

## **SUB NATIONAL IMPLEMENTATION OF EITI: ISSUES PAPER**

**A paper prepared for the EITI International Advisory Group (IAG) by the EITI Secretariat**

### **1. Key Questions for IAG**

- 1.1 What further work would the IAG like the Secretariat to do on Sub-national implementation of the EITI before the Oslo Conference?**
- 1.2 Does the IAG agree the Secretariat should pursue all, or elements of the additional work proposed below in 4.1 (a and/or b, and/or c)?**
- 1.3 Does the IAG agree with the initial assessment of proposed models?**

### **2. Introduction**

2.1 Members of the IAG have previously requested the Secretariat to give further consideration to how the EITI might increase transparency over payments and revenues. With this in mind, the secretariat has commissioned a study to provide insight into the possible expansion of EITI to the sub-national level<sup>1</sup>. The draft paper (which is summarised below) is available on request from the Secretariat.

2.2 This paper summarises the significantly longer study and some key elements of the Secretariat response. The study will be revised in the light of comments from the Secretariat and of discussion in Baku, and a final version will be posted on the Website. It is for the IAG to determine how they wish to take this work stream forward.

### **3. Report Summary**

3.1 The report addresses the possible expansion of the EITI to include ensuring that resources generated by extractive industries are distributed transparently at the *sub-national* level. This assumes that, if citizens of natural resource-rich developing countries are to understand the volumes of revenues flowing, and where to, then the information provided by such initiatives as the EITI should include details of these inter-governmental payments to sub-national levels.

#### **Current Transfer Mechanisms**

3.2 Sub-national governments receive non-renewable natural resource (NR) revenues through three principal mechanisms: in the majority of cases, countries have adopted **intra-governmental (or inter-governmental) revenue assignment** – where NR revenues are collected at national level and then assigned (shared downwards) to sub-national levels in the form of grants, matched funding or soft loans; **internally generated revenue (IGR)** – where sub-national government authorities collect their own NR revenues – for example through royalties, surcharges

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<sup>1</sup> Sub-National Implementation of EITI (Issue Paper), March 2006, prepared by Business and Development Performance, Overseas Development Institute (Michael Warner and Kyle Alexander)

on the national tax base (eg corporate income tax), local business taxes, charges, registration fees or social levies; and the final method: **transfers between sub-national levels of government** – though these are rare in practice. The report also distinguishes between **attributable flows** where NR revenues are explicitly transferred, and **non-attributable flows** where NR revenues are mingled with other transfers from the national to sub-national levels.

### **Potential Countries for Sub-National Implementation of EITI**

3.3 17 countries<sup>2</sup> (of 56 natural endow-entitled countries reviewed) had intra-governmental (or inter-governmental) revenue assignment from national government to sub-national government jurisdictions. 12 of these countries make intra-governmental NR revenue transfers to both 2nd and 3rd tier levels of sub-national government (SNG), ie federated states or provinces, and municipalities or districts. The remainder appear to be transferred to 2nd tier only.

3.4 A further 16 countries have no discernable arrangements for assignment of NR revenues from national to sub-national levels, but might be included in an expanded EITI programme on the rationale that conventional intra-government revenue transfers incorporate a predominance of NR resourced revenues.

**Table i Countries of Possible Interest to EITI Implementation at the Sub-National Level**

A. Countries with statutory or policy frameworks for intra-governmental assignment of attributable NR revenues.		B. Countries where conventional intra-government revenue transfers incorporate a predominance of NR resourced revenues (excluding countries in column A)	
2nd tier transfers only – <i>italics</i>			
Angola	Mexico	Algeria	Azerbaijan
Bolivia	<i>Nigeria</i>	Botswana	Cameroon
Brazil	Papua New Guinea	Brunei Darussalam	Ecuador
<i>Chad</i>	Peru	Republic of Congo	Indonesia
Colombia	Philippines	Equatorial Guinea	Iran
Ecuador	Russia	Gabon	Iraq
Indonesia	<i>Sudan</i>	Kuwait	Kazakhstan
Kazakhstan	Venezuela	Libya	Mexico
<i>Malaysia</i>			

### **Issues for Sub-National EITI Implementation**

3.5 Expanding EITI to include implementation at the sub-national level raises two broad categories of issues. First there are the changes that will be needed to broaden the concept of validated and reconciled accounts, that is to capture intra-governmental transfers as well as company-to-government revenue transfers. Related to this is the complexity of the task given the many different transfer

<sup>2</sup> All 17 countries are oil or gas producers; although three (Peru, Philippines and Papua New Guinea) are regarded under EITI as mineral-rich rather than hydrocarbon rich.

mechanisms and routes, and the progressively poor quality of fiscal records the lower the level of government.

3.6 Second, intra-governmental assignments of NR revenues to the local level has additional associated economic and social risks – over and above the national level implications of the “resource curse”. These risks include: magnified fiscal volatility, constraints on national government to perform its redistributive and budget stabilisation functions, new claims from non-producing regions for a share of the ‘national’ wealth, and risks to the political stability of the region and country if these trends are resisted by central government.

