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Allocation of Taxing Powers

by
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Sub-central taxes are needed because sub-central governments spend large sums. This article discusses some key issues in sub-central taxation from an economist's perspective, including the scale and role of sub-central governments, their main revenue sources, and questions of equity, tax sharing, economic management and accountability. A more detailed discussion explores the relative shares of domestic taxes and business taxes.

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This article covers some key issues in sub-central taxation from an economist's perspective. Its examples are confined to OECD member countries. It uses the abbreviation SCG for sub-central government, and it has seven sections, as follows:

1. The scale and role of SCGs. Many key issues in sub-central taxation relate to these two underlying issues.
2. The main sub-central revenue sources and sub-central taxes within OECD countries. It is helpful to see at the outset which are the main sub-central taxes in OECD countries.
3. Five key issues in sub-central taxation: equity; tax sharing; economic management; the relative shares of sub-central domestic and business taxes; and accountability.
4. Sub-central property taxes.
5. Sub-central income taxes.
6. Sub-central business taxes.
7. Other possible sub-central taxes.

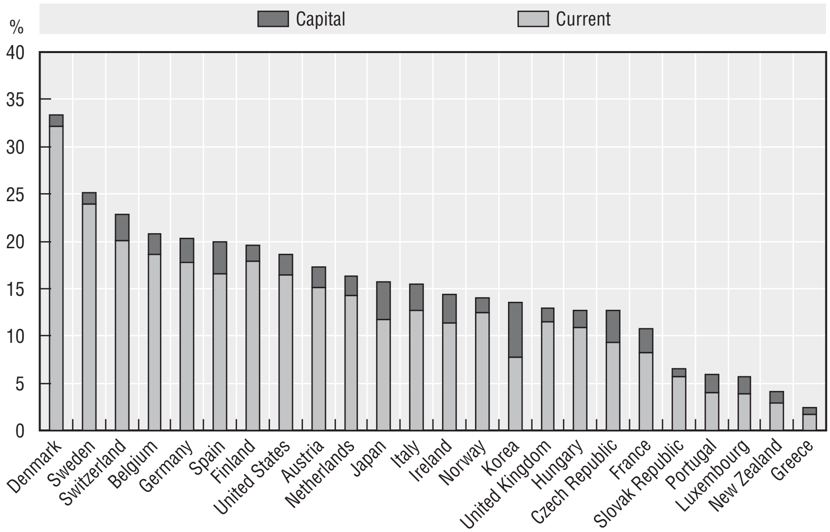
1. The scale and role of SCGs

1.1. The scale of SCG spending

Sub-central taxes are needed only because SCGs spend large sums. Some idea of this is given in Figure 1, which is based on OECD national accounts data. This figure concerns the latest years for which data are available, the years varying slightly between countries. Figure 1 covers 24 of the 30 OECD countries: the exceptions are Australia, Canada, Iceland, Mexico, Poland and Turkey for which the OECD national accounts do not have data.

Figure 1 shows that sub-central spending ranges from over 25% of GDP in Denmark and Sweden to below 5% in Greece and New Zealand. However, a majority of the countries (20 of the 24) have figures within the range 5% to 25%. Figure 1 also breaks sub-central spending into current and capital spending. On average, capital spending accounts for about a seventh and current spending for six-sevenths. While loans may be used for capital spending, they are rarely used for current spending; thus taxation, grants or other sources have to cover the great bulk of SCG spending.

Figure 1. **Subnational spending as a percentage of GDP in 2004**[1]



1. This figure double counts grants from states to local authorities and from upper to lower local authorities because it includes this expenditure as grants paid by the upper tier and also as spending on services by the lower tier.

Source: OECD.Stat, *National Accounts*.

1.2. A spectrum of roles

While the general level of sub-central spending may be similar in many countries, the roles of SCGs often vary between countries. Indeed, the roles often vary between individual sub-central services in any given country. There is a spectrum of roles which an SCG may have over any given service, ranging from it having substantial autonomy at one end to it being largely an agent of the central government at the other end.

1.3. Autonomous functions

There are several arguments for giving SCGs a substantial degree of autonomy over some services. These arguments include the following:

- It allows the quality and quantity of service provision to vary between areas in accordance with local preferences. In contrast, central provision tends to be uniform.
- It allows people who do not like the service provision in their areas to migrate elsewhere.
- It is likely to facilitate more variety, experiment and innovation in service provision.

- Having more than one tier gives electors more opportunities to signal their preferences.
- Having more than one tier means that each elected representative needs to supervise fewer services and so can be better informed about them.
- Having more than one tier may help electors to evaluate the costs of each tier's services, although this is possible only if each tier has perceptible taxes that relate to that tier's costs.

For services where these arguments are accepted, there are several further arguments for raising the majority of revenue with taxes whose rates are locally set, a situation consistent with recommendations of the Council of Europe (2004, pp. 6, 8 and 11). These arguments include:

- SCGs need substantial tax power to avoid the problems of gearing. For example, an SCG which raised only 10% of its revenue in taxes would need to double its tax rates to raise its spending by 10%. This may confuse voters.
- SCGs that rely substantially on grants, or even on taxes whose rates they cannot set, may spend the money inefficiently and yet blame their poor services on under-funding.
- Sub-central politicians, bureaucrats and voters may take more care with money that arises from taxes under their control than with money from other sources.
- When a central government pays grants, it may well feel that it should control how the grant receipts are spent, because it is accountable to its national taxpayers for this money.

1.4. *Agency services*

Sometimes SCGs effectively administer a uniform national service on terms laid down by the central government. A problem here is that if the SCGs have a mix of autonomous services and agency services, then their voters may occasionally get confused. With agency functions, there are several arguments for having most of the revenue coming from central government grants. These arguments include the following:

- The central government is likely to take a more responsible view about how much sub-central expenditure to require if it has to raise the money itself.
- Local voters will be confused if they have to pay local taxes to local politicians who actually have negligible discretion over how that money may be spent.

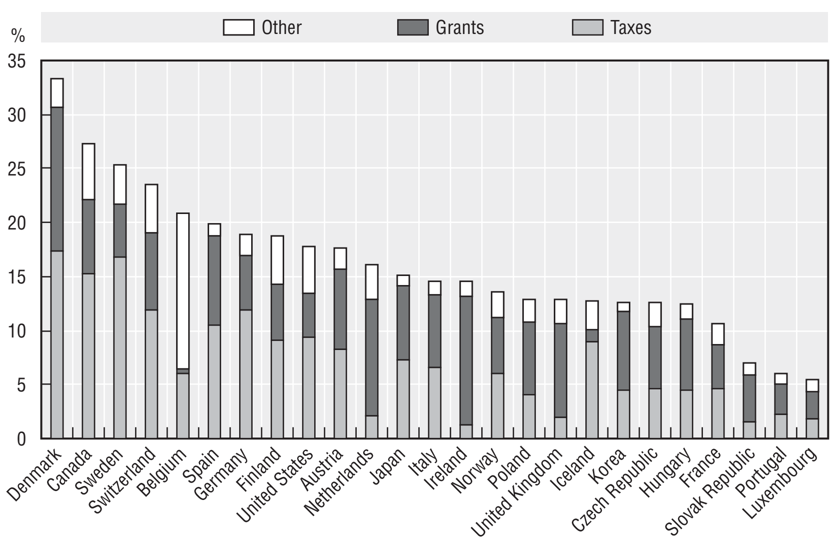
1.5. *Mixed services*

Sometimes central governments argue that they work in partnership with SCGs, and hence that there are "mixed" services with a mix of national and sub-central control. Here there is a case for dividing the revenue roughly equally between grants and taxes. Although a mixed partnership approach sounds appealing, it can cause confusion and conflict if the central government and the SCGs have mandates for different policies.

2. The main sub-central revenue sources and sub-central taxes

Section 1 argues that the correct balance between sub-central taxes and grants may vary according to the balance of sub-central services between autonomous ones, mixed ones and agency ones. Whether individual countries follow this argument is a matter of debate, but certainly the balance between different revenue sources varies greatly. This is shown in Figure 2 which gives the main sources of revenue for OECD countries for which revenue data are available in the OECD national accounts (*i.e.* excluding Australia, Greece, Mexico, New Zealand and Turkey). The varying revenue sources are shown again in Figure 3 as a percentage of total revenues.

