ADAPTING TO THE FISCAL ENVIRONMENT

Local governments, revenue and taxation powers

Mark Sandford

Introduction

The central approach of this chapter is that, following Ambrosanio and Bordignon (2006) and Martinez-Vazquez (2015), the shape of local government revenue sources and taxation systems is best understood through an empirical lens. Taxation, like politics, is the art of the possible, and this is no less true of the choices about structures, the degree of local discretion, and the proportion of local authority finance that is raised locally. An empirical glance at the heterogeneity of local government revenue systems suggests that their shape is driven by public administration heritage, broader political developments and historical contingencies (Caulfield 2000; Loughlin et al. 2011; Blochliger and King 2007). This could, of course, equally be said of local governments themselves.

This perspective contrasts with the literature on the economics of local government finance. The points of consensus of this substantial literature are rarely reflected in real-world practice, either in terms of the taxes available to local authorities, their interaction with other sources of revenue, or the rationales for change. Even where the need for change is accepted among government institutions, historical contingencies are frequently critical in triggering its occurrence (Shah and Thompson 2004: 3). The starting point for understanding local government taxation should therefore be almost anthropological, tracing the qualitative influences driving local government and public finance as systems. Local authorities are not, and cannot be, atomised economic actors: they exist in systems of governance, constitutional contexts, and are subject to political and cultural pressures. To deliver public services and respond to local people’s economic and welfare concerns, they must maintain relationships with dozens of public bodies (Smoke 2015). These may have their own electoral mandates, cover overlapping or broader geographical territories, or have access to larger sources of funding or broader legal powers.

Thus, this chapter summarises the observable practices of local authorities’ taxing and revenue-raising capacities; looks at commonly used taxes; and notes some recent innovations in revenue-raising practice. It can only be a glance at a highly heterogeneous environment. Local sources of revenue includes the familiar (property taxation, fees, shared revenues) alongside more exotic beasts. Their characteristics in different states arise in the context of their environment – principally local government’s functions, and the balance between local
Adapting to the fiscal environment

government as central government agent and as an actor in its own right (Caulfield 2000). Local government finance forms an element of a broader economic system. Its shape is influenced by central funding practice, political priorities, and the national economic outlook; and, as with local government itself, changes to local government finance systems can often be second-order effects of broader political struggles.

On this view, local taxation systems should not necessarily be expected to be coherent or rational. They are best understood as manifestations of the dynamic and ongoing relationship between local and central government within each given state. The economically ideal ‘autonomous local government’ is elusive in global practice. Much more common is a multi-layered relationship, consisting of a tangled web of past intentions and political convenience. Central government also provides an essential legal and financial management framework for local authorities (DFID 2015).

The relationship is characterised by co-operation and conflict on several fronts at any one time. Taking this into account, it is not surprising that most local authorities receive some form of transfer funding (grant) from higher tiers of government. They will often use transfers to carry out functions on behalf of central government. Equally, it is common for local authorities to have access to less funding for these functions than they require (‘unfunded mandates’) – and/or to face restrictions in their access to sources of revenue. It is this type of ‘push factor’, arising from dynamic pressures on revenue, that accounts for local authorities’ frequent attempts to access innovative or unconventional sources of funds (Martinez-Vazquez 2015; DFID 2015; Glaeser 2011).

Economic theories

Much early scholarly assessment of local government taxation took place through the lens of economics. The lodestone of this perspective is Charles Tiebout’s 1956 paper ‘A Pure Theory of Local Expenditures’. Tiebout postulates individuals as consumers who select a local government area according to its fit to their preferences for ‘public goods’. As such, local authorities are conceived purely as providers of public services, with none of the broader strategic responsibilities that normally characterise a ‘government’. Tiebout acknowledges that his model is an ideal type; and he has little to say about appropriate sources of revenue for local authorities (see Oates 1972; Brennan and Buchanan 1980). Richard Musgrave’s The Theory of Public Finance (1959) balanced this perspective with the ‘ability to pay approach’, citing a long history of views that the incidence of tax should be progressive. He recommended that only immobile tax bases, and those that were relatively evenly spread between localities and formed a stable source of revenue, should be taxed locally. Redistribution and macroeconomic management should be left to higher tiers of government. This may be cited as a more ‘progressive’ response to the Tiebout–Oates perspective. Conversely, Brennan and Buchanan advocate taxing mobile factors of production precisely because this incentivises tax competition between localities.

