



# Economic Premise

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## Taxation and Decentralization

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*Strengthening subnational governments is high on the policy agenda of many developing countries. From an economics perspective, the most important potential benefit from decentralization is the increased efficiency (and consequent welfare gain) that comes from moving governance closer to the people. To achieve this benefit, however, close attention must be paid to the design and implementation of subnational tax systems.*

Some people have argued that fiscal decentralization may improve welfare not only directly, but also indirectly by helping alleviate such other problems as economic development, revenue mobilization (see box 1), innovation in public service delivery, accountability of elected officials, capacity development at the local government level, and grassroots participation in governance. What more can one ask?

However, to be successful in attaining the potential benefits from decentralization, subnational governments must have the power to control their employees, and local residents must have the power to control their governments (normally through elections). Moreover, there must be sufficiently accurate information available for voters to evaluate the fiscal decisions of local governments, and sufficient incentive and interest for them to exercise their power responsibly. Unfortunately, in many developing countries, few if any of these conditions may be satisfied.

Significant tax assignment to subnational governments is common in developed countries: in Sweden and other Scandinavian countries, for example, local income taxes are important, whereas state and local governments in the United States often impose both sales and income taxes. In most developing countries, however, central governments have been

reluctant to release taxing powers to subnational governments. On average, the subnational tax share of total taxes in developing countries is only about 10 percent, or less than half of that in industrial countries. These figures have changed little in the last 30 years (Bahl and Bird 2008). The result is that most subnational government expenditures in developing countries are financed through transfers (including shares of national taxes, usually distributed on a formula basis). As a rule, even the few taxes that subnational governments have are costly and difficult to administer. This note discusses the case for improving the design and increasing the role of such taxes.

### Assigning Subnational Taxes

The traditional theory of fiscal federalism prescribes a very limited tax base for subnational governments. The only good local taxes are said to be those that are easy to administer locally, are imposed solely (or mainly) on local residents, and do not raise problems of harmonization or competition between subnational—local or regional—governments or between subnational and national governments. The only major revenue source that passes these stringent tests is usually

### Box 1. Decentralization and Increased Revenue Mobilization

In principle, fiscal decentralization may increase revenue mobilization by involving subnational governments more directly in taxation. Typically, central governments rely on a combination of company income tax, individual income tax, value added tax, and excises and customs duties. In many developing countries, however, small firms, most individuals, and owners of immovable property are all underrepresented in the tax base as the result of the combination of high entry levels (thresholds) and widespread evasion.

Subnational governments may have the potential and—if the intergovernmental transfer system is properly designed so as not to penalize success in revenue raising—the incentive to reach this tax base. In that case, increases in subnational government tax revenues will not be offset by reductions in central government tax revenues; instead, they will reduce the need for intergovernmental transfers from central revenues.

To an extent in some countries, local governments do seem to have broadened the tax base by employing a variety of tax instruments and by taking such administrative measures as placing levies on the sales of firms' assets, requiring licenses to operate, establishing betterment charges, and creating various forms of property taxation.

Such taxes and charges often are unpopular with those who pay them, and some may constitute an unduly costly and undesirable burden on new businesses. However, they do illustrate that—at least in some instances—decentralized governments may have a comparative advantage in raising revenue because they have ample opportunity to identify businesses in the community and to gain some knowledge about those firms' assets and the scale of their operations.

the property tax, with perhaps a secondary role for taxes on vehicles and user charges and fees. Because central governments generally are reluctant to provide subnational governments with access to more lucrative sales or income taxes, it is not surprising that, to some extent, property tax–driven decentralization has become both conventional wisdom and common practice in many developing countries.