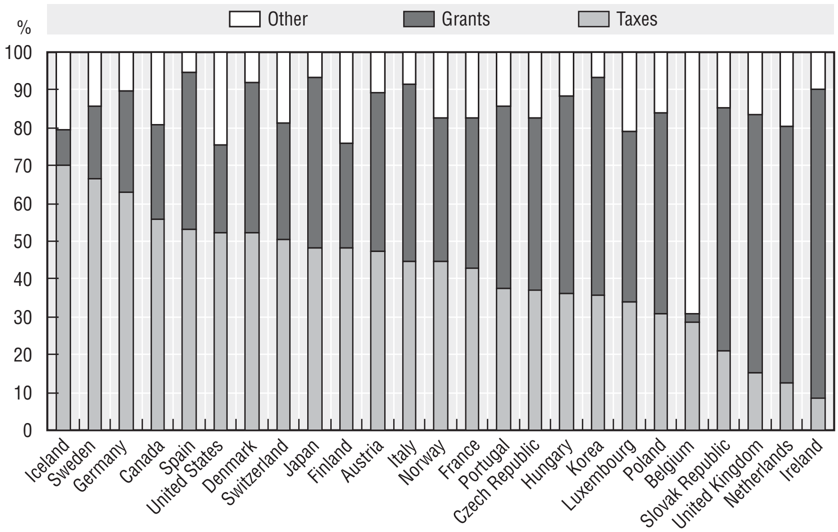
Figure 2. **Subnational revenues as a percentage of GDP in 2004**[1]



1. This figure double counts grants from states to local authorities and from upper to lower local authorities because it includes the revenue needed to finance these grants with the upper tier's revenue, and the revenue from these grants with the lower tier's revenue.

Source: OECD.Stat, *National Accounts*.

Figure 3. **Revenue sources for states and local authorities (percentage) in 2004**[1]



1. This figure double counts grants from states to local authorities and from upper to lower local authorities because it includes the revenue needed to finance these grants with the upper tier's revenue, and the revenue from these grants with the lower tier's revenue.

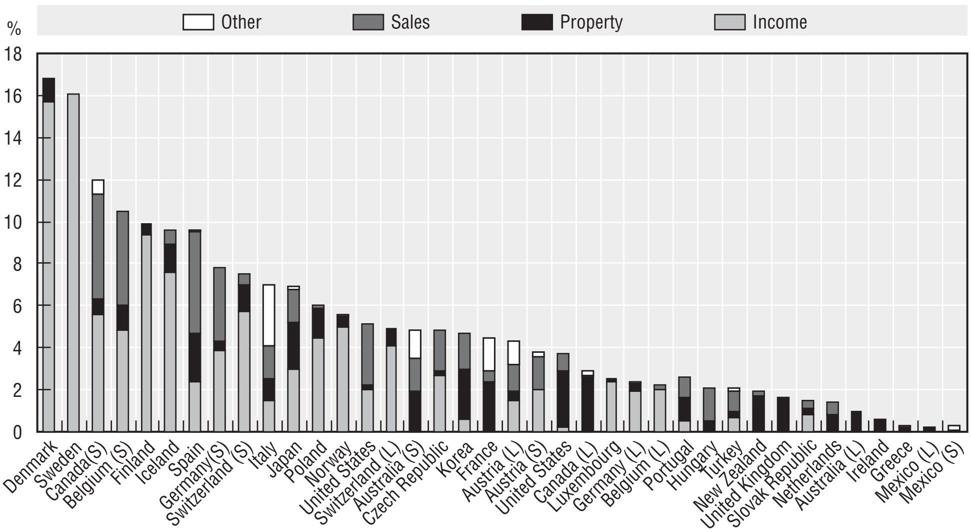
Source: OECD.Stat, *National Accounts*.

Figure 4 gives the yield of the main sub-central taxes in each tier as a percentage of GDP, for all 30 OECD countries. The figure separates the state and local government tiers (as shown by "S" or "L"). Four points about the relative importance of the various taxes should be noted:

- Income taxes, property taxes and sales taxes are the most common.
- Sub-central income taxes are of exceptional importance in Scandinavian countries.
- Sub-central property taxes tend to be important in Asian and English-speaking countries.
- Sub-central sales taxes are quite common, although SCGs rarely set the rates.

The most common "other taxes" are payroll taxes, which occur in Australia, Austria and Canada. The most sizeable "other taxes" are the business taxes in France and Italy but each of these taxes effectively has as its base a mixture of two or more taxes (payrolls, profits or property) so that neither is a wholly different type of tax.[1] Australia's states also have licence duties on retail outlets such as filling stations and liquor stores; sometimes the states make the licence fee proportional to the outlet's turnover, and in such cases these fees effectively become sales taxes by another name.

Figure 4. **Subnational taxes as a percentage of GDP at market prices**



Note: S means state government; L means local government.

Source: OECD, *Revenue Statistics*, various years. The data are for 2002, except for Portugal which are for 1999.

3. Five key issues in sub-central taxation

Suppose it is decided that SCGs should raise some tax revenue. There are several possible taxes, and a choice must be made against a range of criteria. But before exploring these criteria, in Sections 4 through 6 below, it is helpful to consider some underlying issues, most of which arise again later in this article.

3.1. Equity: the benefit approach versus the ability-to-pay approach

There are two basic approaches to deciding how to share the burden of taxes between members of society: the benefit approach and the ability-to-pay approach.

The benefit approach sees taxes as being analogous to prices charged for using a service, and it argues that people who receive more benefit from a service should pay more. For example, toll roads and petrol taxes create a link between the benefits that different people receive from roads and the taxes that they pay. Sub-central taxes tend by their nature to have some attributes of the benefit approach because local residents pay them, and these local residents are also likely to be the beneficiaries of most of the local services that they finance.

However, there are problems with benefit taxes. One problem is that they try to replicate a market system, yet many of the services provided by SCGs are given to SCGs because market provision would fail in one or more ways. For example, some SCG services are provided for people who cannot pay, such as education for children and social services for people in need. Another problem is that measuring benefits of services like fire services is extremely difficult.

In practice, there is wider support for the ability-to-pay approach which argues that the taxes that people pay should reflect their ability to pay. Incomes are probably the best measure of ability to pay, but they are not perfect. To illustrate one problem, take two people who have the same weekly income, so that they are treated as equals with an income tax. However, one is well qualified and earns the income by working just three days on a highly paid job and spends the rest of the week on leisure pursuits. Meanwhile, the other person is poorly qualified and struggles to earn the same income in five days with overtime. Many people would argue that the former actually has more ability to pay for public services than the latter.

The ability-to-pay approach raises the issue of how tax payments should vary with ability to pay. Suppose that ability to pay is measured by incomes. Many people would argue for either a progressive tax, where payments rise more than proportionally with incomes, or for a proportional tax, where payments rise proportionally with incomes. The other possibility is a regressive tax, where payments rise less than proportionally with incomes; but these taxes are often opposed on the grounds that by taking a larger slice of poor people's incomes, they are too hard on the poor.

3.2. Shared taxes

Some countries allow SCGs to secure large tax revenues, but with no sub-central discretion over tax rates, by using shared taxes. Among the best-known examples of tax sharing are those in Austria and Germany, which cover the states as well as municipalities and the federal government. A country can have several shared taxes with different percentages of the total yield of each tax going to SCGs.

The sharing arrangements can also differ in how they allocate the share of one tier between the authorities at that level. The usual alternatives are to divide the shares in proportion to the tax arising in each area, or to their populations. The Council of Europe (2004, p. 9) suggests the former approach on the grounds that it encourages the authorities to develop their tax base. But others might argue that the encouragement given to development should depend on the need for development, and that it should not be distorted by this sort of fiscal incentive.

A shared tax is a relatively cheap way of securing tax revenues for SCGs, as shared taxes cost little more to collect than central taxes. The only extra cost is that of obtaining data for the allocation formula, such as ascertaining the tax yield or the population of each area.

