LOCAL TAXATION IN SELECTED COUNTRIES: A COMPARATIVE EXAMINATION[1]

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INTRODUCTION

Over the past decade, local governments everywhere have faced a similar pattern – declining grants from senior governments, devolution of additional funding responsibilities, and a limited tax base that may not be sufficient to meet future fiscal challenges and objectives. This, in turn, has raised a number of issues around local taxation. Some of these issues are discussed in this paper.

Part B consists of an international comparison of local taxes. In particular, it reviews the pattern of local taxation in OECD countries and comments on the fiscal autonomy that local governments have in making their own tax decisions.

Part C outlines a financing model that is generally used for evaluating local tax issues. Using this model, the paper attempts to answer the following two questions. What is the appropriate role for local taxes? Of all the taxes used by local governments, is there one that is more desirable or appropriate than others in funding local services or should a mix of taxes be used?

Part D examines a number of issues in local taxation; specifically, what should local government be expected to fund from their limited tax base? Is one tax preferred over another? Who should set local tax rates? Should

[1] This paper was first prepared under the auspices of The Consortium for Economic Policy Research and Advice (CEPRA) in November 2003 -- a project of cooperation and technical assistance sponsored by the Canadian International Development Agency (CIDA). The project is being carried out by the Association of Universities and Colleges of Canada (AUCC), working in conjunction with experts in academia,

New Zealand, and the United Kingdom). By contrast, local governments in ten countries get less than 10 percent of their tax revenue from the property tax.

restricted to only one tax of any significance.

From the information provided in Table 1, there are no definitive conclusions that can be drawn about patterns of local taxation across OECD countries nor can anything be concluded about the appropriateness of one tax over another tax. There is nothing in the data to suggest that local government is more or less efficient, effective and accountable if it has access to a range of taxes as opposed to only one major tax. Local government access to a specific tax or taxes is dependent on a number of things including the local government's capacity to administer the tax; the types of expenditures that local government must fund; the willingness of a senior level of government to assign taxes to local government; constitutional and legislative requirements; and a variety of other factors.

Fiscal autonomy in local taxation

International experience tells us that an essential ingredient in creating a good local public sector is a responsive and responsible local government. A necessary condition for such a government is that it possesses the fiscal capacity to provide required and desired levels of

Table 2: Local Government Taxes by Type of Tax Autonomy in Selected OECD Countries								
	Extent of Tax Autonomy							
	Local government sets			Revenue split under tax sharing arrangements				Senior govt. sets local rate and base
Country (1)	tax rate and base (3)	tax rate only (4)	tax base only (5)	Set by local govt. (6)	Only changed with consent of local govt. (7)	Fixed in legislation (8)	Determined by central govt. (9)	(10)
	Percentage distribution of local taxes							
Federal:								
Austria	9	11			81			
Belgium	13	84				2	1	
Germany	1	52			47			
Switzerland		97				3		
Unitary:								
Czech Republic	2	5	3			90		
Denmark		96				4		
Finland		89				11	1	
Hungary		30						
Iceland	8	92						
Japan		94						
Mexico						74		
Netherlands		100						
New Zealand	98							
Norway		5				1		
Poland		45	1		54			
Portugal	49	14						
Spain	33	51			16			
Sweden	4	96						
United Kingdom		100						

rates are lower for residents of the province than for non-residents of the province.

In summary, municipal governments are free to set their general tax rate. Their tax base and rate structure (across property types), however, are frequently controlled or restricted by provincial legislation, rules and regulations.

United States: In some states in the U.S., there is considerable variation in a municipality's access to local taxation. For example, in some states, municipalities are permitted to use an income tax, a sales tax, and a property tax. In other states, municipalities may be restricted to the property tax only; in still others, they have access to the property tax and a municipal sales tax. Regardless of the tax or taxes permitted, state approval or permission has either been legislated or granted.

