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State and Local Taxation

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49 State and local taxation

State and local taxation comprises those taxes that are collected at the sub-federal government levels in order to finance state and local public services, assigning discretion in the determination of rates and bases of these taxes to sub-federal governments. Consider a nation with different layers of government that are only serving administrative purposes. Each government level only distributes the public services to and collects the taxes from that nation's citizens upon which they agreed at the national level. In such a country, no state or local taxation is necessary since the level of public goods and services is uniformly decided upon for the whole country. This leaves citizens in some local jurisdictions, which prefer more public services than the national average, as much dissatisfied as citizens in local jurisdictions, which prefer less. It is possible to provide public services, the benefits of which are geographically limited and which are not national in scope, at different levels in different sub-federal jurisdictions. Enabling citizens to consume publicly provided goods and services at different levels according to their preferences makes everyone better off without making someone worse off. In order to let people, who want to consume more, pay a higher tax price for those state and local services, taxes must be differentiated accordingly between states and local jurisdictions. In such a world with a differentiated supply of publicly provided goods, each individual can reside in a jurisdiction where a certain level of public services is provided to adequate tax prices. The art of state and local taxation is the assignment of different kinds of taxes to government levels such that an invisible hand properly guides a nation in an ideal world to an optimal multi-unit fiscal system. This is not necessarily the case in the real world and some answers exist why fiscal systems are not optimal.

1. The rationale of tax assignment to the state and local levels

The basic idea of a power to tax for states and local jurisdictions is that their public goods and services should be financed by those citizens benefiting from them and deciding on their quantity and quality. In this case, individuals choose their place of residence according to their preferences and their dislike for congestion. A set of fiscal jurisdictions consisting of equal taste communities then results from a process of 'voting by feet' (Tiebout 1956). Olson (1969) calls the basic condition for such an outcome the 'principle of fiscal equivalence'. It requires to assign which public goods and services should be provided at which level of government. The guideline for this decision is the geographical incidence of those benefits and the costs borne by citizens in order to finance them. As some public goods and services cannot reasonably be provided at the local level, some kinds of taxes may not be assigned to the local level for good reasons, too.

There are numerous reasons why the proper assignment of tasks and the power to tax to the sub-federal levels are crucial to avoid sub-optimal outcomes. For example take the Scala in Milan, the famous Italian opera house. As it is partly financed by user charges and partly by subsidies paid from general taxes of the city, it will be congested because residents living in the suburban towns are able to visit it paying only the user charges and thus a lower price than the city's citizens. Nonresidents receive some of the benefits from the public service without paying an adequate tax price. This spillover is one of the externalities that Gordon (1983) summarized in his treatment of an optimal tax system for sub-federal jurisdictions. Another externality exists if nonresidents pay some of the taxes of a state or a local jurisdictions. Taxes are exported to nonresidents and state and local governments thus have an incentive to provide public services at a higher level than their residents prefer. An example of tax exporting can be found in the taxation of tourist trade or of natural resources in some U.S. states. Already for the year 1962, McLure

(1967) estimated for the U.S. states that overall tax export rates were between 19 and 28 percent in the short run. In the long run, only ten states exported more than 24 percent of their taxes or less than 16 percent. The estimates are corroborated in a more recent study by Metcalf (1993). Mieszkowski (1983) estimated the ”total waste” in Alaska in the beginning of the eighties that accrued from excessive public revenues and expenditures that were possible because of high natural resource taxes to about $500 million or thirteen percent of estimated petroleum revenues. Tax exporting is not limited to commodity taxes or natural resource taxes. It may also occur if individuals, firms or capital are mobile.

If factor mobility is allowed for, the problems of sub-federal taxation are even enhanced. If a state or community levies a higher personal or corporate income tax than its neighboring jurisdictions, its mobile citizens or firms emigrate (or move their capital there) in order to enjoy a lower tax burden. Such a situation is characterized as tax competition. Doing so, mobile factors reduce the tax burden of residents and firms in the state or community they move to and increase the tax burden in those jurisdictions they emigrate. These changes in tax burdens are usually not considered by public authorities in these jurisdictions in deciding on the level of public goods and services such that these are provided at a lower than ”optimal” level. Since there is a local loss from taxation that does not correspond to a social loss, the cost of public services is overstated and jurisdictions will tend to under-spend on state and local public services. Buchanan and Goetz (1972) call this effect a fiscal externality.