However, it was argued above that, with autonomous services, SCGs should have some taxes whose rates they can set. If this argument is accepted, then shared taxes should not be the only tax source for such services. Arguably, shared taxes are more appropriate for sub-central services that are intended to be provided on a more or less uniform basis and hence, perhaps, on a more or less agency basis.

Another problem with tax sharing is that the central government might well see the shared tax revenues as part of its own revenues which it is giving away, and in this case it may want as many controls as it would want with grants. This problem is greatly reduced in Austria and Germany because the shares of the shared taxes that go to the lower tiers typically have some constitutional guarantee, so that the central governments in those countries cannot easily see these shares as part of their own revenues that they are giving away.

3.3. Economic management

Sometimes central governments say that they would be willing to have more taxes set by SCGs, except that such taxes would make it harder to control total demand in the economy and thus harder to have successful stabilisation policies. This argument is weak both in theory and in practice.

To see the theory, suppose that sub-central tax and grant financed spending is a typical figure of about 10% of GDP. And suppose that SCGs raised their spending by a tenth, that is by 1% of GDP. If they financed this extra spending with higher taxes, then household disposable incomes would fall by 1% of GDP. Households would tend to reduce their spending by about 0.9% of GDP and to reduce their saving by about 0.1%. So the overall rise in total spending would be a 1% rise in sub-central spending, minus the 0.9% fall in household spending. This is a trivial 0.1% of GDP, or about 1/1 000th.

Of course, there would be cause for concern if the SCGs financed their extra spending with loans, for taking out these loans would not necessarily cause much fall in other expenditure. This is a common and convincing argument for regulations regarding sub-central borrowing. It might also be argued that high sub-central tax rates could act as a disincentive to economic activity, although in theory many taxes, such as income taxes, could act as an incentive to some people while acting as a disincentive to others.

To see what happens in practice, one study explored whether the OECD countries with the most sub-central tax power performed badly (King and Ma, 1999a and 1999b). The study considered the period 1984-95 and divided the OECD countries into 11 centralised ones (where sub-central taxes accounted for under 12% of total taxes) and 12 decentralised ones (where sub-central taxes accounted for over 20% of total taxes). In that period, inflation averaged 4.6% in the decentralised countries, far less than the 10.8% in the centralised ones. And unemployment averaged 5.6% in the decentralised countries, far less than the 10.0% in the centralised ones.

3.3.1. The "common pool" issue

Another argument for constraining the level of SCG taxation is that SCGs and the central government share a common pool of taxable resources that can in principle be taxed. If SCGs take a larger share of this pool, then the central government may come under pressure to take a smaller share. Equivalently, of course, SCGs might argue that central taxation should be constrained because rises in central taxes put them under pressure to cut their own taxes. Certainly there is a case for discussions between the tiers on the aggregate level of taxation. However, any argument that the central government should be free to take from the pool as much as it chooses and leave SCGs with whatever extra amount of taxation is felt acceptable seems to put SCGs at an unfair disadvantage. And in any case, care should be taken in restraining local democracies from raising taxes when local people want higher spending.

3.4. The balance between domestic taxes and business taxes

The benefit approach to taxation offers some guidance to the important but often ignored question of the balance between domestic and business taxes. It is arguable that the total yield of sub-central business taxes should relate to the benefits from sub-central services that are received by businesses, whilst the total yield of sub-central domestic taxes should relate to the benefits from sub-central services that are received by households. This proportion will vary between countries, depending on the exact decentralised services. But typically, sub-central services tend to confer more benefit on households than on businesses.

For example, a United States study concluded that the share of the benefits on businesses of state and local services was around 13%, although the share varied considerably from state to state; yet businesses tended to pay a proportionately larger share of sub-central taxes (Oakland and Testa, 1995). Likewise, a study in the city of Vancouver, Canada, concluded that businesses used fewer city services than households but nevertheless paid more city taxes (KPMG, 1995).

When businesses pay a disproportionate share of taxes, business development may be adversely affected (Thomma, 2004, p. 11). And if tax rates vary between areas, business location choices may also be affected.

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3.5. Accountability

The concept of accountability is often raised in the context of SCG taxation. It is helpful to see accountability as an example of the problems between principals and agents. In a principal/agent situation, a principal transfers resources to an agent and in return expects to receive effort devoted to the principal's objectives. In the SCG context, local residents can be seen as principals who pay taxes to the SCG and in return expect the SCG, as agent, to devote effort towards their objectives.

The problem is that the agents may not respond fully to the principals' wishes, for a whole range of reasons. For example, the agent may know things that the principals do not, such as the true cost of public services and the efficiency with which resources are being used; this is called asymmetric information. Also, agents may have their own objectives, such as trying to maximise their budgets in the belief that this will maximise their prestige.

There is no perfect solution to problems such as these. Political accountability helps, with elected representatives competing for votes. Ideally, sub-central political accountability implies that those who vote in a sub-central election, and who exert some ultimate control, should also be those who pay for and receive the benefits of the services provided by the authority in question. This prevents their voting decisions being distorted by subsidy.

Thus true SCG accountability may be compromised when those who vote and receive the benefits do not coincide well with those who pay. Figures 2 and 3 show how in almost all OECD countries, grants make up a sizeable proportion of SCG revenue. This means that SCGs can be seen as partly accountable to central governments, and not fully accountable to local voters.

Views about the desirability of this divided accountability will depend on the extent to which sub-central services are seen as largely autonomous, mixed or agency functions. But even if it is accepted that the central government should be a co-principal, there is still the issue of how well SCGs respond to that co-principal's wishes. Various monitoring devices may be imposed to try to ensure that they respond reasonably well.

The question of the balance of funding for SCG expenditure between sub-central taxes and grants is sometimes termed "average accountability". A different issue is the question of who pays for changes to an SCG's spending at the margin, which is often termed "marginal accountability" (Fender and Watt, 2002). If a country has lump-sum grants, then all changes in SCG spending will fall on sub-central taxpayers, so that any individual SCG decision to increase or decrease its expenditure can be considered to be purely a matter for local residents.

4. Sub-central property taxes

This section covers the key issues that arise with sub-central property taxes, starting with the yield. The section covers both domestic and business property taxes, and the latter are considered again in Section 6 as a comparison with other possible sub-central business taxes.

4.1. The total tax yield and its adequacy

Across the 30 OECD countries, sub-central property taxes have an average yield of around 1.2% of GDP. Only about half of this arises from taxes on domestic property. The highest property tax yield is 3.3% of GDP in Canada, where about 1.8% arises from domestic property.[2] Admittedly the United Kingdom had a higher figure, of around 4% in all and 2% on domestic property, until the 1990s. Nevertheless, it is clear that property taxes cannot on their own cover the majority of sub-central spending except in the least decentralised countries. So, unless a country has very few sub-central services that operate on a reasonably autonomous basis, property taxes alone would not satisfy those who argue that the majority of the current revenue needed for these services should come from sub-central taxes.

However, if there was a willingness to accept two sub-central taxes, then experience suggests that there would be a chance of raising an adequate yield without having a sub-central income tax, by instead having a combination of a property tax and a sales tax. But it would be easier to raise the yield by using an income tax with either a property tax or a sales tax.

4.2. The buoyancy of the tax yield

SCGs often object to property taxes on the grounds that the value of the base tends to remain static and hence lacks buoyancy, aside from new building. So the tax rate must be raised annually to keep up with any rises in price levels. SCGs often claim that voters have "illusions" and mistake rises in tax rates for real increases in spending, and hence they blame SCGs for extravagance. This problem is avoided with an income tax. However, it could also be avoided with a property tax if there was annual revaluation, as occurs in parts of Canada (Kitchen, 2005, p. 9), although this might prove costly in cases where revaluations generate many appeals.

From an economic perspective, however, it is not clear that a lack of buoyancy is a problem. Indeed, people may suffer more illusions with an income tax whose real yield rises in times of economic growth without any rise in tax rates; for in this situation people may not realise how much their real tax payments rise each year. Whatever views different individuals may have on the importance of buoyancy, it would be hard to construct an argument that justified the common arrangement where central governments rely on buoyant taxes while confining SCGs to non-buoyant ones.

