Step 3:** Administrative reforms
  a) Increase coverage (geographical information system, mapping)
  b) Upgrade valuation (training, procedures)
  c) Unified record keeping (interagency cooperation and unique numbering system)
  d) Improve collection rate (reduce preferences, reduce compliance cost, toughen enforcement)

**Step 4:** Reform the property transfer tax to remove the incentive to under-declare the value of property sales.

**Step 5:** Establish a monitoring activity with quantitative indicators of success with property tax reform.

---

### 3.2.3. Some Final Thoughts

Experience has shown that the property tax works best as a local government tax, as evidenced by its important role in financing local government expenditures in industrialized countries around the world. Yet fiscal decentralization, and particularly the notion of empowered, self-reliant local governments, has not yet been as warmly embraced in developing and transition countries as it has in richer ones. An interesting implication here for fiscal planners, and for those who would provide assistance to them, is that the demand for property tax financing is likely to grow in the future as local governments play a larger role in service delivery. This could become an important consideration as donors, analysts, and policy makers map out country strategies for property tax development.

### 3.3. LOCAL BUSINESS TAXES

Theory, empirical evidence, and common sense all suggest that it is economically beneficial in most circumstances to keep local and regional taxes on business, especially those impinging on capital investment, as low as possible. Those taxes (apart from user-fees such as for water and sewage) depress investment and distort economic decisions. They reduce economic output and the potential standard of living. Moreover, by breaking the connection between those who pay taxes and those who benefit from the expenditures financed (often the case with larger businesses, less frequently with smaller ones, which are usually local), business taxes may reduce local accountability and weaken the critical “hard budget constraint” needed to ensure that decentralized public sector decisions are efficient (Bird 2001).
In both developed and developing countries, however, some form of business taxation is in practice generally the most elastic (and locally controllable) source of revenue at the subnational level. Moreover, as many have argued (for example, under the name of “market-facilitating federalism”), when local governments gain directly by encouraging economic growth, as they do when their tax revenues expand more or less automatically with increased economic activity, they are more likely to follow “market-facilitating” policies. Finally, when decentralization results from (or is accompanied by) increased responsiveness to local citizens, local governments are inevitably tempted to impose taxes on “business”—that is, on “someone else”—when they can, rather than directly confronting their citizen-voters. (This may not be “good” policy, but it is usually good politics.) Budgetary needs, growth objectives, and political realities thus all often point in the direction of taxes on business. It makes a big difference just how this is done, however.

Many forms of local and regional business taxation exist around the world. Among the most common are corporate or enterprise income taxes, taxes on internal trade (such as the octroi in India), gross receipts taxes, fixed or proportional taxes varying by type of business and location (such as patente), local sales taxes (often falling to a considerable extent on intermediate business activities rather than on final consumers), and nonresidential real property taxes (relatively common in developing countries, the political issues can be quite different from those described in section 3.2). A variety of licenses and fees unrelated to any services provided by the public sector also may be imposed.

As the policy matrix set out in Table 3.3 shows, the various distinct forms of business taxation can be compared (Bird 2005). All of these approaches may “work” to varying degrees, in the sense of producing some revenues for local governments, and some of them may even be buoyant enough to keep up with expenditure needs. However, most do so at the expense of introducing new (and unneeded) distortions into production and allocation decisions and are hence not desirable ways to foster economic activity and growth. A business income tax may need to distinguish between “firms” and “establishments,” as a corporate income tax levied only on a firm’s headquarters may disproportionately benefit some jurisdictions, while others, perhaps burdened by the infrastructure and service needs of, say, a manufacturing subsidiary, lose out. Some taxes, such as octroi (domestic trade taxes) and gross receipts taxes, are particularly unpalatable to economists due to their distorting effects. Others, such as business (corporate) income taxes, are difficult to impose locally and discourage rather than encourage the growth of the formal economy (both because of their compliance costs and because they penalize success rather than stimulate it).

While the matrix of local business taxes shown in Table 3.3 is, of course, as inherently subjective and open to controversy as the broader matrix of Table 3.1, on the whole it appears to suggest that local governments in developing countries wishing to tax business activities have, in principle, the choice of a (relatively good) “modern” business tax or a (generally not very good) set of presumptive levies. More sophisticated, larger urban areas may be able to use the former, while less sophisticated and smaller jurisdictions may have to rely on the latter.

The business property tax (that is, higher rates applied to commercial or industrial property than to residential property), relatively popular in many developing countries, presents even more problems than most other taxes on businesses. Placing a higher tax rate on business property than on residential property deters investment and, as it usually results from efforts to avoid taxing citizens and voters, it erodes accountability. Lower tax rates on business property also distort investment decisions and are generally seen as unfair by citizens. In addition, a pernicious temptation arises to set rates higher for some types of businesses (or business owners) than for others. Property transfer taxes may also hit businesses more heavily than they do the average local citizen, again with the potential result of deterring investment. Where property values are reasonably accurate and up to date, however, this problem may be mitigated.

41 Also referred to as “market-preserving federalism,” especially in the context of developed countries when the trend is moving in the direction of increased intervention in the market by the public sector.

42 Personal income tax surcharges at the regional level are workable, however, provided a good national tax serves as a base; unfortunately, this is seldom true in developing countries (Bird and Zolt 2005). Regional sales taxes may in some instances also be viable and, if carefully designed and implemented (by no means easy), may not prove too distorting; however, this path can and should be pursued only by a relatively few of the more advanced developing countries (see Bird 2010).
Table 3.3. Business Taxes Found at Local Level

<table>
<thead>
<tr>
<th>CRITERION</th>
<th>PROPERTY TAX (HIGHER THAN ON RESIDENTIAL)</th>
<th>BUSINESS INCOME TAX</th>
<th>GROSS SALES TAX</th>
<th>VAT</th>
<th>TAXES ON TRADE</th>
<th>PATENTE/LICENSES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue adequacy*</td>
<td>Potentially yes</td>
<td>Unlikely</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, at regional level</td>
<td>Yes</td>
</tr>
<tr>
<td>Revenue buoyancy**</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Perhaps, if indexed</td>
</tr>
<tr>
<td>Correspondence of payers and beneficiaries</td>
<td>Not high</td>
<td>Not high</td>
<td>Not high</td>
<td>Potentially satisfactory</td>
<td>Not high</td>
<td>Potentially satisfactory</td>
</tr>
<tr>
<td>Progressivity***</td>
<td>Not likely to be high</td>
<td>Largely unknown</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Administrative cost</td>
<td>Relatively high (if done well)</td>
<td>Not usually feasible locally (but regional surcharge possible)</td>
<td>Not high</td>
<td>Perhaps reasonable regionally</td>
<td>Feasible, but high cost</td>
<td>Feasible but not cheap to set up properly</td>
</tr>
<tr>
<td>Compliance costs</td>
<td>Not high</td>
<td>Medium</td>
<td>Low</td>
<td>Higher than sales tax</td>
<td>Very high</td>
<td>Probably moderate if well designed</td>
</tr>
<tr>
<td>Latitude for corruption</td>
<td>Moderate</td>
<td>Probably high in most countries</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Very high</td>
<td>High</td>
</tr>
<tr>
<td>Political acceptability</td>
<td>Moderate</td>
<td>Low</td>
<td>Fairly high</td>
<td>Unknown</td>
<td>Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Local accountability</td>
<td>Low</td>
<td>Low (depends on rate discretion)</td>
<td>Low</td>
<td>Moderate</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Effect on regional disparities</td>
<td>No change</td>
<td>No change</td>
<td>No change</td>
<td>No change</td>
<td>No change</td>
<td>No change</td>
</tr>
<tr>
<td>Distortionary impact</td>
<td>Moderate</td>
<td>Moderate</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
</tbody>
</table>

Source: Bird 2006, 238.

*An assessment of the importance of the revenue source relative to the expenditures of a local government.

**A measure of how well revenues keep up with general economic growth and inflation.

***An indication of whether the tax increases with the wealth or income of the individual taxpayer, such that it is not more of a proportional burden for poor taxpayers than for rich ones.
In practice, most developing countries today have understandably followed the more familiar presumptive path, with such variously named levies as the “patente,” the “professional tax,” the “industria y comercio,” the “single business fee,” the “simplified tax,” and so on. (For additional examples, see Appendix 4 and Appendix 8 for case studies on Kenya and Tajikistan, respectively.) The greater elasticity and reduced distortion of a “modern” approach to taxing local business, however, suggests that this as yet unexplored alternative may be worth more detailed examination, perhaps particularly with respect to the large and rapidly growing metropolitan areas found in many emerging markets. Such areas should and could do much more to finance their own growth in ways that would make them more politically responsible to those whom they govern a simple flat-rate business tax imposed on an accounts basis on (essentially) the costs of the business’s factors of production (Bird and Slack 2007).43

3.3.1. A “Modern” Local Business Tax44

The problem is how to realize the potential virtues of local business taxation – essentially an elastic revenue source and increased autonomy – while minimizing such vices as economic distortions, high administrative costs, and breaking the “correspondence principle” by permitting local governments to “export” (non-benefit) taxes to nonresidents.

One way to achieve this is to impose what has been called a business value tax.45 Businesses add value by combining labor and capital with other purchased inputs. The value added by labor is the cost of labor (wages and salaries) while the value added by capital is the cost of capital (both debt and equity). The base of such a local business tax would thus consist of revenues less purchases of inputs (except labor). From an administrative perspective, such a tax base could be calculated in three broad ways. The first is simply to add back appropriate amounts of interest and wages to the base of a business income tax as usually calculated. A second approach might be to impose, in effect, a payroll tax and an appropriate tax on capital. The third and probably easiest approach in most countries might be to tax essentially the same base as a VAT.

Compared to a conventional VAT, a business value tax has three important distinguishing features. First, it is a tax on income, not consumption: that is, it is imposed on profits as well as wages or, to put it another way, on investment as well as consumption. Second, as a tax on production, rather than consumption, it is imposed on an origin rather than a destination basis; and thus in effect taxes exports but not imports. A third distinction is administrative: the tax would be assessed on the basis of accounting records (or equivalent estimates) rather than on a transaction basis and collected annually (or by periodic payments based on an annual assessment).

Such a tax has several advantages: it discriminates less against investment than do income or property taxes; it is also likely to be less susceptible to base erosion; because it has a larger base, lower rates are possible, so that economic distortion costs are lower; and revenues are more stable than income taxes but more responsive to changed economic conditions than property taxes. Moreover, to the extent the rationale for taxing business at the local level rests on benefit or entitlement grounds, a business value tax can be argued to be more equitable than an income tax in any case.46

Although this is not the place to do so, obviously much more would need to be worked out about many details before introducing such a tax in any country. As yet, however, the very unfamiliarity of this idea appears to have discouraged its use: no one, it seems, wants to be a fiscal pioneer.47 Most countries are hence stuck with

43 As Bird and Slack (2008) note, the problems in small rural areas are quite different in urban areas; as a rule, the only fiscal basis acceptable to local governments in such cases is some form of tax based on property.

44 This section was prepared by Richard Bird for IFC Conference on Local Taxes and Regulations in 2009.

45 This concept was introduced in Bird and Mintz 2000 and spelled out (for Canada) in Bird and McKenzie 2001; see also Bird 2005. Similar taxes have been used in France and Japan.

46 To reduce potential for corruption and evasion and to prevent abuse by “overtaxing” exporting firms, a single rate tax should be imposed on all business.

47 South Africa recently considered such a tax. In the end, it decided not to adopt it, although a number of metropolitan areas are continuing to explore the possibility. Italy and more recently Japan and France do, however, have such taxes. More limited forms of taxes along these lines may also be found in Hungary and in a few U.S. states.
essentially “presumptive” forms of business levy; nonetheless, even such levies can and should be designed and implemented with much more care than is generally evident in practice in order to improve their elasticity and to reduce both their distorting effects and their vulnerability to abuse.48

3.4. SIMPLIFIED (PRESUMPTIVE) TAXATION AT THE LOCAL LEVEL49

Compliance with standard taxation regimes on business profits or income generally requires businesses to keep appropriate books and records. For micro and small enterprises (MSEs), standard recordkeeping requirements are not only costly; they often exceed the capacity and skills of the small business operator. At the same time, many local revenue authorities in developing countries lack capacity for tax administration. For these reasons, simplified accounting (even for any relatively large businesses in their jurisdictions) may be more appropriate than alternative, more complex business taxes.

Methods must therefore be identified to adjust the tax system applicable to MSEs to their relatively low levels of recordkeeping and accounting capabilities. Institution of a simplified presumptive tax system (that is, one used in place of a business profit tax, as described below) is the most frequent and popular approach in this respect.

A large number of developed and developing countries worldwide use some form of a presumptive tax system for MSEs, especially at the local level. These systems vary considerably in scope of application, criteria used to determine the tax liability of the MSE, and performance. No standard principles or uniform experience is available to guide the design and application of presumptive systems. This section will focus on fees functioning primarily as business taxes; chapter 4 will consider license fees primarily intended to cover the cost of enforcing business regulations imposed for reasons other than raising revenue. In practice, the line between the two can be blurry.

The MSE community generally welcomes introduction of a presumptive taxation system: at the national level, because it often results in a lower overall burden than that imposed by regular business tax regimes; and at the local level, since it often replaces a plethora of “nuisance license fees.” MSEs may encounter some downsides to this system as well, however (see Box 3.5).

Key Points

- Presumptive taxation is becoming an increasingly popular instrument for reducing the MSE compliance burden and (it is hoped) bringing informal MSEs into the tax net.
- The application of presumptive systems should be limited to small businesses experiencing difficulty keeping proper books and records. Abuse of the system by larger enterprises must be avoided.
- A good presumptive system requires extensive data analysis to properly estimate MSE profit potential, which has rarely been attempted in practice in developing countries.
- A large number of different approaches can be taken to tax MSEs on a presumptive basis. The most common systems are a simple turnover tax and a tax based on business indicators; asset-based taxes are also used.
- Different approaches could be used for different segments of the MSE population.
- Presumptive systems should not act as a disincentive for business growth. Therefore, they must be well coordinated with the standard tax regime.
- A presumptive tax system represents a tradeoff between simplicity and fairness.

Key Actions

- For MSEs able to keep at least basic records, a turnover-based system is the appropriate approach, as it facilitates migration into the standard tax system.
- Turnover-based systems imply a risk of tax evasion due to underdeclaration of business turnover. For countries that cannot sufficiently control this risk, an indicator-based system could be a better system option.

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48 See Bird and Wallace 2004 for a general discussion of presumptive taxation.

49 This section is largely taken from IFC 2007, section 2.5, “Simplified (Presumptive) Taxation.”
Micro-enterprises should be subject to very simple regimes. A general patent is a good option for this MSE segment.

Incentives should be provided for MSEs keeping books and records, for example, in the form of a reduced tax rate to compensate for higher compliance costs.

Contrary to the view expressed sometimes by tax policy makers in developing countries, presumptive tax systems are not easy to design and require substantial preparatory work. In particular, the risks are high of arbitrary features in presumptive taxation. These can include an excessive tax burden falling on some groups of small taxpayers while others are undertaxed and an excessive gap between the standard and the presumptive tax regimes that can impede migration into the standard regime for successfully operating and expanding MSEs. Even where a presumptive tax system is in place, options to reduce compliance costs by facilitating compliance of small businesses with standard taxation rules should not be neglected. In particular, businesses able to comply with simplified bookkeeping and accounting standards should be required to do so. Depending on the level of literacy and education, this could limit the application of proper presumptive systems to the taxation of micro-businesses, which are large in number but usually small in size and profitability.

### Box 3.5. Possible Advantages and Disadvantages of Presumptive Tax Systems

**Advantages**

- Lower compliance costs
- Tax liability more predictable
- Less interaction with tax administration, which in turn may lower opportunities for corruption
- Generally lower tax burden

**Disadvantages**

- No incentive to improve bookkeeping
- No relief in case of losses
- Potential disincentive to grow or use most efficient mix of inputs
- Risk of abuse
- Fairness concerns

### 3.4.1. Main Categories of Presumptive Taxes

Presumptive tax systems can be grouped into five basic categories:

(i) Systems based on turnover or gross income
(ii) Systems based on indicators
(iii) Simple lump-sum patents
(iv) Systems based on agreement between taxpayer and tax administration
(v) Asset-based systems

Each of these categories generally offer a number of alternatives, and categories as well as subcategories differ substantially in the resources required, from both the taxpayer and the tax administrator, to operate the system. All presumptive taxes currently in operation, however, could benefit from more analysis than they have received to date to further understanding of their impact both on business decision making and on revenue performance. The taxonomy of presumptive systems is presented in the following table.
<table>
<thead>
<tr>
<th>TYPE OF SYSTEM</th>
<th>TAX BASE / INDICATOR</th>
<th>SELECTED COUNTRIES WHERE USED</th>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
</tr>
</thead>
</table>
| Patent         | Type of activity        | Bulgaria, Kosovo, Egypt; a number of African countries, Central Asia | a) Easy to administer  
b) Positive incentive effects, as additional earnings above average (presumed) income taxed at a zero rate  
c) Minimize tax administration discretion, therefore reducing risk of corruption | a) Poor revenue performance  
b) Does not take into account taxpayer specifics  
c) Violates vertical equity  
d) Regressive |
| Indicator-based system | Group of indicators as proxy for business income | Spain, Italy, Argentina | a) Positive incentive effects, as additional earnings above presumed income taxed at a zero rate  
b) Tax burden differentiated according to size of business operation | a) Distorts investment decisions (in particular may create disincentives for hiring labor and expanding business assets)  
b) Selection of appropriate indicators, studying sectoral profitability, and establishing specific correlations between indicators and presumed income is difficult and requires substantial resources  
c) No tax reduction for loss-making MSEs  
d) System design requires substantial amount of external data, which may not be available |
| Turnover based system | Business turnover | Russia, Kazakhstan, Tanzania | a) Guarantees minimum level of vertical and horizontal equity  
b) Easier transition from presumptive to standard regime, as turnover is also decisive element of tax calculation in standard systems  
c) High revenue potential compared to other presumptive systems | a) High risk of turnover under-declaration  
b) High risk of corruption  
c) System generally favors businesses with high profit margins |
| Agreed systems | Indicators plus agreement between taxpayers and tax administration | Syria, Yemen; previously France, Israel | a) System can reflect taxpayer specifics | a) Extremely high corruption and collusion risk (including loss of official revenue and unlevel playing field)  
b) System requires extensive data collection and analysis and is costly and time consuming |
| Assets         | Usually fixed assets, sometimes just real estate | Various | Relatively immobile | Deters investment |

In practical terms, Kelly and Devas (1999) stress that certain administrative actions will be required in order to improve the effectiveness and efficiency of the license fee system:

- Compiling an accurate register of businesses, with the information required to properly assess the fee liability; these registers need to be constantly updated.
- Cross-linking this business register information with other relevant third-party business data (for example, telephone, electricity, water, tax departments, business association directories, trade organizations and chamber of commerce) to ensure full coverage of the revenue base.
- Establishing an effective system for classifying and measuring businesses in order to assess liability; this needs to minimize the scope for under-declaration or collusion; having assessment registers available to the public can help in this.
- Establishing an effective system for billing and bill delivery.
- Developing accountable payment collection systems, using banks and convenient payment points.
- Providing sufficient powers to enforce payment (for example, through fines, penalties, cancellation of business privilege, and ultimately through closure of premises); …
- Computerization offers enormous opportunities not only for cost saving but also for accurate record keeping, billing, accounting, crosschecking and reporting. The use of a system of taxpayer identification numbers, ideally coordinated with the national tax system, offers considerable potential for crosschecking liabilities.\textsuperscript{50}

\textsuperscript{50} Kelly and Devas 1999, 17–18.
4. Regulatory Reform at the Subnational Level

Where a reasonably sound fiscal system is in place, standard regulatory reform stands a good chance of proving sustainable and delivering substantial positive impacts. This chapter looks at reform options for subnational jurisdictions with budgets not significantly dependent on revenues from licenses, permits, and fines in excess of the costs needed to implement the relevant regulations. Other cases will normally need to address the reforms described in the previous chapters before expecting strong results from the reforms described in this section.

More detail regarding licensing reform is available in IFC “How to Reform Business Licenses” (World Bank Group Investment Climate Advisory Services 2010), and more detail about how to implement a subnational regulatory reform project is available in the toolkit for “Simplification of Business Regulations at the Subnational Level” (World Bank Group SME Department 2006). The following is a summary of the key points of regulatory reform.

4.1. RATIONALE FOR GOVERNMENT REGULATION

The rationale for government regulation includes addressing identified market failures or achieving other broad public interest objectives. Criteria commonly used to justify and explain the rationale for government regulation, all of which are relevant at the subnational level, include the following:

- **Externalities**: Unregulated or poorly regulated markets generate uncompensated benefits (public safety) or costs (such as pollution) to others.
- **Public goods**: Individuals who have not contributed to production cannot be prevented from consuming that good, or consumption does not reduce ability of others to consume (for example, general police protection and street lighting).
- **Information failures**: Parties to a transaction have incomplete or flawed information about costs, benefits, and risks, including asymmetric information which gives the party with more information an advantage over the other party (for example, insurance products, large-scale construction services, and second-hand cars).
- **Natural monopoly**: The nature of a product can result in one producer (or a small number of producers) exercising nontransitory market power to the detriment of consumers.
- **Public interest objectives**: These include a wide range of specified equity or other broader community preferences, such as discouragement of gambling or protection of cultural resources.

The presence of market failure or public interest objectives only justifies government regulation where the benefits of regulation exceed the costs of the market failure and where regulation is the best (that is, most efficient) means of achieving policy objectives.

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51 This chapter is largely taken from World Bank Group Investment Climate Advisory Services 2010, “How to Reform Business Licenses.”
Sound regulation requires not only efficiency, but transparency and proper incentive structures as well. Box 4.1 provides a checklist, based partly on work undertaken by OECD, which identifies the several key features of good regulation. High priority features for developing countries are highlighted in bold.

<table>
<thead>
<tr>
<th>Box 4.1. Features of Good Regulatory Administration and Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governance of the regulator</strong></td>
</tr>
<tr>
<td>• Managing risks, including identifying, prioritizing and mitigating risks affecting both the effectiveness of the regulator and the compliance of business with regulations</td>
</tr>
<tr>
<td>• Accountable decision making, persons delegated regulatory powers have a clearly defined role, are accountable, and are guided by clear policies and procedures</td>
</tr>
<tr>
<td>• Managing performance, including effective management and communication</td>
</tr>
<tr>
<td>• Managing probity, effective mechanisms to minimize corruption or misconduct</td>
</tr>
<tr>
<td><strong>Information management</strong></td>
</tr>
<tr>
<td>• Clear guidance on what data should be stored and how it should be stored</td>
</tr>
<tr>
<td>• Systems ensure appropriate data captured, stored, used properly, and protected</td>
</tr>
<tr>
<td><strong>Relationship management</strong></td>
</tr>
<tr>
<td>• Communication with stakeholders is open, transparent, responsive, and cost effective</td>
</tr>
<tr>
<td>• Complaints and appeals are managed quickly, effectively, and transparently</td>
</tr>
<tr>
<td>• Relationship outcomes (often defined in service charts and codes of conduct) are measured and reported on in a transparent manner</td>
</tr>
<tr>
<td><strong>Resourcing issues</strong></td>
</tr>
<tr>
<td>• Regulators rarely have all the resources required to meet stakeholder expectations so resources should be allocated effectively and efficiently to high priority risks</td>
</tr>
<tr>
<td>• Cost recovery through fees and charges should only be applied where businesses benefit directly from regulations and should transparently recover only direct costs</td>
</tr>
<tr>
<td>• Fees and charges should be avoided where the regulations generate significant community benefits or generate other risks and costs (that is, cross-subsidization or corruption)</td>
</tr>
<tr>
<td><strong>Receiving applications and monitoring compliance</strong></td>
</tr>
<tr>
<td>• Regulators should have effective, efficient, and transparent processes for receiving applications from businesses, assessing compliance, and making decisions</td>
</tr>
<tr>
<td>• The compliance monitoring should include a clear, documented strategy, risk-based work program; and timely, evidence-based and objective compliance processes</td>
</tr>
<tr>
<td>• Requirements should be easily accessible and understood by businesses, and communicated in an effective and timely manner</td>
</tr>
<tr>
<td>• Monitoring and compliance strategies should minimize unnecessary burdens</td>
</tr>
<tr>
<td><strong>Addressing non-compliance</strong></td>
</tr>
<tr>
<td>• Response to noncompliance should be commensurate with the risks generated by noncompliance and the compliance history of the business</td>
</tr>
</tbody>
</table>

(continued next page)
Regulators’ response should be timely, proportionate, lawful, and properly documented

A clear plan is in place to manage and assist the return of the business to compliance

Responding to adverse events which may cause harm

Regulators should try to ensure that they are aware of adverse events when they occur, are ready to respond where appropriate, and have the ability to review processes to respond to any lessons learned


A large proportion of business regulation at the subnational level involves licenses, permits, and other authorizations. The term *licensing* is most often used to describe clearance for an individual or firm to carry out a certain type of activity on a regular basis, such as medicine, banking, or construction. The term *permit* is sometimes used to denote a particular clearance for a much more specific individual activity, such as a construction permit for a particular building or a permit to allow a particular event, such as a trade fair, on public property during a certain period of time.