The effects of tax competition among states and local jurisdictions are similar to those of international tax competition and they vary according to different degrees of mobility of individuals and firms, to the number of mobile factors, to the number of jurisdictions involved in that competition, to the size of the jurisdictions involved and to the number of tax instruments available to tax authorities. The assessment of the usefulness of these effects becomes rather complicated if competition using tax instruments is complemented

by competition using public expenditures, like subsidies or specific infrastructural services, but also tax expenditures like tax holidays to attract mobile production factors.

The impact of tax competition on the possibilities of state and local governments to redistribute income by tax-transfer schemes is relatively clear-cut. Stigler (1957) already stated that ”redistribution is intrinsically a national policy” (p. 217). Suppose that a region adopts a progressive income tax program designed to achieve a significantly more egalitarian distribution of income than exists in neighboring jurisdictions. If rich and poor households are mobile, such a program would create strong incentives for the wealthy to move out to neighboring jurisdictions. In this case, local redistribution induces sorting of the population, with the richest households residing in the communities that redistribute the least by income taxes. A more equal distribution of income would result, but it would be caused largely by an outflow of the rich and a consequent fall in the level of per capita income in the jurisdiction under consideration (Oates 1972). At the central level, this problem does not occur, because mobility is reduced, the larger a jurisdiction.

There are not many theoretical arguments against this line of reasoning. Most of them rely on imperfect mobility of individuals. But the more mobile people become, the better this mechanism should work, the less possible should state and local redistribution by a progressive income tax be. However, according to Buchanan (1975), all individuals have an incentive at the constitutional stage to agree to income redistribution because they are fundamentally uncertain about their future positions in income, health and employment. At the post-constitutional level the rich might agree to income redistribution by the government because they, first, are interested in a public insurance scheme against fundamental privately uninsurable risks for themselves and their children, and, second, against exploitation by the majority of the poor residents and increasing crime rates. Particularly the second reason is important for the rich: they pay a premium for obtaining social peace. Janeba and Raff (1997) argue that individuals will agree to decentralized income redistribution because it is a credible commitment of the poor majority to the rich

minority that the latter is not exploited at the post-constitutional stage. The rich allow for the agreed extent of redistribution because a constitutional competence for income redistribution at the federal level leads to a larger public sector with more income redistribution. From this perspective, decentralized redistribution might be possible and even more efficient since redistribution is closer to citizens' preferences.

2. Guidelines for a reasonable tax assignment

This reasoning leads to some guidelines for tax assignment of different taxes to the state and local levels. The bottom line is that state and local jurisdictions should finance the services they provide by charges or quasi-charges to the beneficiaries (Musgrave 1983) or they should use those tax bases which have low interregional mobility (Wildasin 1980). Land and natural resource taxes and to a lesser degree also real estate taxes are thus especially suited for purpose of state or local taxation. A property tax for example is a good candidate for being assigned to the local level at least as far as residential property instead of business property is taxed. A property tax is basically a tax on land and construction built on it and it can thus be considered to be a tax on a relatively immobile tax base.

Consumption taxes are inappropriate at the local level because the inter-jurisdictional mobility leads to cross border shopping or tax exporting, but they become suitable for the state level if the region is large enough. However, the technological development, in particular internet shopping, reduces the possibility for state governments to levy a tax upon consumption. If individuals, firms and financial capital are fully mobile a comprehensive income or profits tax should not be assigned to the state and local levels because it were necessary for such a taxation to be optimal that a jurisdiction should be able to tax all income of its residents in the other jurisdictions. This is certainly not a realistic case. Beyond this, taxation of wage income tends to reduce this tax base less

than the taxation of capital income and it could thus be more easily taxed at the state or even local level unless tax authorities cooperate and exchange information about taxpayers' incomes. And even profits taxes can be levied at the state or local levels if investment is specific to the locality such that a firm cannot easily relocate. The latter is particularly the case for Not-In-My-Back-Yard (NIMBY) firms like waste incinerators or nuclear power plants. These firms have difficulties finding a location and assigning local jurisdictions the power to tax their profits gives these communities an incentive to provide such firms with a location.

