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# Local Taxation: Principles and Scope

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## 1. Introduction

There is broad agreement among economists as well as political scientists that many public services should be provided at low level of government in order to enhance the efficiency of the public sector and to increase its responsiveness to voters' preferences and demand for collective services. The European Union has explicitly recognized the principle of "subsidiarity" in its intergovernmental relations by which public functions should be exercised at the lowest possible tier of government unless they are positively provided more effectively at a higher level.

The theory of federalism has established an operational framework for assigning expenditure functions to the various levels of government, central, state and local. The literature is not reviewed in this paper.<sup>1</sup> It can be observed, however, that, in practice, expenditure assignment follows the theoretical guidelines rather closely, and that there is little variety, in principle, as to the assignment of such functions like defense, foreign policy, and international trade to the central government, and education, health, or housing to lower levels of responsibility.

However, the decentralization of public functions raises the question of local finance and taxation in particular. While guidelines to local taxation can also be found in the theory of federalism, their impact on actual arrangements is remarkably weak. The way local services are financed in different countries varies widely. While Scandinavian countries typically raise significant local revenue from own taxes (on average as high as 15 percent of GDP), local budgets in Austria, Germany, France, Japan and the United States also rely heavily on local taxation (albeit at a lower level; see chart 1). However, many countries finance local budgets mainly through grants (apart from the Scandinavian countries--which also use grants intensively--, in particular Italy, the Netherlands and the United Kingdom).<sup>2</sup> Most scholars agree, however, that local taxation *is* an important part of local autonomy that is so cherished by economists and political scientists alike.

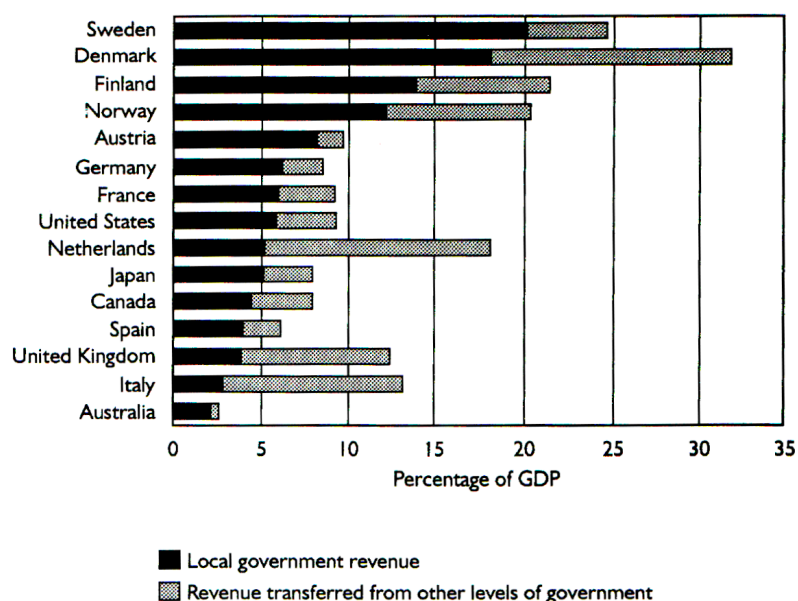
This paper attempts to summarize main principles that govern local finance and local taxation in particular, and to discuss their implications. While some of the criteria will support each other guiding into the same direction, others are in sharp contradiction to each other. It has to be acknowledged that the various principles discussed must conjointly determine the scope for local taxation. One criterion may be binding while all other principles rank a particular tax favorably as a local revenue source. If local taxation is to be strengthened, this calls for the easing of the binding constraint whenever this is feasible through tax policy and administrative or organizational measures.

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<sup>1</sup> See, however, the "classical" contribution of Oates (1972), and a more recent review of the literature in Walsh (1993).

<sup>2</sup> When comparing local internationally, it has to be recognized that the federal countries (Austria, Germany, the United States, Canada and Australia) also have an important middle tier, which performs many of the functions that are assigned to local government in unitary states.

**Figure 9-1.** Local Government Revenue and Revenue Transferred from Other Levels of Government



Note: Data are for 1991 except for Spain, Norway, and Finland (1990), Japan and the United States (1989).

Source: International Monetary Fund (1993).

## 2. Principles of local taxation

The paper discusses the following principles for local finance and taxation:

1. Local accountability
2. Tax-benefit link
3. Non-distortion
4. Regional equity and long-term efficiency
5. Reliability and stability of tax bases
6. Tax-sharing as implicit insurance, and
7. Administrative simplicity.