In the rest of this chapter, *license* and *licensing* are used more broadly and cover the usual meaning permits, similar clearances and authorizations. Licensing is a commonly used form of regulation that affects specified businesses and occupations by regulating entry into markets and conduct within markets. Licenses typically impose on businesses a range of conditions, obligations, and rights. Breaches of licensing conditions usually result in imposition of sanctions—such as a fine or revocation of permission to perform an activity—by the relevant regulatory authority.

Examples of activities falling within this definition of licensing include the following:

- registering a business, including for tax purposes
- planning and building approval procedures
- obtaining permission to operate a business in a particular sector, such as tourism
- securing licenses to manufacturer, import, export, or sell particular types of goods and services
- registering a business or premises to allow use of particular equipment or to store particular materials
- acquiring permits needed to discharge gas, liquid, or solid waste

The process of administering a license typically involves one or more of the following four steps:

1. *Notification/Application*. The business provides specific information (often a range of documents) required by a regulator to apply for a license to conduct specified business activities in a specified sector.
2. *Prior approval to operate*. The regulator issues a license that provides the business with approval to operate in a specified sector.
3. *Conditions*. The business is expected to comply with the standards, conditions, and requirements specified in the license. Conditions can be applied prior to or after prior approval.
4. *Enforcement*. The regulator enforces the specified license conditions, standards, and requirements through a variety of measures, including screening processes prior to approval and verification processes after issuance of the license. Enforcement efforts can take the form of audits, inspections, and so on.
Debate is ongoing about what activities should or should not be subject to licensing. Box 4.2 lists the most common activities usually subject to licensing in almost all countries (and often administered at the subnational level). In many countries, especially those with a common law tradition, business activities not included on such a list, termed a “negative list,” do not require a license. For example, construction usually requires licensing, both because unsafe construction can be extremely dangerous (for example, in the event of an earthquake or severe flood) and because it is not easily monitored by a client (that is, most people who hire a building contractor do not know enough to monitor whether the contractor is cutting corners to save time or money).

By contrast, a number of countries have a history of requiring licenses for all commercial activity (that is, what is not explicitly allowed is prohibited). For example, countries regulating in this way may require computer consultants to get licenses, even though poor service does not usually result in physical danger for the client or the community and most clients successfully rely on a consultant’s reputation when deciding to hire one.

### 4.2. LICENSES APPROPRIATE FOR THE SUBNATIONAL LEVEL

Which licenses are most appropriate for the subnational level? While the principle of “subsidiarity” suggests that regulation should devolve to the most local level possible, questions always arise about the capacity of local administrators to enforce compliance with regulations effectively and efficiently.

Generally speaking, regulations affecting relatively broad-level environmental and public health issues should be handled at a high enough level to encompass all significant “spill over.” In such cases, national governments will usually set standards and at least supervise their implementation, even when regulation takes place under the auspices of lower levels of government, for example, regarding air and water pollution.

Kelly and Devas (1999) argued that local government regulatory licensing can be socially desirable under three conditions:

- There must be a significant market failure related to an activity which is essentially of a local nature
- The benefits from regulating the activity should outweigh the costs of regulation
- The regulatory licensing should be the most effective form of government intervention

The first condition stipulates that the local level should use regulatory licensing only if the market failure relates to an activity that is essentially of a local nature. To understand this condition, it is useful to look at the example of a driver’s license. . . . Driver licenses are issued by the national or state level government because the public good benefits “spill over” local government jurisdictions and because there are economies of scale in the design, issuance and monitoring of driver’s licenses. . . . A more local example would be the issuance of restaurant licenses that are justified for public safety. In this case, the regulatory benefits are almost exclusively captured within a local jurisdiction – thus, restaurant and bar licenses are normally granted by local governments.53

In the majority of developed countries, subnational governments are most likely to have control over primary and secondary education, real estate and construction, agriculture and fisheries, and basic health.

However, one of the major considerations in this decision is assessing competence and capacity. In developing countries, many municipal governments for large urban areas are quite sophisticated, while civil servants in smaller towns may lack the skills and experience to undertake useful regulation or inspection. In such cases, higher levels of government can more effectively provide the necessary expertise and thus should assume control of the relevant regulation. Intermunicipal service agreements also offer a solution to lack of local capacity. Over time, as experience and skill levels spread more widely, formerly restricted municipal governments can assume greater control over regulation, while central governments work to ensure uniform implementation.

52 See, for example, Moullier 2009.
53 Kelly and Devas 1999, 4–5.
Box 4.2. Typical Categories of Activities Subject to Licensing

1. **Environmental protection**: control pollution and environmental hazards

2. **Sensitive and hazardous substances**: control over movement of and activities with radioactive substances, dual-use goods, precursors, and other controlled substances

3. **Agriculture and fishery, food safety**: control of food supply chain, including sales of chemicals used in agriculture, farms, food processing establishments

4. **Medicine and pharmaceutical activity**: medical and veterinary establishments, manufacturing and trade in medicines and other controlled substances (the medical profession is controlled mostly in the form of regulation of professional activities of individuals and specialists by simply requiring graduation from a recognized educational establishment or by requiring their ongoing accreditation with professional bodies and receipt of certificates of competence from professional bodies)

5. **Security**: control over movement of and activities with arms, ammunition, explosives, and so on, including control over establishment of private armed units, that is, security services

6. **Banking and other financial market participants**: licensing of banks (and to a different degree financial intermediaries and related service providers in different jurisdictions); licensing is predominantly used to establish a system of regulation and control over deposit-taking institutions, “recognized banks,” and “licensed deposit takers” to protect depositing public

7. **Excise goods**: activities related to manufacturing and trade in excise goods (tobacco, liquor, petroleum, and precious metals and stones)

8. **Transport services**: commercial transport services by air, rail, and sea; commercial transport by road as well as some related services, such as freight forwarders and possibly motor vehicle dealers

9. **Construction**: activity of construction service providers (in reformed countries construction service providers are no longer licensed; regulation that exists is mostly in the form of regulation of professional activities of individuals and specialists by requiring their accreditation with professional bodies, receipt of certificates of competence from professional bodies, and so on)

10. **Education**: in some jurisdictions, establishment of educational institutions (mostly though, observance of specific requirements for the content of programs under accreditation schemes)

11. **Provision of liberalized utility services**: production, transmission, distribution, and supply of thermal energy and electricity

12. **Communication**: provision of telecommunication services, broadcasting, and postal services

13. **Real estate**: land surveyors and real estate valuators; sometimes also agents

14. **Customs**: activities of service providers (customs brokers), control over premises presenting fiscal risks (duty-free trade, storage of goods without customs clearance)

15. **Gambling and lotteries**: operation of gambling establishments and organization of lotteries

16. **Mining and resource extraction

17. **Other** (for example, provision of employment services, certifying the means of measurement, operation of crematoria, sale of fireworks, and so on)

Kelly and Devas (1999) note that local regulations may be used to protect local business interests from competition. This was a significant problem in Russia in the 1990s, and it was combated by the federal government both through legislation that removed licensing authority from subnational governments and by an explicit mandate for the Anti-Monopoly Commission to restrain regulatory barriers to trade between different subnational jurisdictions. However, it may have gone too far in denying subnational authorities the ability to set some regulations, such as building standards, according to local conditions.

4.3. GOOD PRACTICE LICENSING ADMINISTRATION

A number of important administrative and process issues affect the management by regulators of licensing regimes. These features of good practice licensing administration are described in Box 4.3.

In most cases, best-practice licensing administration requires regulators to display all of the features and attributes described below. Where a licensing regulator has weaknesses in one or more areas, administration is likely to be poor. Furthermore, where particular problems with licensing administration are evident (such as unnecessary costs imposed on business or enforcement activity generating high levels of corruption), the regulator may have weaknesses in the relevant key areas. This indicates systemic problems within the licensing regulation that will require several targeted and integrated solutions to resolve.

**Box 4.3. Features of Good Practices for Licensing Administration and Practice**

1. **Search and application**
   - Businesses should be able to obtain in an easy and timely manner clear and comprehensive guidance material and well-designed forms. They should be able to easily communicate with the regulator.
   - Businesses should be informed of the steps involved and the time likely to be taken by the regulator in assessing and responding to their applications for licenses.

2. **Approval**
   - Regulators should assess and respond to applications for licenses in a timely manner and follow relevant policies and guidelines.
   - Assessment should employ risk-based methodology.
   - Decisions should be fully documented and subject to a credible appeals process.
   - Internal processes should minimize scope for conflict of interest and corruption (such as review of decisions by peers or more senior staff).

3. **Conditions**
   - Business should have a clear understanding of applicable licensing conditions and obligations and of their rights.
   - License conditions and obligations should be the minimum necessary to ensure compliance.
   - Regulators should be mindful of compliance burdens on businesses and should have effective strategies to minimize compliance burdens.
   - Regulators should have internal systems and processes to monitor and report on compliance with licensing requirements.
   - Compliance monitoring should include a clear documented strategy, risk-based work program, and timely, evidence-based and objective compliance assessment processes.

(continued next page)
### Box 4.3. (continued)

**4. Enforcement**

- Enforcement should be commensurate with the risks generated by noncompliance and the compliance history of the business.
- Regulators’ responses should be timely, proportionate, lawful, and properly documented.
- Enforcement strategies should be effective in ensuring compliance but should not impose on business unnecessary obligations, costs, or risks.
- A clear plan should be established to manage and assist the return of the business to compliance.
- Strategies should be in place to minimize the risk of corruption, including clear and credible appeals processes (such as review by a higher authority and judicial review).

*Sources: OECD 1995; OECD 2002; Bureau of Industry Economics 1996a; Bureau of Industry Economics 1996b.*

### 4.4. LICENSING FEES AND CHARGES

License issuance, administration, or revalidation often involves the imposition of fees or other charges. For example, fees and charges may be payable for activities such as a license inspection or audit. In principle, the transparent imposition by the licensing regulator of any fees and charges due can be considered appropriate on a cost recovery basis if licenses generate direct benefits for the business receiving the license, as when they receive authorization to carry out a potentially dangerous but lucrative activity such as building construction. Furthermore, fees and charges may be appropriate where businesses generate negative effects on the broader community, such as pollution.

The right to impose fees can be misused, of course. Misuse most often takes one of three common forms. First, regulatory instruments (such as licenses, permits, and other forms of authorization) may be introduced without a justified regulatory rationale: they are simply imposed to increase revenue. Second, a larger fee may be collected than is necessary to cover the cost of administering the regulation (if, for example, it cannot be justified by the need to account for externalities). Finally, although licensing generates significant social gains to the community, excessive fees can act as a tax on these public benefits (see Box 4.4). As described by Blore et al. (2004), “fees [for permits and licenses] can be raised above the cost of the regulatory activity, turning them into a form of taxation (for example, using building permit fees as a form of development tax), but with the risk that high fee rates may encourage evasion, thereby undermining the very regulatory function that justifies the fees.”

In practice, these conditions are difficult to meet, especially where a functioning, broadly based taxation system is lacking. However, this is more often a problem at the subnational than at national level of government.

The imposition of licensing fees and charges also generates a range of significant costs and risks, including fees and charges in excess of the cost of providing direct regulatory services. License fees and charges often generate significant compliance costs on businesses (for example, as in Kenya before 2000). They can also distort regulatory decision making in the following ways:

- Regulatory decisions made based on revenue maximization objectives rather than the goal of protecting the public interest or addressing market failure
- Excessive and unnecessary regulation (such as multiple agencies issuing separate licenses to operate in each jurisdiction)

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54 This section derives in large part from an unpublished 2010 IFC report to the Government of Yemen by Marc Reichel, titled “Rationalizing Administrative Fees: An Approach to Reform Direct Regulatory Costs to Businesses.”

55 Blore et al. 2004, 71.
• Cross-subsidization within the regulatory agency
• Lack of transparency and accountability

When these conditions occur, licensing regulators will not deliver minimum-cost regulatory services to the community. Systems operating in this way may also encourage several types of corruption, such as use of license inspections to extort money from a business. These outcomes impose a wide range of very significant and identifiable systemic costs on the community.

**Box 4.4. Principles for Imposing Licensing Fees**

While this chapter emphasizes the costly consequences of misuse of regulatory fees, imposing such fees need not be negative. Government agencies can appropriately impose regulatory fees in a transparent manner under the following circumstances:

- on a cost recovery basis, when licensing generates direct benefits for the firm receiving the license
- when the business generates negative effects on the broader community, such as by polluting

However, when licenses generate broader benefits for the community (such as enhanced health, safety, or security outcomes) than for the business, imposing licensing fees may be inappropriate and may inflict undue costs on the community. In such cases, license fees essentially impose a “tax” on services provided by the business to the benefit of the broader community. In this situation, the taxation system should ideally be strengthened so that inefficient and costly fees can be reduced over time and eventually replaced by more efficient revenue mechanisms (including strengthened intergovernmental transfers or an appropriate local business tax).

Such revenue measures are sustainable only when a functioning, broadly based taxation system is in place. When this is not the case, establishing such a system should become a long-term objective. In the short run, however, when regulations protect broader policy objectives (such as health, safety, and the environment), license fees may be applied if two conditions are met:

- revenue collected provides tangible health, safety, or security benefits for the community that clearly exceed the direct and indirect costs on the business and the community of collecting license fees
- licensing revenues are collected more effectively and at lower cost than is the case for broader taxation measures

Thus, assuming superfluous administrative services and their fees have been eliminated, the fees for the remaining – justified – regulatory services usually still require rationalization. Basic “cost recovery” of administrative fees is the dominant principle in developed countries. Countries applying it include Australia, Canada, Denmark, the Netherlands, Germany, the United Kingdom, and the United States, to name just a few. The European Union as well made cost recovery its leading principle for setting administrative fees. Box 4.5 provides the legislative base for the principle in Europe.

At the same time, all countries applying the principle of cost recovery do allow for exemptions. Australia, for example, does not apply it under the following conditions:

- It is not cost effective; or
- It would be inconsistent with government policy objectives;\(^{56}\) or
- It would unduly stifle competition and industry innovation (for example, through “free rider” effects).

\(^{56}\) Such “policy objectives” are very specific, for example, those applying to casinos; they are narrowly defined and must be approved at the highest applicable government levels.
Cost recovery can be defined and approached in two different ways: fees are designed to cover total average costs (including all capital costs and overheads), or they are meant to cover the marginal cost of specific transactions. Both methods are explained in Box 4.6.

**Box 4.5. The Principle of Cost Recovery in the European Union**

Article 13 (2) of the European Union Directive 2006/123/EC on Services states that authorization procedures and formalities shall be easily accessible and any charges which the applicants may incur from their application shall be reasonable and proportionate to the cost of the authorization procedures in question and shall not exceed the cost of the procedures.

**Box 4.6. Methods to Calculate Cost Recovery through Administrative Fees**

**Average Total Cost:** The primary goal is that the total fee income matches the total administrative costs – including both fixed and variable costs. The instrument to achieve this goal is often referred to as the general cost calculation, in which the total annual costs (including all overhead, maintenance, depreciation, interest, and so on) are calculated for a defined administrative unit. These costs must then be met by the fees paid for an estimated number of annual applications. This may also include a mark-up percentage to cover the costs of anticipated future modernization and expansion of services, as is required in most cases in Singapore, for example.

**Marginal Cost:** This approach aims to set fees equal to the direct administrative costs (or variable costs) caused by the individual or class of application(s). The instrument to achieve this goal is often referred to as a single cost calculation, in which the average direct administrative cost caused by a specific application (mostly payroll, stationery, transport, and so on) is calculated and charged as a fee.

Though the principle is straightforward, calculating the cost of services can be complicated in practice, and each country applies its own cost calculations, including or excluding different cost items. Box 4.7 describes the costs included by administrators in Australia and in Germany when calculating the cost of specific services.

**Box 4.7. Examples of Calculating Cost Recovering through Administrative Fees**

**Germany (Hamburg)**

Every two years, each fee collecting authority must submit a cost calculation for the next calendar year. Before costs and income can be calculated, the administrative unit and the time period must be defined. The relevant administrative unit is defined as all administration involved in the deliverance of the administrative service for which the fee is requested. The time period is the calendar year.

**Categories of Costs**

- **Personnel costs:** Cost of personnel depends on the structure of the respective administrative unit; the Revenue Authority issues salary tables every year to be used in the cost calculation. They are converted in hourly rates for the cost calculation of services.

(continued next page)
Box 4.7. (continued)

- Nonpersonnel costs: This item includes the cost of utilities, travel costs, cost of vehicles plus insurance and maintenance, training costs, rent/lease/mortgage of buildings, and other costs (archive, data collection, and so on)
- Capital costs (depreciation, interest)

Categories of Income

- Estimated income from administrative fees based on the current fee structure and estimated number of incidents
- Potential income lost because of exemptions or reductions

Fees for new procedures are calculated by applying the principles for costs as mentioned above.

Australia

All products to be cost recovered should recoup at least their direct costs. Allocating direct costs to products or services is relatively straightforward. Allocation becomes more difficult where indirect and capital costs are involved.

Indirect and capital costs can be distributed in a number of ways. For example, under Fully Distributed Costing, costs are allocated on a pro rata basis (options include allocation according to the number of staff involved in the activity or on the basis of the shares of direct costs devoted to the activity). One form of Fully Distributed Costing, Activity Based Costing, is more accurate in how it allocates indirect costs. It links an organization’s outputs to activities used to produce those outputs, which in turn are linked to the organization’s costs.

The appropriate approach to distributing capital and overhead costs can vary depending on the characteristics of the agency. The agency should balance accuracy and precision against the costs of particular methods, and justify the method chosen.

A particular problem for developing countries is the tendency to overstaff the civil service often with relatively low-paid personnel. Many such officials take advantage of the opportunity to threaten to deny or delay a license, thereby extracting a bribe. Before preparing an analysis of the relevant costs for licenses and fees, therefore, efficient staffing levels should be estimated and used as a basis for optimal fee calculations. In cases where civil servants are not needed for a particular function, they can in many cases be retrained for other, more useful functions, including private sector employment or even entrepreneurship.

The existing fee regime should be reviewed and updated on a regular basis. The time span for fee review varies. For example, Germany reviews every two years; Canada stipulates a period between three and five years; and Australia developed a review schedule for each authority.

4.5. FEE PAYMENT PROCEDURES

Introducing an efficient fee payment procedure can be part of regulatory reform. Leading principles (also applicable for local taxes) include the following:

- avoidance of multiple payments
- cash payments only where absolutely necessary
- reliable bookkeeping
- safe and secure transaction methods

A summary of payment procedures and their main characteristics is provided in Table 4.1.
### Table 4.1. Payment Procedures

<table>
<thead>
<tr>
<th>PROCEDURE</th>
<th>PROCESS</th>
<th>DISADVANTAGES/RISKS</th>
<th>EXAMPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Debtor has to go to authority, pays at a teller and gets receipt.</td>
<td>- Bribery</td>
<td>This is usually the most convenient way for small businesses to pay fees, and a diminishing number of developing countries utilize this method for most fee and tax payments.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Leakage</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Costly (collection, accounting)</td>
<td></td>
</tr>
<tr>
<td>Bank transfer</td>
<td>Debtor requests own bank to transfer money to the state account. She or he keeps receipt of order.</td>
<td>- Debtor must have bank account</td>
<td>In developed countries, taxes and some fees are paid by bank transfer only.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Debtor must go to bank</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Paperwork</td>
<td></td>
</tr>
<tr>
<td>Internet transfer</td>
<td>Debtor uses own bank’s website or website of the authority to transfer funds.</td>
<td>- Debtor must have bank account</td>
<td>More and more developed countries offer services on the internet and allow payment via the internet, either by bank transfer or credit card.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Debtor must have internet access</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Website and security issues exist</td>
<td></td>
</tr>
<tr>
<td>Telephone unit transfer (nascent approach; very little experience as yet)</td>
<td>Debtor transfers telephone units via own mobile phone to a government number.</td>
<td>- Debtor must have mobile phone</td>
<td>Though technically possible in many developing countries and utilized between private users, this method is not yet utilized for transfers from private citizens to the state. For example, in Kenya, Sierra Leone, Liberia, and many other African countries phone unit transfer is a well-established payment method between private parties.</td>
</tr>
</tbody>
</table>

Source: Reichel 2010.
5. How to Move Forward with Subnational Reforms

Earlier chapters described reform content; this chapter will introduce the practical considerations in initiating subnational reforms, including issues of timing and sequencing.

Given the importance to sound governance at the subnational level of the broader fiscal framework, the first step before embarking on a reform plan should be an assessment of that framework in terms of the subnational governments’ needs and responsibilities: What revenue does the targeted regulation provide for subnational jurisdictions? What requirements for expenditure does it impose on them? And are revenues and required expenditures in a reasonably healthy balance?

5.1. WHERE TO BEGIN?

It is critical to understand the existing framework (or lack thereof) for the subnational investment climate before trying to develop recommendations for improvement. Where serious deficiencies are present, it will be important to take steps to achieve sustainable reforms, even if some short-term, stop-gap measures must be undertaken alongside longer-term structural reforms.

The first step in assessing the fiscal framework is to gather the data and information indicated in the checklist below.

1. Assess the legal framework for subnational revenue:
   - What sources are allowed or not allowed (including both taxes and fees)?
   - What transfers are available, and on what basis?
   - What expenditures are required or expected?

2. Collect hard data on municipal budgets for income/expenses:
   - Sources of Income
     - Transfers from higher levels of government (and/or aid)
     - Own-tax revenue (full inventory of taxes and revenues obtained from each)
     - Fees (full inventory of fees and revenues obtained from each)
     - Other (for example, rental income)
   - Expenditures
     - Capital
     - Current

Once the necessary data is in hand, it must be analyzed. As seen from the lessons of successful systems discussed in earlier chapters, the investment climate must be supported by a sound, integrated relationship between the national and subnational levels of government. Such a system generally includes the following features:
1. A clear framework setting out the mandates for subnational governments in both business regulation and taxation (including license fees). Such a framework should be established by national legislation and should articulate clearly the rights and responsibilities of subnational governments at all levels with regard to:

- Allowable sources of taxation, including parameters for defining the base, minimum and/or maximum rates, and mechanisms for setting and changing bases and rates
- Expected areas of regulation and the parameters within which subnational jurisdictions can exercise their authority (for example, ensuring against protectionism and barriers to entry and trade throughout the country)
- The basis for charging fees
- Accountability and reporting requirements
- Avenues of recourse for citizens

2. A clear framework for fiscal transfers that realistically match subnational expenditure mandates with available resources. Generally speaking, a country’s subnational jurisdictions with strong bases of own-source revenue should be expected to cover all (or nearly all) of their required expenditures, while jurisdictions with fewer income sources usually should receive transfers from higher levels of government to cover any gaps between own-source revenue and necessary expenditures. However, as mentioned in chapter 3, such transfers should not be subject to regular “negotiation” nor should they deprive subnational administrations of proper incentives to operate efficiently and maintain a competitive investment climate.

3. Resources for capacity building at the subnational level to improve abilities in managing their mandates for business regulation and taxation. Most subnational administrations in developing countries suffer from a lack of capacity. They have often been relegated to “low priority” by both national governments and donors, who have tended to focus on national-level ministries and agencies. At the same time, subnational administrations have been held back from assuming many of the responsibilities carried out by their counterparts in developed countries. Thus, to the extent that greater decentralization is considered desirable (for example, to “bring government closer to the citizens”), it would be beneficial for national governments (with the support of international donors) to develop capacity-building programs alongside the expansion of responsibilities inherent in the decentralization process.

4. Accountability that extends from the base (that is, citizens) through subnational governments to national governments (including national agencies operating at the subnational level). As articulated by Schaeffer and Yılmaz (2008):

   In a well-functioning local government budget and managerial structure, a local government is subject to accountability to its citizens, accountability to public agencies and accountability to higher-level governments. These kinds of accountability are referred to as: bottom up—by the local government to local citizens; horizontal and vertical accountability by the local government to higher-level governments. Bottom-up accountability may include citizens acting through the electoral process or indirectly through civic organization (that is, NGOs, civil society) or the news media. To promote government accountability, government budgets and expenditure programs need to be disclosed to the public. Governments that do not yet have laws or regulations allowing for public consultation and monitoring of budgets should consider enacting such legislation.

If it does not yet exist (or needs substantial improvement), such framework legislation for subnational administrations should be developed on the basis of extensive stakeholder consultation involving representatives of the national government, subnational administrations, and civil society.

5.2. BUILDING ON A SOUND FOUNDATION FOR SUBNATIONAL REFORMS: REVENUE

Once a country has established a sound framework (or has at least begun to plan one), it should be possible to proceed to a more detailed assessment of the revenue base of its subnational administrations. This may include

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57 Schaeffer and Yılmaz 2008, 11.
developing one or more appropriate subnational-level tax bases, including at least limited authority to set rates (for example, within specified bands, as described in section 3.1).

Detailed guidance on how to reform the revenue framework itself is beyond the scope of this handbook, beyond the tax instrument discussion in chapter 3. Wide-scale fiscal reforms are usually undertaken with the assistance of the World Bank (Poverty Reduction and Economic Management), the International Monetary Fund, or a major bilateral donor program (for example, the United Kingdom’s Department for International Development, the United States Agency for International Development, or Germany’s Gesellschaft für Technische Zusammenarbeit). The following brief summary, however, indicates the general shape of efforts to improve the revenue base of subnational governments.

