

## Subnational Revenue Distribution

### Natural Resource Revenues in a Decentralized Context

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#### KEY MESSAGES

- National governments often share the responsibilities of governing with local governments through a process of *decentralization* or *deconcentration*, including on natural resource governance.
- In many resource-rich decentralized countries, subnational governments receive resource revenues through either *direct payments* from companies or resource *revenue transfers* from national government.
- Deciding whether subnational governments should receive resource revenues is often a complicated policy debate involving competing objectives, including promoting national cohesion, interregional equity, responding to local claims on natural resources, compensating producing regions for the negative impacts of extraction, and effective national fiscal management.
- Timely, accessible revenue transfers and information is necessary for subnational governments to fulfill their functions.

*The central government should link revenue distribution to the expenditure responsibilities of local governments, and be proactive in building the capacity of local governments to manage these responsibilities.*

– Natural Resource Charter, Precept 7

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#### WHAT IS SUBNATIONAL GOVERNANCE?

This primer discusses the relationship between national and subnational governments and the options national governments have for sharing or distributing revenue to them. This primer can be read in conjunction with the one on Subnational Revenue Management, which explains the challenges and opportunities subnational governments face when they receive these funds.

Countries often break up their government structure into smaller units to be able to better respond to needs across different geographic areas. In some countries, the government is organized through a process of *deconcentration*, where the national government appoints and stations officers at provincial or district levels. In deconcentrated countries, the national government sets the policies and makes decisions about how revenues are spent in provinces, districts and cities. Other countries have *decentralized* systems where the subnational government body selects its own leaders and has the authority to make policy decisions. While there is a general trend of decentralization throughout the globe, the extent of decentralization varies from country to country. For example, in Zambia the provincial level of government

This primer is intended for use in conjunction with Precepts 5, 7 and 8 of the Natural Resource Charter.

is politically deconcentrated, appointed by the national government, but the district level is partially decentralized. The district governments in Zambia can collect their own taxes, but they must get national approval for all development and spatial plans. In contrast, Indonesia is famous for its rapid decentralization, which gave more than 400 districts the power to collect taxes, save revenues and draft medium-term plans.

### WHAT EXTRACTIVE REVENUE STREAMS COME TO SUBNATIONAL GOVERNMENTS?

At least 30 countries (including 29 ranked in the 2017 Resource Governance Index) have systems to distribute resource revenues to subnational governments: that is, municipal, district, state or provincial governments. How, when, and how much revenue is acquired by the subnational governments varies from country to country. These funds primarily come through either direct payments from companies to subnational governments or transfers from national to subnational governments.

**Direct payments:** A company’s direct payment to a subnational government may be the result of contractual obligation, national law or local regulation. For example, in Argentina, Australia and Canada, provincial governments collect a royalty from mining companies. Subnational governments in Indonesia and Philippines collect fees over mineral licenses they issue. In Peru, until recently, mining companies set up a social fund at the local level that was overseen by subnational governments.