### 2.1 Local accountability

Local politicians should be responsive to the expressed preferences of their local citizens, or encounter defeat in local elections. This is the basic principle of accountability of local policy makers, and it is essential both for economic efficiency and democratic representation. The principle calls for own tax bases of local governments, and it works against the financing through grants or tax sharing with higher levels of government. General revenue raised by and transferred from other levels of government tends to blur the issue of local responsibility and accountability. The principle also supports the quest for policy discretion of local politicians and parliaments, and it entails the right to determine

their own tax rates.<sup>3</sup>

Discretion in local tax policy is a necessary, but not sufficient conditions for accountability. Accountability also implies that local taxes be borne by local citizens. There must be equivalence between the provision of local public goods and the tax carried by local voter-citizens. If taxes can be exported onto taxpayers of other jurisdictions, accountability is reduced as local voters can shift the burden of financing the local budget onto others. Local incidence or non-exportability of the tax must be valid at least at the margin, for incremental or higher-quality services, while standard local services might be finance through transfers from other jurisdictions. However, standard local services must be defined in a way so as to avoid strategic behavior, i.e. they must be outside the control of local government.

The accountability criterion favors a local personal income or a property tax. A tourist tax or local business taxes rank poorly under this principle because these taxes can usually be "exported" to other jurisdictions.

Accountability also calls for a strict separation of local public budgets and entrepreneurial activities of local government. While the local budget is subject to voters' control and is ultimately financed through taxation, companies--although public--operate outside the electoral process and should exclusively be subject to market discipline. This does not preclude public ownership of such firms, or the use of profits for financing public budgets; neither does it preclude subsidies to local firms where they are related to public benefits and subject to political control.

## 2.2 Benefit-tax link

The benefit-tax-link principle emphasizes efficiency aspects of local taxation as to the provision of public goods. If a link can be established between a tax and the willingness to pay for a public service, the tax plays a role similar to a price in a *quid-pro-quo* market transaction. This would enhance individual (and/or collective) welfare in the provision of public goods. While market prices will automatically emerge in functioning markets for private goods, a tax-price for public goods is more difficult to establish. Yet for many local services fees and user charges as well as contributions of beneficiaries to the financing of local investment projects can be defined and employed successfully.

A tourist tax -- although in conflict with the accountability criterion -- can be defended under the benefit-tax principle as long as it is sensed to be an equivalent to a payment for local services received. Furthermore, the principle works in favor of local business taxes whenever local services are perceived as factor inputs by local firms and hence "purchased" through the tax. Although one may object to the business tax on grounds that it can be "exported" to other jurisdictions and thus fails to strengthen accountability at the local level, the argument is weak when taking an integral view of the tax. Moreover, the objection rests on very narrow assumption as to the shifting of the tax.

It is not certain, for instance, that a local business tax is shifted onto producer prices and thus "exportable" as held by its opponents. The tax may represent payment for local inputs that would otherwise appear in private costs of the firm. This is true whenever the benefit-tax link prevails. Local business taxes may thus be used to finance local infrastructure for business, to lower the firm's operating costs via communal services, and so forth. Cost-reducing effects might also show up indirectly, for instance in labor productivity when the

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<sup>3</sup> It should be noted in passing that the accountability principle also calls for autonomy in local public borrowing.

quality of the local labor force improves through education, recreational facilities or health care.

The benefit-link principle may also call for an intermediate level of government whenever local benefits exhibit spillovers that accrue to a region rather than to a locality. In this case, benefits can be "internalized" for the beneficiaries of a region, and the tax be seen as a market equivalent for the service consumed. This could eventually be achieved through negotiated payments among groups of municipalities that share the costs of a supraregional local service; it may also be achieved by the establishment of functional regional bodies or districts (like utilities for water and energy supply, or waste disposal).<sup>4</sup>

### 2.3 Non-distortion

Taxes should be non-distortive in that they do not affect allocation decisions in the private sector; taxation should ideally be "neutral" in that sense. Most of the existing taxes fail on this criterion, but market choice is typically limited within the nation as a whole, which works as a barrier against non-neutrality at that level. At the municipal stratum, however, the criterion has a particular importance since taxpayers can always avoid a high level of local tax by shifting the tax base to low-tax jurisdictions. This leads to horizontal tax competition among local government with potentially ruinous consequences for the municipalities' ability to raise tax revenue at all.