The United States experience with a municipal income tax may be of relevance because of the variation in the way in which it is applied. Table 3 records 1999 personal income tax rates in cities over 125,000 people. Taxes are generally imposed as a flat rate ranging from a low of one percent to a high of almost five percent on residents. In some cities, a lower rate is applied to commuters. In some states, the tax is divided between the jurisdiction where the person resides and where the person works. In total, approximately 3,800 local governments currently levy local income taxes in the United States. Although, local governments in Pennsylvania (one state out of 50 states) account for 2,800 of the total, localities in fifteen other states also rely on this tax.[6] Further, local income taxation is primarily a municipal tax, but in some states (Indianna and Maryland, for example), it is a county tax. As well school districts rely on income tax revenues in Pennsylvania, Ohio and Iowa.[7] In terms of revenue importance for municipalities, income tax revenues generate well over 20 percent of local tax revenue in Ohio and Pennsylvania and about 30 percent in Maryland. In some cities, this revenue source is so important that it accounts for more than 50% of city own source revenues.[8]

Also, in the U.S., local governments in thirty-one states and the District of Columbia levy general sales taxes. Across these states, a relatively low rate of 0.25 percent is imposed in a number of transit districts to subsidize public transportation. In other states, the rates may be as high as five percent with revenues not earmarked for specific expenditures.[9]

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[6] James D. Rodgers and Judy A. Temple (1996), "Sales Taxes, Income Taxes, and Other Nonproperty Tax Revenues", in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Fourth Edition (Washington, D.C.: International City Management Association), 229-258, at 242-243.

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allocate its scarce resources to those services that will provide its people with as large a bundle as possible of services that they want. That is all that is meant by efficient resource use.[16]

In short, correctly set user fees and tax rates promote efficiency in two ways. First, "by providing information to public sector suppliers about how much clients are actually willing to pay for particular services". Second, they do this "by ensuring that citizens value what the public sector supplies at least at its (marginal) cost".[17]

Accountability is enhanced when the design of a tax, user fee or expenditure is clear to taxpayers. Furthermore, the closer the link between the beneficiaries of a government service and payment f(oa3baoa3y()-5.4(m,(pmioiceand pay)-7n(r0.0001 Tc0.0071.153 TDween tlmsgn)Tjy)-ices ality efficiency, accountability, transparency, and fairness.

For services providing mainly collective or 'public goods' benefits (specific beneficiaries cannot be identified), user fees are inappropriate. Instead, these should be funded from a local tax imposed on residents (or exported to the same extent services are) with necessary adjustments through the use of grants to account for spillovers; that is, benefits from these services that spill over into neighbouring communities should be funded from something other than a local tax.[21]

Local governments should not have to fund programs specifically directed toward the redistribution of income among individuals (social services and social housing, for example) nor should they be responsible for funding services that are national or state-wide in their impact and scope (education and health, to name two). These functions are more appropriately the responsibility of central and state governments and should be funded by them.

Grants from senior levels of government also have a role in funding local services. Specifically, conditional grants should be used for partial or full funding of services generating spillovers and for services in which the state has an interest (to ensure uniform or minimum standards, for example). Unconditional grants play a role in filling the fiscal gap (mismatch in local own source revenues and expenditure responsibilities) and in supporting municipalities in their attempts to provide comparable levels of service for comparable tax rates (equalization).[22]

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[21] Under this view, user fees or charges are retained for funding those services whose costs and benefits can be assigned to specific properties or individuals (water and sewers, and a portion of transit and recreation, for example). For an excellent discussion of the benefit model of local finance, see Richard M. Bird, "Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization" (1993)

feature for local governments faced with increasing cost of local services. Fourth, it may be administratively easier for local governments in some countries to piggyback onto the state income tax than it would be to set up a new locally administered property tax system.

Many local governments in the countries summarized in this paper (Tables 1 and 2) currently rely on more than one local tax. In addition to the comments in the preceding paragraph, there are solid arguments for a mix of local taxes.[32] First, any single tax like the property tax is almost certain to create local distortions, some of which could be offset by other taxes. For example, the property tax may discourage investment in housing. A personal income tax, on the other hand, may encourage investment in owner-occupied housing because the imputed income of owner-occupied housing is not taxed. By relying on a number of different tax sources, there is the possibility that the distortions in one tax could be counteracted by the distortions in other taxes.

Second, additional tax sources would make the overall local tax structure more flexible, thus permitting local governments to choose taxes that fit local conditions and circumstances. For example, sales taxes might be chosen in situations where the benefits of services are enjoyed by commuters and visitors. Property taxes might be chosen where there is a need for a stable revenue source.

Third, additional tax sources could increase the revenue elasticity of the local tax base and allow it to adapt more easily to rising costs and service demands. The property tax is not an elastic source of revenue because it does not increase very quickly in times of economic growth (or decrease very quickly in time of economic slowdown). Other tax sources (such as sales and income taxes) are more elastic sources of revenue and would allow municipalities to benefit from economic success and to share in economic failure.