These perspectives all share a weaving of normative factors into proposed economic/constitutional structures. In practice, decisions to decentralise rarely arise from rational economic calculations. They are normally driven by short-term political considerations (Shah and Thompson 2004; Fjeldstad 2015; Smoke 2015). Moreover, effective implementation of changes in fiscal structures require the building of capacity and influencing of attitudes, among central and local governments and taxpayers (Smoke 2015). Fiscal structures normally have some connection with the responsibilities of local authorities; and responsibilities are frequently joint or concurrent between central and local government. This contrasts with the economic literature, which tacitly assumes a ‘dualist’ approach, where tasks are neatly allocated to one tier or another.
In practice local government systems can rarely avoid interlocking with one another. Even the most dualist approach will include points where different tiers co-operate to increase effectiveness. ‘Concurrent functions’, where more than one tier of government has a legal responsibility, are commonplace. Local authorities may seek influence over regional or national functions, in response to local electoral pressure. Disputes between tiers regarding jurisdiction may arise, and may be settled in constitutional courts. Local fiscal systems could be expected to reflect these messy patterns (Ambrosanio and Bordignon 2006: 321).

Additional considerations apply in developing countries. There, debates around fiscal decentralisation may be overshadowed by questions over the effectiveness and legitimacy of the state. Bahl and Linn (2014) note that fiscal centralisation is the norm in developing countries. Local governments may face challenges establishing a functioning local administrative apparatus, and local taxation systems may face allegations of corruption or clientelism (Smoke 2015: 43). Fjeldstad suggests that:

local governments [in Africa] seem to raise whatever taxes, fees and charges they are capable of raising, often without worrying excessively about the economic distortions and distribution effects that these instruments may create.

(Fjeldstad 2015: 149)

Popular acceptance of tax systems and visible impartiality in their enforcement are also key to their functioning in such a context. Where effective administration is absent, particularly sharp instances of centralisation can ensue. For instance, property taxes, despite being popular (and theoretically optimal) sources of local authority revenue in OECD countries, are centralised in China and Indonesia, while they are controlled at state level in India, Nigeria and Pakistan (Shah and Thompson 2004).

**The obstacles to economic rationality**

This is not to say that economic criteria do not matter for the functioning of a taxation system. Indeed, property taxes, licensing and fees, and shared income taxes crop up repeatedly in real world systems, as might be inferred from Musgrave’s perspective. But these exist within a broader funding climate. In particular, most local governments receive intergovernmental transfers driven by political imperatives (Martinez-Vazquez 2015). The circumstances giving rise to these imperatives include:

- Variations – sometimes severe – in tax base and wealth between local areas within a single state (UN-Habitat 2015: 11). This would mean, for instance, that a 5% rise in a given tax would raise much more revenue in some areas than others. This might occur because properties are more numerous or valuable, the inhabitants’ incomes are higher, or more use is made of chargeable services.
- Varying economic or social need across local areas. How this translates into a funding system depends upon the state’s priorities. If local authorities are expected to make nationally mandated public services available on a needs basis, there are likely to be initiatives towards redistributive funding. Some local authorities will receive more funding per capita than others.
- Central governments’ use of local authorities as delivery agents for central policies. These may relate to delivering public services (as above), or to more diffuse responsibilities. Often, though not always, such responsibilities will be accompanied by grant funding (‘intergovernmental transfers’).
Adapting to the fiscal environment

These pressures should be taken into account when assessing aspirations towards greater local ‘fiscal autonomy’. It is not uncommon for reviews of local government to recommend that local government should raise an increased quantity of its own revenue, without offering any particular rationale for this view (e.g. UCLG 2010; CoE 2004; UN-Habitat 2015). Local fiscal autonomy, and the constraint of central government influence over local authorities, can often be regarded as an absolute good. This aligns with the economic literature on local government finance, and it can often reflect the aspirations of some local governments themselves. But greater local fiscal autonomy could reduce the capacity of local authorities to fulfil the type of tasks outlined above. This is recognised by the European Charter of Local Self-Government, which recommends provisions for horizontal equalisation as well as access to a buoyant and diverse range of local revenue sources (CoE 1995).