Following from this reasoning is another rule for tax assignment: Progressive taxation, designed to secure redistributional objectives, should be assigned to the central level. A progressive income tax should thus be a federal tax. Moreover, as the case of Alaska illustrates, a large natural resource tax base permits local jurisdictions to provide public services at a low tax price leading to an attraction of individuals and firms at an inefficient scale. On these grounds, a case for central taxation of natural resources may be made whereby the central natural resource tax may apply to an excess base only, while leaving the average base for sub-federal use.

All in all, these basic considerations led Musgrave (1983) to present the following tax assignment to government levels: The local level should rely on property taxes and payroll taxes, the state level on a resident income tax, a consumption tax and a natural resource tax, and the federal level on an integrated progressive income tax and a natural resource tax for large natural resource bases. All government levels should additionally rely on fees and user charges as far as public services are attributable to particular users or certain groups of users. This possibility is probably reduced from the local to the federal level. According to Musgrave, corporate source income would ideally be included in the integrated base of the federal income tax. These propositions become substantially more complicated, if inter-jurisdictional tax agreements providing for tax

credits or deductibility are considered. Federal tax deductibility of state and local taxes for example may mainly serve taxpayers with higher income and is thus regressive.

3. Tax assignment in some OECD countries

A first look at real tax systems in OECD countries quickly reveals that tax assignment is not necessarily Musgravian (Pola, France and Levaggi 1996, Pommerehne and Ress 1996). The U.S. seem to come closest to those rules of tax assignment. The U.S. states are prohibited by the U.S. constitution from levying taxes on imports or exports but otherwise they may adopt any type of tax that does not egregiously discriminate against citizens of other states. U.S. States have a lot of freedom in defining their tax bases, in setting tax rates, and in offering tax abatements to induce business to locate within their state. Finally, the states grant tax authority to differing degrees to local jurisdictions, too. While there are only minimal restrictions on state power to tax in the U.S., the federal level nevertheless relies mainly on the individual income and corporate income taxes, the states on sales taxes and natural resource taxes, and the most important source of revenue at the U.S. local level is the property tax. Although state tax revenue from individual income and corporate income taxes is non-negligible, it is only about one fifth of the respective federal revenue. Such a favorable judgment about the U.S. tax system is however only justified on a first glance. According to Feldstein and Metcalf (1987) for example, the federal tax deductibility of personal income tax liabilities led many states to rely more heavily on deductible personal income taxes than on other type of revenue.

Apart from the U.S., e.g. in Canada and Australia and particularly in Europe, the assignment of taxes to the state and local levels differs considerably from the Musgravian model and varies widely across countries. In Canada, personal and corporate income taxes are the most important revenue sources of the federal level. The most visible of taxes in Canada, the personal income tax, is however also the most important revenue

source of the provinces. On the one hand, there are fairly significant income tax rate differences between provinces. On the other hand, arrangements between the Canadian federal and provincial governments on sharing the bases for the personal and corporate income taxes have a long history going back at least to the Second World War. There is as well a large variation in sales tax rates from Newfoundland to Alberta as the second important revenue source of the provinces. Canadian local jurisdictions, like those in the U.S., mainly rely on property taxes.

In Australia, the federal government exclusively levies taxes on personal and company income, sales taxes and (nearly exclusively) excise taxes. The bulk of state own source tax revenues are derived from payroll taxes, stamp duties and associated taxes on financial transactions, and so called franchise (i.e. business license) fees on alcohol, tobacco, and petroleum products that are not so much differing from excise taxes as well as lots of smaller revenue sources. Local governments, on the other hand, derive their revenues almost entirely from property taxes. Australian states also obtain revenue from the central government on the basis of a revenue sharing arrangement.

The Australian tax system is not as different from the German and Austrian system of state and local taxation. In particular Germany has established an extensive revenue sharing arrangement of personal and corporate income and value added taxes as the most important taxes accounting for about three quarters of total tax revenue. These are really shared taxes in the sense that German state governments decide on them together with the federal government. The federal government has on its own discretion only the gasoline tax and a surcharge on income taxes while the German states have no own power to tax. The local governments can rely on property taxes and local business taxes.