3.7 A decision to extend EITI programmes of transparency and accountability to the disbursement of NR revenue assignments from national governments to producing (or non-producing) SNG jurisdictions, will need to carefully balance the benefits of effective revenue management for poverty reduction and reduced fiscal mismanagement, with the risks of fuelling these unintended negative consequences.

### **Measures to Improve Sub-National Revenue Management and Transparency**

3.8 For the combined reasons of (i) magnified fiscal volatility at SNG level, (ii) constraints on national government to perform either its horizontal redistributive function or macro-economic budget stabilisation function, and (iii) the risks to political instability, many commentators argue that it is best not to share NR revenues with sub-national levels but instead to fully centralize oil, gas and mineral revenues.

3.9 Where such intra-government transfers do take place, the following measures are recommended:<sup>3</sup>

- complete and timely statistical information on fiscal performance made available;
- the amounts of revenue involved should be kept relatively small, i.e. relative to total revenues within the SNG jurisdiction;
- depending on the scale of the potential fiscal volatility, appropriate safeguards and transparency to protect levels of critical recurrent expenditure; and
- sub-national government jurisdictions assigned other more regularised sources of revenues, e.g. production excises and local surcharges on corporate income taxes;
- overlap of NR revenues with other sources (as with Mexico);
- assignment of taxation powers and expenditure responsibilities to central and sub-national governments based on stable principles, rules and agreed formulae, clearly and transparently formulated, and implemented as legally prescribed, in an open and consistent manner;
- rules and procedures for modifying these revenue sharing arrangements established;
- revenue transfer systems should address vertical imbalances between the central and local governments, and horizontal imbalances across local governments, e.g. in producing and non-producing states;

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<sup>3</sup> p23, Ehtisham, A and Eric, M. (2002) *ibid*; IMF (2005) *Guide on Resource Revenue Transparency*, June 2005, Washington DC, IMF, p35; Brosio G. (2003) *Oil Revenue and Fiscal Federalism*, In Davis et al, 2003

- the formulae for revenue sharing to take into account macroeconomic considerations and national fiscal policy objectives, and entail setting fiscal deficit targets and expenditure ceilings for sub-national governments to curtail demand in periods when large natural resource revenue spikes occur, thereby avoid unsustainable levels of recurrent expenditure; and
- an intra-governmental regime established to operationalise the above, executed through fiscal responsibility laws, internal stability pacts or other institutional arrangements that seek to coordinate fiscal management between central and sub-national governments.

### **Management of Sub-National EITI Implementation – Four Models**

3.10 The report suggests four models for EITI implementation at the sub-national level:

#### ***Model I - Comprehensive Approach***

3.11 Reporting and reconciliation would be undertaken for all material assignments involving NR revenues from national government to state, provincial, district and local levels. The approach would embrace both attributable and unattributable NR revenue transfers, and include disbursements between different sub-national levels, as well as tax and levy payments made by companies to SNGs. To improve both its manageability and defensibility, some arbitrary threshold for the proportion of unattributable NR revenues in transfers should be established. Substantial skills and institutional capacity building efforts would need to accompany the model, not least to lower levels of government to prepare relevant and aggregated fiscal accounts.

3.12 Because the model embraces unattributed NR revenues it is likely it would overlap considerably with the efforts of other international agencies working on intergovernmental transfers, fiscal decentralisation and fiscal transparency. Alignment with these other initiatives will be critical, for example in establishing the templates for authorities and companies to generate aggregated data. Perhaps the most acute challenge to this model, however, would be in constructing effective oversight mechanisms, both within the systems of local government (elected assemblies and councils) and with regard to civil society participation in the processes by which the reports on disbursements and revenues would be produced and reviewed.

#### ***Model II – Attributable Revenues [limited scope (either attributable revenues; or second tier)]***

3.13 In light of the constraints facing Model I, focus only on directly attributable intra-governmental NR revenue assignments. This would avoid the complexities of tracking NR revenues that are 'mixed' with other revenue sources. Included in this model would be material payments made by companies directly to the same levels of sub-national governments that are in receipt of NR revenues transferred from central government.

3.14 A variation of Model II would be to exclude any SNGs lower than state level, in Federated countries, or lower than provincial level in Unitary states, ie to

concentrate only on transfers from central government to 'the next level down'. This would considerably reduce the number of reconciliations required.

***Model III – Materiality Approach***

***[limited scope (materiality of dollar value or level of risk )]***

3.15 This model could entail consideration, not only of the dollarised volume of revenues, but also of (i) the level of the risks associated with these transfers in terms of worsening mismanagement, corruption, poverty and political insecurity, and also (ii) the opportunities presented by the revenues for poverty reduction and reduced political instability.

3.16 Under this model, efforts by EITI to support validation, reconciliation, oversight and capacity building would respond to the 'benefits-tax principle'. In other words efforts would focus not only on the relatively large NR revenue transfers from national government to oil or mineral producing states, but also pick up on the royalty payments made to affected communities and/or business taxes paid by companies to resource-poor district authorities, since in both cases they are each highly 'material' to the recipient SNG jurisdiction.