In practice, the interplay between state-wide priorities and local discretion determines the shape of a local government funding system. This ‘interplay’ is frequently a conflict. For instance, where a central government prioritises using local authorities as delivery agents, real fiscal autonomy is likely to be low. Where tax bases vary, this may lead to variations in outcomes. Central government may balance this with grant funding, but to a limited extent. Explicitly or implicitly, any local funding system will navigate a balance between these considerations.

Variations in wealth between local government areas, and thus tax bases, are referred to as horizontal fiscal imbalance (HFI). HFI may be counteracted by a system of horizontal equalisation. This will often be implemented via general, un-ring-fenced grants. This prevents differences in revenue-raising capacity between wealthier and less wealthy areas from translating directly into the level of local public services provided. Alternatively, conditional grants may be allocated on a needs-related basis, and these may be ring-fenced for use on public services that are mandated by a higher tier of government. Needs assessment may be a particular concern if local authorities act as agents for national services; but it can equally feature where this is not the case.

As noted, it is extremely rare for local authorities to raise all of their revenue locally. The phenomenon of vertical fiscal imbalance (VFI) indicates the existence of a gap between revenue raised locally and revenue spent by a local authority. Almost all local government systems exhibit some degree of VFI: Blochliger and Kim (2016: 97) describe it as ‘probably inevitable’. Indeed, it is common globally for local authorities to obtain a majority of their revenue from sources over which they have no direct control, either in the form of central grants or funds from shared or assigned revenues (see below).

Aspirations towards ‘fiscal autonomy’ amount to aspirations to reduce VFI. Concepts of ‘accountability’ are often found at the root of these intentions. The argument in short is that local authorities’ accountability to taxpayers is promoted by a direct relationship between local taxation and spending (Martinez-Vazquez 2015; Slack 2009). In addition, Blochliger and Kim (2016) argue that grant systems are more susceptible to political interference, and that localisation of taxes incentivises efficient tax collection and identification of the tax base. Logically, to the extent that VFI – and any system of horizontal equalisation – is present, accountability and its accompanying benefits are reduced. In its pure form, this is the ‘benefit model’ of local government (Bailey 1999; Glaeser 2011; Musgrave 1959). This sees locally raised taxes as providing a direct relationship between electors and local governments. Electors pay a desired amount in tax for an agreed basket of public services.

There is no room here to explore these debates in detail, except to note that the assumptions of the ‘benefit model’ disregard the broader location of local government in a system of governance. They also disregard the broader strategic, place-shaping and representation roles that are characteristic of local authorities. Moreover, accountability can be defined more widely than purely fiscal responsibility to taxpayers. Many local authorities tackle
accountability in part via transparency, audit, and public consultation mechanisms. Taxation is not the only route through which local preferences may be determined:

All local governments, however, need to be responsible, accountable, and efficient. To do so, they need to raise their own revenues as much possible, adhere to an open and visible municipal budgetary process, and engage in transparent and prudent financial management.

(Slack 2009: 72)

The tangled web: local government revenue sources

Any empirical local government finance system comprises a dynamic equilibrium between the pressures noted above, subject to external political forces. This reminds us that local government is a form of government – a complex organisation facing multiple responsibilities, pressures, incentives, disincentives, legal requirements, financial requirements, and aspirations. Interdependence with other public bodies is high; local capacity is variable; and complex and multi-layered partnerships proliferate. Multiple sources of funding are a source of resilience in such a context (Martinez-Vazquez 2015). Indeed, access to a range of sources of funding could be more valuable than access to only one or two sources, even if the latter offered larger revenue streams.