There may be good reasons why central governments often are reluctant to give much tax discretion to local governments. For instance, they may fear losing some degree of macroeconomic control. In addition, fiscal decentralization may shift resources from central governments that have higher rates of capital spending to regional and local governments that spend relatively more on consumption goods and services. If the result is a lower overall rate of useful spending on infrastructure, national growth could be harmed. Similar-

ly, fiscal decentralization may shift the composition of public capital investments away from national priorities. Moreover, if fiscal decentralization takes the path of increasing reliance on own-source revenues, then local governments with greater fiscal capacity (such as large cities in which there is both a larger tax base that is easier to reach and a better chance of developing the administrative capacity to collect taxes) have an advantage; and regional inequality is likely to increase. Finally, revenue decentralization may result in higher administrative and compliance costs.

Counterarguments may be made to support increasing local tax autonomy. For instance, local residents are likely to hold officials more accountable if local public services are financed to a significant extent from locally imposed taxes and charges that local residents must pay, rather than from central government transfers. Local taxes should be both visible to local voters and large enough to impose a noticeable burden that cannot be easily exported to nonresidents. Reliance on own-source taxes has the important advantage of imposing fiscal discipline on subnational governments. Requiring local governments to finance a greater share of expenditures from their own revenue sources drives up the tax price of public services and, hence, tends to reduce upward pressure on subnational government expenditures. In contrast, heavy reliance on intergovernmental transfers—the common situation in most developing countries—has precisely the opposite effect of expanding local demand for increased public services (financed largely by others), unless unusually great care is devoted to ensuring that transfers have no effects at the spending margin (Bird and Smart 2002).

### Principles of Revenue Assignment

Who should levy what taxes and how effectively they can do so have been major issues in some countries. This is not surprising because the correct revenue assignment in a multilevel government structure is not at all clear in principle and often is controversial in practice. There are two fundamental problems:

1. The central government inherently can collect most taxes more efficiently than can subnational governments (*vertical imbalance*).
2. The potential tax bases available to the subnational governments vary widely from jurisdiction to jurisdiction (*horizontal imbalance*).

To some extent, vertical imbalance may be solved if subnational governments are permitted to impose variable surcharges (perhaps within a set range) on central taxes. However, even if the vertical imbalance issue can be resolved by adjusting revenue assignments, the degree of horizontal imbalance is invariably worsened by decentralizing taxing pow-

ers because those who have more to tax are obviously better off under this system than are those who are less favored. Consequently, in countries where interjurisdictional disparities are a concern, more decentralized taxes imply a need for more equalizing transfers to poorer regions.

Four basic principles for assigning revenues to subnational governments may be suggested:

1. *Efficiency*—Subnational taxes should not unduly distort the allocation of resources.
2. *Accountability*—Governments at all levels should bear significant responsibility at the margin for financing the expenditures for which they are politically responsible.
3. *Sufficiency*—Ideally, own-source revenues 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.
4. *Localization*—Subnational taxes should burden only local residents (and businesses), preferably in relation to the perceived benefits they receive from local services.

Economists often emphasize the first of those criteria, efficiency. The importance of the second criterion, accountability, has already been noted briefly. Sufficiency, the third criterion, focuses on fiscal imbalances: it is motivated by the argument that the lighter the load put on intergovernmental fiscal transfers, the more likely it is that they will be able to do their job adequately. Finally, although the last criterion listed, localization, is related both to reducing distortion (criterion 1) and increasing accountability (criterion 2), it also reflects a common assumption with respect to subnational finance—namely, that the principal task of subnational governments cannot and should not be income redistribution. Although local governments often are critical deliverers of services to the poor, they are seldom well suited to play any substantial redistributive role in terms of financing such services.

### What Is a Good Subnational Tax?

Among the characteristics that might be sought in a good subnational tax are the following:

- The tax base should be relatively *immobile* so local authorities have some leeway in varying rates without risking the loss of too much tax base.
- The tax yield should be *adequate* to meet local needs and sufficiently buoyant over time to cover expected increases in the local expenditures being financed.
- The tax yield should be relatively *stable and predictable* over time to facilitate development and implementation of sound local fiscal practices.