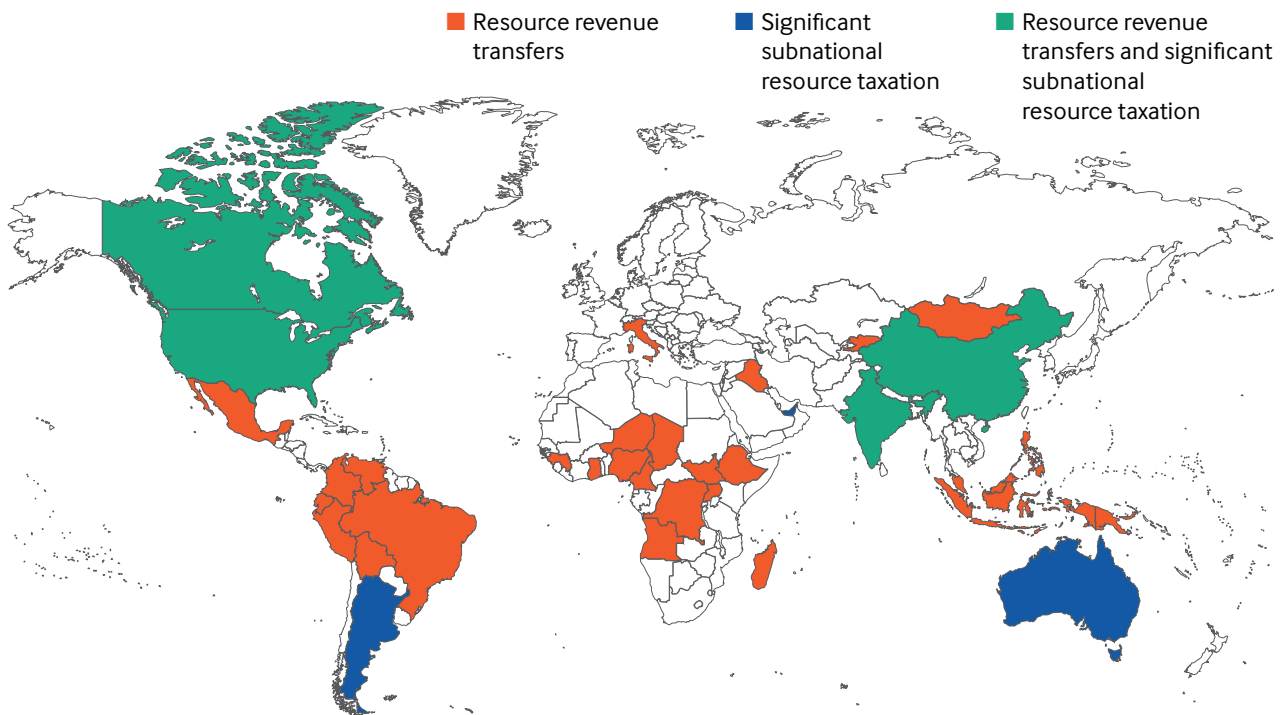
**Resource revenue transfers:** Resource revenue transfers are revenues from extractive companies collected by the national government that are transferred to subnational governments. These transfers are separate from intergovernmental transfers or grants made from a general pool of funds.

How much is transferred to which region varies greatly. Some countries transfer a share of resource revenues from an extraction project back to the subnational government in

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Figure 1. Countries with Natural Resource Revenue Sharing.

Source: Andrew Bauer, et al. *Natural Resource Revenue Sharing* (NRGI, 2016) p. 30



the region where extraction takes place, usually according to a formula. Other countries use an indicator-based formula to distribute resource revenues, with a calculation of each area’s share based on several characteristics, such as population size, per capita income or revenue collection effort.

**Case study: Indonesia**

Indonesia’s “big bang” decentralization of 2001 left subnational governments with unprecedented power to collect and expend revenues, and new responsibility to provide services to their citizens. Those designing the revenue sharing framework wanted to balance national unity with local control. After years of dictatorship, many of the resource-rich regions were among the least developed, and there was concern that the diverse archipelago could quickly disunify. In response, the government established multiple means of sharing resource revenues with the districts and provinces. Two regions, Aceh and West Papua, with large natural-resource wealth and a history of conflict were given 70 percent of all oil revenues in their regions until 2027, after which they will receive 50 percent. The remaining resource-rich local governments receive considerably less at 15.5 percent of the government’s profits from oil: 6.2 percent to the producing district, 6.2 percent to all other districts in the producing province, and 3.1 percent to the producing province. (See Figure 2.) While initially resource-rich districts and provinces had few resources to manage the extra funds, today some are developing stabilization and savings funds, transparency mechanisms and improved development plans.

**DESIGNING RESOURCE REVENUE SHARING POLICY**

Political scientists and economists often debate about whether natural resource revenue sharing is the most efficient or effective use of natural resource revenues. Public sector economists, often concerned with the volatility of resource revenues and the limited capacity of local governments, tend to caution against resource revenue sharing without an adequate budget stabilization mechanism. Others emphasize the local political, environmental and economic impact of natural resource extraction. They suggest that resource revenues should be shared to address negative local impacts, address local claims over resources and promote central-district harmony. Some argue that failure to share revenues with subnational governments could increase the possibility for conflict.

