Natural Resource Governance Institute

Subnational Revenue Management

Improving Local Development Through Resource Wealth

KEY MESSAGES

- Subnational governments share many of the same challenges of managing natural resource wealth as national governments, with the added challenges of decentralization constraints, high potential for conflict, migration, and environmental and social impacts.
- Subnational governments can address volatility by using fiscal rules to limit distributions to the annual budget and instead distribute revenues to funds or managing debt.
- Medium-term development planning is a key tool for subnational governments to take advantage of the limited nature of natural resource revenues and the direct expenditures from companies.
- In order for subnational governments to manage their natural resource revenues optimally, they must have access to information from the national government and companies about revenue payments, sharing formulas and production projections.

"Resource management requires maximizing the costs for affected communities, while enhancing the benefits."

— Natural Resource Charter, Precept 5

WHY SUBNATIONAL REVENUE MANAGEMENT?

Many countries decide to distribute some of their natural resource revenues to subnational governments. As discussed in the subnational revenue distribution reader, the process and amount of revenues shared with subnational governments varies greatly from one country to the next. This reader discusses how subnational governments can manage these revenues when they are received and highlights some of the special challenges that subnational governments face.

WHAT ARE THE CHALLENGES OF SUBNATIONAL REVENUE MANAGEMENT?

When subnational governments receive these revenues, they have the opportunity to use them to invest in the long-term economic and social development of their community. Subnational governments face many of the same revenue management challenges as do national governments. Resource-related revenues tend to be volatile and large, posing risks of crowding out other industries and resulting in inefficient budgeting practices. To add to the challenge, many subnational governments have fewer powers and skills than national governments to react to these challenges.

This reader is intended for use in conjunction with Precepts 5, 7 and 9 of the Natural Resource Charter.

Some of the additional challenges subnational governments can face include:

- **Decentralization constraints**. The laws that govern *decentralization* of power—the way power and responsibility is shared between national and local governments—can limit the options a local government has to respond to known extractive-industries challenges. For example, *fiscal* constraints on subnational governments—rules that dictate how much the local government can spend or save and for what types of projects—often make it less compelling or impossible to use some of the expenditure-smoothing tools available at the national level, such as savings funds or the ability to borrow. For example, if a subnational government has to return any unspent revenues each year, it cannot try to build a reserve to cushion the highs and lows of extractive prices. Some subnational governments are also directed by national governments to use their resources on certain types of projects, such as infrastructure, which may make it difficult to plan for maintenance of those projects. Similarly, subnational governments may be limited in the tools they have to respond to breaches of social or environmental impacts.
- **Variety of revenue sharing and collection schemes.** Revenue streams for subnational governments are often quite complex, especially when they involve revenue sharing from the national government. Subnational governments often do not have direct access to necessary information about revenue streams or resource projections to create accurate financial forecasts. To be successful at revenue collection, the subnational government must monitor a variety of potential revenue streams.

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- **Dealing with high community expectations**. At a subnational level, community expectations are particularly high once natural resources are discovered. Local communities will directly observe the initial infrastructure changes as a result of exploitation and often have expectations for a quick benefit. These expectations can put additional pressure on local governments and company corporate social responsibility (CSR) programs to respond with more popular but less strategic programs, such as large sports venues.
- **Discontinuity between CSR and local budget timing, planning and implementation**. In addition to paying taxes and royalties, extractive companies will often financially contribute to the community through a social investment program. These social programs are often disconnected from the local authorities' budgeting and planning cycle. As a result, it is not uncommon to see, for example, a new school in a resource-rich community that goes unused for years because the local government has not included or cannot include the additional payroll costs in its annual budget.
- **Technical capacity to forecast, plan, budget and lead multi-stakeholder deliberative processes**. While the technical capacity of subnational governments is often less advanced than national governments, this is particularly so in terms of natural resource governance. As noted above, managing the influx and volatility of natural resource revenues is a challenging problem even for advanced economists and requires personnel with an advanced understanding of these issues. Further, the particular challenges of natural resource wealth necessitate hosting multi-stakeholder dialogues to build consensus and ensure that citizens are consulted and informed of decisions made.