- To strengthen local accountability, it should *not be possible to export* much, if any, of the tax burden to non-residents.
- The tax base should be *visible*, again to ensure accountability.
- To be acceptable, the tax should be perceived by taxpayers as reasonably *fair*.
- The tax should be relatively *easy to administer* efficiently and effectively so that the cost of administration is a “reasonable” proportion of revenue collections and that compliance costs (those incurred by taxpayers) are relatively low (see box 2).

Not everyone may agree that all these characteristics are necessarily or equally desirable. For example, is it unequivocally good that subnational governments be insulated either from the tax base consequences of their tax rate choices or from inflation? Moreover, the characteristics that may be sought in a local tax that is ideal from the point of view of local governments may not be compatible with the charac-

#### Box 2. Administering Local Taxes

The key characteristic of a “local” tax in terms of accountability is that the local (or regional) government should be politically responsible for the tax imposed. That usually requires the local government to be able (perhaps within limits) to set the tax rate. However, neither this nor any other assignment principle requires that local taxes be administered by the local government.

The issue of administration thus can be considered apart from the revenue assignment issue. Many ways of organizing subnational tax administration exist in different countries. In the United States, at one extreme, each local government may be responsible for administering its own taxes. At the other extreme, there may be only one tax authority responsible for administering the taxes at all levels of government. Although no country appears to go quite that far, Canada has moved a long way down the path with respect to provincial taxes, and countries such as Denmark have both an integrated information system and strong operational synergies between levels of government. In some cases, the “national” tax authority may be directed by a board that includes significant representation from subnational governments. There are countries in which subnational governments may even be responsible for much of the administrative work involved in administering some national taxes. In others (often regarding the property tax, for example), one level of government may establish the tax base (the cadastre) while another level (or levels) sets rates and both collects and enforces the tax.

teristics that are ideal from the central government's perspective. Both levels might agree that the tax base should be immobile, and perhaps that tax yields should be stable and adequate to meet local needs. But central governments should be concerned also about ensuring that little, if any, of the tax burden is exported to nonresidents and that the local tax base is visible to provide accountability. Subnational governments are likely to view such attributes quite differently. Finally, because not all subnational governments are the same, the appropriate tax mix in most countries is likely to differ not only between regional and local governments, but also among governments of different sizes and complexities at each level.

## Decentralization and Fiscal Autonomy

Unless local governments have a significant degree of freedom to alter the level and composition of their revenues, neither local autonomy nor its essential partner, local accountability, can be achieved. In particular, some degree of rate flexibility with respect to a significant component of local revenues seems essential if local taxes are to be both adequately responsive to local needs and decisions and instrumental in making local leaders more accountable to their citizens.

A potential danger in permitting local governments even limited freedom to tax is that they may not use fully all the revenue sources open to them for fear of fiscal competition or adverse political consequences, thus allowing the level and quality of public services to deteriorate—the infamous “race to the bottom.” Of course, if the service in question is one of national importance or one in which there is a strong national interest in maintaining standards, it presumably should be funded and the extent to which it is achieved should be monitored by the central government. Even with respect to strictly local services, if intergovernmental fiscal transfers are properly designed, this monitoring should not be a problem (Bird and Smart 2002).

In the ideal world envisaged in the fiscal federalism literature, if local residents do not like what their local government does or does not do, they may (try to) “throw the rascals out” at the next election. To put this another way, the freedom to make mistakes and to bear the consequences is an important component of local autonomy in any country. Indeed, unless subnational governments are given some degree of freedom with respect to local revenues, including the freedom to make mistakes (for which they are accountable to their citizens), responsible and responsive subnational government is unlikely to develop. If, as in many developing countries, there are inadequate mechanisms for local accountability, or if those who fail to collect local taxes or to spend revenues efficiently are bailed out by discretionary transfers, countries are likely to

have both problems in managing decentralization and less-than-satisfactory policy outcomes.