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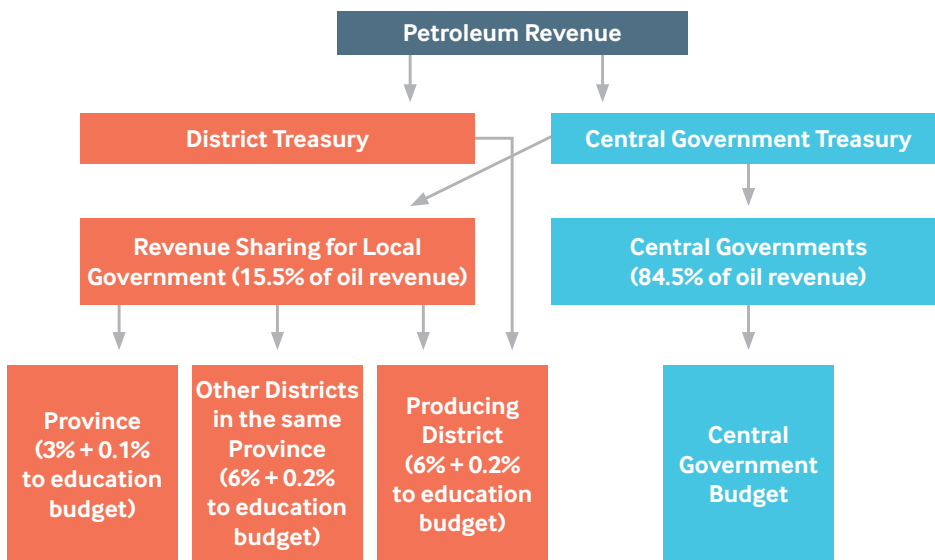


Figure 2. Indonesia’s petroleum revenue sharing regime.

Governments respond to these tensions with a variety of policies. Figure 3 provides a snapshot of the variety of revenue sharing schemes among different countries. Whatever revenue sharing scheme a country decides to implement, timely and transparent sharing is necessary for the local government to be able to use the revenues most efficiently. As discussed in the subnational revenue management brief, transparency can also help the subnational government project revenues owed and plan better for medium and long-term development.

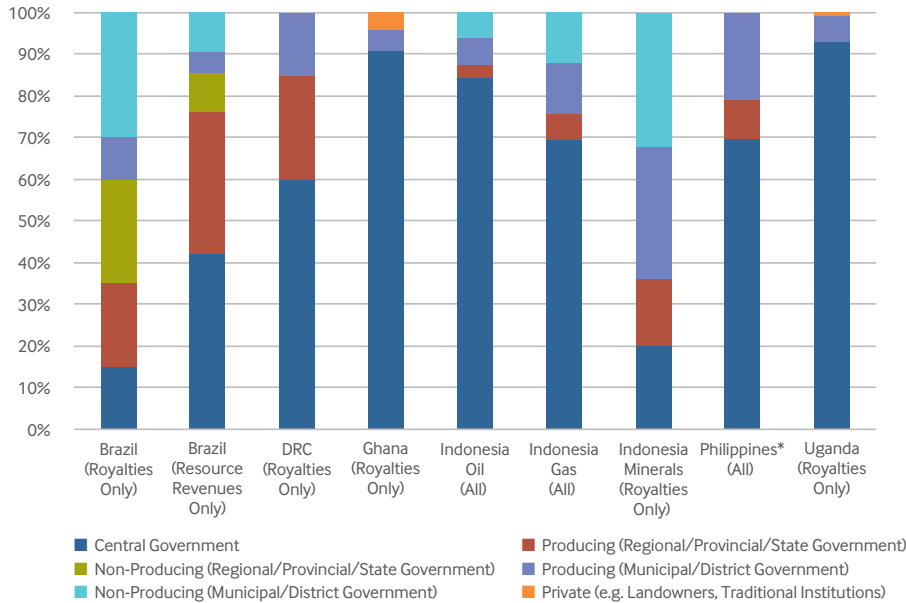


Figure 3. Samples of resource revenue distribution.