It is important to view local taxation capacity in the context of other sources of income. It is common for other sources of income to exceed the revenue available from local taxes. The most common sources of income for local authorities are:

- **Intergovernmental transfers** (grants). These are distributed to local authorities by higher levels of government (regional/state or central). They may be (but are not always) associated with particular responsibilities carried out on behalf of those governments, and therefore they may (but need not) include legal limits on what the funds may be spent upon (conditional or ‘ring-fenced’ grants). Canada’s provinces transfer funds to local authorities to the value of some 20% of the localities’ total revenues; of these funds, 80% are ring-fenced. Alternatively – or at the same time – grants may be distributed according to some form of assessment of local need for local government services. This type of grant functions as a counterweight to horizontal fiscal imbalance, but without direct legal requirements applying to how the funding is used.

- **Distribution of public funding** is a highly complex field with its own extensive literature (e.g. Smith 2006; Steffensen 2010). Comprehensive redistribution systems covering local government funding as a whole are rare (UCLG 2010: 16). OECD analysis suggests that redistributive grants reduce disparities between local authorities within states considerably (Blochliger and Kim 2016: 98). Nevertheless, local authorities frequently experience ‘unfunded mandates’ – legal responsibilities accorded by higher-tier governments but without adequate revenue to carry them out. Some states, such as Poland, have constitutional provisions banning unfunded mandates (Banaszak 2013).

- **User charges**: These exemplify the ‘benefit model’ of local government. They are charged to individuals or organisations in return for a specified local service. They are popular and relatively politically acceptable in the USA, Canada and Australia (Caulfield 2000) and in some states in Africa (Fjeldstad 2015). Their use can reduce reliance on local taxes (Ambrosanio and Bordignon 2006: 308). Fees may be charged for a broad variety of services, such as licences for specific types of business (e.g. selling alcohol); rents for public housing; construction licensing; vehicle registration; or waste disposal (Boetti et al. 2012).
Adapting to the fiscal environment

User charges can be distinguished from trading income (see below) in that they are charged for statutory services or for services over which the local authority has an effective monopoly. Fees do not normally constitute a large proportion of local government income where functioning taxation or intergovernmental transfer systems exist. The power to set fee levels does not necessarily reside with the local authority. A fixed rate, or range, may be set by a higher tier of government.

- **Trading/commercial income.** This relates to local authority services (e.g. leisure, housing, or legal services) that compete with those available on the open market. However, it may also refer to charges for utilities (water, gas and electricity) and for urban transit, which may be either fully publicly owned or dominated by the local public sector. States vary in the degree to which they permit local authorities to practise commercial activity. In many states, local authorities are permitted to derive income from their own property and charge for the provision of local services. Access to revenue from this source is also influenced by the degree of privatisation in the state in question: states which have privatised or deregulated utilities will be unable to directly benefit from revenue from them.

- **Borrowing.** Local authorities frequently have access to money markets, bond markets, or national/municipally owned lending agencies. Borrowing is the most common source of funds for significant capital expenditure. This is normally used for infrastructure investment (urban transit systems, housing, renewal of public utilities, or property). The sums involved frequently dwarf the annual revenue available to an authority, and capital investment allows the cost of an asset to be spread over a longer period of time (‘intergenerational equity’).

Local borrowing is normally included in any assessment of a nation-state’s financial health. This leads central governments frequently to seek to manage local government borrowing levels. This may range from limits on sources of finance or limits on amounts borrowed through to a legal requirement for approval or an outright ban. For instance, Ethiopia, India, Indonesia, Korea, Mexico and Peru require central government approval for local authority borrowing. Lithuania, Poland, Czech Republic and Slovenia forbid borrowing from foreign bodies (Shah and Thompson 2004: 18).