Fourth, access to other tax sources may permit local governments to avoid large property tax increases. Politically, this can be attractive given the extent to which increases in property taxes are highly visible and often unpopular with local taxpayers.

In general, arguments for more than one tax at the local level are particularly strong for large cities and city-regions, particularly when tax rates are set locally. Large cities and city-regions would be able to collect considerable revenues from these sources.

Are there other theories of local taxation?

As noted in this section, the benefits based model of local taxation is an appropriate model for addressing local tax issues. Are there other theories of local taxation that might be appropriate? In general, the answer is no.

Discussion of taxation based on ability to pay criteria – an alternative to benefits received taxation - is commonly used for evaluating national, state, region, or provincial tax policy where these more senior levels of government have access to a wide range of tax instruments and where they are responsible for funding services that are more income redistributional in nature. Ability to pay as a base for local taxation is not thought to be appropriate for at least two reasons. First, the constitutional role of local government in every developed country makes them creatures of the province, state, canton, or laender with their flexibility and choice of tax instruments severely restricted and controlled.[33] Second, services provided by municipal governments or that ought to be provided by municipal governments are those that are most efficiently and equitably funded from benefits based taxes (see section D.1 below) at the local level.

Issues in Local Taxation

Recent trends, in most countries over the past decade, have displayed the following pattern. Senior levels of government, almost everywhere, have devolved additional spending responsibilities onto local governments while

[32] Rodgers and Temple (1996), supra footnote 5, at 229.

[33] Kitchen (2001), supra footnote 12.

simultaneously reducing grant funding for these governments.[34] To offset this, municipalities have increased their reliance on own source revenues - user fees, permits, charges and whatever local taxation powers they have. At the same time, the growing importance of globalization has increased the importance of international cities. Cities are the major incubators of economic prosperity and the quality of urban life has become a prime determinant of location decisions made by firms and investors. International cities do not speak through their state or central governments; rather they speak for themselves. In this context, there has been increasing pressure, in some countries, to give cities access to additional taxes and greater autonomy in making their own fiscal decisions.

These trends or patterns raise a number of fiscal issues that are important for local governments in any country. These will be discussed within the benefits based taxation model and will draw upon practices in a number of countries. Some of the discussion may repeat what has been mentioned above but only where the repetition is intended to help in emphasizing a point or points.

What public services should local taxes fund?

Within the benefits based model of financing public services, local taxes should fund those services that benefit local residents/taxpayers. In general, this means that local governments should fund a service unless it generates 'spillovers' or involves a redistribution of government.

Spillovers: This occurs when the provision of a specific service in a municipality affects residents of other municipalities. Spillovers (externalities) may consist of two types. Positive spillovers occur if residents of neighbouring municipalities receive a given service free of charge or for a user fee or tax that is less than the service's cost. Negative spillovers occur when residents of neighbouring municipalities incur costs for services from which they derive no benefit or over which they have no control.

If the benefits of a particular service accrue almost exclusively to local residents, then the local government should be responsible for setting policy, acting as service manager and financing the service. If spillovers arise, there is a role for transferring responsibility for the service to a higher level of government to ensure the provision of the appropriate quantity and quality of service. If the spillovers are province-wide or state-wide, then the responsibility should be at the provincial or state level. If the spillovers are not province-wide but affect an area larger than the municipality, there may be a case for establishing a district, regional or metropolitan governing structure in order to internalise these externalities.

Redistribution of Income: In general, the central or state level of government should pay for programs whose primary purpose is the redistribution of income.[35] The reasons for this are twofold: first, the more senior levels of government have access to a broader mix of taxes, some of which are more closely related to

[34] Ibid.

tax with local governments setting the local tax rate. For property taxation where a senior level of government is not involved, local administration will be necessary.

For single tier local governments, local tax rates should be set by the governing council of the jurisdiction responsible for spending the money. For two-tier local governments where the they could be used to distort decisions deliberately to achieve certain municipal land use objectives. For example, if higher tax rates slow development and lower tax rates speed up development, a deliberate policy to develop certain neighbourhoods instead of others might be achieved through different tax rates for different locations.

Variable property tax rates have recently grown in popularity in some jurisdictions; for example, municipal governments are now permitted to use variable property tax rates in three Canadian provinces - British Columbia, Alberta, and Ontario. Variable tax rates may also be achieved by applying the general property tax rate to one or more groups of properties (certain neighbourhoods or downtown business area, for example) whose assessments have been increased because these properties receive additional municipal services. Special assessments and special area financing are common in some municipalities; for example, the city of Halifax in Canada has over 60 such areas with different rates.