Horizontal tax competition among jurisdictions has two dimensions: (i) it imposes discipline on the variability of tax rates; and (ii) it restricts taxation to tax bases that cannot easily be transferred to other municipalities.

The first issue vanishes if all municipalities impose the same tax rate. This could either be achieved through national legislation or through horizontal cooperation. Yet uniform rates are in conflict with the accountability principle and should be avoided under this aspect. Furthermore, some regional variation in tax rates is likely to be tolerated by taxpayers. This is in view of the benefit-tax principle as long as these variations reflect the regional pattern of demand for public services. Thus tax-rate variability is desirable and--within the limits imposed by the benefit-tax principle--also feasible. Ruinous competition--by which local governments underbid each other through lowering tax rates mutually until they reach a zero-level--can be avoided by national legislation that imposes a "floor" on local tax rates.<sup>5</sup>

The second issue is usually addressed by selecting an immovable local tax base. As long as the tax base cannot be shifted to other jurisdictions, taxation is neutral and efficient (in the sense that it does not exhibit "excess burden"). The argument is in strong support of a local property tax and a local income tax based on the residence principle. It also favors a local business tax. In particular a local land tax seems to be an ideal candidate under this guideline.

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<sup>4</sup> In the United States, even education is organized in this fashion -- through school districts. While education is, of course, a service, it involves substantial "externalities" (benefits) for society as a whole, which renders it intrinsically different from a quasi-private service like water and electricity supply. This must also affect the financing of the service. In particular, it calls for equalizing grants in order to establish regional equity of educational opportunities, and/or to compensate for regional spillover effects. Financing education according to a pure benefit-tax principle is thus inappropriate.

<sup>5</sup> This approach was also adopted by the European Union with regard to her member countries in the case of VAT and excise taxation.

While land is indeed physically immobile, the tax base of a land tax may not be, however. This is the case whenever municipalities have the right to define their own valuation rules or to concede tax preferences and exemptions at their discretion. Under these circumstances, the tax base might be eroded although the physical base remains untouched and is, of course, immobile.

This calls for national legislation as to the definition of the local tax bases. Valuation rules, tax preferences and exemptions relating to local tax bases should all be uniform throughout the nation in order to avoid the *de facto* erosion of a base that is physically immobile. With standard rules for the tax base, no tax benefits can be reaped by the inefficient cross hauling of tax bases from one municipality to another. The only incentive to reallocate resources from one jurisdiction to another should subsist in the differential of tax rates.

Standard rules for local tax bases are also commendable in view of our next point, regional fairness. Horizontal tax competition among municipalities must, however, be allowed to operate--as is required under the principles of accountability and public service efficiency (benefit-tax link). However, it should be restricted to the setting of tax rates only.<sup>6</sup>

#### 2.4 Regional equity and long-term efficiency

Local taxation should ideally reflect a regionally equitable revenue pattern for reasons of distributional justice among jurisdictions. This is, of course, a pure value judgment, yet it may also be warranted on political grounds if social fairness and cohesion of the nation are felt to enhance political stability. On these grounds, taxes on bases that are unevenly distributed across jurisdictions (like natural resources) are *not* suited for local use because they usually entail large regional inequities. The regional-fairness principle is difficult to realize in practice since the distribution of most tax bases can be expected to be regionally inequitable to some degree. A local turnover tax is, however, closely linked to local economic activity, and it would rank higher, on this scale, than most other taxes.

The principle of regional equity contradicts the aforementioned neutrality argument which views the local immobility of the tax base as efficiency improving. Indeed, natural resources--like land--are locationally immobile and should rank high as local tax bases on neutrality grounds. But those regions that are devoid of such resources often perceive this as unfair. Moreover, the neutrality argument takes a narrow view on efficiency as it dwells on the non-interference of taxation with the allocation of *private* goods; it disregards the benefit-tax-link criterion, which stresses the more efficient use of *public* goods.

Under the benefit-tax link argument, natural resource taxation at the local level should be avoided. This is because it is most unlikely that local public services and infrastructure financed through local resource taxation would enhance *collective* welfare and/or be sustainable in the longer run.<sup>7</sup> Economic history is full of examples where a temporary resource boom has financed local investments that failed to produce the expected returns over a longer term. More generally, the longer-term rates of return of natural resources

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<sup>6</sup> Restricting tax competition among local governments to the setting of the tax rate has the further advantage of reducing information costs of taxpayers. If tax base competition is allowed, the information requirements for locational decisions--in particular of businesses--might become formidable. Undesirable transaction costs pertaining to the non-transparency of the tax system must result.