- Reforms in the area of general business tax administration (at all levels of government)\textsuperscript{58} and local tax administration\textsuperscript{59} are usually a sound “no regrets” approach—it is beneficial for and needed by most of the World Bank Group’s clients, regardless of the urgency of regulatory reform or local tax reform.
- Capacity building in the area of property or land tax development is similarly beneficial in its own right (for example, sound cadastres and valuation systems as a basis for long-term finance as well as for the purpose of taxation, as described in section 3.2); this process tends to be slow, however. In working toward this goal, investment climate reformers must work in cooperation with urban land registry/cadastre reformers. As cadastres become more comprehensive and valuation systems more reliable, scope for local land/property tax systems is enhanced.
- Design of sound business tax systems for relatively sophisticated regional governments or large metropolitan areas may include features such as those described in section 3.3.
- Improvement (or establishment) of presumptive business taxes for the subnational level should take into account the considerations described in section 3.4.

5.3. BUILDING ON A SOUND FOUNDATION FOR SUBNATIONAL REFORMS: LICENSE FEES

In countries with a demonstrated need to reform their subnational business license systems (especially if the motivation is reducing costs for businesses), it is critical to gauge the subnational administrations’ ability to manage the revenue implications of license reforms.

This process involves the following steps:

1. \textit{Estimate the revenue implications of recommended regulatory reforms.}
   - Determine for each license or permit:
     - Will it be retained or eliminated (following the considerations outlined in sections 4.1 to 4.3)?
     - If it is going to be retained but reformed, what is the current fee and what will be the new fee (following considerations outlined in section 4.4)?
     - How many such licenses/permits were issued in each of the past five years?
   - Total the loss of revenues from all recommended reforms, based on above data.
   - Estimate the dynamic effects (short term versus long term, if a reduction in costs might lead to an increase in the number of transactions and therefore an increase in revenue from the associated fees).

2. \textit{Estimate the expenditure changes as a result of reforms.}
   - Will improved efficiencies lead to lower public sector administrative costs?
   - What will happen to public sector staff made redundant by reforms?

\textsuperscript{58} World Bank Group Investment Climate Advisory Services 2009a.
\textsuperscript{59} Blore et al. 2004.
How to Move Forward with Subnational Reforms

3. **Estimate changes in unofficial payments as a result of reforms.**

- To what extent are public servants dependent for their income on unofficial payments and gifts? If it is significant, how will they react to the reforms? Will they accept them, resist them, find new rent-seeking opportunities, or leave the public for the private sector?

If fees from licences or permits represent more than about five percent of the budget, reducing them substantially will likely be difficult without putting in place alternative sources of revenue. Lacking clear alternatives, higher level reforms to enhance “own-tax” revenues (that is, either national legislation or possibly even a constitutional reform) may be necessary, as described above.

A typology of situations may be thus developed providing guidance in “where to begin” working to improve the subnational-level investment climate (see Table 5.1).

The general process of developing reforms at the subnational level is well described in IFC SME subnational toolkit (2006). An important benefit of working at the subnational level is the opportunity to encourage healthy competition among jurisdictions within the same national framework. Thus, both the subnational Doing Business framework for measuring reforms, and more generally, the interjurisdictional competition and tournament approaches can help motivate reforms and keep them going, assuming the fiscal framework is conducive.

### Table 5.1. Typologies of Approaches to Subnational-Level Investment Climate Reform

<table>
<thead>
<tr>
<th>Reform Priorities, depending on circumstances</th>
<th>Sound Financial Situation</th>
<th>Poor Financial Situation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sound Regulatory Regime</strong>&lt;br&gt;Regulations are legally based, fulfill policy needs, are business friendly, and are enforced consistently and fairly</td>
<td>Sufficient resources to cover cost of mandated services; sufficient “own taxes” to motivate a sound investment climate</td>
<td>Lack of resources to cover cost of mandated services; lack of “own taxes” to motivate a sound investment climate</td>
</tr>
<tr>
<td><strong>Poor Regulatory Regime</strong>&lt;br&gt;Some regulations are extra-legal, exist primarily to raise revenue or provide rent-seeking opportunities, are cumbersome or confusing, or are inconsistently enforced</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Undertake regular regulatory impact assessment reviews of new regulations</td>
<td>- Improve revenue collection efficiency; improve rates of compliance</td>
<td></td>
</tr>
<tr>
<td>- Monitor fiscal situation and adjust as necessary</td>
<td>- Develop (in coordination with national level) appropriate tax base(s) given economic activities in the jurisdiction and capacity of tax administration</td>
<td></td>
</tr>
<tr>
<td>- Set fees for cost-recovery</td>
<td>- Inventory and review of licenses/permits (including strong stakeholder input)</td>
<td></td>
</tr>
<tr>
<td>- Guillotine unnecessary or extra-legal licenses/permits</td>
<td>- Guillotine unnecessary or extra-legal licenses/permits; undertake as soon as possible for those without revenue implications</td>
<td></td>
</tr>
<tr>
<td>- Streamlining of necessary licenses/permits</td>
<td>- Inspection reforms to ensure fair and consistent enforcement</td>
<td></td>
</tr>
<tr>
<td>- Inspection reforms to ensure fair and consistent enforcement</td>
<td>- Set fees for cost-recovery</td>
<td></td>
</tr>
<tr>
<td>- Set fees for cost-recovery</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Authors.

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60 A good example from Nigeria is IFC “Smart Lesson” by Catherine Masinde (2011), available at: https://smartlessons.ifc.org/smartlessons/index.aspx.


5.4. BUILD IN STAKEHOLDER DEVELOPMENT, MONITORING, AND EVALUATION

While many of the most important benefits of reform are difficult or impossible to measure (for example, improved quality of regulations), progress can be monitored in a number of ways to determine whether reforms are mostly “on track” or have gotten “off track.”

It is relatively straightforward to monitor the reform process from activities (for example, public-private dialogue, training, and so on) through legislative debate and revision to the enactment of reforms. But as difficult as it is to get reforms officially enacted, this is the “easy part” compared to the process of ensuring sound implementation of reforms that benefit businesses and lead to desired impacts, such as increased levels of investment, productivity, employment, value-added, and tax revenues.

5.4.1. Managing Stakeholders and Ensuring Sound Implementation of Enacted Reforms

Once reforms are enacted, it is critical to ensure that they are implemented consistently as envisioned throughout the jurisdiction. Unfortunately, reforms are sometimes officially “enacted” but ignored in practice. Thus, reforms (both legislative reforms and more detailed regulatory reforms that may be promulgated through decrees, “circulars,” or “implementing regulations”) must be well publicized both to the public sector officials responsible for carrying them out and to the private sector constituents to whom they apply.

Public sector officials will often need training to implement reforms correctly and consistently. Consistency requires both that all officials interpret the laws and regulations the same way and that officials treat all constituents the same way.

The private sector also requires detailed information about the reforms, covering both their content (that is, what has changed) and the possibilities for recourse if some bureaucrats continue to do things “the old way.” In this regard, it can be helpful to consider the following steps:

- Mobilize business associations to educate their members and to stand up for them when their rights are being infringed.
- Encourage the press to report on implementation progress.
- Develop “feedback mechanisms” for constituents to report on problems, such as hotlines or suggestion boxes (paper based or electronic) to be used on an as-needed basis and/or small but representative surveys of applicants.
- Put in place legal mechanisms for recourse, not only within the subnational administration but also independently through the court system.

It is critical for subnational administrations to be responsive to (and to avoid becoming defensive about) feedback from constituents that may point out shortcomings in the implementation of reforms. In the normal course, problems will arise. What is important is that they are just as routinely identified and addressed. When private sector stakeholders are given the means to report concerns and then see those issues corrected, they will be more likely to come forward with constructive suggestions as well, encouraging more new investment and business growth.

On the other hand, if stakeholders’ complaints are systematically ignored or rebuffed, they will become cynical and entrenched in their view that “nothing ever changes.” Entrepreneurs who are sufficiently mobile will be tempted to move to another jurisdiction with a better investment climate, including a fairer tax system.

5.4.2. Verifying Outcomes and Impacts

Whether reforms are fully or only partially enacted, it is beneficial to verify their expected outcomes and impacts. Most immediately, businesses should enjoy savings in time and costs, as well as reductions in confusion,
bureaucratic harassment, unfair treatment, and other “irritation costs.” Such outcomes are often measured by business surveys or the “standard cost model.” At a minimum, the sound, consistent implementation of enacted reforms should be independently verified (for example, using feedback from business associations).

The reforming agencies should themselves track and verify changes in official fees as well as the numbers of transactions. They should be able to regularly report on revenues received as well as the volume of activity (for example, evidence of improved compliance; changes in numbers of applications for registration, licenses, permits, or renewals; rates of inspections and fines imposed; and so on). Ideally, such official data can be verified and cross-checked by carrying out a survey of a representative sample of businesses, starting with a baseline before reforms are enacted and undertaken at periodic intervals thereafter.

Cost savings may come from reductions in official fees as well as from efficiency improvements that reduce the amount of time that businesses spend on compliance and suffering delays that may have hampered cash flow. Such savings in turn may result in lower prices for consumers (especially in competitive markets), higher investment, new business creation and levels of employment.

All these impacts should positively affect public sector revenues. While business surveys (including the World Bank Enterprise Surveys) can provide evidence regarding new business investment and employment, the relevant subnational administrations should be collecting, analyzing, and reporting on trends in collection of their own-tax revenues and other sources of revenues. If they are not capable of undertaking this task, they should receive training and technical assistance to build this capacity.

Last but not least, public sector agencies (at all levels) need to verify the benefit side of regulation: improvements in public health and safety and/or the environment. This in turn requires regular and systematic collection of data on emissions, incidents of workplace fires and accidents, incidents of food poisoning and similar impacts. Those charged with this task should take into account that not all benefits of regulation can be easily measured with objective data; for example, it may be difficult to distinguish between food poisoning and influenza.

In all cases, it is necessary both to prioritize reforms and to recognize that the reform process is never “finished.” Even developed countries are continuously reforming to keep up with changing technology, global integration, and the need to stay competitive. For low-capacity subnational jurisdictions, the most important task may be to decide on an initial reform program with two to three key elements that can fulfill both these goals:

- demonstrate some tangible improvements in the short run to encourage stakeholders to continue the process (for example, elimination of costly or annoying regulations that bring little benefit to the welfare of the jurisdiction)
- lay the foundation for medium- to long-term sustainable development (for example, by establishing a sound “own-source” tax base)

5.5. CONCLUSION

Carrying out isolated regulatory reforms at the subnational level where jurisdictions rely on registration or license fees for a significant portion of their income will likely lead to disappointment (including insufficient implementation, reversals, and “new ways” for the authorities to continue with the same old behavior). Similarly, stop-gap measures to generate revenues for subnational governments that do not take into account the dynamic effects of taxing mobile factors of production risk killing off private sector growth. As indicated earlier, the complex set of questions posed by the intersection of taxation, decentralization, regulation, and the development of the private sector offers no simple or universal solution. Each country presents a distinct, complex set of issues. Equally, however, most developing countries should pay more attention to the effect of

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63 OECD 2010.
64 Coolidge 2009; see also OECD 2004.
local business levies on the development both of the local public sector—“state capacity” at the front end, as it were—and of the formal private economy.

What local governments do and how they do it is often a critical and unduly neglected component of both political and economic development. Getting the local taxation and regulation of business “right” from this perspective, while not a solution in itself, is undoubtedly one important ingredient in improving development outcomes in many countries. Thus, for sustainable subnational reforms to improve the investment climate, it is usually necessary to assemble teams of experts and stakeholders who can address these key aspects:

- Fiscal and regulatory issues
- National- and subnational-level concerns
- Both short-term and medium- to long-term effects

65 On this question, see Brautigam et al. 2008 and Everest-Phillips 2008.
CASE STUDIES

Appendix 1. Canada: Simplifying Regulations and Financing Local Governments through Growth

Finding the best approaches through subnational tax and regulatory reforms: A lesson from British Columbia, Canada

ISSUE AND OBJECTIVE

While there is a broad consensus in Canada that some taxes and regulations are essential and beneficial, compliance with local tax and licensing procedures is also seen as highly burdensome for businesses, perhaps even to the extent of holding back economic growth. Hence reducing administrative burdens has become a key policy objective, with tax and regulatory instruments being given particular attention. However, many jurisdictions that have considered regulatory reforms seem to have been deterred by concern about the impact on local revenues. Governments must undertake reform in such a way that they ensure revenue sources for local governments without placing impediments in the way of businesses.

This appendix focuses on British Columbia (BC), a pioneer and leader among Canadian provinces in business licensing and regulatory reform. The general objective of this case study is to lay out BC’s most fruitful lessons and practices to better inform future reforms in other subnational jurisdictions. The appendix is organized into seven sections. The first provides an overview of subnational revenues and transfers in Canada, and the second summarizes Canada’s regulation costs. Section 3 introduces a brief description of BC’s provincial government and examines the main drivers for regulatory reform there. The design of BC’s regulatory reform policy is covered in section 4, while section 5 reports its main results. The next section emphasizes a specific tool, the mobile business license, introduced in several municipalities in BC, analyzing the impact of this reform on local government revenues and on businesses’ cost savings. The final section discusses the main lessons learned and factors of success that contribute to and sustain a dynamic business environment without reducing local revenue.

1. OVERVIEW OF SUBNATIONAL REVENUES AND GOVERNMENTAL TRANSFERS IN CANADA

At the provincial level in Canada, the tax base includes corporate income tax, sales taxes (in different forms, primarily value-added taxes, as described below), fuel taxes, tobacco taxes, taxes on insurance premia, and a limited number of other tax bases (see Table A1.1).

The Income Tax Act is a key component of the Canadian tax law and is administered by the Canada Revenue Agency (formerly known as Revenue Canada). Under Tax Collection Agreements

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66 This case study was written by Laura Kaliszewski, New York University, with input from Jacqueline Coolidge, Investment Climate Advisory Services of the World Bank Group.
<table>
<thead>
<tr>
<th>Tax</th>
<th>BRITISH COLUMBIA</th>
<th>ALBERTA</th>
<th>SASKATCHEWAN</th>
<th>MANITOBA</th>
<th>ONTARIO</th>
<th>QUEBEC</th>
<th>NEW BRUNSWICK</th>
<th>NOVA SCOTIA</th>
<th>P.E.I.</th>
<th>NEWFOUNDLAND</th>
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<td></td>
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<td>General rate</td>
<td>10.5</td>
<td>10</td>
<td>12</td>
<td>12</td>
<td>14</td>
<td>11.9</td>
<td>12</td>
<td>16</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td>Manufacturing rate</td>
<td>10.5</td>
<td>10</td>
<td>10</td>
<td>12</td>
<td>12</td>
<td>11.9</td>
<td>12</td>
<td>16</td>
<td>16</td>
<td>5</td>
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<td>Small business rate</td>
<td>2.5</td>
<td>3</td>
<td>4.5</td>
<td>0</td>
<td>5.5</td>
<td>8</td>
<td>5</td>
<td>5</td>
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<tr>
<td>Small business threshold</td>
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<tr>
<td>(Can $000s)</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>400</td>
<td>500</td>
<td>500</td>
<td>500</td>
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<tr>
<td>Corporation Capital Tax</td>
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<td></td>
<td></td>
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<tr>
<td>Nonfinancial</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0.1/0.3</td>
<td>0.225</td>
<td>0.24</td>
<td>0</td>
<td>0.15</td>
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<td>Financial</td>
<td>0.33/1</td>
<td>0</td>
<td>0.7/3.25</td>
<td>3</td>
<td>0.54/0.675</td>
<td>0.72</td>
<td>3</td>
<td>4</td>
<td>5</td>
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</tbody>
</table>

Source: British Columbia 2010, 149.
* percent of taxable income
between the federal and the provincial governments, most income taxes are collected by the federal government. The effective federal rate is 28 percent. Each provincial income tax rate is calculated the same way as the federal tax (except for Quebec), although the rate varies from one province to another.

Recently, in order to boost business and provincial growth, several provinces decided to harmonize tax collection by implementing a single value-added sales tax. Provincial sales tax and federal goods and services tax have been replaced by a harmonized sales tax in half of the Canadian provinces: Nova Scotia, New Brunswick, Newfoundland, and Labrador, and more recently Ontario and BC. In these provinces, taxes on goods and services are levied by the federal government at a higher rate than in other provinces, and additional revenue from harmonized sales tax is distributed by the federal government to the five participating provinces. The amounts remitted by the Canada Review Agency differ from one province to another as each province sets its own provincial sales tax rate within the harmonized sales tax. For instance, while Ontario combined its retail sales tax with the goods and services tax to create the harmonized sales tax at the rate of 13 percent, BC implemented the harmonized sales tax at the rate of 12 percent by merging its provincial sales tax with the goods and services tax. By introducing the harmonized sales tax, provinces aim to improve the competitiveness and productivity of their business environments as well as to attract new investments and reduce administrative costs for taxpayers and businesses. Above all, the long-term objective of this harmonization process is to generate economic growth by stimulating job creation and additional revenue to be spent in public services. For instance, BC estimates that harmonization will save over Can$2 billion in costs for businesses by removing around Can$1.9 billion of sales tax and saving around Can$150 million annually from administrative and compliance costs.67

Regarding the five other Canadian provinces, Quebec, Saskatchewan, Manitoba, and Prince Edward Island, levy provincial sales taxes (similar to goods and services tax in Quebec), while Alberta and the three territories of Nunavut, Yukon, and Northwest Territories have no sales tax.

During the Great Depression, in response to the provinces’ lack of revenues, a system of federal-provincial transfers made up of three components was introduced: the population-based health and social transfers that have been both merged and demerged since 1995; the tax-base differentials-driven equalization system; and small formula-driven transfers in various fields. These major transfers provide significant financial aid to provinces and territories to spend mainly as they wish, although they are labeled for health, education, or social spending. The government also invests in specific areas in the provinces and municipalities (for example, labor market training, infrastructure, and short-term policy priorities) and provides financial support through trust funds and direct targeted support.

As per the Department of Finance Canada, these transfers were estimated to account for about 19 percent of provincial and territorial revenues in 2010. Historically, the tax transfer mechanism began to operate in 1977 as part of a federal-provincial-territorial arrangement. The federal government then transferred 13.5 percent of its personal income tax base and one percent of its corporate income tax base to the provinces and territories. According to the government’s statistics, since its implementation, tax transfers received by provincial and territorial governments have increased from Can$2.7 billion in 1977–1978 to Can$57.7 billion in 2010–2011. Of this, Can$21.1 billion will come from tax transfers and Can$36.6 billion will represent cash transfers.

In 2010–2011, BC received more than Can$5.1 billion through federal support and transfers. These transfers are estimated to account for more than 10 percent of BC revenues every year (see Table A1.2).

Hence, they allow provinces to correspondingly increase the tax revenue they collect (see Table A1.3).

Municipal governments in BC (similar to most other provinces) have only one major tax source—property taxes (in addition to sales of services)—and so receive about 7–9 percent of their budgets from governmental transfers (see Figure A1.1).68

67 For details on expected benefits, see http://www.hstinbc.ca/making_your_choice/faqs/benefits_of_an_hst/.

### Table A1.2. Federal Support to British Columbia

<table>
<thead>
<tr>
<th></th>
<th></th>
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<tbody>
<tr>
<td><strong>Major Transfers</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Canada Health Transfer</td>
<td>2,795</td>
<td>2,798</td>
<td>3,065</td>
<td>3,162</td>
<td>3,354</td>
<td>3,583</td>
<td>3,777</td>
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<td>Canada Social Transfer</td>
<td>1,188</td>
<td>1,214</td>
<td>1,344</td>
<td>1,385</td>
<td>1,435</td>
<td>1,485</td>
<td>1,527</td>
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<tr>
<td>Equalization</td>
<td>590</td>
<td>459</td>
<td></td>
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<tr>
<td><strong>Subtotal</strong></td>
<td>4,573</td>
<td>4,472</td>
<td>4,409</td>
<td>4,547</td>
<td>4,789</td>
<td>5,067</td>
<td>5,304</td>
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<td><strong>Direct Targeted Support</strong></td>
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<td>Labour Market Training Funding</td>
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<td>67</td>
<td>79</td>
<td>33</td>
<td>33</td>
<td>33</td>
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<tr>
<td>Wait Times Reduction</td>
<td>82</td>
<td>158</td>
<td>158</td>
<td>79</td>
<td>33</td>
<td>33</td>
<td>33</td>
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<tr>
<td><strong>Subtotal</strong></td>
<td>82</td>
<td>158</td>
<td>158</td>
<td>146</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<tr>
<td><strong>Total - Federal Support</strong></td>
<td>4,655</td>
<td>4,630</td>
<td>4,567</td>
<td>4,693</td>
<td>4,889</td>
<td>5,167</td>
<td>5,404</td>
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<td><strong>Change from 2005–06</strong></td>
<td>-25</td>
<td>-88</td>
<td>+38</td>
<td>+234</td>
<td>+512</td>
<td>+749</td>
<td></td>
</tr>
</tbody>
</table>

#### Per Capita Allocation (Canadian dollars)

- 1,111
- 1,092
- 1,061
- 1,072
- 1,098
- 1,142
- 1,183


### Table A1.3. British Columbia - Revenue by Source 2007–08 to 2011–12

<table>
<thead>
<tr>
<th></th>
<th></th>
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<tbody>
<tr>
<td>Taxation Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income</td>
<td>6,956</td>
<td>6,093</td>
<td>5,156</td>
<td>5,861</td>
<td>6,124</td>
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<tr>
<td>Corporate income</td>
<td>2,250</td>
<td>2,038</td>
<td>1,131</td>
<td>847</td>
<td>1,102</td>
</tr>
<tr>
<td>Harmonized sales</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3,784</td>
<td>5,376</td>
</tr>
<tr>
<td>Property</td>
<td>1,795</td>
<td>1,848</td>
<td>1,885</td>
<td>1,906</td>
<td>1,908</td>
</tr>
<tr>
<td>Property transfer</td>
<td>1,068</td>
<td>715</td>
<td>855</td>
<td>900</td>
<td>1,045</td>
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<tr>
<td>Corporation capital</td>
<td>117</td>
<td>108</td>
<td>56</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other*</td>
<td>7,220</td>
<td>7,395</td>
<td>7,940</td>
<td>4,124</td>
<td>3,103</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>19,406</td>
<td>18,197</td>
<td>17,023</td>
<td>17,422</td>
<td>18,658</td>
</tr>
<tr>
<td>Natural Resource Revenue</td>
<td>3,778</td>
<td>3,848</td>
<td>2,705</td>
<td>3,208</td>
<td>3,683</td>
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<tr>
<td>&quot;Other fees and licenses&quot;</td>
<td>1,450</td>
<td>1,386</td>
<td>1,359</td>
<td>1,480</td>
<td>1,425</td>
</tr>
<tr>
<td>Other Revenue**</td>
<td>6,261</td>
<td>6,003</td>
<td>6,281</td>
<td>6,394</td>
<td>6,826</td>
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<tr>
<td>Contributions from Federal Government</td>
<td>5,931</td>
<td>5,989</td>
<td>6,834</td>
<td>7,685</td>
<td>7,283</td>
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<tr>
<td>Commercial Crown Corp. Net Income</td>
<td>2,974</td>
<td>2,905</td>
<td>2,848</td>
<td>3,001</td>
<td>3,082</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>39,800</td>
<td>38,328</td>
<td>37,050</td>
<td>39,190</td>
<td>40,957</td>
</tr>
</tbody>
</table>

**Source:** British Columbia 2010, 154.

*Other sales taxes; carbon, fuel, and tobacco taxes; insurance premium and hotel room taxes.

**Medical services plan premiums; post secondary education fees; investment earnings; asset dispositions, reimbursements for health care and other service provided to external agencies, and other recoveries.
2. BROAD OVERVIEW OF THE COST OF REGULATIONS IN CANADA

Regulations can be costly for local governments, businesses, and consumers. Several aspects related to the cost of regulations and licensing should be considered:

- **For local governments**: Administrative costs include those related to the time and money spent by municipalities to administer, communicate, and enforce rules.

- **For businesses**: Compliance costs include those related to the time spent by the private sector to understand and comply with these rules and to obtain the required documents. Official fees, unofficial charges, and lack of information may also create additional costs limiting a firm’s capacity to expand its activity, lowering rates of return and creating barriers to entry. These in turn lead to opportunity costs of economic activities never undertaken due to these regulations.

For consumers: Consumer costs include those related to higher prices, fewer choices of products, lower wages, and loss of time.

Excessively numerous, overlapping, or inappropriate regulations, often referred to as red tape, consist of “counterproductive government rules and regulations that provoke a variety of frustrations including complying with rules that make no sense or deliver little in the way of benefit and much in the way of cost.” This regulatory burden tends to be especially heavy for small businesses, which pay much more on a per-employee basis compared to larger enterprises. Moreover, cost of compliance for businesses may be much higher than cost of regulations for municipalities. The Canadian Federation of Independent Business (CFIB) estimates that one Canadian dollar spent by governments to administer regulations approximately corresponds to a Can$20 cost for private sector compliance. These costs are not registered in any government budget, thus “making regulation equivalent to hidden taxation.”