The less federalist European countries usually have taxing authority at the local level. In the United Kingdom, however, there is not only no regional or state level of government, but local British authorities basically have not much power to tax, only some power in

determining tax rates of the local property tax on real property. The formerly existing local business tax in the U.K. was abolished by Thatcher who cut the contributions of local taxes to local revenue sharply after the unsuccessful attempt to introduce the poll tax in the 1980's. There are some recent changes in the U.K. in the end of the 1990's to establish regional authorities in Scotland, Wales and Northern Ireland providing at least the Scottish government with some power to tax. The U.K. thus appears to follow the trend in Europe to more decentralized government structure with a power to tax for sub-federal governments as well. Over the past 25 years, systems of regional government have been given an enhanced role in taxation in France, Italy and Spain. In France, there are three levels of sub-national government: the local level with about 36,000 cities and communities, about 100 *départements* and 22 regions. Since 1986, the importance of these sub-national governments has increased. All three levels have the possibility to levy a property tax on real property (land and construction built on it), a local business tax ('taxe professionelle') and something similar to a residents' income tax ('taxe d'habitation'). All three taxes are subject to central regulation, but nevertheless there is a non-negligible variation in tax rates.

In Belgium, there is a development to fiscal federalism since it is agreed that the sales and property taxes will become exclusive taxes for the regional and local levels. Apart from smaller taxes, the three Belgian regions can additionally levy a supplementary rate on the personal income tax which may be positive, a surcharge, or negative, a tax reduction. Although there is some regulation of the local and regional power to tax income, the variation of rates is considerable. In contrast to that, local governments in the Netherlands can only levy property taxes.

An interesting pattern of local taxation can be observed in the Nordic countries. Basically, Denmark, Finland, Norway and Sweden are unitary countries with only two government levels. According to the studies in Rattsø (1998), local governments have considerable power to tax in Denmark and Finland, less so in Sweden, and only to a

limited extent in Norway. In Denmark and Finland, local governments can rely on taxes on property and personal income (nearly) without restrictions for setting tax rates accompanied by a considerable variation. In Sweden, local taxation consists mainly of personal income taxes with less variation in rates due to the central regulation of local governments. In Norway, most tax revenue originates from income and wealth taxes shared with the central government giving local authorities taxing power only within a narrow band. Since 1979, all local governments apply the maximum rate. The property tax is not available to all local governments, but is restricted to urban areas and certain facilities (notably power plants). In addition, local property tax rates are also limited to a narrow band.

In Switzerland, states (cantons) have the basic power to tax personal and corporate income as well as capital. The local jurisdictions can levy a surcharge on cantonal direct taxes and raise own property taxes. The central government relies mainly on indirect (proportional) taxes, the value added tax and specific consumption taxes like the mineral oil tax. It can also rely on a source tax on income from interest. There is, finally, a small but highly progressive federal income tax, which, together with revenue from the source tax on interest income, amounts to 34 percent of total federal tax revenue in 1995, while the cantons and municipalities rely on income and property taxes to about 50 percent of their total revenue and 95 percent of their tax revenue. In addition, personal and corporate income taxes in Switzerland vary considerably between the cantons. Taking the value of the (weighted) average for Switzerland as 100, the index of the tax burden of personal income and property taxes has been varying from 55.6 in the canton of Zug to 135.8 in Fribourg in 1995 while the index of corporate income and capital taxes varied from 57.6 again in Zug to 145.6 in Nidwalden.

Table 1 about here

As the overview of these selected OECD countries in Table 1 indicates, there is no clear picture which kinds of taxes are assigned to the state and local levels. Local jurisdictions regularly levy property taxes as well as fees and user charges. Some power to tax personal income, at least labor income, is attributed to state and local governments in the U.S., Canada, France, Belgium, the Nordic countries and Switzerland. In some instances, like Germany, France and Switzerland there exist even local business taxes in the discretion of sub-federal jurisdictions. But on the whole, the assignment of taxes does not follow along Musgravian lines and there is a considerable variation in federal regulation of sub-federal taxing power.