Another danger is that subnational governments may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for their existence. To avoid this problem, it may be desirable to take two steps:

1. Limit the access of subnational governments to taxes that fall mainly on nonresidents—such as most natural resource levies, preretail-stage sales taxes, and, to some extent, even nonresidential real property taxes.
2. Establish a uniform set of tax bases for local governments (perhaps differing for such categories as big cities, small towns, and rural areas), with a limited amount of rate flexibility providing room for local effort while restraining unproductive competition and unwarranted exploitation.

If inappropriate tax bases are assigned to subnational governments, wasteful competition and undesirable tax exporting may result. Moreover, when inadequate tax bases are assigned, the result may be the imposition of a variety of undesirable and distortionary fees, levies, and informal charges—often outside the normal budgetary process. In such instances, it is common for central governments to blame incompetent or corrupt local governments for such undesirable outcomes. In reality, however, the fault may lie less with subnational politicians and officials (who, for the most part, are simply responding to an implicit incentive structure that allows them to shift tax burdens to others, to impose taxes and charges irresponsibly, or perhaps to demand and receive increased transfers or borrow irresponsibly) than with the central government that established such a dysfunctional structure.

## Smarter Subnational Taxation

However subnational tax systems develop in the future in developing countries, it is clear that much can and should be done to strengthen the deficient property taxes already in place in most countries. For example, the property tax should be simplified and applied uniformly. Cadastral maps should be updated and valuations made more consistently and currently. Improved use should be made of information flows from property registries, local building license authorities, public utilities, and so forth. In addition, close attention generally should be paid to improving the “sharp end”—collection and enforcement—and the technically more costly (and less immediately productive in terms of revenue) mapping and surveying of the traditional cadastral approach.

Although the property tax is a useful, even necessary source of local revenue, it seldom can provide sufficient resources to finance a significant expansion of local public

services in most countries. Indeed, many countries have been hard-pressed even to maintain the present low relative importance of property tax revenues. Although the assessment and collection of property taxes certainly can be improved in most developing countries, it is difficult to administer these taxes equitably in a rapidly changing environment; and it is always difficult to greatly or quickly increase revenues from this source. Nonetheless, a low-rate, uniform property tax has an important role to play in financing local governments, whether urban or rural; indeed, such a tax is probably the only general tax source available in most rural areas.

Apart from user charges (including those related to motor vehicles), which are not discussed here, the other main source of own revenue found in many countries is some form of local business tax or license system. Whether or not there is an economic case for such taxes, the political reality is that practically any subnational government permitted to impose such levies does so. Given the restrictions on (and unpopularity of) residential property taxes and the unreliability of central transfers in many developing countries, most property taxes are imposed on businesses. In addition, other business taxes often provide almost the only way in which subnational governments have been able to expand revenues in response to perceived local needs.

To an extent, there is an economic case for some local business taxation. Where it is not feasible to recoup the marginal cost of cost-reducing public sector outlays through user charges, a form of broad-based general levy on business activity may be warranted. If this is the rationale, from an economic perspective, it may be argued that the best form of tax on business might be a nondistorting low-rate, broad-based tax similar to those imposed by subnational governments in Italy (the IRAP); and, more recently, in both Japan (the modified enterprise tax) and France (the new uniform business tax). For further discussion, see Bird (2005).

Finally, intermediate regional governments in some countries are responsible for important and expensive services, such as health, education, and welfare. These expenditures

often are financed largely through central government transfers. However, when regional governments are also expected to contribute to financing such services, they often need access to some broader revenue source—perhaps income or consumption taxes. Because these tax bases also are the main revenue sources for central government, maintaining an efficient, effective, and accountable public sector can be a tricky problem. Although detailed discussion of this issue is beyond the scope of this note, the key to resolving these complex problems is to keep in mind the close interdependence between the assignment of expenditures and revenues between levels and units of government and the design and role of intergovernmental transfers (Bird 2010).

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