A recent survey of the CFIB reports that Canadian enterprises spend approximately Can$30.5 billion annually to comply with regulations from all levels of government. According to the same study, based on more than 7,000 Canadian small businesses, 65 percent consider that government regulations and paper burdens are the greatest obstacles to their activities. The survey relates that for 41 percent of the respondents, regulations could be reduced by 10 to 25 percent “without sacrificing the public interest goals of regulations.” While the economic impact on local governments of such eventual regulatory reductions should be also quantified for a more accurate cost assessment, the CFIB estimates that savings on these regulatory costs could lead to increased investments in health care, education, jobs creation, wage raises, and higher productivity. Another CFIB survey report found that 26 percent of business owners would not have started their operations if they had known the costs they would incur.

Hence, it seems that the welfare of the Canadian economy, as well as living standards, could be raised by simplifying and rationalizing these regulations. In the same survey, business owners reported that if the cost of regulations were reduced, they would use the savings to invest in equipment and business expansion as well as to increase employee wages and benefits. Moreover, the CFIB study illustrates the burden that regulations create on businesses. Asked what would facilitate compliance with rules and procedures, entrepreneurs mentioned as their main concern simplified regulations, reduced numbers of regulations, and better communication regarding new regulations. All these data point to the governments’ lack of awareness of the impact on business of compliance costs. They also demonstrate that important efforts to improve the investment climate remain to be undertaken, even in a developed country such as Canada. The lack of political will and the pressure of activists and interest groups for additional regulations are part of the explanation. But the absence of regulatory burden-tracking and the lack of effective public accountability also tend to reduce the overall efficiency of the system.

In short, if regulations and compliance costs were simplified, available resources could be assigned to more productive goals, enhancing the investment climate. Some provinces across Canada have come to realize the benefits that could result from streamlining and rationalizing the regulatory and taxation system. Many of these

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69 Jones et al. 2005, 1.
70 As per CFIB’s 2005 report, small businesses pay five times more on a per-employee basis compared to larger enterprises. Whereas enterprises with fewer than 5 employees spend Can$5,317 per employee per year to comply with regulations, businesses with more than 100 employees pay Can$1,104 per employee per year. This can be explained mainly by the more limited resources of these small enterprises and by the much more competitive environment they face.
72 Jones et al. 2010.
73 In reality, the total cost of regulation is much higher, as this estimation does not include the following: “costs governments incur to administer regulation, money spent on lobbying for reduced or improved regulation, economic activity that never happens as a result of regulation, time and money that individual citizens spend directly on regulatory compliance, stress, frustration and fear that regulations can cause.... If this estimate did include these factors, it could easily be triple the estimate arrived at for this report.” Jones et al. 2005, 5.
74 Jones et al. 2010, iii.
75 Of course, the more competitive the industry, the more such cost reductions result in lower prices for consumers.
reforms have been inspired by the success of one particular province, BC, which has pioneered measures intended to facilitate entrepreneurship at the municipal level.

3. MAIN DRIVERS FOR THE REGULATORY REFORM

Canada’s westernmost province has been a pioneer in making it easier for entrepreneurs to do business. In the 1990s, BC (with a number of other Canadian provinces) was characterized by low economic performance, poor business confidence, and regulatory excesses and discrepancies. The public became increasingly dissatisfied, creating motivation for change. Already in 1996, BC innovated by launching a one-stop shop business registry program, facilitating business registration at all three levels of government. Thanks to this process, the time needed to register a business has been gradually reduced, and almost 200 organizations have collaborated with the one-stop shop, including municipal governments.

In 2001, political changes and regulatory reforms in BC inspired promising successes in other Canadian provinces. After a decade of bad economic results and the public’s growing frustration with the still high levels of regulation, these issues became prominent in the 2001 election. Concern over BC’s proliferating regulations became the central argument of the opposition party’s campaign. Once elected, therefore, Gordon Campbell and his liberal government promised to reduce the regulatory burden by one-third within three years, improving BC’s business climate overall and making it “the most small business friendly jurisdiction in Canada.”

4. DESIGN OF THE REGULATORY REFORM

Following the 2001 election, one of the first governmental objectives in BC was to cut taxes substantially. Hence, the income tax has since been reduced by 25 percent, and both the provincial tax on production machinery and equipment and the corporation capital tax on nonfinancial institutions were removed. The new government also streamlined numerous excessive rules in various sectors, including mining, oil, gas, forestry, and real estate. In addition, more than 3,000 fees and licenses were examined, and 43 percent of them were simplified or eliminated.

BC’s Regulatory Reform Policy includes the following steps:

- Measuring administrative burdens
- Setting targets for burden reduction
- Reporting progress publicly towards such targets

The objectives and tools of the Regulatory Reform Policy objectives include the following:

- Reduction of regulation burden by one-third
- Assignment of a Minister of State for Deregulations
- Introduction of a Regulatory Criteria Checklist
- Removal of two regulatory requirements for every one introduced
- Adoption of a three-year Regulatory Reform Plan
- Consultations between the public and private sectors and creation of the Red Tape Task Force

A central concern of the newly elected government was to find ways to measure progress towards achieving the one-third reduction and to make results publicly accountable and transparent. To realize these objectives,

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77 Ministry of Small Business, Technology, and Economic Development 2010a; includes a description of the Ministry’s priorities.
78 Ministry of Small Business and Revenue 2008b.
the BC government adopted the “regulatory requirements”\textsuperscript{79} as a main accounting tool to measure reduction in red tape. The government appointed a Minister of State for Deregulations to be exclusively in charge of regulatory reform. Originally reporting to the Minister of Competition, Science, and Enterprise, today the office, called Straightforward BC, is part of the Ministry of Small Business, Technology, and Economic Development. Only three months after the election, the provincial Executive Council of BC approved the establishment of a Regulatory Reform Policy, applicable to every proposed regulation, legislation, and policy. A major concern was to make every effort to keep the new policy easy to understand, simple to apply, and straightforward to comply with.

One of the core instruments of this new policy was the introduction of a Regulatory Criteria Checklist\textsuperscript{80} applicable to the flow of all new regulations (see Box A1.1).\textsuperscript{81} All ministers and heads of regulatory authorities were made responsible for implementing the new policy and regulations according to the checklist. Requiring regulators to comply with the eleven criteria constituted a new and innovative approach to regulations in BC: “it put the onus on government to make the case that additional regulation was necessary, to ensure adequate consultation, to keep compliance flexible, and to reduce the total amount of regulation.”\textsuperscript{82} This mechanism not only ensured that all proposed legislation and regulations were result-based, in plain language, and necessary and justified, but it also introduced the obligation to track all regulations added or eliminated or the justification for any not addressed as required by the criteria. In the case of a negative response to any of the 11 categories, the ministries had to provide an explanation. Moreover, at the end of the checklist, ministries had to report how many regulatory requirements would be added or eliminated and what would be the net change. Starting in 2001, for every one regulatory requirement added, two had to be removed. Having achieved the initial target of one-third reduction in 2004, a new target of no net increase has been introduced and extended to 2012.

For every new law or regulation introduced, the checklist was submitted to the Executive Council for review. Providing a very effective internal check on regulations, these documents were also made public when legislations were enacted or regulations introduced. This method established a new way of thinking “from one where regulation was seen as the answer to any problem and the private sector was viewed with some suspicion to one where questions are asked, alternatives are considered, and the contribution that businesses make to the economy is more respected and understood.”\textsuperscript{83} Each minister became accountable in the legislative assembly and at the cabinet table, reporting all the regulatory requirements contained in its statutes, rules, and policies and including a signed copy of the regulatory checklist for every new regulation introduced.

Another priority for the regulatory reform initiative was to require ministers to adopt a clear three-year Regulatory Reform Plan specifying how they would reach the one-third reduction target. To track their progress in reducing red tape and achieving the “no increase” goal, ministers were also required to publish quarterly progress reports listing the measures they had taken and explaining how they were meeting the target. The database was easy to maintain and was kept up to date by each ministry. In addition, the newly created Deregulation Office was responsible for maintaining a central regulatory requirement record to ensure that measurement and accountability goals were met.

Another key goal of BC’s regulatory reforms, and likewise a crucial concern for developing countries, was to keep implementation costs low. The reform office began with only five employees and a budget of Can$500,000. Most of its budget was financed at the provincial level, without any transfers or grants from the national government. For additional funds, the department relied on the cooperation of others ministries and on complementary revenue instruments, such as the mobile business license or BizPal (discussed more fully below).

\textsuperscript{79} A “regulatory requirement” is defined in BC’s Regulatory Reform Policy as “a compulsion, obligation, demand or prohibition placed on an individual, entity or activity by or under the authority of a provincial Act, regulation or related policy.”

\textsuperscript{80} As per the regulatory criteria checklist, “The purpose of the checklist is to demonstrate that legislative and regulatory changes have been developed according to the regulatory reform policy, while still protecting public health, safety and the environment.” The checklist can be viewed on the Small Business Roundtable website: http://www.smallbusinessroundtable.ca/publications/Documents/Checklist_writeable.pdf.

\textsuperscript{81} Replacing the Regulatory Impact Assessment in place in BC until 2001.

\textsuperscript{82} Jones 2010, 10.

\textsuperscript{83} Ibid., 20.
Box A1.1. Regulatory Criteria Checklist for British Columbia

The checklist includes several questions in eleven different categories:

A) Reverse Onus/Need Is Justified:
   - Has the scope of the public policy problem been assessed?
   - Is government intervention necessary to address the problem?

B) Cost-Benefit Analysis:
   - Is the benefit to government or external partners worth the increased cost to small business and those who must comply?

C) Competitive Analysis:
   - Has the impact of the requirements on BC’s economic competitiveness been assessed?
   - Have the requirements been compared with other relevant jurisdictions?

D) Streamlined Design:
   - Do the requirements avoid or eliminate duplication or overlap with federal or local government requirements or those of other ministries?
   - Has business process mapping been undertaken to streamline the requirements and lessen the time needed by small business to comply?

E) Replacement Principle:
   - Will one regulatory requirement be eliminated for each new regulatory requirement introduced by the legislation or regulation?

F) Results-Based Design:
   - Does the design reflect government’s commitment to regulatory requirements that are results-based and use scientific evidence?

G) Transparent Development:
   - Are the requirements transparent for ease of access, understanding, and compliance?
   - Has small business had the opportunity to see and comment on the proposed requirements?

H) Time and Cost of Compliance:
   - Has the amount of time required by small business to comply been reduced?
   - Can compliance occur with existing resources of small business?
   - Have government service standards been set?

I) Plain Language:
   - Have the requirements been drafted in plain language and in a way that facilitates compliance?

J) Simple Communications:
   - Will this change be communicated?
   - Can it be described in less than one page?

K) Sunset Review/Expiry Principle:
   - Has a date been set to review the requirements to ensure continued relevancy?
   - Does the legislation or regulation contain a sunset provision for requirements to expire?

Source: Villarreal 2010, 44.
In addition, the coordination and collaboration among all levels of governments, citizens, and various independent actors has played a positive role in the progress of the reforms. For instance, the Federal-Provincial-Territorial Committee on Regulatory Governance and Reform brings together a network of various experts to discuss best practice for regulatory reforms. Likewise, the business community has been particularly involved in the reform, lobbying to improve the business climate. The Regulatory Reform office was also in contact with other jurisdictions eager to inaugurate their own reforms, such as Newfoundland, Ontario, Nova Scotia, and with the federal government. In addition, the government constantly looked for recommendations and feedback, organizing various roundtables, workshops, training sessions, and even annual conferences to share issues and concerns with public servants, citizens, and entrepreneurs. To reach its objective of one-third regulatory reduction, for example, the new government launched an important campaign of consultation among businesses to identify priorities for simplifying or removing regulations. To help in this task, BC government created the Red Tape Task Force, responsible for listing and prioritizing more than 600 requests from the private sector. The recommendations of the Task Force were then transmitted to each ministry to help them build these suggestions into their deregulation plans. Finally, the unique nature of the reform, with its criteria checklist and its public accountability focus, also induced a constant incentive for ministries to consult with stakeholders and businesses.

Another key element of the design of BC’s regulatory reform plan is its involvement in accessibility measures and e-registry facilities. In late 2005, in partnership with Yukon and Ontario provinces, the BC government introduced the BizPal initiative, an online service involving multiple levels of governments across Canada. This program provides businesses with a powerful research tool for rapidly identifying all the permits and licenses required by the three levels of governments to open a business, to reduce the time necessary for entrepreneurs to find out about applicable licensing requirements and, consequently, to boost the registration of new start-ups in the provinces. This research time has in consequence been reduced from about 7 hours to about 20 or 30 minutes. Whereas the partnership makes all decisions regarding the overall program, each province is responsible for implementing and managing BizPal within its jurisdiction. As of mid-2010, 85 of the 160 BC municipalities offered the service, and the goal is to expand coverage steadily.

Finally, BC has become a leader in e-government innovations. With the same goals of rationalization and time-saving, the government implemented the BCeID instrument, which allows businesses to log in to any online service of participating governments with a single password. BC also implemented the “National Business Number,” a single identification number for each business, to facilitate data-sharing between the different authorities.

5. MAIN RESULTS OF THE REGULATORY REFORM POLICY

In 2001, the first count of BC’s regulatory requirements recorded 382,139. At that time, the objective was to remove two regulatory requirements for every one introduced. At the end of the three years, BC had eliminated more than 144,000 regulations: a 37 percent reduction that exceeded the 33 percent original target. Most importantly, the government confirmed that this goal has been achieved without harming public health, safety, or environmental concerns. Going forward, the government decided to implement a new target of no net increase from 2004 to 2007. As shown in the table below, the target of zero increase has not only been respected, it has been exceeded by almost ten percent. The target has been extended to 2012. As of 2010, the BC government had eliminated more than 152,000 regulations, a reduction of over 42 percent. Moreover, since 2010, regulatory reform has become a regular topic in all Small Business Roundtable consultations organized throughout the province to promote continued progress.

84 http://www.bcbizpal.ca/.
85 Ministry of Small Business and Revenue 2008b.
87 Ministry of Small Business and Revenue and Ministry Responsible for Regulatory Reform 2006.
Along with other key reforms and agreements implemented at the same period in Canada, the regulatory reform policy contributed to the impressive growth in business and job creation in BC, starting in 2003. Before the launch of important reforms in 2001, BC economic growth was 1.9 percent points below the Canadian average, but between 2002 and 2006 it rose to 1.1 percent points above the average. In addition, BCStats reports a similar trend regarding the number of new businesses established, which rose from 157,421 in 2001 to 176,124 in 2009. This extension of the tax base in turn had a positive impact on local government revenue. According to the Labor Force Survey of Statistics Canada, the rate of unemployment in BC has been reduced almost by half, from 8.8 percent in 1998 to 4.6 percent in 2008, with the majority of the jobs created after 2002.

These successful results have inspired other provinces across Canada, such as Nova Scotia, Newfoundland and Labrador, Ontario, Quebec and Saskatchewan; their commitments to reduce red tape have already achieved significant results. For instance, in 2005 Nova Scotia launched the “Better Regulation Initiative,” aimed at reducing businesses’ paperwork burden by 20 percent by 2010. To date, the project has achieved a 15 percent reduction in regulatory requirements, and the time needed to obtain a license has dropped by 91,000 hours, saving businesses around Can$2 million per year. Similarly, the reduction or elimination of more than 170 fees in Newfoundland and Labrador allowed businesses to save approximately Can$30 million.

6. A CRUCIAL TOOL AT THE MUNICIPAL LEVEL: THE MOBILE BUSINESS LICENSE

Forced to name the single most effective BC reform initiative applicable to other Canadian provinces (and many other countries, for that matter), the choice would most likely be the mobile business license (MBL). This instrument successfully streamlined the regulatory burden and reduced costs for businesses while maintaining and even increasing revenue for local governments.

Within the framework of the 2006 Union of British Columbia Municipalities convention, Premier Gordon Campbell introduced the idea of a single business license that could be recognized in any jurisdiction of the province. The Ministry of Small Business and Revenue was charged to work in partnership with local governments,
Union of British Columbia Municipalities, and stakeholders with the objective of developing a model for simplifying BC’s licensing processes while maintaining municipalities’ discretions to set local standards for businesses operating within their jurisdictions.

While business licenses generally represent less than one percent of municipal revenues, they can be particularly burdensome for the private sector, especially for enterprises operating across several municipalities. In fact, the lack of business license harmonization among Canadian provinces and even among municipalities can harm both businesses and consumers by fragmenting the market and by making requirements complex, excessive, and redundant. Hence, the key purpose of the MBL was to allow businesses to operate freely across the province without having to purchase a new business license from each municipality in which it might operate: one general license would allow a business to operate in any jurisdiction in the province. Examples of mobile operators served by these MBLs are plumbers, electricians, painters, and others.

The MBL’s benefits for businesses and consumers were predictable, but less clear was their likely impact on local government revenues and autonomy. Consequently, some local governments at first resisted its implementation, and the Single Business License Initiative was abandoned. In January 2008, however, the BC government decided to implement a 12-month Mobile Business License Pilot Project in 17 municipalities in the Okanagan-Similkameen area.

Before the MBL was instituted, mobile businesses were required to obtain licenses from their home municipalities as well as nonresidence business licenses for each municipality in which they operated. The price of nonresidence licenses varied considerably from one municipality to another. Under the Pilot Project, mobile businesses were not exempt from the requirement of obtaining an MBL in their home jurisdictions, but in place of multiple nonresidence licenses, they could now purchase a single additional MBL for all of their activities in any of the 17 participating municipalities. The MBL did not introduce any additional fees for those businesses not operating outside their home jurisdictions—an important point in acceptance of the program. The MBL cost Can$150 annually and was purchased from the business’s home municipality. Each municipality retained the revenue generated by MBL sales and shared the information on MBLs issued using a central online database managed by the BC province. Also, businesses remained responsible for complying with the bylaws of each municipality in which they operated. Full authority of municipalities over the license attributions as well as over their ability to govern was preserved.

The key question was whether the MBL has been successful in reducing red tape for small mobile businesses while increasing compliance and avoiding loss of critical revenue for municipalities. Some observers predicted a decline in the total number of licenses sold and consequently a loss in revenue for some local governments.

However, an Okanagan-Similkameen Interim Review of the Pilot Project reports that the program has been very successful in meeting its goals. The main results of the review demonstrate that the project has made it easier to do business by reducing red tape, without creating a burden on municipalities. First, a survey taken after implementation of the project reported a high level of satisfaction among municipal administrators and mobile businesses on MBL simplified business. The top benefits include “only having to deal with one licensing municipality, less paperwork, ease in complying with the licensing requirements of multiple municipalities, cost effectiveness, and the ability to take assignments in a larger geographic area.”94 Second, contrary to the anticipated outcome, local government revenues increased following the implementation of the MBL, for two reasons: the program lowered the administrative workload of license processing, a benefit to municipalities, and, more importantly, it boosted licensing compliance rates and consequently increased local revenue in most municipalities. Between 2007 and 2008, the Interim Review reported the sale of 1,922 MBLs, generating Can$500,006, compared to the sale of 501 in 2007, generating Can$352,221. This represents an augmentation of 64 percent of the number of MBL sales and a regional revenue gain of over Can$160,000. However, not all municipalities saw an increase in revenue.

94 Ministry of Small Business and Revenue 2008a, 3.
In aggregate, an increase in the number of new businesses registered can be expected as the sales of the MBL have clearly expanded. For instance, according to David M. Duke, a former business license inspector who implemented the program in BC’s Capital Region District in 2000, the number of licensed contractors in the municipalities increased by 20 percent in the period following implementation. The Pilot Project may also have created a more competitive environment, leading to a larger choice of contractors and services available for consumers. For instance, in the Yukon Territory, the former Executive Director of the Yukon Federation of municipalities reported that the program has created “a ‘win-win-win’ situation for governments, businesses and consumers,” specifying “consumers have benefited as contractors can work throughout the territory, providing them with greater choice and speeding up the completion of works projects.”

Thus, the implementation of the MBL has proven to be a powerful low-cost opportunity to improve the investment climate while benefiting almost all parties involved. The reform clearly illustrates how provincial governments, municipalities, the private sector, and citizens can collaborate to reduce red tape and promote economic growth. Finally, this model has been used as an example of successful MBL implementation in other BC municipalities bordering the Pilot Project area. In 2008, the MBL was renamed inter-community business license; the program was made permanent, and others municipalities were invited to participate. (Some have declined through lingering fears of loss of revenue and control).

More broadly, the success of this model has been a good starting point and catalyst, inspiring and stimulating similar initiatives and agreements in Canada and in others countries. So far and despite the clear benefits of the MBL, however, too few similar initiatives have been undertaken in other Canadian regions and provinces.

7. FACTORS OF SUCCESS, LESSONS LEARNED, AND CONCLUSIONS

BC is the first province in Canada to measure regulatory costs publicly and to commit itself to reducing red tape, implementing steps to track progress, and streamlining the regulatory burden while maintaining local revenue. A recent report from the Fraser Institute rates the province third based on its overall provincial investment climate index. Compared to BC’s former position at the very bottom position of Canada’s ten provinces in 1999–2001, this represents substantial progress.

Several distinctive ingredients of BC reforms have been crucial for its success, including the following:

- Political leadership support
- Independence of ministries
- Implementation of powerful mechanisms to measure and track the progress of the reform
- Public accountability and transparency
- Constraints on regulators
- Revenue mitigation

First, regulatory reforms have benefited from strong support at the highest provincial political level, which treated the reform as a top priority. Moreover, BC was the only province that appointed a minister entirely responsible for supporting regulatory reform and advising and guiding other ministers.

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95 Personal correspondence with David M. Duke, former Business License Inspector with the District of Saanich, who implemented the program in the Capital District Region and now serves as Consultant to the BC Ministry of Small Business and Revenue, in Armstrong 2007, 5.

96 Personal correspondence with Tom Patterson, Executive Director, Yukon Federation of Municipalities; ibid.

97 Palacios et al. 2009.

98 The index is built on the economic attractiveness of a municipality in term of its taxes, regulation, flexible labor markets, and infrastructure as well as on an evaluation of whether its policy contributes to and sustains a friendly investment climate.

99 Regarding key points for effective regulatory reforms, see “A Ten-Point Plan for Effective Regulatory Reform,” in Jones et al. 2005; also see Villarreal 2010.
Second, the regulatory reform policy was highly decentralized, allowing each individual minister to set up an appropriate regulatory plan and making regulators responsible for achieving results and reporting regulatory counts. This intentionally decentralized policy bet on the assumption that independent ministers are better aware of the issues and needs of their constituents than would be a centralized structure. In addition, regulators took their responsibility seriously and were conscientious about the regulatory reform process. The decentralized structure also helped to overcome ministers’ initial bureaucratic resistance by increasing their ownership of the reform. They soon realized that the reforms preserved their authority and their independence to optimize their mandate and that the Deregulation Office was only there to guide them. Most importantly, use of a decentralized policy avoided the need to build a new bureaucracy to administer the reform.

Another strength of the BC reform policy was its use of powerful mechanisms to measure and regularly track progress. Any effective regulatory reform should give the public the means to understand and measure their compliance costs and should impose constraints on regulators and help them to determine priorities among regulations. Transparency, public accountability, and constraints on regulators resulting from the tracking requirement undeniably played a key role in the success of the policy. In this sense, the Regulatory Criteria Checklist was a powerful tool not only to force ministries to take active part in the reform but also to establish a unique mechanism of external accountability.

This case demonstrates that implementation of a rational and efficient subnational tax and regulatory reform can generate significant cost savings and revenue and can be a crucial element of any attempt to support economic growth without hurting public good expenditures and services delivery. Clearly, the right approach can simplify procedures and reduce red tape, enhancing competitiveness and promoting a better investment climate, economic growth, productivity, and prosperity while preserving those essential regulations that protect public goods and the revenue needed for public services.

Ten years ago, BC was the only province committed itself to reducing the regulatory burden on its businesses and to measuring publicly the progress of its reforms. The BC approach continues to promote business growth in the province, encouraging other provinces, such as Nova Scotia, Newfoundland and Labrador, Ontario, and Quebec, to focus on reducing red tape. A crucial challenge remains, however: ensuring that these reforms and their improvements stay in place, resisting political reversals over the time. Currently, no mechanisms guarantee the durability of the reforms or the permanence of the positive changes achieved.

BACKGROUND

In the 1990s, after the break-up of the Soviet Union, Russia under President Boris Yeltsin enacted many market reforms, including, most prominently, privatizing state-owned enterprises and freeing prices. During the same period, Yeltsin famously encouraged regional governments to “take as much sovereignty as you can handle!” However, tax policy allowed for very little fiscal autonomy over official tax bases and rates.

While the Yeltsin administration declared its support for regulatory reform and removal of administrative barriers to investment, its various presidential decrees were sporadic, haphazard, and generally went unenforced. The federal bureaucracy, headed by a series of prime ministers, was not well coordinated and had little effective control over the subnational governments (regional and local), each of which had their own requirements for business registration, licensing, inspections, and product standards (see Box A2.1). Differing “quality standards” acted as effective protectionist measures impeding trade between regions, while licensing and registration requirements were regularly abused for rent-seeking.