4. The political economy of state and local taxation

Given these differences in tax assignment to state and local authorities, the question arises which institutional and political factors explain the tax structure in different countries. An early contribution to the choice of taxation in a political economy framework originates from Pommerehne and Schneider (1980). They develop a model of Australian tax and expenditure structure along with a model of selfish government behavior assuming that the re-election constraint is not always binding. In choosing among tax instruments, a government in power is only urged to follow the preferences of a majority of voters if an election approaches and the re-election constraint is binding due to low government popularity. Between elections, the government can follow its ideological preferences. This modeling of government behavior proved to be clearly superior compared to the traditional models of government behavior in ex-post predictions of important variables (government spending, GDP, etc.). In contrast, Hettich and Winer (1999) assume that the governing party or coalition always maximizes the expected votes which by themselves depend on the consequences of policies for the

economic welfare of voters. In making fiscal choices, political parties thus take into account economic, political and administrative factors that determine the nature of electoral support and opposition associated with alternative ways of taxing. The authors present empirical evidence on the reliance on income taxation and income tax structure of the U.S. states in 1985 and 1986 supporting their hypotheses.

Inman (1989) finds that redistributive concerns strongly influence the decision of the 41 largest U.S. cities between 1961 and 1986 to rely on property taxes, sales taxes or user charges. The higher the demand of local voters for redistributive services, the less city governments rely on fees and user charges as well as sales taxes and the more on property taxes. Hunter and Nelson (1989) present evidence for the impact of interest groups on the local revenue structure. The higher the share of wealthy homeowners in local jurisdictions in Louisiana, the lower the share of property tax revenue and the higher the share of charges.

Besides vote maximizing behavior of politicians and interest group influence for redistribution in their favor, tax competition is a third factor determining the structure of taxation. However, the expected impact is ambiguous. On the one hand, tax competition for mobile capital and workers may lead to a convergence of tax rates to a low level. On the other hand, tax competition may lead to increases in tax rates if a state's geographic neighbors follow suit when it raises its tax rates. Such behavior might occur due to yardstick competition between states and local jurisdictions (Besley and Case 1995). Due to their incomplete political information, voters evaluate the fiscal performance of representatives in their jurisdiction by comparing it to the fiscal performance of neighboring jurisdictions. If a state's neighbor increases tax rates, this state has an increased possibility to raise its taxes as well. Arkansas State Senator Doug Brandon once said: "We do everything everyone else does".

Finally, the structure of state and local taxation, like federal taxation as well, is influenced by the degree of fiscal illusion among taxpayers. The more complex a tax system, the more incorrect voters' perceptions about their true tax burden and thus their tax resistance, the more easily representatives can increase taxes in order to finance new spending. Pommerehne and Schneider (1978) present evidence for Swiss local jurisdictions that the extent of fiscal illusion attributed to the complexity of the tax system is less pronounced, the more voters can determine taxes and spending directly in fiscal referenda. Moreover, Matsusaka (1995) finds that U.S. states which allow for the use of initiatives in their constitutions rely more on fees and user charges than on broad based taxes increasing the visibility of contributions to the public sector and the equivalence between public services and tax prices.

5. Concluding remarks

Although a comprehensive assessment is still too early, the state and local taxation, that is defined on the basis of state and local power to tax, appears to be the outcome of political decisions shaped by constitutional provisions and influenced by economic and administrative restrictions. Voters, representatives, bureaucrats and interest groups deciding upon taxation under the decision making provisions of their constitutions and taking into account the mobility of tax bases and the accompanied tax competition and tax exporting determine to what extent state and local jurisdictions rely on property, income and sales taxes or on user charges. The differences in these political, institutional and economic factors explain why there are so many differences among countries in their reliance on tax sources at the state and local levels.

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Table 1

State and local tax assignment in selected OECD countries

Country	States	Local Authorities
U.S.A.	Income tax	Property tax
	Sales tax	Sales tax
	Natural resource tax	
Canada	Personal and corporate income tax	Property tax
	Sales tax	
Australia	Payroll taxes	Property taxes
	Stamp duties	
	Franchise fees	
Germany	No taxing power	Property tax
		Business tax
U.K.	No state level	Property tax
France	Property tax	Property tax
	Business tax	Business tax
	Residents' income tax	Residents' income tax
Belgium	Personal income tax surcharge	Personal income tax surcharge
	Property tax	Property tax
Switzerland	Personal and corporate income tax	Personal and corporate income tax surcharge
	Inheritance tax	Property tax
	Wealth tax	

Norway	No state level	Personal income tax Property tax
Denmark	No state level	Personal income tax Property tax
Musgravian ”optimal” assignment	Residents’ income tax Consumption tax Natural resource tax	Property taxes Payroll taxes