4.3. The tax base: annual values versus capital values

Property taxes assign a value to each property. Generally, the value is taken to be either the current capital value of the property or the current annual value – that is, the annual sum which the property would command if it was rented out. As capital values can be seen as the present value of future income streams, it may seem that either of these choices would generate an identical burden on each taxpayer, assuming that either approach would be used to raise the same yield. However, this parity between the two approaches may not always apply. The reasons for this include the following:

- Assessed annual values may reflect rents before allowing for landlords' costs, such as insurance or agents' fees. Assuming that a property tax is meant to be a tax on property alone, any annual values that are used should allow for such costs and so make the two approaches the same.
- Some property owners, especially with land, may not use their property and may just hold it on speculation that its value will soon rise. Someone who owns a plot of land in a growing suburb may prefer to keep it vacant until its price has risen to an attractive level, and so its current annual value is zero. To preserve equity between this property owner and those who use their plots, it would be appropriate to tax this property owner to the same extent as the others are taxed.
- More generally, some property owners may not use their property in the most productive way. Thus actual annual values may not fully reflect actual capital values, assuming that the latter are meant to reflect an open market where the property would be bought by the person who could put it to its most productive use.

If these differences can be resolved so that the two approaches are equivalent, then it seems wise to choose as the base the one for which there are more data for property assessors to use. Thus if the majority of business property is rented, while the majority of homes are owner-occupied, then there would be a case for using annual values with the former and capital values with the latter. In practice, most countries use capital values.

4.4. The tax base: current values versus site values

A further issue with the property tax base has provoked wide interest over the years. This arises from a concern that a typical property tax deters development, because it applies to buildings as well as land. For example, suppose the rate of return on property is 5%. A land owner may have a property with a current annual value of X. By spending 10X on improvements, the owner's income would rise by 0.5X to 1.5X. The owner might feel that, in the absence of a property tax, this improvement was just worthwhile. But if there was a property tax of, say, 10%, then the owner's net income would rise by only 0.45X, and the improvement might not occur. Likewise, a typical property tax may deter owner-occupiers from undertaking home improvements (Kitchen, 2005, p. 7).

In principle, this problem could be resolved by taxing land alone, and by also taxing each plot of land in line with the value that it would have if it was put to its most productive use. Australia's state and local property taxes are close to this. In these conditions, development would not lead to a rise in taxation, so development would not be deterred. However, there may be times when the effects of a property tax deterring development are actually welcome: for instance, this might apply to heritage sites, parks and congested areas (Kitchen, 2005, p. 5). A compromise is to have a graded tax where land values – or site values – are taxed at a higher rate than improvements.

There is a further issue to note with taxing site values. To ensure that this practice does not deter development, the tax must apply to all land. For example, if agricultural land is exempt, then the owners of agricultural land will be discouraged from developing it and converting it to other uses. But if a sub-central property tax does apply to all land, then it puts the burden of paying for sub-central services on those with the most land; for example, residents may be subsidised by the owners of farms and forests. In practice, the introduction of such a tax depresses the value of such land, and the burden of a new permanent land tax falls chiefly on the current landowners. Of course, if the site value tax was confined to, say, residential property, then any fall in property values resulting from the new tax might be offset by a rise resulting from improved sub-central services.

4.5. *The spread of the tax yield between authorities*

At first sight, it may seem obvious that a sub-central tax should ideally have a base that is well spread out among the various SCGs. Otherwise, low tax base areas could face major problems when they try to provide adequate services at acceptable tax rates. However, it is possible to address this problem with some form of equalisation grants that will help low base areas, and indeed the Council of Europe (2004, p. 4) recommends such grants. As a result, it may seem that the spread of the yield is not relevant after all.

However, even with equalisation grants, an unequally spread base can cause problems. These problems include the following:

- If the overall sub-central tax base is low, and the grants are independent of sub-central tax rates, then low base areas may suffer from acute gearing problems.

- If the overall sub-central tax base is high, then high base areas may warrant negative grants which, though justified, might prove very unpopular. Most probably, negative grants would not be introduced. In that case, these high tax base areas will have a very favourable position compared with other areas.
- The fact that some authorities will be heavily dependent on grants may result in the central government wanting to control how they spend their grants; in turn, it may feel inclined to impose similar controls over all authorities.
- The more equalisation there is, the more taxpayers in high tax base areas will subsidise those in low tax base areas through the central tax and grant system. Unless the tax is an income tax, this could well lead to low income areas subsidising high income areas. Whilst this would be defensible in fiscal terms, it would be hard to defend politically.

The spread of the property tax base varies from country to country. Moreover, in any given country, it is affected by the SCG boundaries. For example, if these boundaries create separate authorities for different parts of large cities, then inner city areas may be well endowed with business property and enjoy an advantage over the suburbs. But if the boundaries are widened to include the whole city and its suburbs, then any authority that includes a city and its suburbs may be highly favoured compared with other more rural areas.

The spread of a property tax is also affected by the exact base that is chosen. For example, the base of a site value tax might be very low in remote areas and very high in major city centres.

4.6. Administration

It may be best for the central government to supervise the general rules over the property base, and perhaps also undertake valuations. The central government may also determine which classes of property are exempt, not least in an attempt to prevent competition between SCGs on this issue. It should be noted that exemptions create distortionary effects, so they should be kept to a minimum (Kitchen, 2005, p. 8). However, unless the central government is sharing in the tax, it may be best to leave tax collection to SCGs, to give them an incentive to collect as much revenue as possible.

Property taxes often appear to have relatively low administrative costs. But it should be noted that data on these costs often concern years when no revaluations were made. The costs of revaluations and appeals should really be added. One way of reducing the annual relative costs of running a property tax on domestic property is to use the values for another tax and so spread the valuation costs over two or more taxes. The most obvious example of such an additional tax is a net wealth tax, but an inheritance tax could also make use of property values.

4.7. Valuations

In general, it is best to have frequent valuations in order to keep the tax up-to-date and to make the impact of revaluations on individual properties modest. With computer technology, annual revaluations are feasible, as in parts of Canada (Kitchen, 2005, p. 9).

Of course, revaluations may give rise to appeals. In this context, it is worth noting that the United Kingdom council tax, which simply puts domestic properties into one of eight bands, has resulted in very few appeals. This is because it is worth appealing only for properties whose values are close to a band limit; also, even in those cases, owner-occupiers often like their property to be in a high band, believing that any extra tax payments may be offset by the band affecting the value perceived by future buyers. In contrast, at the time of the 2001 revaluation of the much smaller property tax in the Netherlands, there were appeals "*en masse*" (Sterks, 2004a, p. 5).

In practice, many countries have revaluations only rarely. For example, there has been no full revaluation in Luxembourg since 1941, or in Germany since 1965, or in France since 1970, or in Belgium since 1975; and ten-year intervals are the norm in Norway and some Swiss cantons. However, these property taxes are all relatively small. Among countries with large property taxes, revaluations range from annual in parts of Canada, to frequent in most parts of the United States, and every five years for the business property tax in the United Kingdom.

4.8. Certainty and predictability

Ideally, a tax should afford certainty to taxpayers over what tax they owe, when it is due, and how they need to pay. And it should offer predictability to SCGs over the revenue they will receive when they set their tax rates. A property tax scores highly in both respects.

With a property tax, taxpayers face just two uncertainties, as follows:

- Taxpayers may be unsure how much their tax rate will rise in future years. However, this problem should be small. If a country's property tax burden is relatively stable in relation to GDP, then its property tax rates may rise in such a way that property tax payments are relatively stable in relation to incomes. Of course, some authorities may raise their tax rates more rapidly than others, but this would happen with any sub-central tax.
- Taxpayers will be unsure what will happen to the relative values of their properties after the next revaluation. Their perceptions are likely to be

particularly dim if revaluations are well spread out over time. Of course, this unpredictability can be greatly eased by frequent valuations.