- **Lack of experience anticipating and managing social and environmental impacts**. Subnational governments often lack the technical knowledge and understanding to predict and manage harmful impacts from extraction.
- **Lack of local market capability to capture local content benefits**. Local governments often do not have the technical knowledge or decision-making power to magnify the economic gains of extractives in the local economy. Provisions for local economic impact, known as *local content* terms, are often negotiated at the national level, either for each contract or in a national legal framework. If these negotiations take place at the national level, they may not include considerations about local priorities, the capacity necessary to take up the opportunities, or the need to create an enabling environment. For example, a road or a port built for the company could also benefit the local economy if done with both goals in mind.
- **Poorly organized civil society**. At the national level, organized and technically competent civil society has become a strong check in some resource-rich countries. Civil society at the subnational level often lacks the technical and institutional capacities necessary to monitor and participate in decision making.

TOOLS FOR SUBNATIONAL REVENUE MANAGEMENT

Subnational governments have essentially four choices when facing a revenue windfall: increase spending, decrease taxes, pay down public debt or save revenues. When revenues unexpectedly decline, they can cut spending, increase taxes, borrow from financial institutions, draw on public savings or ask the central government for financial assistance. Of course, not all subnational governments have all of these options available to them.

Smoothing expenditures. Subnational governments can lower the impact of volatile revenues by decoupling the revenues from expenditures in the budget through rules that limit spending, called *fiscal rules.* Subnational governments can create fiscal rules that require limitations on spending within the annual budget and distribute the remaining revenues to savings funds or managing public debt.

Development planning. One means of improving spending outcomes, that is, the benefits experienced by the community, is by creating detailed, costed and comprehensive development plans. These multi-year plans can help governments transition toward a diversified economy and overcome development bottlenecks. Development planning is also an opportunity to align subnational government spending with spending by other actors, such as extractive companies and the national government. The *medium-term expenditure framework* (MTEF) is a process that links medium-term development planning to the annual budget. The MTEF can help subnational governments be more disciplined in following the development plan during the annual budget cycle.

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Investing in investment process. One of the major challenges facing subnational governments is having the bureaucratic capacity and economic size to invest resources efficiently. Resource-rich governments can invest in qualified personnel who can assist with the planning, budgeting and expenditure-monitoring process.

More information about revenue management tools can be found in the revenue management reader.

Case study: Peru

Subnational governments in the Piura and Arequipa regions of Peru receive revenue distributions from the national government that represent a share of the oil and mining revenues in their region. Though the revenue is distributed each month, for years subnational government officials did not know how much to expect during the next month or whether what they were receiving was appropriate. The regional governments in Piura and Arequipa set out to change this by developing revenue forecasts. First, government officials, with help from civil society researchers, investigated the components of revenue transfers from the national government. Once they understood the variables involved in the revenue transfers and how commodity prices were applied, they could use publicly available information from the national government to create revenue forecasts. Arequipa's first attempt at revenue forecasting was only 1 percent different from the amount received in the forecasted year. The success of forecasts in Piura and Arequipa has attracted attention from other regional governments in the country.

TRANSPARENCY

In order for subnational governments to effectively plan for the management of natural resource revenues, they must have access to timely, accurate, relevant information from the national government and extractive companies.

One challenge for subnational governments is to understand the amount and timing of potential natural resource revenues. *Revenue projections*, estimates of how much revenue the subnational government expects to receive over time, can help them anticipate space for development planning and the need to adjust for volatility. In order to create accurate revenue projections, subnational governments must have information about the revenue-sharing formula, company payments to the national government, contract terms, production volumes and costs. When this information is available to subnational governments in a timely manner, they can plan for how to manage these revenues and confirm whether the revenues they are receiving are appropriate.

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QUESTIONS TO ASK:

- Do subnational governments have access to natural resource revenues in my country? If so, what is the source?
- How does the power of subnational governments to manage natural resource revenues differ from that of the national government in my country?
- What tools do subnational governments in my country use to address the volatility and finite nature of the extractive resources?
- Are subnational medium term development plans costed? Do they benefit from participation of the community?
- Is all the necessary information available for subnational governments to understand what revenues they should be receiving?

ADDITIONAL RESOURCES

Bauer, Andrew, *Subnational Oil, Gas and Mineral Revenue Management* (RWI, 2013), available at: http://www.revenuewatch.org/sites/default/files/RWI_Sub_Oil_Gas_Mgmt_EN_rev1.pdf.

Morgandi, Matteo, *Extractive Industries Revenues Distribution at the Sub-National Level* (RWI, 2008), available at: http://www.revenuewatch.org/publications/extractive-industries-revenues-distribution-subnational-level.

Pellegrini, Matteo, and Varsha Venugopal, *From Conflict to Collaboration: Lessons learned from RWI Interventions in oil, gas, and mineral producing areas* (RWI, 2013), available at: http://www.resourcegovernance.org/publications/fact_sheets/conflict-collaboration.

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