The balance of revenue from each of these sources of income is highly variable. Economic differences generate variations within states and between years. Comparison of the average percentages of revenue that derive from each of these sources between states also reveals enormous variation (Blochliger and Kim 2016). This, again, reflects the heterogeneity of local government roles and functions between states.

**Financial incentives**

The balance between sources of revenue, and the terms on which revenue is obtained from each source, work together to create a unique basket of incentives for local authorities in each state. For instance, where property taxation dominates, local authorities may seek (among other things) to use policy levers to increase the property tax base. Where shared income tax makes a major contribution, we might expect to see a close interest taken in effective tax collection, in debates over the exact share of tax revenues to be passed to local authorities, and in any horizontal redistribution mechanism. Where transfers make up a substantial proportion of funding, local authorities may develop a supplicant relationship with the transferor, emphasising their need levels or alleging the existence of ‘unfunded mandates’. Direct financial incentives – as opposed to general demands for efficiency – may also be established by central government. In England, the Business Rates Retention Scheme incentivises growth in the commercial property tax base
by allowing growth in tax revenue through the creation of new buildings to be retained over a 7-year period, while subjecting revenue from existing properties to a pooling mechanism.

Where central controls limit the variation in local tax revenue, or real or perceived unfunded mandates are present, local authorities may seek to develop revenue raising capacity in ways that are less subject to central control. The revenue available from such sources may be marginal to an authority’s spending requirements, but it can nevertheless offer relief from spending pressures. This approach also allows authorities to avoid the political consequences of raising local taxes. Political pressures against this are no less fierce at local level than at national level.

Alternatively, local authorities may simply deliberately overspend, calculating that central government will come to their rescue at the end of the year with supplementary grants rather than impose spending reductions and suffer political consequences. Local authorities have successfully pursued this course in Brazil and Argentina in recent years (Gordin 2016).

How local is a ‘local tax’?
The level of local control over ostensibly ‘local taxes’ may vary. A local authority with full control of a local tax would expect to:

- set the rate – including any reliefs and exemptions;
- define the tax base – again including any reliefs and exemptions;
- collect the tax, and retain the revenues collected.

Internationally, the number of ‘local’ taxes that meets each of these criteria is fewer than might be expected (OECD 1999; Blochliger and King 2007). Many limits have developed on local authorities’ discretion over ‘local taxes’. The power to set the rate may be limited by the central or state government, or it may hold discretionary powers to prevent large rises. Many property taxes are raised and lowered within nationally defined limits. For instance, Estonia’s counties may impose a land value tax of between 0.1% and 2.5% of the value of land. Norway’s municipalities must set a property tax of between 0.2% and 0.7% of each domestic property’s assessed value.

Similarly, the tax base may be defined by central government. Thus, for instance, although revenue and rate-setting is localised, tax bands, exemptions, reliefs and allowances may be fixed nationally. For instance, the bulk of Sweden’s income tax revenue is retained by municipalities (24%) and counties (7%); but the bands are set, and the tax base defined, by the central government. This benefits taxpayers by avoiding complexity arising from multiple systems. This means that local authorities’ discretion is focused almost entirely on the rate of tax. Since the rate of tax is the most critical element in an individual’s tax bill, it carries the highest political salience. Political considerations may therefore, in practice, limit local authorities’ discretion.

Assigned revenues
Alongside local taxation powers, many states operate ‘shared taxes’ or assigned revenue systems. A proportion of revenue from specified national taxes is allocated to local government. This could be classified as a form of intergovernmental transfer rather than a local tax, the total quantity of which is determined by actual revenue levels. Nevertheless, there is evidence that local access to national tax bases promotes better services (DFID 2015: 25).

Normally shared taxes are collected centrally and distributed to local governments (though the reverse situation does occur in transition economies: see Shah and Thompson 2004: 10). Revenue may then be distributed to the authorities in which they were raised (the ‘derivation
principle’), or they may be subject to some form of horizontal equalisation (Martinez-Vazquez 2015). This means that some local authorities may only see a limited relationship between the tax collected in their area and the revenue that they themselves obtain.