As far as property tax yields for SCGs are concerned, there are perhaps three main sources of unpredictability, as follows, but each of these should be very small:

- There will be small differences between the number of new properties expected and the number that are built.
- There will be small errors in the forecast number of empty properties that may be exempt.
- There will be small errors in the forecast default rates.

On the other hand, compared with income tax yields, property tax yields are far less sensitive to business cycles. Overall, then, property taxes score well for predictability as well as certainty.

4.9. The choice of taxpayer

With a property tax, it must be decided whether the owner or the occupier of a rented property will be liable for payment. Almost all countries tax the owner; among countries with large property taxes, only the United Kingdom taxes occupiers. Perhaps most countries tax owners because they believe that in the case of rented property, the owners are typically richer than the occupiers, so that taxing the owners means taxing those who are most able to pay. Or perhaps the countries tax owners because most voters believe that the owners are more able to pay.

In practice, landlords may be able to pass much of the burden to occupiers through increases in rents. For example, suppose authority A introduces a property tax to finance improved schools. Area A will now be a more attractive place in which to live, so tenants will be willing to pay higher rents. Of course, not everyone will benefit from the schools, so not everyone will be willing to pay higher rents; thus the owners may still end up bearing some of the burden. But, even in this case, in the long run, property owners may not replace buildings when they reach the end of their serviceable lives. So then the supply will fall and hence rents will rise again.

In fact, the share between landlords and tenants is likely to be the same irrespective of who is formally liable for the tax. If the tax is imposed on occupants, and fewer people wish to live in the area, then tenants may pass some of the burden to landlords in the form of lower rents. Given the equivalence between the two arrangements, there may be a case for taxing occupiers rather than owners. The reason for this is that by taxing occupiers, it is possible to introduce circuit-breakers or rebates of some type that will pay some or all of the property tax for poor occupiers, irrespective of whether they are tenants or owner-occupiers.

4.10. The taxpayer and equity – or the fairness of the tax burden

Figure 4 suggests that voters will accept a higher yield with sub-central income taxes than with property taxes. No doubt one reason for this is that with a property tax, taxpayers receive a single large bill once a year, whereas with an income tax their payments may be deducted in small amounts at source (Thomma, 2004, p. 10). But many people also worry about the equity of a property tax, believing that incomes indicate ability to pay better than property values do.

However, the fairness of a property tax raises the question of its incidence – that is, who really pays it. With owner-occupied property, the incidence falls wholly on the owner-occupier. But, as noted above, with rented property tenants may not feel the whole incidence because some of the incidence may fall on landlords who are typically relatively wealthy. So a domestic property tax may be somewhat less regressive than is often believed (Oates, 2005, p. 1). Moreover, if a property tax payment can be offset against income tax or profits tax, then some of its incidence is shifted to other taxpayers, and this means that the property tax incidence is affected by the progressiveness of the tax system as a whole.

Of all the property taxes in OECD countries, the United Kingdom council tax is probably the one that makes most adjustment for ability to pay. This tax offers discounts to single adult homes and to homes occupied only by students, and in future it may offer discounts for pensioner homes. Also, this tax has an accompanying system of rebates that offers up to 100% of the payments for the poorest people. Nevertheless, even this tax is widely felt to be unfair. This is because, as with all property taxes, some people with high incomes happen to live in low property value areas, and *vice versa*. Low income citizens in a costly housing area may well wonder why, in addition to having to use larger shares of their incomes to buy or rent property, they are then also deemed to be more able to pay property taxes than people in low property value areas.

Whilst this discussion, like most, has focused on the vertical equity aspects of a property tax, horizontal equity should not be ignored. A property tax that relies on old valuations means that two people whose properties are currently worth the same may nevertheless pay very different amounts in tax, and that two people whose properties are currently very different in value may nevertheless pay the same amounts in tax. Thus frequent revaluations are needed to preserve horizontal equity (Sterks, 2004b, p. 2).

A further aspect of equity, or fairness, is that a property tax is based on assessed values, and inevitably these may differ from true values. Thus some people might object that their valuations are unfair simply because they believe them to be wrong. In contrast, an income tax is based on actual incomes. Just imagine if the property tax could somehow be based on actual property values while an income tax was based on some rough estimates of incomes; then the relative unpopularity of these two taxes might change substantially.

4.11. Differential tax rates for business and domestic properties

In many countries, SCGs are allowed to charge different rates on domestic and non-domestic property. Typically, as in Canada and the Netherlands (Kitchen, 2005, p. 10; Sterks, 2004a, p. 3) the higher rate applies to business property. It may be argued that this is fair because businesses can claim the tax as an expense against profits taxes. However, there are two reasons for being concerned about differential rates.

First, if businesses can claim their taxes against profits taxes, then effectively an SCG is subsidised by citizens elsewhere who must make up for most of the foregone profits tax yield by paying more in other taxes. Thus profits tax deductions are effectively a hidden form of tax exporting, which causes sub-central services to be subsidised by non-residents.

Second, differential tax rates are likely to mean that businesses will pay more for SCG services than households. The only way in which this would not be true would be if there was some other large sub-central tax, probably an income tax, on residents alone. In turn, as businesses generally get far less benefit from SCG services, businesses will be seen as subsidising SCGs.

These sources of subsidy are a problem. For example, subsidies may encourage SCGs to overspend. Also, they may help create an over-taxation of the business sector and thereby hinder development. Perhaps the main hope is that when differential tax rates do occur, the rates on businesses will be held down by some competition between SCGs to attract new businesses.

4.12. Differential tax rates among domestic or business properties

Occasionally, as in Canada, SCGs are also allowed to charge different rates on different domestic properties or on different business properties. If this practice is used to reflect the different costs of providing services to properties in different localities, then it may be felt beneficial by making the tax more of a benefit tax.

Arguably, differential rates may produce further benefits (Kitchen, 2005, p. 14). For example, suppose a city centre has many high value apartments which, being placed close together, create relatively low costs for some services; this might apply to rubbish collection, because the rubbish from many dwellings can be collected at one point. In contrast, properties on the suburban fringes of this city are well spread out and, although their values are lower, they create higher costs for some services; for example, it may take a long time to visit and collect the rubbish from the well-spaced homes. So people in the centre generate lower costs but pay more taxes. In this situation, there is an incentive for urban sprawl, with people trying to build on the city fringes. Differential tax rates could be used to make the fringe properties pay more tax and the city centre ones less.

However, there may be problems with implementing differential rates. In particular, such a practice may raise the possibility of endless debates about the appropriate rates in different areas.

4.13. Promoting efficient spending levels: visibility and perceptibility

Ideally, sub-central taxes should help to produce a situation where SCGs spend at the "correct" levels from an economist's perspective. That is, they should spend more only when the value to taxpayers of the benefits from the extra spending exceeds the cost of the extra taxes. However, this criterion is unlikely to be met if sub-central taxes are invisible or imperceptible, for then sub-central voters will not know how much they are paying in tax.

Domestic property taxes are perhaps the most visible of all taxes, since a taxpayer receives a statement each year of all the payments due over the year. So these taxes receive understandable support in this respect. However, it is worth asking whether it is any less acceptable for SCGs to have imperceptible taxes, like income taxes, than is the case for the central government.

4.14. Promoting efficient spending levels: tax exporting

Tax exporting occurs if the burden of a tax falls partly on non-residents. The result is that sub-central services are effectively subsidised by non-residents. Of course, some sub-central services do benefit non-residents, particularly perhaps commuters, other day visitors and night visitors, so some exporting does seem acceptable; but it could be argued that, in most countries, non-residents typically pay far more than their due share through the grants system, so that there is no need for them to make further contributions through tax exporting. The subsidy effect of tax exporting means that authorities may be encouraged to overspend. Also, there is inequity between SCGs with a large business sector and SCGs with a small one, because the former can presumably export a larger proportion of their property tax.

There is little or no problem with tax exporting in the case of domestic property taxes. Indeed, with owner-occupied properties, it is clear that the tax burden falls on the local owner-occupiers. And even with tenanted properties owned by non-residents, it was argued above that much of the incidence will fall on occupiers, especially in the long run.