Although the official tax regime allowed for little formal autonomy at the subnational level, Mikesell (2007) described fiscal administration as follows:

In the early transition years, dual subordination in tax administration was a significant concern in Russia and other countries of the former Soviet Union: while tax inspectors were organizationally part of the central government … the field staff had considerable loyalty to local authorities because those authorities provided office space, heat, supplies, and other amenities, if not salaries or salary supplements and it was common for regional authorities to have the right to approve appointments of regional administrators of the central tax authority. This created administrative and financial problems. In this period, not all tax liabilities were collected and not all collections were in live cash, as opposed to payment in kind. Divided loyalties brought subnational budgets favored treatment. Regional and local governments got cash; the central government got payment in kind [from businesses] that could be valued at whatever amount the collection authority chose.101

After the financial crisis of 1998, the Ministry of Finance began a series of tax reforms to overhaul the tax code, while the Ministry of Economic Development and Trade began work on legislation to reform company registration, licensing, and inspections. Investment Climate teams of the World Bank Group were invited by the Federal Antimonopoly Service of Russia and several regional governments to undertake a study of administrative barriers to investment (covering barriers from all

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100 This case study was written by Jacqueline Coolidge, Investment Climate Advisory Services of the World Bank Group.
101 Mikesell 2007, 44–45.
Box A2.1. Tax and Administrative Barriers to Investment in the Russian Federation, 2000

Registration procedures included company registration along with registration for tax, four different “social funds,” the statistical agency, local authorities, and (for most joint-stock companies) anti-monopoly clearance and the securities commission. Procedures were opaque, complex, and cumbersome. Several agencies, such the securities commission, were said to point applicants to a specific “affiliated consulting firm” that would assist the company to prepare the application in the “right way”—for a hefty fee (which would in turn be shared with agency officials).

Although an earlier licensing reform (1998) had attempted to limit licensing to a (rather lengthy and sometimes vague) “negative list,” procedures were still complex and duplicative. The validity of licenses was typically one year only. Fees were opaque and often seemed discretionary. Licenses issued in one region would often not be valid in other regions, and they were sometimes used for protectionist purposes.

A famous story in the annals of administrative barriers described how fire-safety inspectors from different levels of government had contradicting rules about how high up the wall a fire-extinguisher should be placed, such that businesses installed two hooks and moved the fire extinguisher depending on which inspector was knocking on the door.

As of 2000, businesses could be subject to over 30 different taxes (excluding taxes associated with oil, gas, and minerals extraction). The four “social taxes” on payroll were all calculated on different bases and were payable at separate locations.

One district tax official, describing the pre-reform tax code, said “Our tax system is very complex. It is impossible to avoid mistakes. When we find a mistake, we can assess fines and penalty interest, which are compounded over time. We can take a healthy company and drive it right into bankruptcy!”

Source: Authors.

levels of government). The resulting study documented severe problems of bureaucratic delay and harassment, including cronyism and an unlevel playing field, with substantial differences across regions.

The results of the World Bank Group Administrative Barriers Study\textsuperscript{102} were taken up by the Ministry of Economic Development and Trade as input to help it design a series of reforms, the most important of which were new federal legislation on inspections (late 2001), licensing (2002), and company registration (2002 and 2004). The reforms were designed to mitigate the burden on entrepreneurs, reduce the number of licenses and inspections imposed on business, streamline registration and licensing procedures, and put control over all such procedures under the federal government, stripping authority for these areas—including fees—from subnational governments.

Meanwhile, the overhaul of the tax code, between 1999 and 2002 consolidated taxes, streamlined tax calculation and filing procedures and lowered tax rates. A separate set of reforms were enacted in the area of “fiscal federalism,” in part to correct the serious lack of fiscal autonomy at the subnational level (and at the same time rein in the excessive administrative autonomy of tax officials at the subnational level). However, a strong tendency remained for fiscal federal relations to “crowd out” changes in own revenue through changes in shared revenue and transfers. Subnational governments with a “surplus” of revenues (including Moscow, St. Petersburg, and a number of resource-rich regions) were required to make net transfers to the central government, while those with a deficit between their spending obligations and their own revenues received net transfers, subject to negotiation.

Such a system deprived most subnational governments of any incentive to expand their own tax base by encouraging private investment. Empirical evidence in Russia showed the following:

\textsuperscript{102} FIAS 2001, 361.
Firstly, fiscal incentives of local politicians in Russia are very weak; indeed, on average, they are nonexistent, since changes in own revenues are almost entirely offset by changes in shared revenues. Secondly, [the empirical evidence shows that] the number of businesses formed depends positively on the strength of fiscal incentives [to rely on own revenues]. And thirdly, the strength of fiscal incentives [to rely on own revenues] positively affects the efficiency of public spending.\textsuperscript{103}

REGULATORY REFORMS

The reforms of 2001–2004 were quite sweeping in their scope and included measurable targets for specific regulatory burdens. In addition to centralizing control and stripping powers from subnational governments, the laws included the following provisions:

- \textit{Inspections reform (August 2001)}: Inspecting agencies are allowed a maximum of one “regular” (planned) inspection every two years for an individual firm; in cases where violations are found, the inspector is required to write a formal notice, levy an official fine (depending on the severity of the infraction), and return to confirm correction of the violation; in cases where no violations are found, this must also be recorded, and the next regular inspection cannot take place for another two years.

- \textit{Licensing reform (February 2002)}: The list of activities requiring licenses was reduced from about 250 to just over 100; the duration of license validity was increased to a minimum of 3 to 5 years (previously a one-year duration had been the most common).

- \textit{Registration reform (July 2002 and January 2004)}: The first reform set a maximum of 5 working days for processing of a correctly completed application; the second reform mandated the establishment of “one-stop shop” registration (at the local branch of the federal tax administration) and included a set list of documents for the registration process.

In practice, the reforms were not implemented thoroughly and comprehensively in all jurisdictions, and “enforcement” of implementation by the federal authorities was often weak. As a result, anecdotal evidence suggested that some regional and local governments made significant efforts to ensure sound implementation of the reforms, while others dragged their heels or actively resisted the reforms. (These responses are discussed more fully below.)

FISCAL FEDERAL REFORMS

Russia has been through many tax reforms, with a very strong degree of formal central control during the mid-late 1990s and a somewhat improved degree of own revenue for regional and local governments after 2002. As of 2006, the central government still sets all parameters for the definition of the base of each tax\textsuperscript{104} and collects and administers all taxes at all levels.\textsuperscript{105} Regional and local governments have authority to set tax rates (within specified bands) and have 100 percent assignment of the revenues from the following taxes:

- Regional taxes:
  - Enterprise property tax
  - Transport tax
  - Tax on gambling businesses
- Local taxes:\textsuperscript{106}
  - Personal property tax
  - Land tax

\textsuperscript{103} Zhuravskaya 2000.
\textsuperscript{104} De Silva et. al 2009, 64.
\textsuperscript{105} Mikesell 2007.
\textsuperscript{106} These taxes are assigned to the lowest, “settlement” level of local government.
The tax revenues that are assigned 100 percent to the federal government are as follows:

- Federal taxes
  - Value-added tax
  - Single social tax
  - Excise taxes (other than those for alcohol and fuel)
  - Mineral resource extraction tax (for natural gas)
  - Water assessments

All other taxes are federal in terms of both base and rate authority, although revenues from some taxes are shared with subnational governments. Federal taxes with shared revenue assignment are shown in Table A2.1.

The share of revenues out of total consolidated revenues was estimated as follows:107

- Regional: 38 percent (of which 60 percent is under limited regional control of rates)
- Local: 8 percent (of which 10 percent is under limited local control of rates)

Most importantly, the revenue structure of regional and local governments varies greatly across Russia, with averages as shown in Table A2.2.108

The more important point is that the averages conceal huge disparities across regions, with several regions providing net transfers to the federal government and the rest receiving net transfers (which are often inadequate to cover all mandated expenditures).

**IMPACT OF REFORMS**

At the outset of the reform process, Ministry of Economic Development commissioned a series of business surveys of 2000 small and medium enterprises in 20 regions (including both panel data for licensing and inspections reforms and targeted samples of new businesses to capture reforms related to company registration). These were undertaken starting in early 2002 and repeated five more times, ending in the fall of 2006, to monitor the impact of the reforms.109

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108 Ibid., 70.
The subsequent analysis of the reforms, based on survey data, shows clearly that implementation of reforms has been very uneven across regions and that regions implementing the reforms most thoroughly were those least dependent on shared revenues and transfers from the federal government.

Their overall conclusions are that:

On average, the reform reduced de facto regulations only to a small extent; reform had differential effect across regions; reform progress was better in regions with transparent government, low corruption, independent media, powerful industrial lobby, and stronger fiscal autonomy. \(^{110}\) We find some evidence that reform boosted entry of small businesses and their employment and had no effect on pollution or public health.

The analysis of the survey data took advantage of the differential timing of each of the reforms and the opportunity to measure the level of violation of the objective “targets” specified in the reform legislation (as described above):

- Number of agencies required for registration
- Number of days for registration
- Number of inspections
- Number of illegitimate licenses imposed on businesses
- Term of license validity

The analysis also included, as explanatory variables, measures of the following:

- Government transparency
- Control over corruption

\(^{110}\) Specifically through natural resources or the strong fiscal base of large urban areas.
Local access to independent media sources
Strength of local industrial lobby
Strength of fiscal incentives of regional governments (share of own tax revenue in the regional budget)

Disappointingly, the analysis of the survey data found that the average impact of the reforms overall was rather small: “We find that the reform caused a statistically significant albeit not terribly large improvement in the average regulatory burden.”

More striking were their findings on the variations across regions. The analysis first considered survey evidence on the “enforcement” of the reforms across regions (for example, the degree to which “one-stop shops” were actually available for applicants and whether the applications were processed within the stipulated five days, whether businesses reported being subjected to “illegal licenses” or to licenses with a validity of less than three years, and whether they were subjected to inspections more frequently than stipulated by law).

When considering new businesses, the analysis confirmed that “fiscal incentives” (defined by the paper as regions with secure “own revenue” and not dependent on transfers) significantly affect reform progress “in reducing the number of windows for registration,” but not necessarily in reducing the number of days required for registration.

For established firms, the fiscal incentives “significantly improve the enforcement of reforms in limiting the number of sanitary inspections” but not necessarily for the number of illegitimate licenses or their term of validity.

More generally, “The difference in reform progress between the best and worst regions in terms of . . . fiscal incentives . . . is between 6 to 7 percentage points of the share of violations of reform targets. . . .”

As a second step, the analysis considered data on impacts measured as follows:

- Number of (active) small businesses
- Number of employees in the small business sector (per capita)
- Air pollution (measured emissions)
- Public health (morbidity from injuries and poisoning per 1000 people)

More specifically, the analysis considered the relationship between the level of de facto implementation of the reforms and the measures of impact listed above. The analysis of the data:

yield statistically significant negative effects of . . . the share of firms with frequent sanitary inspections on net entry [of new small businesses]. . . . In addition, the share of firms that had to visit more than one agency in order to register and the share of firms with frequent sanitary inspections in a region have a significant negative effect on small business employment as a share of population.

The opposite is equally true: regions where businesses can reliably register at a one-stop shop (instead of having to visit multiple agencies) and where businesses are reliably protected from unnecessary inspections are regions more conducive to the expansion of new small businesses and associated with higher levels of employment in small businesses.

111 Yakovlev and Zhuravskaya 2009, 17.
112 Ibid., 21.
113 Ibid.
114 Ibid., 18.
At the same time, the data confirm that deregulation has not had any noticeable effect on levels of air pollution or morbidity due to injuries or food poisoning.

It is important to note that the motivations, across many different interacting parties, to support or resist reform are very complex. The fiscal reforms in Russia were initially spurred by the 1998 financial crisis. The regulatory reforms, which centralized control over business licensing, registration, and inspections (as well as product certification) were supported by Vladimir Putin, who was very anxious to “rein in the regions” and stop the centrifugal forces that threatened to weaken the central government.

In reaction to the reforms (which deprived local governments of fee revenue and also deprived officials of many rent-seeking opportunities), many local governments tried to take advantage of the one strong lever they had remaining for control over the private sector: their ownership (or control) over the majority of land available for commercial and industrial activity. As they lost control over business regulations, they began to exploit their powers as (near) monopolist landlords, including offering favorable lease terms to “cronies” and much worse terms for potential competitors.

In this context, land reform in Russia had a close connection with both regulatory and tax reforms affecting private business. While the federal government pushed privatization of land (again to avoid the threats of alternative sources of concentrated political power building up in various regions), local governments complained about the loss of revenue from rental income. This situation in turn led to the decision to give local governments 100 percent of the revenues from land taxes (which had previously been shared with higher levels of government).116

Unfortunately, such land taxes are still less than 3 percent of the budgets for local governments (on average) while “own nontax revenue” (including entrepreneurial activity) provide over 12.5 percent of their budgets. The land taxes lack buoyancy, because relatively few jurisdictions have the capacity yet for market-valuations of the tax base and rely instead on administrative valuation (for example, formulae for the area of the property and floor-space, general location, and type of building). In cases where local governments’ “entrepreneurial activity” competes with private businesses (either in the markets for goods/services or for factors of production such as land, labor, and capital), the incentives do not appear strong enough to incentivize a good investment climate at that level of government.

Meanwhile, other recent analyses of fiscal federalism in Russia argue that “rentier regions” (those with major revenues deriving from oil/gas or mineral extraction) appear to result in “excessive centralization of regional government spending” vis-à-vis local levels of government. For nonrentier regions, “a 10 percent point increase in the share of federal transfers in the regional revenue is associated with a 3 percent decrease in the degree of fiscal decentralization” at the local level.117 Conversely, higher levels of fiscal decentralization are associated with improved quality of municipal utilities.118

The analysis suggests that it may be beneficial for Russia to expand the possibilities for subnational governments to develop “own-source” revenue (including further devolution of taxing power down to the local level), which in turn may help encourage such governments to improve their investment climates. The expansion of the tax base should then allow for improved revenue performance and an ability to finance improved public services.

At a minimum, local governments must build capacity for market valuation of land, which should improve revenue buoyancy and increase fairness. Other possibilities to consider would be to shift the federal government’s share of taxes on small businesses (both the “simplified tax” and the “single tax on imputed income”) as well as those on agricultural enterprises to the local and regional levels. Such a reform would enhance the incentive for subregional governments to support reforms that would improve the potential for growth led by private sector and help to deter corruption.

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117 Freinkman and Plekhanov 2008.
118 Freinkman and Plekhanov 2009.
Appendix 3. China: Turning Fees into Taxes

China started with a fiscal model in the 1950s, quite similar to that of the Soviet Union that relied heavily on the “profits” from state-owned enterprises and allowed almost no fiscal autonomy for local governments. The economic reforms in China that started in the 1980s included a divergent fiscal path, however, one that resulted in quite high levels of fiscal autonomy at the subnational level. In fact, for a period of time, the central government found itself starved of resources and in need of clawing back revenues from subnational governments, which in turn resorted to “extra-budgetary” sources of revenue to make up the difference. These revenue sources were generally opaque and often extremely burdensome for most small businesses, a problem which has apparently abated somewhat in recent years (Wong and Bird 2005), but in any event they cannot be said to have held back overall economic growth.

Jin, Qian, and Weingast (1999) provided a favorable analysis of the “market-preserving” fiscal federalism in China, finding that there were “strong correlations between local government revenue collection and local government expenditure . . . . We also find that stronger fiscal incentives—measured in terms of higher marginal revenue retention rate—implies [sic] faster development of non-state enterprises and more reform in state-owned enterprises.”

Jin et al. (1999) report that before the market-opening reforms, “the shares of local government expenditures in total government expenditures were 46% for 1971–75 and 50% for 1976–80. After the reform, the shares were 51% for 1981–85 and 60% for 1986–90.” But taking into account price subsidies, the share for the latter period is closer to 50 percent.

A major fiscal reform in 1994 was designed in large part to “recentralize” the fiscal system, as well as to modernize it to improve efficiency. Wong and Bird (2005) note that during the 1980s, the Soviet-style turnover taxes created unsustainable distortions. “Local governments [and their associated enterprises] seeking to maximize revenues would choose to enter sectors where the sum of profits and tax rates was above average even if profit rates were expected to be low or even negative.” These were replaced with a VAT system for manufacturing, a business tax on services, and excise taxes. The new VAT greatly mitigated the “undesirable allocative effect of turnover taxes.”

The new tax-sharing system moved the fiscal system away from negotiated revenue sharing to a mix of tax assignments and tax sharing between different levels of government. The VAT, in particular, became a shared tax with 75 percent of the revenues assigned to the central government (which meant that over half of all revenues now went to the central government).

There are three categories of public sector revenues in China: budgetary funds, extra-budgetary funds (EBF), and “self-raised funds,” which include various fees, user fees, and surcharges (the definitions for “extra-budgetary funds” and “self-raised funds” overlapped considerably).

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119 This case study was written by Jacqueline Coolidge, Investment Climate Advisory Services of the World Bank Group.
120 Jin, Qian, and Weingast 1999, 1.
121 Ibid., 11–12.
122 Wong and Bird 2005, 6.
123 Ibid.
REVENUE ASSIGNMENTS BETWEEN CENTRAL AND SUBNATIONAL GOVERNMENTS

Taxes Exclusively Assigned to the Central Government

- Excise taxes
- Taxes collected from headquarters of railroads, banks, and insurance companies
- Income taxes, sales taxes, and royalties from offshore oil
- Energy and transportation fund contribution
- 70 percent of three sales taxes from certain state-owned enterprises, including power, petrochemicals, and nonferrous metals
- All customs duty, VAT, and excise taxes on imports
- Enterprise income tax collected from banks and other financial institutions

Taxes Shared Between the Central and Local Governments

- Value-added tax (75 percent central, 25 percent provincial)
- Natural resource taxes (coal, gas, oil, and other minerals from domestic enterprises)
- Construction tax (outside state planned)
- Salt tax
- Industrial and commercial tax, and income tax levied on foreign and joint venture enterprises
- Security and exchange tax (50 percent central, 50 percent provincial)
- Enterprise income tax
- Personal income tax

Taxes Exclusively Assigned to Local Governments

- Business (gross receipts) tax falling on sectors not covered by VAT
- Rural market (stall rental) trading tax
- Urban maintenance and construction tax (surcharge on business tax, excise, and VAT)
- Urban land-use tax
- Vehicle and vessel utilization tax
- 30 percent of three sales taxes from certain state-owned enterprises, including power, petrochemicals, and nonferrous metals
- Value-added tax on land
- Education surtax
- Entertainment and slaughter taxes
- Property tax
- Surtax on collective enterprises
- Resources tax
- Fines for delinquent taxes

The tax-sharing system helped encourage commerce and trade, and it also allowed for much greater disparities between regions, since revenue-rich regions were allowed to keep more of their own revenues. However, under the tax-sharing system and the more centralized system, all regions (including the wealthiest) depended

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124 Wong and Bird 2005, 8.
at least to some degree on central transfers to finance required expenditures. This in turn led to increasing fiscal deficits for local governments, and they therefore turned to various EBF and “self-raised funds” to meet their needs.

Until 2005, the VAT system was in fact not a true destination-based consumption tax, but more of an origin-based production tax that (among other problems) penalized investment. This was mostly rectified starting in 2005, first in a few pilot provinces and later rolled out throughout the rest of the country. The enterprise income tax allows for many tax preferences and “is usually paid exclusively in the jurisdiction where the headquarters of the enterprise are located.”

Officially, local governments have no true tax autonomy: “all ‘local’ taxes are assigned, with both rates and bases set by the central government.” However, tax administration is very decentralized. This proved to be very inefficient, as collection costs were estimated at 3–4 percent of revenues “and as high as 10 percent or more in some localities.” Meanwhile, the local governments felt the need to squeeze as much revenue as possible from other sources, including business fees, which became very burdensome. A nation-wide audit found that the EBF amounted to “about 50 percent higher than the reported figures and equal to 6 percent of GDP.” Later estimates went up to 15 percent of GDP, but between murky definitions and the lack of incentives to report such figures, the actual shares may be even higher.

Wong and Bird explain as follows:

Two common types of EBF are found in the world: (1) Special accounts segregated from the budget and intended for carrying out a specific activity, or to benefit a specific agency. These accounts are often organized as funds or as self-balancing accounting entities. (2) Revenues raised outside the budget framework by administrative units as well as off-budget payments by the Treasury, the central bank, or any other organization which has authority over public money. Type 1 EBF are earmarked funds that are protected from annual budgetary deliberations. Type 2 EBF are nonbudgetary revenues of branches of government. Type 1 are thus extra-budgetary by use and Type 2 by source. … EBF in China are extra-budgetary by both source and by use. …The primary motivation for the development of EBF in China, especially at the subnational level, has clearly been revenue enhancement rather than earmarking. … While most EBF have legal authorization from some level of government or branch, these decrees usually lack specificity and rarely contain detailed criteria for the use of funds. Many are internal documents known only to the relevant authorities.

The administration of the EBF was even more inefficient than taxes. According to Wong and Bird, “surveys by the State Tax Administration show that collection costs can absorb as much as 30 percent of revenues collected.” Nevertheless, local governments prefer the fees and levies to taxes “because they confer more discretionary power to lower level agents” and are obviously prone to abuse.

Thus, in 1998, Premier Zhu Rongi launched a campaign against luanshoufei (reckless collection of fees) and pushed a program to feigaishui (convert fees into taxes).

This turned out to be a slow process. As of 2000, a survey of more than 3,000 private entrepreneurs in China showed that half of respondents expressed substantial grievances about the administration of such fees:

Fees in China are entirely different from use-charges and they may be better understood as quasi-taxes. They are levied by many different bureaucratic agencies and tend to be negotiable. Local governments in

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125 Ibid., 14.
126 Ibid.
127 Ibid.
128 Ibid., 15.
129 Ibid., 17–18.
130 Ibid., 20.
131 Ibid., 22. Others have noted that the discretion allowed subnational governments to avoid the slow and cumbersome bureaucracy in financing urgent infrastructure priorities.
China have considerable discretion in establishing the nature and size of fees to be paid by enterprises under their jurisdiction. This system of fee extraction by local government agencies can generate several problems, including high levels of fee extraction, uncertainty about the amount of fee payment, and high costs in bargaining to lower the fee.132

Inevitably, businesses with a better bargaining position receive better treatment. They may be excused from many fees or may receive preferential access to public resources (including user rights to land as well as loans from state-owned banks) in return for fees, while smaller businesses are forced to pay high fees and are still put at the end of the queue for access to public resources.

Local-level fees can proliferate, and “although in principle the fees should be approved either by the central or provincial governments, in reality this principle is often ignored” or hard to enforce.133 Choi’s article reports the following:

[I]n 1999, the central government abolished 31,710 types of fees imposed on enterprises [and] . . . in 2001, the central government abolished 33, 456 types of fees on enterprises, but [it] has been unable to stop all new license fees introduced by local governments. . . .The autonomy of local governments in fee collection contrasts with their lack of authority in deciding the types and rates of local taxes. . . . For example, the Industrial and Commercial Bureau authorizes business licenses and renews them annually, making it relatively easy for the Bureau to collect fees. The Bureau can simply revoke firms’ business licenses if they do not comply with fee payment requests. Not surprisingly, the Bureau collects various fees from firms, including management fees, which are levied as a certain percentage of sales revenues. . . . A former head of the Bureau at a county-level city in Zhejiang told me in February 2008 that his Bureau had around 200 officials and that every official had responsibility for collecting fees from firms.134

According to Choi’s analysis of the survey data, while the average ratio of fees to revenue for businesses was only a bit over one percent, the range was from 0–10 percent, with the smallest businesses paying the highest proportion of their revenues in fees and the largest businesses paying the lowest.135 Further, “the level of fees paid by private enterprises in the richer coastal provinces was six percent lower than those in inland provinces. This supports the argument that the fiscal distress of local governments leads to heavier fee extraction.”136

While the problem of local level fees has reportedly improved in more recent years with the rapid economic growth in China, it is likely that the wealthier provinces (which have also enjoyed the highest growth rates) have reformed to a greater extent than the poorer inland provinces. The central government has pushed reforms. Choi quotes an official from Zhejiang: “Now it is not allowed for local government officials to undertake cash transactions for payments of more than 1,000 yuan,” which limits the discretion and therefore the motivation for local officials to pursue fee revenues.137

In addition, the central and provincial governments have taken steps to level the playing field by forcing local governments to abolish (at least officially) the practice of designating certain companies for “protection” from fees. Choi quotes an official of the Sichuan provincial government:

This practice had positive effects in a specific time. But this fundamentally violates the principle of competition on a level ground because only a small number of firms obtain benefits from this practice. Therefore, the Sichuan government has abolished this practice and promulgates a new policy. From now on, we will make

132 Choi 2009, 80.
133 Ibid., 84.
134 Ibid., 84–86.
135 Ibid., 94.
136 Ibid., 96.
137 Ibid., 100.
public all types of fees. If government officials collect fees arbitrarily, they will be punished by law. (Chenshi zaobao [City Morning Newspaper], 10 June 2002) 

Choi, however, notes that “local officials are potential losers and could be powerful enough to render reforms ineffective. . . . [S]uccessful fees revenue management reforms may be hard to achieve in poor regions” where they still face fiscal distress. 

An important way around the new restrictions on fees has been for “public service units” to convert “nonproductive” land into commercial ventures, including in many cases what is in reality productive agricultural land near cities, with monopoly rents assigned to the public service units, “in lieu of or as supplements to budgetary appropriations.” This is a problem that appears to have persisted over time, even as abuse of “fees” has subsided. It is likely related to the protests of poor households, peasants, and owners of small businesses who have been displaced in favor of new “industrial and commercial” land for better connected, large-scale business interests.

While poor regions may feel more “need” to resort to such measures, greed may continue to motivate those in the wealthier provinces to take advantage of these opportunities. Thus in China as well as other countries, the relationship between local fiscal reform and license reform drags the issue of businesses’ access to land into the mix and points in the direction of land taxes as an important component of local government revenue reform.