For instance, in Germany, 15% of income tax revenue is retained by the local government sector, but it is assigned to municipalities via an equalisation system. In Japan, in 2013/14, 32% of ‘liquor tax’, 25% of ‘tobacco tax’, 22.3% of ‘consumption tax’, and 32% of income tax were assigned to the local government sector. The funds are collected by the central government, and local needs are taken into account when distributing them. By contrast, Poland allocates income tax revenues direct to the locality in which they were raised. In 2015/16, the Czech Republic allocated 23.58% of income tax and 21.93% of VAT to local government, and Finland allocated 29% of ‘corporate taxation’ to local government.

In these systems, the percentage of each source of assigned revenue may change from year to year. The Japanese government took the decision to increase the consumption tax rate from 1% to 1.7% in 2014, and a further increase to 2.2% is anticipated in 2017. Political controversy may therefore surround the decisions on the percentage of revenue assigned, rather than focusing on the sums themselves.

Each of these phenomena can serve to limit the degree to which ‘local taxes’ act as a source of autonomy for local authorities. In practice, local governments may find that they have little realistic opportunity to alter their revenue levels – or to influence public policy – via sources of revenue described as ‘local taxes’. Even a local authority that appears to raise almost all of its revenue locally may actually have little room for manoeuvre regarding tax levels. It may be hedged in by political or legal limits on adjusting tax levels and tax bases. It may also face legal requirements from higher tiers of government that make it impractical to either increase or reduce revenue levels substantially. Jourmaud and Kongsrud (2003) suggest that the actual ‘taxing capacity’ of local government in a given state may be different from the actual quantity of revenue arising from own or shared sources. In Germany, for instance, local authorities receive considerable shared revenue from agreed sources but have no control over the tax rates.

**Types of local taxation**

Stephen Bailey (1999) postulates eight characteristics that a local tax should aim to meet:

- **Equity**: regressive taxes are to be avoided.
- **Efficiency**: promoting voters’ awareness of the link between taxation and service provision.
- **Visibility**: encouraging voters to be aware of the level of tax they are paying, hence promoting accountability.
- **Autonomy**: local control over the rates of tax, to maximise local electors’ control over the type and degree of service provided by their local government.
- **Economy**: taxes should be easy to collect, with minimal administration.
- **Sufficiency**: a buoyant tax base and flexible rates will help to ensure that revenue keeps pace with inflation and changes in levels of need. This becomes more significant the greater the proportion of revenue that is raised locally.
- **Stability**: tax revenue levels should be stable, affected minimally by economic fluctuations and cycles.
- **Immobile tax base**: it should not be easy to transfer the tax base out of a local authority area if the tax rate changes. This criterion favours property-based taxes – real property being mostly immobile – and disfavours income-based taxes – on the grounds that individuals can move to other jurisdictions. This criterion also points away from sales-based taxes.
No local tax can meet all eight of these criteria fully. A tax can be successfully operated locally if it meets many or most of them. The types of tax that are most frequently used by local authorities globally do demonstrably meet many of these criteria. This section sets out the most common forms of local taxation used.

- **Property taxes.** These most often consist of an annual charge calculated via (1) an assessed value of the property and (2) the tax rate levied on that value. There may additionally be a property transfer tax (‘stamp duty’), though it is less common for this to be under the control of local government. Property taxes frequently form the largest source of revenue for local authorities, particularly in English-speaking countries: in Canada, some 50% of local authority revenues are drawn from the local property tax. The assessed value may relate to either the capital or rental value of the property, or some proportion thereof; or it may be based on the property’s surface area, or some more complex tax base.

  Some states have a single property tax system applying to both domestic and commercial property, while others distinguish between the two: for instance, Sweden has no local commercial property tax. There may also be discrepancies between rates for, and revenues collected from, a property tax. In Poland, 80% of property tax revenues come from commercial property (Loughlin et al. 2011: 489).