In contrast, much of the burden of taxes on business property may be exported, for the burden of these taxes is divided between the firms' owners, employees and customers, many of whom may be non-resident. Indeed, Spry (2005, p. 16) suggests that one reason why some United States authorities opt for property taxes rather than income taxes is because they can export some of the burden of the property tax on businesses.

4.15. Low distortions when tax rates vary between authorities

Ideally, sub-central taxes should not distort people's behaviour, but such distortion is a danger when tax rates differ markedly between authorities. One worry is that varying tax rates may cause the tax base to shift from high rate areas to low rate areas. In this respect, however, domestic property taxes do very well. Conceivably, there could in the long run be a shift in homes from high rate areas to low tax rate areas; but any incentive for this should be largely offset by the high rate area having better services. Of course, if high tax rate areas need high rates because they have low tax bases or high needs, then they will not offer higher services and thus long-run migration could occur. But this effect could be reduced by equalisation grants that allowed for problems of low bases and high needs.

Another worry with varying tax rates is that they may encourage some people to vote for far higher or lower service levels than those for which they would really be willing to pay. Property taxes are subject to criticism here. For example, suppose property tax payments are proportional to property values. Then people with high value properties will pay a very high price for sub-central services, and so they may tend to vote for low service levels. Conversely, people with low value properties may pay very little; and so too may people whose property tax bills are largely or wholly offset by rebates.

The United Kingdom council tax avoids the first of these problems by simply putting all properties into one of eight bands. This banding effectively puts a ceiling on the taxes levied on high value properties and a floor on the taxes levied on low value properties; admittedly some people might argue that this infringes equity. However, the United Kingdom may make the second problem worse through its practice of giving 100% rebates for poor taxpayers.

5. Sub-central income taxes

This section covers the key issues that arise with sub-central personal income taxes, starting with the yield.

5.1. The total tax yield and its adequacy

Figure 4 shows that the highest yielding sub-central taxes in OECD countries are income taxes. Allowing that some countries operate this tax at both the state and local levels, the average yield at sub-central level across the 30 countries is 3.6% of GDP. Some of this (about 0.4%) arises from taxes on corporate incomes, but the great bulk of it (3.1%) arises from taxes on individual incomes. The highest yield is 16.1% of GDP in Sweden, all of it on personal incomes.

These yields show that even in the most decentralised countries, where sub-central spending reaches 30% of GDP, sub-central income taxes could finance well over half of this spending. Thus, even if all the decentralised services in these countries were on a reasonably autonomous basis, sub-central income taxes could satisfy those who argue that the majority of the revenue needed for these services should come from sub-central taxes.

5.2. The buoyancy of the tax yield

Income taxes are highly buoyant. When prices rise, incomes tend to rise, and in turn income tax yields rise with no increase in tax rates. However, as explained in Section 4, it is not entirely clear whether this buoyancy is desirable from an economic perspective, even though it will doubtless be attractive to SCGs.

The problem with buoyant taxes is that voters may suffer from the illusion that their real burdens are not rising, just because tax rates are not rising. If people have this illusion, then it might be expected that sub-central expenditure growth would be most rapid in the countries with the most buoyant sub-central taxes. So it may not be a complete coincidence that the two EU countries shown in Figure 1 to have the highest SCG spending in relation to GDP (Denmark and Sweden) are also shown in Figure 4 to have the highest sub-central income taxes in relation to GDP.

5.3. The tax base

A sub-central income tax will almost inevitably have a base that includes earned income, but there may be some debate about whether it should also include investment income. In equity terms, the ideal must be to include as much income as possible. However, it may be administratively hard to get all the data needed to include investment income, especially if tax payments on investment income are withheld at source, so that not all taxpayers need to file income tax returns. If these problems do arise, then investment income could be taxed at a uniform rate equal to the average sub-central income tax rate, and then the revenue could be distributed to each SCG on, perhaps, an equal per capita basis.

5.4. *The spread of the tax yield between authorities*

As noted in Section 4, there is a case for having a sub-central tax whose base is spread out fairly well across SCGs. The spread of the income tax base varies from country to country and, in a given country, it will be affected by the SCG boundaries. For example, if city incomes are much higher than rural incomes, then the base may be very uneven if cities and rural areas have separate authorities, and yet be quite even if all SCGs have a mix of cities and rural areas.

Even if all authorities have such a mix, there is likely to be some unevenness in the yield, and this will tend to be particularly marked if the authorities are small. In such cases, it may be possible to ease the advantage enjoyed by the wealthy areas by imposing some upper limit on the income that is deemed taxable for sub-central tax purposes. Of course, this might seem to offer an unfair advantage to high income earners, but this advantage could be effectively negated by imposing high central rates of tax on the highest income.

5.5. *Administration*

Income taxes are often claimed to have high administrative costs in comparison with property taxes, although the comparisons are sometimes a little distorted by ignoring the periodic revaluation costs in the case of property taxes. However, in considering the high administrative costs of income taxes, it should be appreciated that these taxes may also have much higher yields. So the administrative costs may be lower as a percentage of the total yield.

For example, in the United Kingdom it has been argued (CIPFA, 2004, p. 36) that the relative costs of administering the income tax are lower than those of administering the domestic property tax; and it should be noted that the United Kingdom's domestic property tax is one of the highest in OECD countries. CIPFA argues that statistics issued by Inland Revenue, who collect the income tax, show that the collection cost of that tax as a percentage of the yield was around 1.4% in 2001-02. In turn, CIPFA suggests that the yield of the domestic property tax would have to rise more than double for the collection costs of this tax to fall to the same level. And this comparison ignores the revaluation costs involved with the domestic property tax.

Of course, the costs of administering a sub-central income tax will be much lower if it is assessed and collected along with the national tax, for then the marginal cost of collecting the tax on behalf of SCGs may be relatively modest. Such an arrangement is sometimes called a "piggy-back" tax (LGA, 2004, p. 7).

5.6. Certainty and predictability

As explained in Section 4, a tax should ideally afford certainty to taxpayers over how much tax they owe, when it is due, and how they need to pay. A sub-central income tax would have a high degree of certainty if it was piggy-backed onto a national income tax, as often happens.

Also, a sub-central tax should offer predictability to SCGs over how much revenue they will receive when they set their tax rates. In this respect, a sub-central income tax may have considerable problems compared with a property tax. This is because the actual amount raised may differ significantly from what was forecast if the local economy performs better or worse than was expected. SCGs may face particular difficulties if they raise less revenue than they forecast. Some countries, like Norway, give no help to SCGs in this position, except to let them borrow temporarily to make up the shortfall; SCGs who borrow for this reason must set higher tax rates in the next year to repay the loans.

Some other countries offer more protection. For example, in both Denmark and Sweden, the central governments collect all income taxes and actually pay each SCG the sum it expected to receive on the basis of its forecast, instead of paying it the revenue that is actually collected from its residents. In Denmark, any difference between the amount that the central government raises in an authority and the amount which it pays to that authority is regarded as a loan from the central government to the local authority or *vice versa*; these loans are all repaid two years later, with interest, under an arrangement known as a "true-up". In Sweden, any difference between the aggregate amount that the central government raises and the aggregate amount that it pays is added to, or subtracted from, the grants that it pays to SCGs two years later, the grants all being adjusted by an equal per capita basis.

5.7. The taxpayer and equity – or the fairness of the tax burden

If incomes are taken to be the best available measure of ability to pay, then clearly an income tax scores well on the ability-to-pay approach. However, with such a tax, a fairly sizeable proportion of the population may fall under some tax threshold and so be exempt. In these circumstances, some rich taxpayers might feel the situation has overlooked the benefit approach too much. They might argue that all citizens should pay something for sub-central services, and hence that a sub-central income tax should run alongside a small additional tax.

National income taxes generally impose higher rates on higher incomes, partly no doubt to raise more revenue, but also in an attempt to make post-tax incomes less unequal than pre-tax incomes. In contrast, individual SCGs often impose their income taxes at a single rate (Thomma, 2004, p. 10). This is probably wise, for it means that SCGs will not get explicitly involved in redistribution. The worry with them getting involved here is not that some very redistributive areas will be harsh on the rich; rather it is that any area which seeks to be more redistributive than the least redistributive area may see its rich citizens emigrating and poor ones coming in, so that each area would have to adopt the least progressive stance.