Differentiated local income tax rates are not common, but they do exist in a few cities in the United States. Use of two different rates can be justified on benefit grounds. Those who work and live in the same city benefit from city services and should pay for them. Those who work in one city and live in another community still benefit from some of the former city's services – local roads and streets, sidewalks, police and fire protection and so on. For this, they should also pay a tax, although at a lower rate than the tax on residents. In cities where split rates are used, the practice is to impose a lower rate of income tax on commuters (those who work in the taxing jurisdiction but live elsewhere) and a higher rate on residents. Here, it should be noted that New York City in 1999 dropped its income tax on commuters in spite of solid analytical and empirical support for continuing with it.[43] The administration of split rate local income taxes is fairly straight-forward. The employer withholds the tax and remits it to the government. The employer also knows the residence of all employees and could apply the rates accordingly.

For consumption-based taxes, however, differentiated tax rates are not administratively possible. A local sales, fuel or hotel and motel occupancy tax, for example, is collected by the vendor. The vendor could not be expected to charge different rates to different customers on the basis of residency or some other characteristic of the customer.

Should local tax rates be regulated?

Regulation of local tax rates may depend on the type of tax used and the role it plays within in a country. If local governments use taxes that are only in their domain (property tax, for instance) and if their tax rates are set to generate required revenues for funding local services, there are no solid economic or political arguments for regulating the general tax rate. In democratically elected local councils where all decision-making responsibilities rest with local councils, citizens/taxpayers have the ultimate control or power over council's tax decisions – the

[43] Chernick and Tkacheva, (2002), supra footnote 30.

recover the cost of services used, it is efficient, fair and accountable. The practice in many countries, however, is for local taxation to overtax business, thus creating potentially serious economic problems for the entire state or country. To prevent harmful and serious consequences, there may be a case for some state regulation.[44] This is discussed in more detail below under the taxation of businesses.

Regulation has also been defended as a way of controlling local government service costs. Cost efficiency in service provision, however, is more effectively achieved through the introduction of competitive elements in the production and delivery of each public good and service, not through regulating tax rates.

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be imposed on the residential sector and not on the commercial/industrial sector.

A more recent study in the United States found similar results. Specifically, it was estimated that the 'business related' share of combined state and local expenditures in the United States is about 13 percent, although there is considerable variation from state to state.[48] These businesses, however, pay proportionately more of the state and local taxes.

Further concerns with this heavy of the non-residential sector arise because this tax represents a fixed charge that the firm must pay. This, by the way, is the same criticism that is directed at capital taxes. Both taxes are fixed in the sense that they are unrelated to the value of municipal services consumed or profits earned. As long as the tax rate is more than necessary to cover the cost of the last unit of municipal services consumed or if there are no economic rents for it to capture, resources will be allocated inefficiently. This over-taxation of the non-residential sector may lead to less economic activity, lower output, fewer jobs and a less competitive business environment.[49]

There is also an issue of whether taxes on non-residential properties play a role in location decisions. Since firms and businesses generally locate where they can maximize profits, the provision of fiscal inducements such as lower property taxes can influence a firm's location decision in the same way as the reduction in other production costs may play a role. The impact of property tax differentials depends on a number of factors including the size of the differential between competing municipalities and whether this differential is sufficient to offset differentials in other costs or market factors.

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[48] William H. Oakland and William A. Testa,

In reality, the extent to which firms and businesses respond to tax differentials depends on many factors. These include, for example, the importance of being in the core of the region or area for business reasons; the opportunity to shift the tax differential on to consumers (of the final service or product), employees and owners; and the enhanced amenities that may be offered by a 'downtown location.'

In a U.S. study of individual office buildings in downtown Chicago, it was found that 45 percent of property tax differentials were shifted forward onto tenants as higher gross rents per square foot and 55 percent were borne by owners.[54] Some firms are apparently willing to pay a premium to locate in the downtown core. This suggests that those firms benefit from 'economic rents' created by that location; large financial institutions, for example, may benefit from a downtown location. Taxing these rents is efficient from an economics standpoint because it will not impact on the location decision. It is difficult to know, however, the extent to which economic rents exist. In other words, it is difficult to know at what rent (or property tax) level a firm will choose to move out of the downtown location.