  A small number of states (examples being Estonia and Australia) use forms of ‘land value tax’ – valuing land distinctly from property upon it (Bahl and Wallace 2008). Land value tax is favoured by economic analysis, on the grounds that it avoids the distortion of incentives. The key advantage of property tax is that property is rarely mobile, thus the tax is difficult to avoid (Fjeldstad 2015). It provides a stable and visible revenue stream. Where property values are only assessed on cycles that are several years long, this can serve to insulate local authorities’ revenue levels from immediate cyclical effects arising from economic downturns (Alm, Buschman and Sjoquist 2012). By the same token, the visibility of the tax, and of any fluctuations in rates and revenue, can be a source of taxpayer discontent (Caulfield 2000). This explains why property values in many states have not been reassessed for many decades, such as France (1970), Germany (1964; 1935 for the former East Germany), and Austria (1973). This affects the relative incidence of the taxes on different taxpayers, and can erode acceptance of the system. More fundamentally, creating and maintaining a cadastral register can be very challenging in developing countries (Devas and Delay 2006; DFID 2015). It can be challenging to establish the legal owner and/or the occupier, or even the existence, of a property.

- **Income taxes.** Localised forms of income tax are particularly common in Scandinavia and northern Europe, and the former USSR. In most cases, ‘local income taxes’ constitute a share of a nationally administered income tax. In Sweden, in 2015/16, municipalities raise income tax at a standard rate of 24%, and counties at a rate of 7%. These rates form part of the national income tax and are collected nationally. Higher rate income tax revenues go to the central government.

  Local income taxes are stable and relatively visible, can be collected effectively, and generate significant income. Some countries (e.g. Kazakhstan and Ukraine) distribute the revenues on the basis of an equalisation formula (UCLG 2010). It is relatively rare for local authorities to be able to vary local income tax rates. Examples of states in which this power is available to local authorities include Croatia, Brazil and Switzerland.

- **Consumption taxes.** Local sales taxes generate significant revenue in North America, but they are also an ancillary revenue source in states elsewhere. They are easy to collect, visible and relatively stable. They are pro-cyclical (i.e. they rise during periods of economic growth, and fall when the economy falls back).
Sales taxes are not progressive in their incidence, and thus their contribution to ‘equity’ is ambivalent. As much economic activity is mobile in principle, variations in rates across localities can lead to spillover effects (‘cross-border shopping’). The closest equivalent in Europe, Value Added Tax (VAT), may not be varied locally within individual European Union states under European law. Many EU states assign a share of VAT revenues to local authorities (e.g. Greece, Czech Republic, Germany).

- Transport, environmental and tourism taxes. Transport related taxes may include parking fees; road pricing (congestion charging); vehicle registration charges; and zones for special emissions levies. Nottingham, in the UK, levies a charge on the provision of workplace parking spaces. Environmental taxes may include fees or levies on waste collection. ‘Tourism tax’ typically consists of a small levy per night on the occupation of hotel beds. This is common in areas with strong regional tourist economies, such as Spain and Malta, but also in local authorities in other states such as Germany, Belgium, Canada and France.