However, suppose it was felt that sub-central income taxes should tax the rich at higher rates without giving the sub-central authorities a direct say in the degree of progressiveness. This could be managed by allowing SCGs to set their tax rate as a proportion of the sum that each of their residents will pay in central income tax. Thus an SCG might set a rate of 15% and require all residents to pay sums equal to 15% of their central income tax bills. In this way, higher rate taxpayers will pay higher fractions of their taxable income in sub-central income tax than will lower rate taxpayers.

5.8. *Promoting efficient spending levels: visibility and perceptibility*

As explained in Section 4, sub-central taxes should ideally help to produce a situation where SCGs spend at the "correct" levels: that is, they should spend more only when the value to taxpayers of the benefits from the extra spending exceeds the cost of extra taxes. However, this criterion is unlikely to be met if sub-central taxes are invisible or imperceptible, so that sub-central voters do not know how much they are paying in tax.

A sub-central income tax would be less visible than a domestic property tax, because taxpayers would not be presented with an annual tax bill. Indeed, income taxpayers might have the tax deducted at source and so get a very imperfect idea of how much sub-central tax they are paying. Once again, however, it is worth asking whether it is any less acceptable for SCGs to have imperceptible taxes than is the case for the central government.

5.9. *Promoting efficient spending levels: tax exporting*

Section 4 also noted that tax exporting occurs if the burden of a sub-central tax falls partly on non-residents. The result is that SCG services are effectively subsidised by non-residents. Of course, some SCG services do benefit non-residents, so some exporting does seem acceptable; but, arguably, non-residents in most countries already pay more than their due share through the grants system without needing to make further contributions through tax exporting.

In practice, there is little or no problem with tax exporting in the case of personal income taxes. This is clearest in the case of a tax on wages and salaries. The only apparent risk is that some of the tax may be shifted to employers who might have to raise their wages to attract staff; and the employers might then further export the tax by having lower profits for owners or higher prices for customers, with many owners and customers perhaps being non-resident. However, assuming that local workers will benefit from the sub-central services and that they still wish to work, there should be little need for wages to rise. So this problem should be very small.

Take next a tax on the income from capital. If this is levied by area A on its residents, then no doubt A's residents would like to get a higher return on their capital to cover the tax. Presumably they have invested their capital in a range of firms and other assets that are frequently located in other areas. If A's residents could demand a higher return, then the non-resident owners, employees and customers of the assets concerned would each meet a share of A's tax burden. But, in practice, these other areas can acquire capital from anywhere, so they would be unlikely to pay a higher return to the citizens of area A.

5.10. Low distortions when tax rates vary

Section 4 explained that, ideally, sub-central taxes should not distort people's behaviour, but such distortion is a danger when tax rates differ markedly between authorities. One worry is that varying tax rates may cause the tax base to shift from high rate areas to low rate areas. Another worry is that some taxes may encourage some people to vote for far higher or lower service levels than those for which they would really be willing to pay.

These problems may be slightly greater with sub-central income taxes than with domestic property taxes, but even so the problems should not be serious. The reason is that if tax rates relate closely to service levels, then people may willingly pay higher sub-central taxes in order to get better sub-central services. However, sub-central income taxes may make sub-central services seem very costly to those on high incomes and very cheap, or even "free", to those on low incomes. So the former may seek to move to low tax rate areas, while the latter may seek to move to high tax rate areas. Also, the former may vote for relatively low levels of services while the latter may vote for relatively high levels. The problems of rich people might be addressed with some upper limit on the amount of income that is taxable for sub-central taxes. The problems of poor people could be addressed by having some small additional tax.

It may be added that Nechyba (1996, pp. 6-9) and Spry (2005, pp. 4-5) suggest that one reason why some United States authorities prefer property taxes to income taxes is because income taxes give an incentive to emigrate to people whose incomes are high in relation to their property values. This incentive is not confined to the rich, but rather applies to people of all incomes who have a high ratio of income to property values. The result is that authorities with high income taxes may end up with a large number of people whose income to property value ratio is low, and hence end up with a lot of people with relatively low income. Admittedly, this problem arises only in the relatively rare case when authorities can choose their tax.

6. The main sub-central business taxes

This section explores the main sub-central business taxes. For convenience, the sub-sections follow those generally used in Sections 4 and 5, although some of the issues that arise with domestic taxes are relatively unimportant with business taxes.

Business taxes generally fall on one or more of business incomes (or profits), business properties, and business payrolls. Often, a business tax relates to just a single base and has the appropriate name. But some business taxes have composite bases. The main two examples are as follows (details from Thomma, 2004, p. 12):[3]

- The French *taxe professionnelle*. For a long time, this was a tax on the rental value of business buildings and equipment along with wages. However, the wages share was phased out between 1997 and 2003, so this tax is now effectively a slightly unusual property tax.
- The Italian *imposta regionale sulle activita produttive*. This was introduced in 1998 and is in essence an origin-based value-added tax. So it is effectively a combination of a profits tax and a payroll tax.

6.1. Possible tax yields

Figure 4 shows that the highest yielding sub-central tax is income tax, with an average yield across the 30 countries of 3.6% of GDP. However, the vast bulk of that sum comes from personal incomes, and on average the yield of sub-central taxes on business incomes is only about 0.4% of GDP. This figure of 0.4% would be slightly enhanced if the relevant profits share of Italy's business tax was added in.

Even so, the average yield of business income taxes is lower than the average yield of business property taxes. The latter probably account for around half the yield of property taxes and so around 0.6% of GDP.

The pure payroll taxes in Australia, Austria and Canada put the average yield of payroll taxes at around 0.1% of GDP. This figure would be slightly enhanced if the relevant payroll shares of the local business taxes in France and Italy were added in.

As with domestic taxes, the maximum yields may be more instructive than the averages. The highest yield for a business income tax is 2.4% of GDP in Luxembourg, followed by 1.5% in Switzerland. The highest yield for a business property tax is surely Canada, with up to 1.5% of GDP, and the highest for a payroll tax is 1.3% of GDP in Australia.

6.2. The adequacy of the total tax yield

Section 1 showed that sub-central spending in most countries is between 5% and 25% of GDP. Typically, about a seventh of this is accounted for by capital spending, which may be financed by loans, leaving current spending at around 7% to 16%. Also, Section 1 suggested that if it is desired to put most sub-central services on a reasonably autonomous basis, then, arguably, more than half of the needed revenue should come from sub-central taxes. This points to a typical minimum of around 4% to 8% of GDP. However, Section 3 argued that businesses should contribute well under half of the revenue, perhaps only an eighth. So the target yield for sub-central business taxes may often lie in the range of, say, 0.5% to 1% of GDP.

The upper target of 1% is met by the highest sub-central business income taxes in Luxembourg and Switzerland, by the highest sub-central property tax in Canada, and by the highest sub-central payroll tax in Australia.[4] So, arguably, any one of these taxes would make an adequate sub-central business tax on its own, at least if it was levied at relatively high rates.

6.3. The buoyancy of the tax yield

Business income taxes and payroll taxes are reasonably buoyant, because their bases tend to rise in line with incomes and prices. So, even at constant tax rates, their yields will rise over time. In contrast, a tax on business property will lack buoyancy, unless there are frequent revaluations.

However, the question of buoyancy is largely immaterial with these taxes. It was argued in Sections 4 and 5 that voters may suffer from illusions of different types with both buoyant and non-buoyant taxes; and as only a very few voters will see the tax bills imposed on businesses, the illusions that might be created by different business taxes seem unimportant.

6.4. The spread of the tax yield between authorities

The spread of different business taxes between SCGs will vary from tax to tax and from country to country. And it will be sensitive to the exact bases used and to the exact boundaries used. For example, if authorities are small, then there may be many areas that are chiefly residential and so have few businesses. However, suppose, as was suggested in Section 3, that business taxes were levied at a level commensurate with the benefits that businesses derive from sub-central services. Then it would be perfectly acceptable for the yield to be highest in areas with the most businesses.