Source: Andrew Bauer, et al. *Natural Resource Revenue Sharing* (NRGI, 2016) p. 37

\*For Producing (Municipal/District Government), 18% goes to municipality and 14% goes to barangay

## 10 RECOMMENDATIONS FOR RESOURCE REVENUE SHARING

Decisions on revenue sharing are extremely context specific, making it difficult to have a one-size-fits-all approach. However, there are some common threads that can be derived from UNDP and NRGi’s research and experiences. Based on this, the following are 10 recommendations for efficient, fair and stable resource revenue sharing.

- 1 **Insist on clear objectives.** Objectives of revenue sharing regimes should be made clear in policy or legislation. Building consensus on a formula becomes more clear when the system is created with a clear agreement on the reason why revenues are shared.
- 2 **Align the revenue sharing system with its objectives.** Align the rules governing distribution of resource revenues with the objectives of the regime. For example, a system intended to benefit affected subnational jurisdictions must target those jurisdictions by properly defining them.
- 3 **Keep expenditure responsibilities in mind.** Decentralization of resource revenues should be aligned with subnational expenditure assignments and the costs of public service delivery. This prevents both wasteful public spending and poor public service delivery when revenues are not aligned with local spending requirements.

- 4 **Choose appropriate revenue streams and fiscal tools.** Governments earn resource revenues through various fiscal tools, such as royalties and taxes. When assigning or transferring revenue to subnational authorities, governments should consider how easy it is to calculate, collect and verify particular revenue streams.
- 5 **Smooth fiscal expenditures and make spending predictable.** Large and unpredictable transfers of resource revenues can destabilize a local economy, while boom and bust cycles can harm economic growth. It is incumbent upon central governments to either provide a predictable, smooth revenue sharing to local governments or provide them with the tools to cope with volatility.
- 6 **Make any revenue transfer formula simple and enforceable.** Any revenue transfer formula must be simple enough for local government authorities or civil society groups to verify compliance because this builds trust between different levels of government and between governments and their citizens. Simplicity also helps prevent corruption since transfers can be more easily verified.
- 7 **Build a degree of flexibility into the system.** Once decisions on revenue sharing are agreed, making changes may be difficult. However, political circumstances and economic conditions change, which may require making adjustments to any revenue sharing formula. Therefore, having built-in provisions to regularly reconsider revenue sharing arrangements can be helpful.
- 8 **Achieve national consensus on the formula.** Building consensus on a revenue sharing formula is crucial for the stability of the formula and for meeting the regime's objectives. A formula should not be implemented if there is still disagreement among key stakeholders as that can lead to conflict.
- 9 **Codify the formula in law.** Any revenue sharing formula should be codified in legislation or regulations as this improves predictability, forces discussion on objectives of any formula, and encourages public debate on proposals.
- 10 **Make revenue sharing transparent and formalize independent oversight.** Project-by-project and stream-by-stream revenue data must be made publicly available, as should the results of annual independent audits covering revenue transfers and subnational tax collection. Without this, subnational governments may not be able to verify that they are receiving their legal share of resource revenues.

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## QUESTIONS TO ASK:

- How does the national government share power with local governments in my country?
- Do subnational governments have access to natural resource revenues in my country? If so, how is their share calculated?
- If there is a resource revenue sharing system, is it meeting the system's objectives? For instance, is the system considered "fair" by all stakeholders and is it delivering economic benefits at the subnational level?
- Is there enough transparency in my country that the subnational governments can independently calculate revenues coming to their area?

## ADDITIONAL RESOURCES

Bauer, Andrew, Uyanga Gankhuyag, David Manley, Sofi Halling, and Varsha Venugopal, *Natural Resource Revenue Sharing* (NRGI, 2016), available at: <http://www.resourcegovernance.org/analysis-tools/publications/natural-resource-revenue-sharing>

Bauer, Andrew, Natalie Kirk, and Sebastian Sahla, *Natural Resource Federalism: Considerations for Myanmar* (NRGI 2018), available at: <https://resourcegovernance.org/analysis-tools/publications/natural-resource-federalism-considerations-myanmar>

Iwerks, Rebecca, and Venugopal, Varsha, *It Takes a Village: Routes to Local-Level Extractives Transparency* (NRGI, 2016), available at: <http://www.resourcegovernance.org/analysis-tools/publications/it-takes-village-routes-local-level-extractives-transparency>

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