<sup>7</sup> Moreover, natural resources evaluated at world market prices might prove to be a very volatile and unreliable revenue source, which must rank low on the next criterion for local taxation to be discussed.

seem to be higher when invested nation- (or even world-) wide rather than confined to the region of origin. It is thus preferable to tax natural resources at the national level not only for reasons of regional fairness, but also for reasons of longer-term efficiency.

In practice, a balance has to be struck between the local government's interest to have its citizens benefit from the wealth of local resources, and the nation's interest to avoid large regional inequities and/or to make more efficient use of resources in the longer-term. This usually calls for some revenue-sharing arrangement between the local and the national governments--which can take various forms and rests ultimately on political negotiation. It must be stressed, however, that this type of tax sharing may not only be more equitable than exclusive tax assignment rules; it may also be efficiency-enhancing, a fact that is not always realized by scholars of fiscal federalism.

## 2.5 Reliability and stability of tax bases

Local governments have to provide services on a continuous and reliable basis; local infrastructure should also expand incessantly with larger, bulky investments being financed either through borrowing or with the assistance of higher-level governments.

While borrowing must, in principle, be available for local governments to bridge emerging revenue gaps, this should neither be used on a recurrent basis, nor for macroeconomic stabilization purposes at that level. However, steady outlay performance calls for a reliable and sustainable revenue base, a base that remains largely sheltered from the cyclical variations of economic activity. It is therefore questionable whether municipalities should be given the progressive personal income taxes because these tend to exhibit greater fluctuations over the business cycle than other taxes--although local income taxation might be commendable for other reasons. This explains why local income taxes are typically proportional.<sup>8</sup> Where local governments are allowed to piggyback on a national personal income tax, a proportional surcharge on the tax base is often preferred to a surcharge on national taxes due or paid.

A local business tax would also rank low on the account of revenue-stability, because local business activities might be subject to large fluctuations over the cycle; it may also be an unreliable revenue source if local businesses face a longer-lasting structural crisis. However, the conclusion is not as straightforward as that. It hinges on the type of business tax employed that varies significantly among countries.

This is not the place to look more closely into local business taxation as such. However, the various forms of business taxation employ very different tax bases. Business activities are assessed for tax purposes on the basis of local (gross or net) turnover, of local value-added, the local wage bill, local business capital, or local profits. Sometimes, effective cash or accrual accounting figures are used; sometimes the tax base is defined in legal terms that are independent from business decisions (for instance standard valuation rules). In some cases the business tax is similar to a minimum tax on notional capital or notional returns.<sup>9</sup> And often, the business tax appears in the form of a schedular tax with different combinations of tax bases.

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<sup>8</sup> Sometimes, the local income tax base is also subject to a maximum for that reason, as implicitly in the German local income-tax-sharing arrangements.

<sup>9</sup> The German "Gewerbesteuer" has elements of a minimum tax in that business capital defined by standard valuation rules (that incorporate parts of long-term debt) is taxed; also the business profit tax base includes part of interests paid on long-term debt which is more reliable and stable than a profit tax base on its own.

The local incidence of these tax bases (for instance, what is local profit?) is not always clear where firms operate at a supraregional level. In these cases, the distribution of a compound national tax base (for instance, national profits) onto municipalities is effected by a standard procedure based on obvious local variables (like local turnover or the wage bill), or a combination of such criteria.

Obviously, no general conclusion can be drawn on the reliability and stability of a local business tax under these circumstances. A minimum tax on local capital is certainly less volatile than a local profits tax. A local tax on gross turnover or on the wage bill would rank somewhere in between. Furthermore, it has been argued that a local minimum tax on capital must lead to perilous erosion of the local capital stock when firms do not make profits and still have to pay tax. This could undermine the longer-term reliability of the tax base itself. These problems encountered within the realm of local business taxation lead us to our next point--the role of local tax sharing as an insurance device.

## 2.6 Tax-sharing as implicit insurance

It is well known that individuals may prefer a reliable and stable certainty-equivalent to volatile and unstable revenue. For this certainty-equivalent they are willing to sacrifice resources and pay an insurance premium.<sup>10</sup> Where risks can be pooled and be defined empirically, private companies will supply corresponding insurance contracts--provided the government establishes rules for orderly market operations.