Perhaps a more serious possibility is that the business tax base may be low in poor areas where wages and property values, and perhaps also profits, are low. This does seem to be a problem with the business tax in Italy (Thomma, 2004, p. 12).

6.5. *Administration*

As sub-central business taxes yield more per taxpayer than sub-central domestic taxes, they should have significantly lower administrative and compliance costs in relation to the revenue raised. Thus administrative costs may not be much of an issue. Nevertheless, it may well be worthwhile to collect any sub-central taxes on business incomes or payrolls along with any national taxes that there may be on these bases.

6.6. *Certainty and predictability*

As the location of business property is not open to doubt, sub-central business property taxes score well on certainty for taxpayers. However, sub-central business income taxes are subject to major difficulties when the profits of multi-area firms must be apportioned between different authorities. Payroll taxes may create similar difficulties for multi-area firms, at least in the case of employees who spread their working time in different areas. Ultimately, some more or less arbitrary formulae have to be used, and the possibility of changes in these formulae creates some uncertainty. For example, Thomma (2004, p. 11) notes that, in the United States, the formulae for profits taxes have traditionally accorded equal weight to property, payrolls and sales, but recently some states have given relatively more importance to sales.[5]

As noted earlier, sub-central property taxes also score well in terms of generating predictable yields for SCGs. But, like sub-central taxes on domestic incomes and sales, sub-central taxes on business incomes and payrolls may produce significantly different yields from those expected if the economy in an authority has an unexpected turn. However, this difficulty could be addressed with similar devices to those discussed in Section 5 in the case of domestic income taxes.

6.7. *The taxpayer and equity – or the fairness of the tax burden*

As business taxes are levied on businesses, their equity implications are often ignored. However, all taxes are ultimately paid by people, and it is pertinent to consider who really pays the various possible business taxes. This is a very complex issue. However, it is likely that with any tax on business profits, business properties or payrolls, or any combination of these, some of the burden is borne by the owners in the form of lower profits. It is also likely that some of the burden will be borne by employees in the form of lower wage rates (because the demand for labour will fall a little), some by other input suppliers (because the demand for other inputs will fall a little) and some by customers (in the form of higher prices). For example, a United Kingdom study on the incidence of business property taxes – which in the United Kingdom are levied on the businesses occupying the property – showed that much of the incidence was ultimately borne by property owners (Bond *et al.,* 1996, p. 33).

Although this is a very brief description of a very complex and indeed uncertain topic, the probability is that the biggest impacts will tend to fall on those citizens who have the highest ability to pay in terms of having high business ownership, high wage rates and high spending levels. So it is unlikely that a full analysis would point to serious equity problems.

6.8. Promoting efficient spending levels: visibility and perceptibility

The argument for having visible sub-central taxes is to help voters understand the cost of the sub-central services from which they benefit. In these circumstances, voters should make informed choices about the level of sub-central services. As few citizens actually pay business taxes directly, it might be argued that this issue is not important in the case of business taxes.

In practice, though, all citizens pay business taxes indirectly, through the effects of these taxes on prices, profits and wages. These tax burdens will be highly invisible, and may well serve to give voters a distorted view of the cost of sub-central services. But this would not matter if the total level of business taxes was commensurate with the level of SCG services provided to them, for then these taxes would not subsidise SCG services provided for households.

6.9. Promoting efficient spending levels: tax exporting

As noted above, the incidence of business taxes is shared in unclear proportions between owners, employees and customers. So, for any individual business, some of the incidence of any sub-central business tax is almost certain to be exported. However, the non-residents who face some of the burden also get some benefits from the services which the SCG provides for the business. So it is reasonable for some of the burden to be exported. Problems would arise only if disproportionately large or small shares of the tax were exported.

Given the uncertainty of how far the burden of each possible business tax is exported, and also how far the benefits of SCG services to businesses are exported, it is impossible to say whether one or other business tax is particularly commendable or unsatisfactory. The probability is that, if the total burden of business taxes was commensurate with the total value of the SCG services which businesses enjoy, then the tax exporting that occurs with these taxes would not be a matter for much concern.

6.10. Low distortions when tax rates vary

It is often feared that businesses will migrate from areas with high rates of business taxes, whether the base be profits, payrolls or property. However, it should be noted that the benefits which businesses derive from sub-central services may typically be greater in areas with high tax rates. If so, then the incentive for businesses to leave these areas will be reduced. Probably the main conclusion is that it might be unwise to make business taxes cover more than the benefits to businesses of SCG services.

Quite aside from business migration, there could be a further problem with payroll taxes if rates vary between areas. This problem is that workers might be tempted to live in areas with high tax rates and good SCG services, but to work in SCGs with low tax rates, so that little of the SCG payroll tax was passed on to them in lower wages. Again, however, this problem would arise only if sub-central business taxes cover more than the cost of the SCG services provided for businesses; otherwise, an area which sets a high payroll tax rate will be able to use the revenue to subsidise the services that it provides for its residents, so a high payroll tax rate will not make that area a more tempting place in which to live.

7. Some other possible sub-central taxes

Few OECD countries have tried to raise large revenues from local taxes other than those discussed in Sections 4, 5 and 6. The only important other taxes are sub-central sales taxes, but these have a number of limitations when used as sub-central taxes. Admittedly they can have high yields, and they also have buoyant yields and relatively low administrative costs. But, on the other hand, their yields may be concentrated in areas with important retail centres, their yields are subject to volatility over the business cycle, their burdens are far from visible, and they may lead to a substantial degree of tax exporting. Moreover, it may be difficult for any given SCG to set its own rates, because any rise in its rates may drive many shoppers elsewhere.

There are two other SCG taxes of note, as follows, although arguably they are even less promising:

- The former poll tax in the United Kingdom. This was a tax whereby all the adults in a given area had to pay the same amount of local tax. It was widely felt to be unfair and was soon abandoned.
- The natural resource revenues used by some of the Canadian provinces. The trouble with using these revenues at a sub-central level is that they favour some SCGs greatly at the expense of others. For example, Saskatchewan

benefits from these taxes and is able to levy relatively low income taxes, while Alberta also benefits from them and does not levy sales taxes. Alternatively, natural resource taxes could cause large variations in service levels between areas, unless large equalisation grant schemes were introduced.

However, there are some other minor taxes that could be of interest, particularly those on motorists. For example, United Kingdom local authorities have the power to charge for road use. London has introduced congestion charging, and there are small schemes in Cambridge and Durham. Admittedly Edinburgh's residents voted against a scheme in February 2005. The government is currently conducting trials on a scheme for tracking motorists by satellite, with a view to possible further charges.

Otherwise, there do not seem to be many promising SCG taxes. In the United Kingdom, a recent review considered a number of possible new local taxes, including localising the stamp duty (that is the transfer tax) on home purchases, along with local green taxes, localised vehicle excise duties, and local tourist taxes. The review concluded that "although some of these smaller taxes and charges might be pursued for particular policy reasons… we have concluded that none of them could achieve a significant shift in the balance of funding" between taxes and grants (ODPM, 2004, p. 53). The review reached a similar conclusion with small local sales taxes. This conclusion seems consistent with a recommendation from the Council of Europe (2004, p. 21) against having numerous small taxes, on the grounds that this would result in high administrative costs and, perhaps, high litigation costs.

Notes

1. Note that the property element of the French business tax has a base that includes business equipment as well as buildings. Also, there is a so-called business tax in Hungary, but this is effectively a value-added tax.
2. There are no official Canadian data on this, but households are thought to pay around 55% of the total property tax yield and hence around 1.8% of GDP in this tax.
3. There is also a so-called business tax in Hungary, but this is essentially a value-added tax rather than a tax levied on businesses, and it is categorised by the OECD as a tax on expenditure.
4. Incidentally, the target of 1% is also well exceeded by the 1.7% that applies to the United Kingdom's business rates, which were formerly a local tax.
5. Incidentally, Thomma adds that this change has been made to make the taxes more like sales taxes and, in turn, to try and export more of the burden to non-resident customers. Tax exporting of business taxes is discussed in Section 6.9.

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