138 Cited in Choi 2009, 100.
139 Ibid.
140 Wong and Bird 2005, 26.
This note briefly presents the background and observed effects of a recent reform in Kenya to consolidate multiple regulatory and revenue instruments issued by local authorities.\footnote{This case study was written by Lars Grava, Jacqueline Coolidge, and Laurent Corthay, Investment Climate Advisory Services of the World Bank Group.}

**SUMMARY**

The single business permit (SBP), introduced in Kenya in 1999, was de facto a presumptive tax that became an important own-source revenue for local authorities. It was aimed at replacing multiple licensing requirements and simplifying the local revenue and regulatory system.\footnote{The note relies on the sources listed in bibliography, as well as on discussions and interviews undertaken in the context of the Kenya Regulatory Performance and Capacity-Building Project implemented by the Investment Climate Advisory Services of the World Bank Group.} However, it did not achieve its objective of reducing the administrative burden imposed on businesses, as many of the licenses it was designed to replace were never in fact repealed, fees remained high, and the “categories” often remained subject to negotiation.

**THE PURPOSE OF THE SINGLE BUSINESS PERMIT**

In Kenya, by the late 1990s, the business licensing system had become very unsatisfactory. The license fee schedule was determined for each municipality through negotiation with central government, but the fees set for different businesses bore no relation to their relative ability to pay. In order to obtain a license, businesses had to meet a number of preconditions, such as obtaining a health clearance certificate. This could be a time-consuming process, with ample opportunities for rent-seeking on the part of the officials concerned. Moreover, businesses were often required to have multiple licenses, including in many cases licenses from both the local and central government. There was huge dissatisfaction with the system among business.\footnote{Kelly and Devas 1999.}

The situation of the Kenyan local authorities was characterized by a high level of informal economic activity, inadequate local government revenues, and poor regulatory governance, leading to a proliferation of licenses, fees, and burdens on both formal and informal businesses. Well over 1,300 different licenses and permits have been documented, of which the majority are administered by the local level.

Still, local governments were strapped for income, and they were largely dependent on the revenues from licenses. Thus in 1999, the government of Kenya established the “Local Authorities Transfer Fund,” which was intended to transfer five percent of income tax revenues from the national government to the local authorities, following a published formula.\footnote{Blore et al. 2004, 48.}

The new 2010 constitution creates 47 “counties,” which are supposed to receive at least 15 percent of central government own revenues.
To address this proliferation of licenses at the subnational level, the Government of Kenya introduced the SBP in all local authorities. The principles and objectives of the SBP included *simplification* (removing multiple and overlapping licenses, self-declaration by applicants, and uniform standards across local authorities), *local accountability* (the Minister for Local Government “pre-approved” the fee schedule but each local authority chose appropriate rates), *local control and planning* (to generate information needed by the local authority for planning, regulation, and improved service), *transparency* (to reduce rent-seeking opportunities; also local authorities were allowed to revoke the SBP only at the written request of a regulatory agent [for example, a health officer], stating that the business had violated a regulatory condition), and *revenue generation* by each local authority. It is important to note that already, by design, the SBP was envisaged as both a regulatory and a revenue instrument.

Consequently, the revised Local Government Act provided:

A single business permit means a permit issued in respect of a class of business activities in lieu of the separate licenses which would otherwise require to be issued in respect of each activity. (Cap 265, Section 2 revised)

The SBP was introduced by the permanent secretary for the Ministry of Local Government and incrementally adopted in local authorities nationwide starting in 1999. It was to be a requirement for all businesses seeking to conduct business or trade, including a profession or occupation, within a local authority’s jurisdiction; valid for one year, it was renewable annually.

**REVENUE IMPACTS OF THE SINGLE BUSINESS PERMIT**

When local governments introduced the SBP in 1999–2000, it became the third-most important source of revenue after the Local Authority Transfer Fund (from the national government) and property-based collections. According to one source, the SBP represented a significant average of 15.9 percent of all locally generated revenues (pre-SBP revenue from licenses was 7 percent) and 11.6 percent of total revenue generated by local authorities (including all revenues collected from within the local authority’s area of jurisdiction and funds realized from local area transfer funds and other external sources) (Pinnacle 2006).

Recent information shows a detailed breakdown of major revenue sources for local authorities. While the numbers for SBP for 2007–08 do not entirely match Pinnacle’s 2006 information, the message remains consistent: the SBP is the third-largest source of revenue for local authorities and comprises a substantial portion of their total revenue (see Table A4.1). However, there is also wide variation across jurisdictions (see Figure A4.1, based on the newly established counties).

**PROBLEMS ENCOUNTERED BY BUSINESSES FOLLOWING INTRODUCTION OF SBP**

Even with the introduction of the SBP, the administrative burden on businesses is still perceived as onerous. It was recently cited by businesses as one of the main regulatory deterrents to business activity at the local level. The Government of Kenya’s Working Committee on Regulatory Reforms for Business Activity in Kenya (2007) noted that:

The single business permit is the most troublesome of all local government licenses. The system of implementation of the single business permit by local authorities is not procedural; furthermore, the enforcement system adopted by the local authorities is crude. Fundamentally, the single business permit has not been de-linked from other licenses.147

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147 Musau 2007, 13.
While business in the formal sector faced continued high administrative and financial costs under the SBP, they have also been exposed and subjected to various other licenses, charges, and fees that should have been consolidated into the permit in 1999–2000. Advertising licenses are seen as the most intrusive of these, while local authorities in Kenya still rely on production (especially in the agricultural sector), transport, and market cesses as output taxes collected at the time of sale or transit.

Businesses further complained that the local authorities tended to select a higher range of “bands” to maximize revenue in the short term (Pinnacle 2006).

Although the tariff structure was intended to be progressive, allowing smaller businesses to pay less than larger ones, the large number of bands greatly increased the complexity of administration. For example, Nairobi City Council had different fees for more than 80 different economic activities, ranging from “small informal sector trade service provider” (K Sh 2000 per annum) to “large high-standard lodging house/hotel” (K Sh 100,000 per annum), with distinctions among large, medium, and small economic actors. The complex structure created ample opportunities for negotiation of the terms (for example, for a hotel that also has a restaurant, bar, and/or retail shop). Definitions were intended to be based on objective criteria, such as floor space or numbers of employees or vehicles, but many arguments still arose over whether businesses were “hiding” workers or vehicles or claiming floor space was used for household rather than business purposes. In addition, the SBP was not always used for its intended function—some local authorities impose the SBP merely for transporting goods through the local authority’s territory for distribution elsewhere.

The application of the SBP was not done even-handedly. While an increase in a business’s economic activity could lead to an increase in the fee category during the annual SBP renewal, reduced economic activity did not lead to a reduction in the SBP fee. The timing of annual payments was deemed to be rigid, and some businesses actually benefited based on the month they started businesses (for example, later in the year) (Musau 2007).

### Table A4.1. Aggregate Revenue Sources for Kenya Local Authorities

<table>
<thead>
<tr>
<th>REVENUE SOURCE</th>
<th>07/08 K SH MILLIONS</th>
<th>% CONTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Authority Transfer Fund</td>
<td>8,232</td>
<td>35.13%</td>
</tr>
<tr>
<td>Road Maintenance Levy Fund</td>
<td>1,485</td>
<td>6.34%</td>
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<tr>
<td>Subtotal Central Government Transfers</td>
<td>9,716</td>
<td>41.46%</td>
</tr>
<tr>
<td>Property Rates</td>
<td>3,067</td>
<td>13.09%</td>
</tr>
<tr>
<td>Single Business Permit</td>
<td>2,232</td>
<td>9.53%</td>
</tr>
<tr>
<td>Vehicle Parking</td>
<td>1,452</td>
<td>6.20%</td>
</tr>
<tr>
<td>Market Fees</td>
<td>1,092</td>
<td>4.66%</td>
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<tr>
<td>Game Park Fees</td>
<td>884</td>
<td>3.77%</td>
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<td>Cess Receipts</td>
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<tr>
<td>Water &amp; Sewerage Fees</td>
<td>392</td>
<td>1.67%</td>
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<tr>
<td>CILOR (contribution in lieu of rates)</td>
<td>327</td>
<td>1.40%</td>
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<td>Plot Rents</td>
<td>198</td>
<td>0.84%</td>
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<tr>
<td>House Rents</td>
<td>160</td>
<td>0.68%</td>
</tr>
<tr>
<td>Others (various fees, permits and charges)</td>
<td>3,157</td>
<td>13.47%</td>
</tr>
<tr>
<td>Subtotal Local Authority Revenues*</td>
<td>13,716</td>
<td>58.54%</td>
</tr>
<tr>
<td>Total Central and Local</td>
<td>23,432</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

* According to information provided by the Local Government Reform Programme, this figure varies widely across local authorities, with the City Council of Nairobi at one extreme having a percentage of 71.7 percent and the lowest local authority revenue at 26 percent.

Source: Kenya Local Government Reform Programme.
Figure A4.1. Revenues in K Shs Per Person, Based on 2008/09 Figures

THE LICENSING GUILLOTINE

Thus, on the advice of the World Bank Group, on 24 February 2005, the Kenyan Ministry of Finance issued a circular to 178 ministries and public bodies throughout the public sector. The circular, titled “Streamlining the Regulatory Environment for Business Activity,” launched licensing reform and established the Working Committee on Regulatory Reforms for Business Activity in Kenya to carry it out.

The mandate of the committee’s work was to carry out a comprehensive review of all business licenses and fees in Kenya and to develop recommendations on how to assure that the results of the licensing reform would not be undermined by a wave of new licenses.

Over two years, the committee carried out most of the research needed to identify and analyze 1,325 licenses. It worked with more than 240 regulators to help them comply with the circular issued by the government, and it brought substantial additional expertise into the reform process by involving sector and other experts to carry out more detailed reviews of licenses in certain sectors (tourism, agriculture, local government, and environment).

As of October 2007, results of the licensing reform were:

- 315 licenses eliminated
- 379 licenses simplified
- 294 licenses retained

Out of the remaining licenses, approximately 300 licenses have been deferred due to new bills under preparation or new laws already passed, and 25 were reclassified and not counted as licenses.

Reforms adopted in late 2008 included recognition that a SBP issued in one local government should be valid across all local authorities in Kenya (not yet comprehensively enforced), and the bands for the SBP have been reduced from 16 to 10. Investment Climate teams of the World Bank Group estimate that such reductions in administrative and direct financial costs imposed on businesses nationwide may lead to cost savings for businesses of approximately $12 million per year, or a reduction of 18 percent of the administrative compliance cost now imposed on businesses. Calculated using a modified version of the Standard Cost Model. See Jacobs & Associates 2008. The impact on short- and long-term revenue for local authorities is still to be determined.

According to a spring 2010 survey of a representative sample of formal businesses in Nairobi, Mombasa, and four other towns in Kenya, the average formal sector business (that is, one registered for taxes with the Kenya Revenue Authority) had three licenses and/or permits, most of which had to be renewed annually. The annual financial cost of obtaining or renewing such licenses and permits averaged about $1,000, plus an average of 30 work-days’ time for the entrepreneur or his/her staff. A particular irritation for businesses are “advertising licenses,” which are imposed not only for billboards, but also for signs on the outside of buildings, including small signs above or next to street entrances. These were recommended for elimination, but are still in force.

In Nairobi, in particular, businesses complain that the SBP is enforced unfairly and is subject to corruption. The categories for sector and size (and the different fees associated with them) are widely claimed to be subject to negotiation. According to the survey evidence, the transport sector and restaurants have the most problems in this regard.

Unfortunately, the reforms apparently stalled in the aftermath of the disputed presidential election at the end of 2007, and in some respects they may have faced some reversals. The majority of businesses surveyed perceived either no improvement over the previous two years or even a worsening of the situation as indicated

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148 Jacobs et al. 2007.
150 World Bank Group Investment Climate Advisory Services, forthcoming.

Appendix 4. Kenya: Merging Multiple Local Regulatory and Revenue Instruments
by responses to the question: “Compared to two years ago, would you say that the burden associated with obtaining/renewing various licenses and permits has increased, remained the same, or decreased?”

<table>
<thead>
<tr>
<th>Table A4.2. Survey Responses to Question on Progress of Licensing Reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>PERCENT RESPONDING REGARDING BURDEN</td>
</tr>
<tr>
<td>-------------------------------------</td>
</tr>
<tr>
<td>Increased</td>
</tr>
<tr>
<td>Remained the same</td>
</tr>
<tr>
<td>Decreased</td>
</tr>
</tbody>
</table>


Kenyan businesses have also complained about coercive enforcement and rent-seeking by local officials, which further fostered resistance to fee payment and encouraged evasion. A well-known, if somewhat anecdotal, situation is the alleged propensity of some local authorities to seek out regulatory infractions on business premises on Friday afternoons, thereby necessitating bribes if the business owner did not wish to spend the weekend in prison awaiting a court hearing on Monday.

Finally, another critical factor cited by businesses is that local services have not improved with the introduction of the SBP. This is a basic policy consideration in justifying reform. Devas and Grant (2003) noted that the local authorities “are also mostly overstuffed and laden with debts, with the result that they have minimal resources with which to deliver services or improve local infrastructure. . . . The financial situation of most local authorities remains dire. Because of poor revenue collection and over-optimistic revenue projections, budgeted resources do not materialize.”

NEXT STEPS

The effectiveness of the SBP in Kenya (and the associated inspections) has been called into question, and various reform initiatives are under way to improve it. The Nairobi City Council has recently taken steps to improve the efficiency and transparency of the permitting process. In addition, the Government of Kenya launched an “e-Registry” of required licenses and permits (see Box A4.1).

In addition to the efforts noted above, steps are being undertaken through the Local Authorities Integrated Financial Operations Management System to reduce the time required for applications and payments for the SBP and other permits and fees to a minimum. Momentum is also building to ban Friday afternoon inspections (as expressed by acclamation at the Prime Minister’s Roundtable with the Kenya Private Sector Alliance on May 13, 2009).

Other solutions involving subnational fiscal reforms, such as the enhancement of the property tax as a means of generating local revenue, may take place in the context of a major new reform to replace the eight “provinces” and one-hundred-plus local governments in Kenya with a new set of 47 “counties” in 2012. While the new Kenya constitution explicitly assigns property taxes to the new county governments, and they will also likely take over the SBPs, it is unclear whether the national government will be able to set parameters or caps for either sources of revenue. The World Bank will provide technical assistance, but the degree of authority over subnational revenues may only be settled in court.

151 Mentioned by representatives of the Kenya Private Sector Alliance at the Prime Minister’s Roundtable, 13 May 2009, and also noted in the Licensing Committee’s Report (2007).

152 Devas and Grant 2003, 313–14.
Box A4.1. The Electronic Regulatory Registry

The “e-Registry” is a central online informational portal of all licenses in Kenya, the portal allows businesses to identify the licenses and permits they may be subject to, based on the business and functional activities they are engaged in.

The first version of this e-Registry (http://www.businesslicense.go.ke/) was operationalized by the Ministry of Finance in August 2009, and provides users with detailed information on valid licenses, including the requirements for obtaining the license, contact information for the regulator issuing the license, license costs, and downloadable application forms. Upon enactment of the Business Regulation Bill, the e-registry will henceforth ensure positive legal security (that is, any license not listed in the e-registry cannot legally be enforced by the authority).

Building on this informational e-Registry, the Ministry of Finance now intends to implement a fully transactional online system for issuing business licenses, both at the national and municipal level.

The Transactional Business Licensing e-Registry will provide regulators with a shared web-based application which will:

- Allow Kenyan businesses to apply and pay for business licenses online;
- Support the internal processing workflows within the regulators; and
- Exchange data with existing legacy systems, as required.

The existing informational licensing e-Registry will continue to be the main conduit for users seeking information on required licenses and will link them to the relevant online application forms once they have identified the appropriate licenses.

Gains from this system will include:

- Increased transparency in licensing processes and reduced opportunities for rent-seeking behavior by government staff
- Improved collection of license fees and reduced opportunities for illegally diverted payments
- Reduced time and cost for the private sector to obtain business licenses and comply with regulatory reporting requirements, and streamlined government processes for license administration
- Improved management information on license processing, including timely information on staff productivity, application backlogs, and revenue projections
- Enhanced regulatory compliance monitoring capabilities, ensuring that registered businesses have obtained all necessary licenses and permits; can eventually also support income tax and VAT monitoring

Source: Authors.
Appendix 5. Tanzania: Local Government Revenue Policies

The case for an adequate and buoyant framework for local taxation that is also pro-poor and pro-business

Tanzanian local government has experienced the progressive, legislative elimination of several own-source revenue instruments and has been inefficient at collecting other own-source revenues. This has greatly affected local fiscal sustainability and has hindered Tanzania’s local and urban development.

Prior to 2003, local government authorities (LGAs) in Tanzania were empowered to define their own local tax structure. The Local Government Finances Act of 1982 allowed an “open list” or permissive approach to local taxation, which gave LGAs wide powers to impose taxes, levies, and fees and set rates within their local jurisdictions. Consequently, the number and type of local taxes, levies, and fees varied significantly from one LGA to another, with large variations in the rates imposed by LGAs on similar tax bases.

Local taxes were criticized for being inefficient—the cost of collection could consume a significant portion of tax revenue for specific taxes; and since LGAs made use of a multiplicity of taxes instead of a few productive ones, a single home or business was frequently and repeatedly bothered for relatively small amounts of revenue. Local taxes were also criticized for being regressive and for creating disincentives for the creation and growth of private enterprises.

Despite the large number of revenue instruments in use, 60 percent of local revenues came from just three sources: (1) the Development Levy, a flat head tax payable by adults over the age of 18 (sometimes with an exemption for women and the elderly), which alone accounted for 20 percent of own-source revenues and was the leading source of revenue for rural LGAs; (2) agricultural and livestock taxes, a major source of revenue for rural LGAs; and (3) licenses and fees (including business licenses).

Amendments to the Local Government Finance Act in 2003 and 2004 significantly reduced the revenue-raising authority of LGAs and reduced the importance of own-source revenues in the intergovernmental fiscal framework.

The first round of amendments in 2003 abolished the Development Levy and a number of minor local revenue sources, the so-called nuisance taxes, largely due to poverty reduction advocates, who criticized these taxes as regressive. The Development Levy was a mainstay of rural LGAs’ finances, and its abolition, without agreement on a local revenue source to replace it, was a huge blow to sustainable local finance. While it may have been a flawed tax, the decision to replace it was taken quickly and without prior consultation with the agency responsible for local government, at the time the President’s Office-Regional Administration and Local Government.

The second round of reforms in 2004 eliminated the business license as a significant source of local revenue. Private sector advocates had criticized this tax as an inappropriate use of regulatory power and as unfriendly to business. Prior to 2004, business license fees were levied annually and typically

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153 This case study was written by Matthew Glasser, Zara Sarzin, and Zhiyu Jerry Chen, Urban Department, World Bank, 8 April 2009.
ranged from T Shs 60,000 to T Shs 1,000,000, depending on the type of business. The system of annual licensing was replaced with a one-off registration system, and fees were abolished for smaller businesses (with turnovers less than T Shs 20 million) and capped at T Shs 20,000 for larger businesses. This eliminated a costly, time-consuming burden for businesses. However, the business license fees were an important revenue source in urban LGAs, and again no prior consultation took place and no plans were made to replace this revenue source.

Finally, the Local Government Finance Act was amended to eliminate all taxes and fees levied by LGAs except those specified in a schedule to the Act. The establishment of a restrictive list of revenue sources does provide a transparent, standardized framework for local taxation, and arguably local autonomy and flexibility can still be exercised within this “closed list.” Rates applicable to the prescribed local taxes and fees can in many cases be determined by LGAs (although often with a maximum rate prescribed by the central government).

As a consequence of the reforms, LGAs’ own-source revenue declined from T Shs 57,740 million in 2002 to T Shs 42,871 million in 2004–05. Before the reforms, own-source revenue accounted for approximately 20 percent of local government fiscal resources. Today, own-source revenues account for approximately 10 percent of total local government finances. This weakens an important accountability link between local government authorities and their constituents. The role of taxation in the public sector is about more than maximizing revenue yield: if structured appropriately, local taxation can help to empower communities, enhance accountability, improve vertical imbalance problems, and improve the efficiency of the public sector. The Government of Tanzania’s growth and poverty reduction strategy (the National Strategy for Growth and Reduction of Poverty) highlights the need for additional tax revenue to reduce budget reliance on external sources. Increasing overall revenue mobilization through improvements in the local revenue system—even by only one or two percent of GDP—could be an important part of this strategy.

Figure A5.1. Composition of Local Government Finances in Tanzania


Most recently, the Financial Laws (Miscellaneous Amendments) Act 2008 was passed, which empowers the Tanzania Revenue Authority (TRA) to evaluate, assess, collect, and account for property rates and other taxes, on behalf of LGAs, for a period of five years. The TRA is also mandated, in consultation with LGAs, to carry out property valuations to prepare the rates-payers list and to issue demand notices. The TRA can also exempt taxpayers. The law came into force on 1 July 2008, with the TRA taking responsibility for the collection of
property rates in Dar Local Authorities. The TRA has established a bank account for each of the Dar Local Authorities, into which taxpayers make direct deposits of rates. After accounting for these collections, the TRA is supposed to provide monthly reports to the Dar Local Authorities and transfer the rates into their accounts. Once the new arrangements are considered to be working well, the intention is to implement them in other urban centers.

As a result of these waves of reforms, LGAs in Tanzania have intensified their collection of permitted taxes and increased their reliance on alternative sources of revenue such as local licenses and permits, fees and charges, and “other revenues” (generally fines and penalties). In fact, own-source revenues have increased from T Shs 42,871 million in 2004–05 to T Shs 79,770 million in 2007–08, and in per capita terms, own-source revenue collections have exceeded their level prior to the reforms.

The share of fees and charges collected by LGAs increased from 10 percent in 2002 to 17 percent in 2007, while the share of other revenues increased from 11 percent in 2002 to 20 percent in 2007. It is not clear that these reforms have improved the make-up of local revenues, and they have certainly created a substantial amount of instability. While the business license fees and the Development Levy had problems, detailed design and administration guidelines might have resolved them. Arguably, these broad-based, well-understood revenue instruments were preferable to the more complex, fragmented, and opaque system of ad hoc levies that have taken their place. The proliferation of ad hoc fees, penalties, and licenses has been an unintended consequence of the regulatory reforms.

Figure A5.2. Trend in Per Capita Own-Source Revenues


In Tanzania, the World Bank and the International Monetary Fund have given needlessly conflicting messages. The Bank’s poverty specialists are understandably concerned about regressivity. The private sector specialists are rightly concerned about barriers to entry and about discretion and cumulative burden. Finally, the urban and local government specialists are concerned about the quantum of local revenue available for operations and maintenance and about the social contract implicit in a healthy local tax system.
The general paradigm would price regulatory services (for example, building permits, health inspections, and so on) on a cost-recovery basis. It is probably healthy to keep these regulatory functions separate from the avowedly revenue-raising functions of a local business tax. However, if one says that regulatory instruments are an inappropriate means of raising local revenues, one must also provide balancing messages indicating what more appropriate revenue instruments would look like.


Appendix 5. Tanzania: Local Government Revenue Policies
In many countries, central governments are reluctant to give authority over buoyant and productive taxes (for example, business taxes) to local governments. Instead, they often authorize a bundle of unpopular, unproductive taxes and fees and then complain that local authorities are not generating enough revenue. For this reason, property rates and local business taxes are two potential mainstays of a local revenue system. They are broad-based, potentially productive, buoyant revenue instruments that can help to strengthen the accountability of LGAs to their residents and the business community.

In Tanzania, property taxation has not lived up to its revenue potential. Property taxes have worked in some African countries (for example South Africa), but in many they do not. One reason may be that the class of property owners overlaps to a significant extent with the class of policy makers at the national and local level. Property-owning politicians and officials would rather not tax themselves. Finding the political will for serious property tax efforts is much more difficult than finding technical solutions to improve the structure and administration of the property tax over time (including valuation, assessment, administration, collection, and enforcement activities). In Tanzania, specific proposals have also been made to expand the scope of the property tax by assigning land rents to the LGA level and ultimately integrating these into the property tax; LGAs have also been encouraged to levy special assessments (“betterment levies”) to cover the cost of specific infrastructure projects with identified localized benefits.

A sound, transparent local business tax can support a healthy and collaborative relationship between local authorities and their business community: both have an interest in the success of local businesses. A 2005 study conducted by the Local Government Reform Programme in collaboration with Georgia State University recommends the consolidation of numerous small local business taxes and levies into a single Unified Local Business Tax. It is envisaged as a broad-based tax on business income, based on gross turnover, which would absorb the City Service Levy, the crop and forest produce cess, the guest house levy, and the fish landing or auction levy. Businesses not subject to these taxes would become subject to a tax payment (a fixed charge based on the type, size, and location of the business).
Appendix 6. Peru: Reform of Municipal Licensing for Small Businesses in Lima

In Peru, the process of getting an operating license forms a significant barrier for firms trying to formalize. Obtaining an operating license and becoming formal are synonymous for municipality purposes. According to documents gathered in the early phase of IFC panel/tracer study of Lima, municipal bureaucracies are the primary obstacle for small and medium enterprises on the way to formalization: 60 percent of the time expended procuring a license is spent meeting requirements imposed by the municipality.