Similarly, local governments have an interest to stabilize their revenue basis and may be willing to trade-in volatile sources of revenue for more reliable and steady elements. Take, for instance, the case where local budgets depend largely on a local business profits tax. This tax can be expected to be highly volatile in response to the business cycle and produce little or no tax revenue during recession. In cases where the municipality depends on a large local employer, the situation could even become critical if the company is forced to go out of business or incurs bankruptcy. This will put strain on the local budget just at a time when revenues are most needed to cope with a local unemployment problem.

Revenue risks and structural uncertainty form yet another rationale for tax sharing between the lower tier and higher-level governments. Again, tax sharing could be welfare enhancing and improve efficiency. In Germany, for instance, local governments have, at one point, handed over a share of their genuine business tax to the state and central governments in exchange for a share of personal income tax. This swap of revenue bases through mutual tax sharing represents an implicit insurance device for the local sector since resources of the business tax are pooled and handed back in the form of a more reliable revenue source, which hinges on overall macroeconomic performance.<sup>11</sup>

This form of tax sharing may be an interesting model for China in the future where the corporation tax is assigned, at present, to regional jurisdictions according to the principle of ownership. While regional governments may be reluctant to share this revenue source in periods of rapid growth and buoyancy, they may be inclined to reconsider their attitude in periods of normal activity or even recession.

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<sup>10</sup> The analysis was first provided by von Neumann-Morgenstern and is found in any textbook on risky decision-making.

<sup>11</sup> In a strict sense, pooling the risks was not the only motive of the sharing arrangements, which could have been effected entirely without bringing in the personal income tax. The fact that personal income tax has a stronger buoyancy than the local business tax led to a strengthening of local revenue over the longer term.



Local tax sharing poses, again, the problem of devising a horizontal regional apportionment formula for the shared taxes. Again, various criteria can be employed, although the most prominent feature is the derivation principle. Yet other criteria are also used where this leads to regional inequities. Local turnover, local value-added, the local wage bill, or local capital installed have already been mentioned when discussing the business tax before. Moreover, local tax sharing arrangements may include equalization provisions: an equal per-capita component or standardized needs criteria based on statistical information outside the control of municipalities. It is questionable, however, whether the central government should engage in local horizontal equalization. The central level should ideally concentrate on equalizing revenue among states or provinces, and leave local redistribution to the middle tier. Provincial equalization of local government finance should, however, be subject to some general principles for the whole nation, which is achieved through framework legislation at the central level.

## 2.7 Administrative simplicity

Local taxes have to be administered by all municipalities alike, large or small. Since smaller jurisdictions face potentially higher administrative costs per unit of revenue raised than larger ones, the local tax system as a whole is constrained by the formers' ability to administer the taxes. Otherwise, regional inequities would result from the effective variance in taxes collected. This calls for a simple local tax system.

Administrative simplicity works against many of the taxes that rank high according to other criteria of local taxation. A local income tax, a local VAT, a local business tax may all be commendable under most criteria, yet they are cumbersome to administer at the local level. Even a property tax, the ideal local tax candidate for most scholars of federalism, rates poorly under administrative aspects since it requires sophisticated valuation rules in order to be efficient.<sup>12</sup>

In many instances there are solutions to administrative problems, however.

First, the design of local taxes can be tailored to administrative conditions. For instance, a local business tax can operate under a nationally standardized tax base that is broad, based on simple cash flow accounting and focused on easily identifiable criteria such as turnover or wages paid. Since the tax is payable only by a small number of business firms, all local governments should be in a position to levy such a tax.

Second, local tax policy can make use of existing administrative procedures and government or non-government institutions. For example, a local income tax could be tagged on the centrally levied income tax in the form of a surcharge on the base or a piggyback tax on the central tax. More complicated valuation procedures, like those required under a local property tax, could be administered at the county rather than the local level--eventually by delegation. And some taxes can take the form of surcharges on services rendered by private or semi-public companies and utilities, like surcharges on electricity or telephone bills, or on the cost of water supplied.<sup>13</sup> The companies that provide the service can easily administer all such levies at low costs, and the rates of the surcharges can be tailored to the local

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<sup>12</sup> Valuation can, of course, be avoided if the tax base is a simple physical measure, like square meters for land, yet this fails to take the economic aspects of land use into account and cannot be considered to be efficient.