There is at least one more positive effect that could arise from shifting the tax burden away from the non-residential sector.[55] Reducing the property tax burden on this sector would reduce the potential for exporting[56] the tax to non-

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[54] McDonald, John F. (1993), "Incidence of the Property Tax on Commercial Real Estate: The Case of Downtown Chicago, *National Tax Journal*, 109-120.

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Furthermore, when the commercial/industrial sector exports its tax burden, municipal government accountability is weakened because the direct link between the government responsible for local services and the ultimate person/agency/body paying the tax is missing.

Concern over the kinds of distortions created by the non-residential property tax has prompted at least one innovative suggestion for reform in Canada.[58] Specifically, it has been argued that revenues from a portion (the amount that exceeds the funds necessary to cover the cost of local services consumed) of the non-residential property tax should be replaced with revenues from a new provincial business value tax (BVT). The BVT would be a value-added tax[59] and would exist alongside the federal goods and service tax (GST). It would be levied on business income; and it would fall on production and not on consumption. Thus, it would be an origin based, rather than destination based tax: it would tax exports and not imports. Municipalities would be able to set local rates that would be 'piggybacked' onto the provincial rate, although the province might impose limits on local surcharges to prevent location distortions. As a value-added tax (essentially, a base that is sales less cost of goods purchased), a BVT would eliminate a number of the distortions created by the current taxation of non-residential property in Canada. Comparable taxes are currently used in Germany and Japan. Italy has a structurally similar tax that is used and administered by larger regions and metropolitan areas.

As for a local corporate income tax, there is no sound economic justification. Capital is highly mobile and the tax is almost certain to be exported, thus making it an unsatisfactory tax for local governments.

What are the conditions for local government fiscal sustainability?

Recent trends around the world to decentralize additional funding requirements from central and state governments to local governments without corresponding grant support has raised the question of whether the latter can be fiscally sustainable in the future. This new fiscal environment has emerged at the same time as cities and urban centered regions have become increasingly important in the competitive global economy. As mentioned earlier, cities and large urban centres are the major incubators of economic prosperity[60] and the quality of urban life has become a prime determinant of location decisions. Growing and expanding businesses engaged in national and international activities locate in cities and urban centered regions where they have access to a highly qualified workforce (knowledge workers) as well as access to business services, transportation and communications networks. Local governments, in providing goods and services and in financing them, can play an important role in attracting and retaining businesses. The provision of local public goods and services affects the quality of life and influences where people live and invest and where businesses locate. The quality of the school system, cultural and recreational facilities, physical infrastructure, social services and the range of housing choices are important factors.

This growing importance of local government raises the question of whether they have adequate fiscal tools or levers to fund necessary local services and facilities. To thrive financially, local governments must have the capacity to generate sufficient revenues to meet their expenditure needs, obligations and commitments. This is affected by at least three things.

1. The cyclical sensitivity of local government funding responsibilities - do expenditure

[58] Richard M. Bird and Jack M. Mintz (2000), " Tax Assignment in Canada: A Modest proposal" in Harvey Lazar, editor, *Canada: the State of the Federation 1999/2000*, (Kingston: Queen's University, Institute of Intergovernmental Relations) at 261-292.

[59] For an evaluation of value added taxes, see Boadway and Kitchen (1999), supra footnote 18, chapter 5.

[60] Michael Cohen (2001), "The Impact of the Global Economy on Cities", in *The Challenge of Urban Government: Policies and Practices*, edited by Mila Freire and Richard Stren (Washington: World Bank Institute), 5-17.

programs vary with the growth or slow down in economic activity (social services, social housing, for example)?

2. The capacity of the local revenue base and local taxes to keep pace with expenditure responsibilities – is there enough revenue provide collective benefits to the local community. Local taxes are not used for services that are income redistributional in nature, that generate spillovers affecting neighbouring communities, and that are designed to satisfy state or national goals or objectives.

In response to the second question, the best taxes are those that are based on an immobile tax base and therefore, borne primarily by local residents (not exported); that do not create problems with harmonization or harmful competition between local governments or local governments and more senior levels of government; and are easy to administer locally. Here, there is a strong case for using a property tax, especially one that includes variable tax rates to capture differences in the cost of providing local public services to different locations within a taxing jurisdiction, different property types and any other property trait that affects local service costs.

Other taxes have also been defended at the local level, even though they are generally less effective at satisfying the criteria for a good local tax. These include an income tax on individuals, some type of consumption based tax that could include a general sales tax, a hotel and motel occupancy tax, and an automobile fuel tax. The only one currently used alone in place of the