In 2004, IFC teamed up with the Municipality of Lima to implement reforms to simplify the licensing procedures in Cercado de Lima. Before reform, the licensing procedure was complex, costly, and time consuming. Entrepreneurs who applied for an operating license had to wait on average 160 days, visit the municipality offices about 11 times, and receive on average five inspections. To overcome this problem IFC and the Municipality of Lima designed a reform to cut licensing time to 1.6 days, reduce compulsory visits to the municipality offices, and require a single inspection.

Before the reform, the central government set an upper limit on the fee that municipalities could collect for licenses. This value was calculated at 10 percent of the Unidad Impositiva Tributaria, the value used to calculate administrative fees. Under the reform, the license fee was set at the real cost incurred by the municipality. The previously fixed fee of $170 became four different fees, depending on the business group involved. As part of the reform, businesses were classified into one of four groups according to the nature of the business activity and the level of risk involved. (A low-risk business pays a lower fee.) By 2006, the weighted average official cost had been reduced to $45. Because this fee is tied to the inflation-indexed monetary value, the fee undergoes slight nominal adjustments, but no real increases. However, the failure to communicate this properly to the beneficiaries has resulted in confusion and false perceptions.

Beyond setting fees, this comprehensive reform effort involved employee training, reengineering, and simplification of the entire process as well as a communications and a sustainability strategy. The reform further included zoning system actualizations, business classification updates, and introduction of a new license allowing two businesses to operate under one address. (For more specific information, see IFC 2010). As a result of the reform, during the first six months after the implementation, the number of firms applying for licenses increased 263 percent (compared to the same period in 2005), and the overall cost of getting the license (including staff time and related costs to the applicant) declined by about 60 percent.

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155 IFC 2010.
IFC commissioned a “tracer study” to assess the impact of the reforms on businesses in Lima. For this purpose, a survey to collect information on several indicators was applied over the same sample of firms at three different periods. The baseline included 600 firms operating in Cercado de Lima without a license (see Table A6.1). Six months after baseline data collection, the second round of data collection was carried out (hereafter, “second round”). Twelve months after the second round, a third wave of data collection using the same survey questionnaire as for previous rounds was carried out (hereafter, “third round”). The final panel obtained allows for the implementation of difference-in-difference estimators. In addition, between the baseline and the second round, an encouragement approach was implemented. This experiment randomly selected a subsample of the original baseline to receive an incentive for obtaining an operating license. In this case, the incentive was a voucher with a monetary gift to be used only by the selected firm to pay a portion its operating license fee.

The price of a license (unchanged by the reform) is different according to the classification of the municipality. A license for a small shop, with an area of 100m² or less (type-I firm), costs S/.280 ($92), while shops with areas of 100m² or more, restaurants, businesses not working with chemicals or other toxic materials (type-II firms) pay

<table>
<thead>
<tr>
<th>Table A6.1. Surveyed Businesses’ Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BASELINE</strong></td>
</tr>
<tr>
<td><strong>FREQ.</strong></td>
</tr>
<tr>
<td>Age of the business (in years)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Size of the store (in m²)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Self-reported value (in Soles)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>In US$</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Number of workers</td>
</tr>
<tr>
<td>Without workers</td>
</tr>
<tr>
<td>With 1 workers (not including respondent)</td>
</tr>
<tr>
<td>With 2 workers (not including respondent)</td>
</tr>
<tr>
<td>With 3 workers (not including respondent)</td>
</tr>
<tr>
<td>With more than 3 workers (not including respondent)</td>
</tr>
<tr>
<td>Legal constitution of the firm</td>
</tr>
<tr>
<td>With the legal form of Natural Person</td>
</tr>
<tr>
<td>Other legal form</td>
</tr>
<tr>
<td>Ownership of the business store</td>
</tr>
<tr>
<td>Operating in an owned store &amp;/or part of the family house</td>
</tr>
<tr>
<td>Operating in a rented store &amp;/or part of the family house</td>
</tr>
<tr>
<td>Donated by a relative or friend</td>
</tr>
<tr>
<td>Others</td>
</tr>
<tr>
<td>Source: IFC 2010.</td>
</tr>
</tbody>
</table>
S/.370 ($122). Initially, to establish the encouragement group, the project offered a voucher worth S/.40 toward the cost of a license. However, only 60 of the 300 firms expressed strong interest in using the vouchers, and only 23 businesses used a voucher to obtain a license. The project increased the value of the voucher to S/.80, to S/.100 and even up to 100 percent of the license fee.

In 39 cases the complete value of the license was offered as an incentive, and even in these cases many firms (23) did not accept. The new team obtained 35 additional licenses. The number of firms that obtained licenses using the voucher was 68, and 27 additional firms got licenses without the voucher. The encouraged group therefore includes 95 firms with licenses. Licenses could not be obtained by 127 firms because they did not fulfill all the requisites. The evolution of the panel dataset is presented in Table A6.2.

<table>
<thead>
<tr>
<th>Table A6.2. Firms with Operating Licenses in the Samples</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BASELINE</strong></td>
</tr>
<tr>
<td><strong>FREQ.</strong></td>
</tr>
<tr>
<td><strong>Cross sections</strong></td>
</tr>
<tr>
<td>License</td>
</tr>
<tr>
<td>No license</td>
</tr>
<tr>
<td><strong>Panel dataset</strong></td>
</tr>
<tr>
<td>License</td>
</tr>
<tr>
<td>No license</td>
</tr>
</tbody>
</table>

Source: IFC 2010.

Getting an operating license is a choice variable from the point of view of the firm or its owner. A departing point for the analysis was that each owner would weigh the advantages of operating with or without a license. Among the advantages of operating with a license are the legal right to work in a specific location and to access certain markets. A license also allows firms to obtain credit from the formal financial sector, access new technology, receive judicial protection as business units, and avoid extraction of rents by public officers. On the other hand, operating without a license allows firms to avoid paying taxes and the costs of health and safety regulations.

The institutional context also influences the decision to operate with or without a license by affecting the costs of procuring the license. The procedures for getting an operating license form a significant barrier for firms attempting to become formal. In Latin America, most municipalities use the operating license as an instrument to enforce zoning, health, and public-safety regulations. In some cases, moreover, the operating license allows governments to obtain information that is later used for taxation purposes. According to information obtained in the panel/tracer study, however, for small and medium enterprises, the municipal bureaucracy is the primary obstacle to becoming formal. IFC’s municipal scorecard reports that “according to entrepreneurs, currently the procedures that must be followed to obtain licenses of operation in most municipalities of Latin America are slow, costly and uncertain.” 156 Faced with this burdensome procedure, some entrepreneurs prefer to continue operating without a license.

The outcome variables selected for the study include revenues, self-reported profits, profits per worker, subjective value of the firm, number of workers, number of wage workers, and investment in infrastructure and machinery. Where the firm requested credit, whether the credit was requested from the formal sector and the amount of credit were noted. In short, the outcome variables related to firm value, firm output, use of inputs, and access to the financial sector.

156 IFC 2010, 3.
The results of the study to date show that possessing an operating license has no statistically significant effect on a firm’s performance. Neither final outcome variables (outputs), such as sales, sales per worker, profits, and profits per worker, nor intermediate outcome variables, such as number of employees, access to credit, and investment in infrastructure and machinery (inputs), are statistically affected. These results are consistent across all the methods implemented, and they hold both in the short term (between the baseline and the second round) and in the medium term (between the baseline and the third round). These results call for more comprehensive interventions aimed at promoting competitiveness among the private sector, including programs to access different types of markets, and technology to deepen the study of the demand for formality among Peru’s economic agents.

Although one final round of the survey is being analyzed, the evidence to date appears to suggest that reform of the procedures for municipal licensing, without either major reduction of fees or other burdens on business (many beyond the municipal level), is insufficient to encourage many informal businesses to formalize or, if they do formalize, to expand output or employment.

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157 For a full presentation of the methodology and results of these surveys, see IFC 2010.
Appendix 7. Subnational Reform Projects in the Balkans

The World Bank Group carried out projects for reform of subnational licenses and permits in both Serbia and Bosnia and Herzegovina. These projects were roughly typical of those carried out in middle-income countries, as described in Box A7.1.

Box A7.1. Overview of Subnational Reform Projects in the Balkans

*Goal.* The goal of the Project is to increase the competitiveness of selected localities and help increase the levels of private investment. The Project focuses on:

a. reducing the cost and time required to comply with business formalities, including licenses and permits in order to reduce the cost and risk of doing business;

b. improving the capacity of governments to manage administrative and licensing procedures related to business operations and deliver services to businesses; and

c. establishing a transparent and legally secure Registry of formalities and related information for businesses and the general public.*159

The project activities in each locality were implemented in four main phases:

*Phase 1: Inventory of formalities preparation.* Local officials mapped all existing formalities affecting businesses and citizens and compiled all supporting documentation for the electronic Inventory of formalities.

*Phase 2: Consultations with business and civil sector.* Focus groups and workshops were convened for individual entrepreneurs, representatives of business associations, chambers of commerce, community, and civil society. The consultations produced feedback on the formalities, along with recommendations for simplification.

*Phase 3: Analysis and preparation of recommendations.* In each locality, a task force of officials systematically reviewed the inventory, and made recommendations for: the elimination or simplification of documents, forms and procedures; elimination of information, shortened deadlines for processing paperwork; reduction in related taxes and fees, elimination of formalities etc. Wherever appropriate, the task forces took into consideration the recommendations from focus groups and workshops, effectively incorporating inputs of all stakeholders in the decision-making process. In addition, set of recommendations for the Republic level in order to simplify the formalities by changing the relevant laws and bylaws is prepared and sent to the Serbian Regulatory Reform Council.

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158 This case study was written by Tarik Sahovic, Boris Divjak, and Jacqueline Coolidge, Investment Climate Advisory Services of the World Bank Group.

159 IFC 2010b, 127.
Phase 4: Adoption and implementation of recommendations. City and municipal authorities adopted recommendations and relevant legal acts; new Internet-based Registries of formalities were established in each locality and a system of quality control was introduced to monitor new regulations.160

The reforms were quite successful in terms of simplifying administrative procedures and reducing costs for businesses (more than $100 million of annual aggregate private sector savings in Serbia and more than $50 million in Bosnia and Herzegovina), but only a small proportion of the savings came from reductions in fees. In the case of the reform project in Bosnia and Herzegovina, where “local fees” made up between 12–19 percent of the total municipal income, reforms did not reduce these amounts to any significant degree for most types of permits (see Table A7.1). The biggest reductions in fee income came from reforms to reduce fees for “urban permits” and “legalization of a building” in Goražde, aggregating to about KM 1.875 million (about $1.25 million). Most other fee reductions were very small—of about KM 10—KM 100 per transaction, yielding only KM 500–KM 3,500 in revenue reductions per reform equal to savings enjoyed by local businesses (see Box A7.2).

<table>
<thead>
<tr>
<th>ITEM</th>
<th>PROJECT WORK COMPLETED (4 LOCALITIES)</th>
<th>BEFORE REFORM</th>
<th>AFTER REFORM</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2009</td>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Transfers from higher level</td>
<td>54%</td>
<td>55%</td>
<td></td>
</tr>
<tr>
<td>Municipal income</td>
<td>46%</td>
<td>45%</td>
<td></td>
</tr>
<tr>
<td>Local taxes (utility and administrative)</td>
<td>6.5%</td>
<td>6.2%</td>
<td></td>
</tr>
<tr>
<td>Local fees</td>
<td>12.5%</td>
<td>12.5%</td>
<td></td>
</tr>
<tr>
<td>Donations (NGO, Foreign donors, etc)</td>
<td>13%</td>
<td>7.3%</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>14%</td>
<td>19%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ITEM</th>
<th>PROJECT WORK IN PROCESS (5 LOCALITIES)</th>
<th>BEFORE REFORM</th>
<th>AFTER REFORM</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Transfers from higher level</td>
<td>54%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Municipal income</td>
<td>46%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local taxes (utility and administrative)</td>
<td>5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local fees</td>
<td>12%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Donations (NGO, Foreign donors, etc)</td>
<td>4%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>25%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ITEM</th>
<th>PROJECT WORK COMPLETED (2 LOCALITIES)</th>
<th>BEFORE REFORM</th>
<th>AFTER REFORM</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
<td>2005</td>
<td></td>
</tr>
<tr>
<td>Transfers from higher level</td>
<td>56%</td>
<td>46%</td>
<td></td>
</tr>
<tr>
<td>Municipal income</td>
<td>44%</td>
<td>54%</td>
<td></td>
</tr>
<tr>
<td>Local taxes (utility and administrative)</td>
<td>5%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Local fees</td>
<td>19%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Donations (NGO, Foreign donors, etc)</td>
<td>3%</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>17%</td>
<td>25%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ITEM</th>
<th>MUNICIPALITIES NOT INCLUDED IN PROJECT (3 LOCALITIES)</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfers from higher level</td>
<td>48%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Municipal income</td>
<td>52%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Local taxes (utility and administrative)</td>
<td>6%</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Local fees</td>
<td>16%</td>
<td>16%</td>
<td></td>
</tr>
<tr>
<td>Donations (NGO, Foreign donors, etc)</td>
<td>13%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>17%</td>
<td>20%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Authors.

160 Ibid.
Box A7.2. Subnational Licensing Reforms in Bosnia and Herzegovina: Goražde

Investment Climate teams of the World Bank Group have been continuously engaged in Bosnia and Herzegovina from immediately following the civil war. Much of the regulatory reform work in the early years focused on diagnostics of the business environment, creation of a single market, and deregulation, trimming the hefty stock of business legislation inherited from several previous systems and from the country’s three autonomous wartime factions. Only in the mid-2000s did the focus shift to include the subnational level: the municipal and entity levels in the Republika Srpska and the municipal, cantonal, and entity levels in Bosnia and Herzegovina’s remaining section, the Federation.

That advisory work initially focused on understanding the regulatory issues at the subnational levels, first the divide among the levels and later the precise definitions of regulations as preparation for streamlining them. The effort required a solid amount of ownership and vision among local leaders, with the consequence that not every local community was equally fit. This was especially so in the pilot days, when the potential extent of reforms had not yet become clear.

Considerable work was conducted at the entity level, which largely regulates the investment climate, while less was done with the federal cantons. The most impressive efforts, however, were displayed by the municipalities in both parts of the country. In fact, the municipalities soon realised that they can contribute to overall competitiveness and thus attract inward investment. As the early reformers began to attract investors’ attention, the issue of local competitiveness became an important development topic, not only in Bosnia and Herzegovina but throughout the Balkans, where the municipalities continue to observe each other closely and engage in fierce competition. While initially this may have been spurred by concerns about image and prestige, later, as some municipalities started to experience sudden increases in investment, competition became a key motivator for other towns to join the reform effort.

One example is the town of Goražde, population about 20,000, situated on the banks of the River Drina in South East Bosnia. Goražde was in a specific geopolitical situation: largely surrounded by municipalities in the Republika Srpska, leaders in this Bosnia and Herzegovina’s town wanted to demonstrate that it could do better than the other towns nearby. While trying to attract donors’ attention, it also moved to improve the business-enabling environment for its smaller entrepreneurs. In addition, the newly elected mayor, who was working with the World Bank Group, came from an opposition party and was young, dynamic, and sympathetic to the private sector cause. Several regional and national drivers thus aligned with the presence of a local political champion and a new administration to favor effective local economic change.

The advisory work focused mostly on analyzing the regulations for constructing and legalizing buildings, an area within the scope of local legislators and, according to local entrepreneurs, one that represented a significant impediment to doing business in Goražde. Together with the authorities, the municipality analyzed the fee structure for the urban construction permit. It was finally decided not to alter the fee directly, but rather to decrease the base (price per m²) for its calculation. Instead of 1,073 KM/m², the new base for calculating the fee is 600 KM/m². This effectively means that the municipality charges less for m² than previously. Similarly, the fee for legalizing existing buildings or licensing the newly constructed ones was unchanged, while the base for its calculation decreased. The same fees as for the urban permit were used, and instead of the 1,073 KM/m² previously used for calculations, a new base was set at 600 KM/m². The change in the base affected both the fee and stamp-duty.

As a result of these reforms, the municipality saw the number of permit applications increase for the first time in the postwar years.

(Continued next page)
In 2009, a total of 236 applications were made, including the following:

- legalization: 80
- urban permit: 102
- building-use permit: 54

In 2010, applications totaled 278—an increase of 16 percent—including the following:

- legalization: 112
- urban permit: 98
- building-use permit: 68

These numbers would likely have been even higher if not for the extensive area flooding in the summer of 2010. The early figures for 2011 continue the rising trend.

The example of Goražde demonstrates how investment and construction activity can benefit from regulatory changes. Even though the fees were lower, because the number of applications rose the municipality did not lose revenue. The business and civil sector savings, however, totaled approximately KM 1.97 million. In addition, the far more transparent regulation of construction and new construction and the general increase in investment into Goražde in turn reflected positively on private sector growth.

* Currency Unit: convertible marka (KM); KM 1.96 = €1.

Formalities with the Biggest Savings Regarding Fees and Stamp-Duties in Bosnia and Herzegovina

All savings are based on the actual frequency of requests in the year prior to the reform.

Goražde

Urban Permit

The fee was not affected directly, but the base for its calculation (price per m²) was decreased. Instead of 1,073 KM/m², the new base for calculation of the fee is 600 KM/m². The municipality will use the recommended charge rather than its previous charge.
SAVING PER FORMALITY

<table>
<thead>
<tr>
<th></th>
<th>FEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>33,110 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>2,483 KM</td>
</tr>
<tr>
<td>Average saving</td>
<td>15,695 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>1,600,890 KM</td>
</tr>
</tbody>
</table>

LEGALIZATION OF THE BUILDING

The fee was not affected directly, but the base for its calculation was decreased. Instead of 1,073 KM/m², the new base for calculation of the fee is 600 KM/m². The change in “base” affected both fee and stamp-duty.

SAVING PER FORMALITY

<table>
<thead>
<tr>
<th></th>
<th>FEE AND STAMP-DUTY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>34,994 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>2,627 KM</td>
</tr>
<tr>
<td>Average saving</td>
<td>3,436 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>274,880 KM</td>
</tr>
</tbody>
</table>

Modrica

BUILDING USAGE PERMIT

The base for fee calculation was changed from 800 km/m² to a fixed amount of fee per 1 m².

SAVING PER FORMALITY

<table>
<thead>
<tr>
<th></th>
<th>FEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>131 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>168 KM</td>
</tr>
<tr>
<td>Average saving</td>
<td>68 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>3,396 KM</td>
</tr>
</tbody>
</table>

The biggest savings in Modrica municipality are produced by the elimination of formalities. No other formality with savings in fees and stamp-duties can be pointed out since the municipality reduced fees and duties in the previous year.

Novi Grad

OPENING OF MERCHANT STORE (Otvaranje trgovinske radnje)

SAVING PER FORMALITY

<table>
<thead>
<tr>
<th></th>
<th>FEE DECREASED FOR 10 KM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual savings</td>
<td>590 KM</td>
</tr>
</tbody>
</table>

OPENING OF SERVICE STORE (Otvaranje usluzne radnje)

SAVING PER FORMALITY

<table>
<thead>
<tr>
<th></th>
<th>FEE DECREASED FOR 10 KM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual savings</td>
<td>490 KM</td>
</tr>
</tbody>
</table>
Zvornik

**Urban Permit**

<table>
<thead>
<tr>
<th>SAVING PER FORMALITY</th>
<th>FEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>5 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>5 KM</td>
</tr>
<tr>
<td>Average saving (according to the frequency for businesses and citizens)</td>
<td>5 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>1,705 KM</td>
</tr>
</tbody>
</table>

**Supplemental Urban Permit**

<table>
<thead>
<tr>
<th>SAVING PER FORMALITY</th>
<th>FEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>11.33 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>11.33 KM</td>
</tr>
<tr>
<td>Average saving (according to the frequency for businesses and citizens)</td>
<td>11.33 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>1,631 KM</td>
</tr>
</tbody>
</table>

Novo Sarajevo

**Construction Permit**

<table>
<thead>
<tr>
<th>SAVING PER FORMALITY</th>
<th>FEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>2 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>2 KM</td>
</tr>
<tr>
<td>Average saving (according to the frequency for businesses and citizens)</td>
<td>2 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>3,258 KM</td>
</tr>
</tbody>
</table>

**Usage Permit**

<table>
<thead>
<tr>
<th>SAVING PER FORMALITY</th>
<th>FEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>10 KM</td>
</tr>
<tr>
<td>Citizens</td>
<td>10 KM</td>
</tr>
<tr>
<td>Average saving (according to the frequency for businesses and citizens)</td>
<td>10 KM</td>
</tr>
<tr>
<td>Annual savings</td>
<td>1,300 KM</td>
</tr>
</tbody>
</table>
Appendix 8: Tajikistan: A Super Patent to Replace All Others?¹⁶¹

Facts about the new Patent in Tajikistan: A simplified tax regime for individual entrepreneurs

Tajikistan has three types of small and medium enterprises (SMEs):

- **Individual entrepreneurs**: sole proprietors of an enterprise without any juridical status
- **Dehkan farms**: owners of private agricultural farms
- **Small and medium companies**: legal entities

This appendix describes the national taxation system applicable to individual entrepreneurs. One-third of individual entrepreneurs find the calculation and payment of taxes to be complicated or very complicated.

Figure A8.1. SME Sector in Tajikistan, 2007

As of 2007, Tajikistan had 115,000 individual entrepreneurs. The following statistics provide a profile of them:¹⁶²

- Average annual turnover: SM 17,000 ($5,340)
- Average annual profit: SM 4,000 ($1,250)
- Average number of employees: 2
- Average monthly salary paid: SM 122 ($38)

¹⁶¹ This case study was written by Alisher Isaev and Christine Bowers, Investment Climate Advisory Services of the World Bank Group.

¹⁶² Currency unit: SM (somoni). All figures use 2005 data. SM 3.2 = $1 (January 2006).
An individual entrepreneur has two choices for legal operation: work under patent or under certificate. In April 2008, amendments to the tax code simplified the patent and introduced an alternative certificate, based on firm turnover, as opposed to the original certificate based on firm profits.

Basic Facts About the Certificate

- The certificate is the standard taxation regime for individual entrepreneurs.
- There is no ceiling on turnover for certificate holders; they may engage in international trade, and they may hire staff.
- Certificate holders pay personal income tax (either the advance minimum tax on revenues or turnover tax), road users’ tax, retail trade tax, social tax, and VAT (see Table A8.2).
- Certificate holders are of one of two types: those whose tax obligations are calculated based on profits and those whose certificate is calculated on turnover. The latter certificate was introduced with the April 2008 tax amendments.
- Certificate holders must record all transactions in a Book of Revenues and Expenses, have a cash register, and provide supporting documents to confirm expenses.
- In 2005, the total tax burden on individual entrepreneurs under certificate was 13 percent of profits.

Basic Facts about the Patent

- The patent is a simplified taxation regime for individual entrepreneurs.
- To be eligible for the patent, individual entrepreneurs must have turnover of less than SM 200,000 annually (about $63,000), may not import or export goods, and may not hire employees.
- Patent holders pay one lump-sum tax consolidating (after the amendments) an entrepreneur’s obligations related to personal income, retail trade, and social tax. Patent holders do not pay VAT or the road users’ tax.
- The cost of a patent is fixed, according to type of activity engaged in by the entrepreneur. The amendments expanded the scope of economic activities available to patent holders.
- The maximum patent price is SM 240 (about $70), for transportation of oil, liquid gas, and cement by specialized transport, and the minimum patent price is SM 30 (about $9), for transportation by motor-scooter.
- In 2005, 92 percent of individual entrepreneurs worked under patent. Their total tax burden was between 5 and 7 percent of profits.

The April 2008 Tax Amendments to the 2005 Tax Code:

- Simplified the patent regime
  - Consolidated personal income tax, retail trade tax, and social tax into one lump-sum payment
  - Freed entrepreneurs from requirements to use cash registers and keep expenditure and income logs for tax inspectors
  - Freed entrepreneurs from calculating their tax obligations
  - Broadened the types of economic activities available to patent holders
  - Introduced a discount for an entrepreneur’s second patent, at just 20 percent of the original (or higher-priced) patent
  - Rationalized the regional coefficients that determine a patent’s price in the different oblasts
- Complicated the certificate regime
  - Introduced a new certificate based on turnover (in addition to the existing certificate based on profits)
  - Expanded road users’ tax (two percent of expenditures) to all certificate holders, regardless of size
  - Instituted a more complicated, less fair profit tax requiring advance monthly payments
• Raised the prices of almost all tax obligations

• The new patent costs more than the old patent. The old patent covered personal income tax only, with separate calculations required for retail trade tax and social tax. The total tax obligation faced by entrepreneurs working on the patent has not changed much under the new patent; most will pay somewhat more and some will pay slightly less than they did before.

• The total tax obligation faced by those working under certificate is now approximately double, in many cases.

Tax revenues from patent and certificates holders in 2009 and 2010 (in millions of somoni) were as follows:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patent holders</td>
<td>49.0</td>
<td>57.8</td>
</tr>
<tr>
<td>Certificate holders</td>
<td>151.0</td>
<td>214.7</td>
</tr>
</tbody>
</table>

Tax revenues from certificate holders are distributed between the state and local budgets, depending on the type of tax, that is, revenues from local taxes (retail trade tax, motor vehicle tax, and so on) go to the local budget. But it is necessary to take into account that the revenue from state taxes (VAT, profit tax, and so on) are distributed among state and local budgets based on the Law of State Budget, which also defines the amount of subventions from the state budget to local budgets.