***Model IV - Black Box***

3.17 A forth model could be designed to accommodate the joint constraints of weak fiscal accounting at sub-national levels, and the risks posed by a sub-national EITI programme contributing to increased NR revenue sharing. In essence, the approach would avoid involvement in intra-governmental NR revenue transfers. Instead, it would seek to enhance transparency and accountability in four areas related to sub-national NR revenue transparency and accountability, but each of which takes place 'prior' to actual disbursements from the national level. These would be to:

- Report on the proportion of total NR revenues derived from a particular producing region (perhaps drawing on the experience of the Nigeria - EITI Physical and Process);
- Reconcile payments and revenues within the various national level accounts that take the proceeds of crude oil, gas or mineral sales through to national level disbursement accounts;
- Report the annual cash value of the proportion available for transfer; and
- Publicise the anticipated 'timing' of disbursements.

**4. Secretariat Overview**

4.1 The Report provides a good basis for IAG discussion on extending EITI implementation to sub-national levels. The four Proposed Models and the summary of existing literature on "suggested measures to improve sub national management and transparency" are particularly useful.

4.2 In taking forward this workstream, the Secretariat has identified a number of issues which the IAG may wish to discuss; and to commission further research. Briefly, these are::

a) The report does not speculate about where, or at what stages in the overall revenue transfer process, the biggest risks from lack of transparency lie. IAG members may wish to suggest that the report look into this issue; or, taking this further, they may wish to consider whether an extension of EITI is the most effective way of tackling such areas;

b) The report currently pays closer attention to those revenues that are raised at the national level and then transferred to sub-national government (intra- or inter-governmental revenue assignment). However, in previous discussion, some EITI stakeholders have noted enthusiasm for seeing EITI extended to internally generated revenues – that is revenues sourced locally by sub-national governments within their area of jurisdiction, eg taxes, or revenues from levies, licenses, fines, etc. IAG members could ask for further work on these latter revenues and in particular on the question of the materiality of such revenues relative to inter-governmental transfers;

4.3 The Secretariat suggests that any future approach to expanding EITI to the Sub-National level should be underpinned by the following criteria – and that further refinements of the suggested models should bear these in mind. This includes:

- Impact – should address significant (material) volumes / risks;
- Simplicity – minimise the burden on Stakeholders to participate;
- Brand clarity - easy to “market” as EITI or sub-set;
- Flexibility – allow adaptation to varied circumstances that exist;

4.3 In addition, in line with the current developments of EITI it will be important to ensure that, for any extensions of EITI, validation should be feasible and straightforward; and consideration should be given to the incentives for stakeholders to participate.

4.4 A quick assessment of the existing models against these criteria suggests:

**Model I - Comprehensive Approach** - good coverage but too complex, and could stray into areas where impact is questionable; Would require significant capacity building so incentives to join may be low – and complex to validate.

**Model II – Attributable Revenues** – Good on simplicity (although may miss some material transfers). A flexible version adaptable to different circumstances may be a good solution. NB – there is an a) and b) to this model. Option a) stronger on simplicity as focuses on transfers to only first rung of sub national Government).

**Model III – Materiality Approach-** An interesting approach but could be too complex to apply as standard. Some of the elements, eg of assessing financial and political materiality could be used as a pre-implementation assessment to decide how best to apply EITI SN in different circumstances.

**Model IV - Black Box** – Scores high on simplicity, and could in some circumstances capture the most material issues around transfer. Would need further investigation to decide if this is likely to be the case.

The models are not mutually exclusive, and it would be possible to take elements of each and produce a broad framework that could be applied in different circumstances.

4.5 From a preliminary consideration, the Secretariat suggest that the fourth model, currently referred to as “The Black Box”, is an interesting and innovative angle on tackling the sub-national issue. It goes less far than the other models – stopping at the stage of building the credibility of the allocatable revenue - but is a pragmatic

extension of the current model. However, IAG members may feel that it is insufficiently ambitious.

4.6 The paper, rightly, notes a number of challenges that will face the extension of EITI to the sub-national level – particularly if the criteria of simplicity is to be met. These include dealing with:

- The variety of transfer mechanisms both between and across countries;
- The very large differences in financial and political materiality connected to different transfers in different countries / regions.
- The far greater number of relevant transactions than are currently being addressed by National level EITI.

An option would therefore be to consider concentrating more on the systems that can deliver transparent outcomes, rather than on tracking the individual transactions themselves. Some of the proposed measures for improving management and transparency at sub-national level (3.9 above) might guide such an approach.

4.7 Finally, the report flags the question of the potential perception that a sub-national element might imply that EITI actively supports separation of NR Revenues from National budgets, despite a near consensus view amongst revenue management experts that this is not good for transparency and stability. Any proposal for a sub-national initiative would need to make clear the EITI position on this issue and the measures that are recommended where separation/decentralisation occurs.