<sup>13</sup> A surcharge on the water bill would also be closely related to the cost of sewerage. It can thus be considered a user charge in accordance with the benefit-tax principle, enhance local service efficiency, and also finance the protection of the environment.

preferences of the municipality. Local governments should, however, pay for administrative services rendered by other government or non-government institutions in order to avoid inefficiencies. A zero-cost tax administration would undoubtedly lead to excessively bureaucratic procedures over the longer run, and it repudiates the principle of accountability.

### 3. Summary and conclusions

It is obvious that not all criteria for local taxation discussed are consistent with each other or could be realized fully at the same time. And it is clear that they jointly limit the scope for local taxation severely. As can be seen from chart 1, only the Scandinavian countries are able to raise a significant proportion of GDP in terms of local taxes, mainly through a local income tax or an income tax surcharge. All other countries depicted in the chart raise, on average, only less than 5 percent of GDP in terms of local taxes with a high of 8 percent for Austria, and a low of 2 percent for Australia (2.5 percent for Italy). All countries make substantial use of complementary grants to the local sector, albeit at varying degrees. It is thus an illusion to believe that local services could exclusively be financed through own local taxes. This is true even for the high-tax Scandinavian countries.

Furthermore, the choice of taxes for local government is also limited. Disregarding smaller taxes--like gambling taxes--more substantial local revenue can be expected from local turnover or sales taxes, a local VAT, a local personal income tax, a local business tax, and a local property tax. A local turnover tax and--*a fortiori*--a local VAT has a number of drawbacks, as it must interfere with similar taxes levied at the national level. Even as a piggyback tax, a local VAT poses problems through the tax credit mechanism. It is not clear whether a local tax credit should be accorded to inventories or the purchase of investment goods, for instance, or which jurisdiction should ultimately bear the cost of the tax credit. A similar question arises as to the redemption of tax for exports (respectively the zero-rating of exports). This is why all countries but one<sup>14</sup> that employ a VAT have refrained from allowing the local sector to penetrate that tax area.

A local turnover tax--unless levied as a single-stage retail sales tax--may face the problem of "cascading" which is the cumulating of tax as goods are transacted among taxable units in the process of production and distribution. For high local tax rates, cascading exhibits significant allocative distortions, and even exports may bear the tax unless provisions are made to redeem traders.<sup>15</sup> A cascading sales tax will have a limited scope, as tax rates must remain low in order to check emerging distortions.<sup>16</sup>

A local retail sales tax may become operational, however, be consistent with accountability, and even work as a benefit-tax. It is, however, more difficult to administer--because of the greater number of taxpayers and the difficulty to impose bookkeeping. Such a tax is thus susceptible to large *de facto* inequities through the negative distributional impact of effective tax collection.

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<sup>14</sup> Brazil operates a sales tax/VAT at all three levels of government with formidable administrative and conceptual problems.

<sup>15</sup> A redemption scheme for local tax on exports raises the question of how and who should finance the scheme. It could also raise suspicion abroad and face countervailing action of foreign trading partners under the GATT.

<sup>16</sup> Hungary operates a local net turnover tax as a business tax with relatively low rates (maximum 0.8 percent).

More promising are the local personal income and local business taxes. The former should take the form of a surcharge or piggyback tax on the national income tax for reasons of administrative simplicity. Yet under the conditions prevailing in China, where personal income levels are still very low, a local income tax will raise little revenue whatever form may be chosen. This condition will, hopefully, improve in the not too distant future. A local personal income tax will then become an interesting option for China. A local business tax is, however, feasible in the short run if care is taken to keep the tax base simple.

Alas, not much can be expected from the local property tax either. While it is *the* ideal local tax in theory, the tax seems to raise little revenue in practice. Only the Anglo-Saxon world appears to raise a more substantial portion of public revenue from this tax. The reasons for the poor performance of the property tax in most countries are found in political impediments that work at the local level, more than in administrative complexities in determining the base. After all, people prefer to avoid the local tax burden and local politicians often have no other choice than to collude with local citizen if they want to stay in power. Nevertheless, a local property tax--albeit fraught with administrative and political problems--*is* an important component of any system of local finance both for reasons of efficiency and equity.

Whatever local tax system may be established in a country, there will be need for grants and there should be local discretion as to borrowing. However, the tax-grants system must be designed in a way as to allow the criteria discussed to operate. Keys to a successful system of local finance are the free working of accountability and the local sector's responsiveness to local demand. This requires a local tax system that responds to demand for local public services--at least at the margin. As to the benefit-tax link, user charges must play an ever-increasing role in the context of local finance.

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