For example, 100 percent of the external VAT, the sales tax on cotton and aluminum, and some other taxes go to the state budget; at the same time the local budgets receive revenues from domestic VAT (excluding revenues from 3 regions), excise, road users' tax, and income from certain other taxes.

Based on Law on State budget on 2011, the subvention among regions is as follows (in millions of somoni):

<table>
<thead>
<tr>
<th>Region</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gorno-Badakhshan Autonomous Oblast</td>
<td>78.9</td>
</tr>
<tr>
<td>Khatlon oblast</td>
<td>188.0</td>
</tr>
<tr>
<td>Vakhat city</td>
<td>3.5</td>
</tr>
<tr>
<td>Varzob district</td>
<td>5.6</td>
</tr>
<tr>
<td>Rasht district</td>
<td>12.7</td>
</tr>
<tr>
<td>Jirgital district</td>
<td>12.3</td>
</tr>
<tr>
<td>Nurabad district</td>
<td>9.4</td>
</tr>
<tr>
<td>Tavildara district</td>
<td>6.3</td>
</tr>
<tr>
<td>Tajikabad district</td>
<td>7.8</td>
</tr>
<tr>
<td>Faizabad district</td>
<td>8.2</td>
</tr>
<tr>
<td>Shahrinav district</td>
<td>9.0</td>
</tr>
</tbody>
</table>

“Other local fees and obligations” includes state duty (that is, registration fees), permits to obtain fees, and so on.

**Basic Facts about Tax Inspections**

• In 2005, the average individual entrepreneur was inspected 15 times. Almost half of these were tax inspections.

• Calculation of the retail trade tax is the main reason for frequent tax audits, involving verification of the entrepreneur's cash receipts.

• The average tax inspection of an individual entrepreneur lasts 3 hours.

• During tax inspections, 63 percent of individual entrepreneurs made unofficial payments.

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163 All data from IFC 2006.
Table A8.1. Differences Between the Old Patent and the New Patent

<table>
<thead>
<tr>
<th>PATENT BEFORE APRIL 2008</th>
<th>NEW PATENT, EFFECTIVE FROM 1 JULY 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clearer issuance procedures</td>
<td>No clear information about required documents and procedures</td>
</tr>
<tr>
<td>Patent rate covers all tax obligations</td>
<td>Fixed price, including only income tax; entrepreneur must pay social and retail trade taxes separately</td>
</tr>
<tr>
<td>Tax inspectors verify only purchase of patent</td>
<td>(1) Availability of patent and receipt confirming its payment (2) Turnover (for trade) (3) Logbook for incomes and expenses (4) Usage of cash machine</td>
</tr>
<tr>
<td>Higher cost of patent (as now includes 2 other taxes)</td>
<td>From SM 7 (informative activities, cleaning of shoes, and souvenirs) to SM 60 (transportation of passengers by vehicles with more than 30 seats)</td>
</tr>
<tr>
<td>20% discount on multiple patents</td>
<td>None</td>
</tr>
<tr>
<td>Regional coefficients revised</td>
<td>From 0.8 (Gorno-Badakhshan Autonomous Oblast, mountainous areas) to 1.5 (Dushanbe, Khujand, and other cities)</td>
</tr>
<tr>
<td>Patents allow broader scope of activity</td>
<td>70 patents; 1 for each subactivity of 49 categories</td>
</tr>
<tr>
<td>Prohibited activities</td>
<td>- employment of staff - foreign trade activity - work at free-standing, permanent premises</td>
</tr>
</tbody>
</table>

Source: Authors.

Table A8.2. Taxes Payable by Individual Entrepreneurs in Tajikistan: A Comparison of the Patent and Certificate Regimes

<table>
<thead>
<tr>
<th>PATENT HOLDER</th>
<th>CERTIFICATE HOLDER (SALES BASIS)</th>
<th>NEW OPTION: CERTIFICATE HOLDER (TURNOVER BASIS)</th>
<th>CHANGE IN CALCULATION FROM PREVIOUS REGIME</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>Included in patent cost</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Advance minimum revenue tax</td>
<td>n/a</td>
<td>About 1% of the prior year’s profits due each month, for a total annual payment of 13% of the prior year’s profits*</td>
<td>n/a</td>
</tr>
<tr>
<td>Turnover tax</td>
<td>n/a</td>
<td>n/a</td>
<td>4% of annual turnover, payable at year-end</td>
</tr>
<tr>
<td>Retail trade tax</td>
<td>Included in patent cost</td>
<td>Up to 3% of cash sales (applicable for goods, not services)</td>
<td>Up to 3% of cash sales (applicable for goods, not services)</td>
</tr>
<tr>
<td>Social tax</td>
<td>Included in patent cost</td>
<td>20% of income**</td>
<td>20% of income***</td>
</tr>
</tbody>
</table>

(continued next page)
Table A8.2. Taxes Payable by Individual Entrepreneurs in Tajikistan: A Comparison of the Patent and Certificate Regimes (continued)

| Source: Authors. | * At year-end, the entrepreneur calculates actual profits. If he or she has overpaid (that is, if less money was made this year than last year), then no refund is due. If she or he has underpaid (that is, more money was made), then additional taxes are owed on top of the advance payments made throughout the year.  
** The entrepreneur’s declared monthly income is the basis for taxation. However, this declared income must be at least an average monthly salary as defined by State Statistical Committee (SM 83 monthly, for social tax burden of SM 16.6). If a Certificate holder hires external workers, he or she must contribute 25 percent of the employee’s salary and 1 percent of her or his own salary.  
*** The entrepreneur’s declared monthly revenue is the basis for taxation. However, this declared revenue must be at least an average monthly salary as defined by State Statistical Committee (SM 83 monthly, for social tax burden of SM 16.6). If an individual entrepreneur hires external workers, she or he must contribute 25 percent of the employee’s salary and 1 percent of his or her own salary.  
**** Certificate holders are not required to maintain records of their expenditures. A standard assumption of expenditures as 70 percent of turnover is used to calculate this tax. |

<table>
<thead>
<tr>
<th>PATENT HOLDER</th>
<th>CERTIFICATE HOLDER (SALES BASIS)</th>
<th>NEW OPTION: CERTIFICATE HOLDER (TURNOVER BASIS)</th>
<th>CHANGE IN CALCULATION FROM PREVIOUS REGIME</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT</td>
<td>n/a</td>
<td>For businesses with turnover &gt; SM 200,000, VAT is 20% of net value added to turnover</td>
<td>None</td>
</tr>
<tr>
<td>Road users’ tax</td>
<td>n/a</td>
<td>2% expenditures</td>
<td>Before applied only to businesses with turnover &gt; SM 600,000</td>
</tr>
</tbody>
</table>

**At year-end, the entrepreneur calculates actual profits. If he or she has overpaid (that is, if less money was made this year than last year), then no refund is due. If she or he has underpaid (that is, more money was made), then additional taxes are owed on top of the advance payments made throughout the year.**

**The entrepreneur’s declared monthly income is the basis for taxation. However, this declared income must be at least an average monthly salary as defined by State Statistical Committee (SM 83 monthly, for social tax burden of SM 16.6). If a Certificate holder hires external workers, he or she must contribute 25 percent of the employee’s salary and 1 percent of her or his own salary.**

**The entrepreneur’s declared monthly revenue is the basis for taxation. However, this declared revenue must be at least an average monthly salary as defined by State Statistical Committee (SM 83 monthly, for social tax burden of SM 16.6). If an individual entrepreneur hires external workers, she or he must contribute 25 percent of the employee’s salary and 1 percent of his or her own salary.**

****Certificate holders are not required to maintain records of their expenditures. A standard assumption of expenditures as 70 percent of turnover is used to calculate this tax.
Zambia’s competitiveness, the health of its business climate, and its capacity for job and wealth creation can all be greatly strengthened by streamlining and rationalizing its business licensing regimes.

In 2008, Zambia’s government, supported by the Investment Climate Advisory Services of the World Bank Group, embarked on a comprehensive reform program to streamline business licensing requirements, to make the licensing regime simpler and more transparent, and to focus licenses on legitimate regulatory purposes. A high-level Business Licensing Reform Committee (BLRC) was set up and mandated to guide, oversee and champion implementation of the reforms. The BLRC committee successfully reviewed all existing business licenses from an efficiency and necessity standpoint and presented its recommendations to the Government in February 2009. The Government has since endorsed the Committee’s Report for implementation, but has called for a further assessment of the likely impacts on revenue of implementing the business licensing reforms.

This report responds to Government’s request for further investigation into the potential revenue implications of business licensing reforms. It proposes policy reform options to mitigate any negative impacts, and outlines measures to reinforce positive reform outcomes. The report aims to provide indicative information and guidance regarding the likely revenue impacts of business licensing reforms. This basic premise should be borne in mind while considering its findings and recommendations.

**KEY STUDY FINDINGS**

i. Comprehensive business licensing reform is likely to have positive implications on Zambia’s overall economic performance. The review of international practices and experiences carried out within the framework of this report concludes that building and sustaining an efficient regulatory environment for businesses promises to enhance country competitiveness and the capacity of enterprises to grow and create jobs. However, it should be noted that these reform impacts are extremely context-dependent and will likely be effective only when implemented alongside other structural improvements in the economy. The study establishes that several African countries have pursued business licensing reforms, and their experiences provide useful lessons for Zambia. Kenya has applied the Regulatory Guillotine to rapidly identify,
review, and streamline all business licenses and associated fees. As a consequence, the country has cut business licensing costs by an estimated 50 percent. Namibia has opted for a comprehensive strategy, setting mid- to long-term reform targets, creating a positive cycle where steady progress reassures businesses and fosters further investments. Ghana has successfully established long-term coherent private sector development strategies that facilitate the prioritization and sequencing of targeted policy instruments. Both Namibia and Ghana have improved intragovernmental coordination, clarified the division of labor between the public and the private sector, and promoted a structured and results-oriented public-private dialogue. Rwanda has centralized the registration process through a one-stop shop for company registration at the Government’s Commercial Registration Department, reducing to two the number of start-up procedures. Botswana has computerized administrative procedures and simplified business licensing and tax registration, cutting the time to start a business and facilitating trade. The government also strengthened investor protection.

ii. This report argues that business licensing reform should not be seen as a stand-alone reform initiative but should be viewed as complementary to other structural reform initiatives, including improving the access to financial services, infrastructure, land and transport axes, improvements in education, and others. In addition to this, dynamic economic modeling undertaken as part of this assessment suggests that licensing reforms can be more sustainable and effective over time if they are accompanied by other measures, such as introducing regulatory quality mechanisms at national and subnational levels.

iii. Business licensing in Zambia is generally focused on revenue maximization\(^ {167}\) not regulatory efficiency and effectiveness. The study covered 368 business licenses (71% of the 517 licenses that exist in Zambia).\(^ {168}\) These include 231 licenses administered by the 11 regulatory agencies and 161 licenses administered by five central government ministries and five local authorities. The five central government ministries surveyed issued 35,515 business licenses in 2006. This figure increased to 243,014 licenses in 2007 and 458,036 licenses in 2008.\(^ {169}\) The study found significant growth in the total number of business licenses issued between 2006 and 2008. Current government policy and practice favors maximizing licensing revenue, often at the expense of efficient regulation of business activities. Ministries and regulatory agencies that seek to maximize licensing revenue generation and, while in the process, encounter financial constraints may receive appropriation in aid or grants.\(^ {170}\) This puts at risk the primary objective and rationale of business licensing, which is the efficient and effective regulation of business activities.

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\(^{167}\) International good practice suggests that business licenses should be priced to cover administrative costs. “Licenses should serve as regulatory instruments rather than fiscal tools . . . public revenues should come principally from taxes. The cost of each license should not exceed the cost to ministries of collecting and reviewing applications.” See World Bank Group SME Department 2006a.

\(^{168}\) The Business Licensing Reform Committee (BLRC) Report identifies a total of 517 business licenses that exist in Zambia. This number is based on a comprehensive inventory of business licenses carried out by the BLRC over the period June to November 2008. The study also identifies a total of 24 business licenses not covered by the earlier BLRC inventory study, including: international driving permits, driving test (Road Transport and Safety Agency), non-resident hunting permit, resident hunting permit (Zambia Wildlife Authority), license for importation of petroleum products (Energy Regulation Board), fire certificate (Chibombo District Council and Ndola City Council), fire station (Mufulira Municipal Council), state lease, land survey license, special right for secondary rights use (Ministry of Lands), registration as seed grower, orange international seed lot certificate, seed analysts license, fumigation registration certificate, wood packaging material license, import inspection report, export inspection report, solid wood products treatment facility registration, special fishing license (ornamental), certificate of origin, lodges and camps fishing license (Ministry of Agriculture and Cooperatives), launch master certificate, registration and survey (Ministry of Communications and Transport), and winding driver’s certificate (Ministry of Mines and Mineral Development).

\(^{169}\) The figures represent a significant underestimate of actual business licenses issued. While all central government ministries surveyed had some information on business licensing revenues collected over the period 2006, 2007, and 2008, a few had information on the number of business licenses issued over the same period.

\(^{170}\) According to the Ministry of Finance and National Planning (MFNP), Appropriation in Aid was intended to assist regulatory institutions to be more efficient in meeting their revenue targets and was not an incentive for licensing revenue maximization. The purpose of Appropriation in Aid was to ease the operations of regulatory institutions. For example, if institution X planned to collect K108n from licensing fees in a given year and demonstrated the need for quick access to resources to enable it meet the target, then MFNP would allow the institution to retain a proportion of funds raised in order to enable it meet its target. However, what has tended to happen is that the institutions see successful access to Appropriation in Aid and grants as a success indicator and a likely source of recognition by the MFNP that the institution is effectively meeting a key performance target.
iv. Business licensing revenue does not constitute a significant revenue source for the government.\textsuperscript{171} The proportion is nonetheless increasing, rising from 1.15\% to 1.21\% and 1.63\% in 2006, 2007 and 2008 respectively.\textsuperscript{172} Regulatory institutions vary in their dependence on licensing revenue. It is more pronounced among a few regulatory agencies. Business licensing for the 11 surveyed agencies represented an average share of approximately 35.1\% of their total revenue in 2008. Available information on 32 of the 72 Councils in Zambia shows that in 2007–2008, business licensing revenues as a proportion of total Council revenues ranged from as low as 0.5\% to under 15\%. Business licensing contributed between 3\% and 11.16\% of total revenues in 2008 for the five local authorities surveyed.

v. Use of Business Licensing Revenues by local authorities: A review of 32 local authorities\textsuperscript{173} and a survey of five selected Councils reveal that, besides meeting the costs incurred issuing and renewing business licenses, licensing revenues are used to fund other Council activities and programs. For example, in 2008, Mazabuka Municipal Council used 58\% to cover costs associated with the issuance and renewal of business licenses while Lusaka City Council used only 8\%. To reverse the trend of local authorities using licensing fees as a source of revenue, alternatives must be found, including a mix of taxes or improving transfers from the central government. Regulatory quality measures must also be introduced at local levels of government.

vi. There is no single model or solution to compensate for the loss of business licensing reform revenue. International experience shows that countries try to compensate for revenue losses using a number of instruments including taxes of different types, more efficient resource allocation, and transfers between levels of government. One possible approach is to introduce a consolidated business permit at local government level. This is what Kenya has done with its single business permit. However, the results have been mixed and local authority revenue loss has not been effectively compensated, reflecting the complexity of the problem and the need to look for context and country specific solutions. Zambia compares poorly with other countries in the region regarding central Government/local authority fiscal transfers. Zambia could implement a robust fiscal decentralization policy to address licensing revenue losses, especially at local levels.

vii. The reform of business permits issued under the Local Government Act is expected to be revenue neutral over the short term. All business permits issued by local authorities under the Act are to be reclassified as levies to be paid over the counter, as already envisaged by the Government for the fiscal year 2011. The ability of local authorities acting under the Local Government Act to introduce new business permits through council resolution presents a challenge to efficient business regulation at local authority level. The main motivation for the proliferation of local government business permits is to raise revenue, not to efficiently regulate business.

viii. Licensing revenue covers a small proportion of local authority running costs.\textsuperscript{174} On average, business licensing revenue covered nearly 15\% of the running costs of the local authorities surveyed, except for Mufulira Municipal Council, where coverage stood at only 2.36\% in 2008. Licensing revenue in relation to local authority running costs was significant for Chibombo District Council and Lusaka City Council during 2007 and 2008.

ix. The repeal of the Trades Licensing Act (Cap 393) is likely to have significant impact on local authority licensing revenues. The repeal of Trades Licensing Act is likely to have a significant impact on licensing revenues among local authorities. Revenues derived from issuance and renewal of business licenses under
the Trade Licensing Act Cap 393 constitute a significant proportion of all business licensing revenues collected by local authorities. For example, of the 1248 business licenses issued by Mazabuka Municipal Council in 2008, 1155 (92%) were issued under the Trades Licensing Act Cap 393. However, it is important to put this potential revenue loss in proper context given that business licensing revenue is a fraction of total council revenue—under 15%, across all local authorities. Overall business licensing revenue loss due to the repeal of Trades Licensing Act regarding the five local authorities reviewed is estimated at K 5,594,770,076 or 5.13% of total council revenues amounting to K 109,020,857,606.

x. Information gaps exist concerning central Government licensing revenue. Currently, few regulatory institutions directly report to Ministry of Finance and National Planning (MFNP) on licensing revenue collection and use. Some regulatory institutions report indirectly through their line ministries or have independent mandates, in which case there is no requirement for regular reporting to MFNP. In addition, the central government income and expenditure dataset, at the MFNP, does not incorporate information on local government business licensing revenues. The consequence is that Government’s audited financial reports do not capture the totality of Government’s licensing revenues and expenditures.

xi. Economic dynamic analysis confirms the opportunity to tailor licensing reforms in Zambia. Adapted to Zambia, the QUEST-A dynamic model applied in this study corroborates the conclusion that licensing reform will have an overall positive impact on Zambia’s GDP growth and inflation. A comparison of the effects on economic growth with and without licensing reform shows imperceptible changes after one year and more significant variations from five years onwards (+0.22%). Projected on a high Total Factor Productivity scenario of +25% over a period of five years, the GDP increase generated by license reductions amounts to about 0.5%. Concentrating license reductions on those Government departments whose income is less dependent on license revenues could minimize such negative impact. The results of the macroeconomic modeling should be interpreted as an indication of trends rather than formal economic forecasting because of the assumptions made in the analysis, and the absence of adequate data (e.g. regarding aggregate figures for new businesses).

**STUDY RECOMMENDATIONS**

Based on analyses and observations, this report makes a number of recommendations that should be read as an indivisible set of policy options aimed at ensuring the sustainability and efficiency of the reform as an integral part of a more comprehensive strategy for Zambia’s economic development and prosperity.

i. **Institute and maintain licensing fee charge policies that support enterprise competitiveness and contribute to lowering the costs of doing business in Zambia.** The overall objective of the reform should be to use licensing revenues only to recoup the costs of administering the licenses. This will help minimize any impacts of high licensing fees, levies and charges on business competitiveness. Using the business licensing process to raise revenue to fund activities and programs (other than meeting the costs incurred in administering these licenses) is inefficient and undermines the quality of Zambia’s regulatory environment for businesses.175 At the same time, however, the implications of the reform on the institutions that depend on licensing revenue should be well considered. Possible solutions include:

• Converting permits into direct levies or fees payable by businesses over the counter, which removes costs associated with licensing procedures. However, such an approach should be sensitive to the overall tax burden on businesses;

• The Ministry of Finance and National Planning should revisit its current approach, which encourages regulators that maximize collection of licensing and other revenues, even if such practices negatively impact the cost of doing business in Zambia;

• More generally, the Ministry should take a stronger position regarding the allocation and use of government resources since these resources ultimately impact the performance of the economy. There is

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175 However, it is also recognized that in those cases where Government needs to allocate limited resources, e.g. telecommunications bandwidth, revenue maximization, through a transparent resource allocation process, may constitute a legitimate policy objective. This is also applicable in situations where Government needs to allocate or manage non-renewable resources.
currently on issues of revenue mobilization and use, especially with those regulatory institutions with independent legislative mandates. There is often no reporting obligation between these institutions and the Ministry. The revenues they raise, however substantial, are used to meet their own objectives and mandates, even where the outcomes may contradict the overall intention of Government to reduce the cost of doing business in Zambia.

ii. **Curb the powers of the subnational authorities to introduce new licenses, and enhance compensatory transfers from central to local authorities.** For the sake of coherence and efficiency, it is vital that there be absolute unity of purposes between levels of government in designing and administering the reform. Streamlining and rationalization on one side should not be undermined by counterproductive policies on the other. It is, therefore, recommended that the power to issue new business licenses be exercised in the context of good licensing practice and that business licenses are issued for regulatory purposes only. Additional revenues required by regulatory institutions to sustain their operations and deliver services should be generated by Government through taxation and allocated accordingly. Transfers by the Government to local authorities, in compensation for loss of revenues from business licensing, should also be enhanced.

iii. **Provide policy guidance and formally communicate Government’s policy objectives regarding regulating business activities.** It is recommended that Government (possibly through the Ministry of Finance and National Planning) provides policy guidance and formally communicates to all regulatory institutions regarding Government’s policy objectives on the regulation of business activities. The policy guidance and communication should aim to ensure that Government’s regulatory policy objectives are not compromised by the business licensing process being used to maximize revenue, especially at local authority level. The policy guidance and communication should, among others, focus on: i) the need for regulatory institutions to ensure regulatory simplicity, transparency and efficiency, ii) the need to build and sustain stable and predictable business licensing regimes that support business planning and enhance investment and enterprise growth, and iii) the need to minimize utilization of business licensing process as a channel for raising revenues to fund activities beyond the direct cost of administering licenses. The policy guidance should also clarify the circumstances under which licensing revenues, beyond the cost of administering licenses, can be raised and used. The Government should also institute appropriate oversight measures to ensure that regulatory institutions conform to the policy guidelines.

iv. **Prevent the proliferation of unnecessary business licenses.** Zambia is encouraged to introduce regulatory quality mechanisms that impose quality control criteria to assess the possible impacts and costs of business licenses on businesses. A type of Regulatory Impact Assessment mechanism could help assess the likely impacts of licenses and their fees, ensuring that regulatory institutions do not introduce or amend licenses that inhibit economic activity and impose unnecessary burdens and costs to the private sector. This quality control mechanism should be accompanied by strengthening institutional capacities for regulatory reform at all levels of government and capacity building of regulators.

v. **Institute measures to compensate for possible loss of licensing revenue occasioned by regulatory reform implementation.** It is recommended that the Ministry of Finance and National Planning institute compensatory measures to mitigate loss of business licensing revenues caused by ongoing regulatory reforms. Compensating for revenue loss should be feasible, even in the short term, given the relatively small contribution of business licensing revenues to both total central government revenues (1.75% in 2008) and total local government revenues (ranging from 1 to 15%, in 2008). Under Government’s comprehensive business licensing reform initiative, the Trade Licensing Act is to be repealed, eliminating all licenses currently issued under the Act. Priority should be given to licensing revenues lost to local governments caused by the repeal of Trades Licensing Act. Potential revenue loss is estimated at K 5,594,770,076 or 5.13% of total council revenues amounting to K 109,020,857,606 in respect of the 5 local authorities directly reviewed under this study. Short-term responses could include: i) enhanced fiscal transfers from the central Government, or ii) reclassify business permits as business levies to be paid over the counter. Undertake a

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176 Some countries, including Kenya, have considered the introduction of unified legislation to guide overall regulation of business activities. The idea is to ensure regulatory efficiency and coherence and avoid duplication and overlaps in regulatory responsibilities and mandates among institutions that regulate businesses.
more comprehensive review of tax instruments and transfer mechanism between levels of government and consider introduction of a single business tax that efficiently consolidates all local government business fees and levies as a medium to long term reform measure.

vi. Enhance capacity of regulatory institutions to maintain timely, comprehensive and accurate information on business licensing activities and revenues and to report and share this information with MFNP. It is recommended that Government enhances its capacity to maintain timely, comprehensive and accurate information by streamlining and strengthening information systems relevant to business regulation. Enhanced reporting and central tracking will ensure effective and efficient collection and use of Government revenues, including licensing revenues, by regulatory institutions. This will also mitigate against possible loss on nontax revenues collected by regulatory agencies. Specifically, it is recommended that both Ministry of Local Government and Housing and Ministry of Finance and National Planning maintain timely, complete and accurate records on local government business licensing revenues and other revenues pertaining to business activities at subnational level.

vii. Reflect all licensing revenue information in Government Financial Reports. Few regulatory institutions currently report directly to MFNP on licensing revenue and expenditure. Some regulatory institutions report indirectly through their line ministries or have independent mandates, in which case there is no requirement for regular reporting to MFNP. The reports also do not capture local authority business licensing revenues and expenditures. The consequence of this is that audited financial reports do not capture the totality licensing revenues and expenditures. This deficiency undermines accountability and efficient services delivery and also constrains MFNP’s economic planning, coordination and oversight functions. The information gap must be addressed, partly through capacity building, and to issue explicit regulations and guidelines requiring local authorities to submit information on licensing revenues and expenditure to the central government.


116 Avoiding the Fiscal Pitfalls of Subnational Regulation