Table 32.1 Own taxes as percentage of local revenue

<table>
<thead>
<tr>
<th>States/regions</th>
<th>Corporate income tax</th>
<th>Consumption taxes</th>
<th>Personal income taxes</th>
<th>Property taxes</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>5.63</td>
<td>22.68</td>
<td>22.24</td>
<td>3.09</td>
<td>7.91</td>
</tr>
<tr>
<td>USA</td>
<td>3.84</td>
<td>29.30</td>
<td>17.42</td>
<td>1.30</td>
<td>0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>7.19</td>
<td>3.51</td>
<td>32.66</td>
<td>8.32</td>
<td>0</td>
</tr>
<tr>
<td>Spain</td>
<td>0.31</td>
<td>3.35</td>
<td>14.78</td>
<td>14.89</td>
<td>0</td>
</tr>
<tr>
<td>Belgium</td>
<td>0</td>
<td>4.85</td>
<td>17.93</td>
<td>10.43</td>
<td>0</td>
</tr>
<tr>
<td>Australia</td>
<td>0</td>
<td>10.24</td>
<td>0</td>
<td>12.16</td>
<td>9.42</td>
</tr>
<tr>
<td>Germany</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1.79</td>
<td>0</td>
</tr>
<tr>
<td>Austria</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Municipalities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>0</td>
<td>0</td>
<td>63.43</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6.13</td>
<td>0.12</td>
<td>39.56</td>
<td>8.32</td>
<td>0</td>
</tr>
<tr>
<td>Denmark</td>
<td>0</td>
<td>0</td>
<td>43.58</td>
<td>2.47</td>
<td>0</td>
</tr>
<tr>
<td>Finland</td>
<td>0</td>
<td>0</td>
<td>41.54</td>
<td>2.42</td>
<td>0</td>
</tr>
<tr>
<td>Norway</td>
<td>0</td>
<td>0</td>
<td>39.55</td>
<td>4.04</td>
<td>0</td>
</tr>
<tr>
<td>Japan</td>
<td>10.67</td>
<td>2.61</td>
<td>11.18</td>
<td>13.89</td>
<td>0.07</td>
</tr>
<tr>
<td>France</td>
<td>0</td>
<td>2.12</td>
<td>0</td>
<td>19.48</td>
<td>14.15</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>30.24</td>
<td>0.28</td>
<td>0</td>
<td>2.27</td>
<td>0</td>
</tr>
<tr>
<td>Spain</td>
<td>0</td>
<td>12.28</td>
<td>0</td>
<td>20.09</td>
<td>0</td>
</tr>
<tr>
<td>Belgium</td>
<td>0</td>
<td>2.79</td>
<td>22.62</td>
<td>5.74</td>
<td>0</td>
</tr>
<tr>
<td>Italy</td>
<td>2.97</td>
<td>8.02</td>
<td>0.77</td>
<td>5.59</td>
<td>11.98</td>
</tr>
<tr>
<td>South Korea</td>
<td>2.49</td>
<td>1.90</td>
<td>2.59</td>
<td>14.19</td>
<td>4.03</td>
</tr>
<tr>
<td>Germany</td>
<td>8.83</td>
<td>0</td>
<td>7.15</td>
<td>6.32</td>
<td>0</td>
</tr>
<tr>
<td>Portugal</td>
<td>4.81</td>
<td>0</td>
<td>3.35</td>
<td>9.31</td>
<td>0</td>
</tr>
<tr>
<td>Hungary</td>
<td>0</td>
<td>14.19</td>
<td>0</td>
<td>2.16</td>
<td>0.04</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>13.53</td>
<td>0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0</td>
<td>4.27</td>
<td>0</td>
<td>5.34</td>
<td>0</td>
</tr>
<tr>
<td>Greece</td>
<td>0</td>
<td>0.43</td>
<td>0</td>
<td>5.33</td>
<td>0</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0</td>
<td>2.10</td>
<td>0</td>
<td>1.42</td>
<td>0</td>
</tr>
<tr>
<td>Austria</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ireland</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: OECD (2014)
The importance of each of these types of tax to local governments is dependent on the quantity of money that each raises. Here, again, there is great variation between states. Table 32.1 shows the percentages of revenue raised from each of these sources. In some states, property taxes raise large proportions of local revenue, while in others they raise far smaller proportions. Assigned income tax revenue makes up a substantial proportion of local revenue in some areas, but in many states it is not used at all. Transport-related taxes and environment-related taxes commonly raise far smaller sums of revenue. Revenues from unconventional sources of funding (see below) may be volatile and/or attached to particular projects or localities: they cannot substitute for more ‘mainstream’ revenues. Thus not all local taxes are equal. A local authority cannot necessarily replace lost revenue from one source with an equal quantity of revenue from any other source at will.

Aside from political considerations, and the size of the available tax base, the degree to which revenues can be raised locally also depends on the state/national tax regime (Martinez-Vazquez 2015: 15). Some states distinguish explicitly between taxes that may be levied by central government and taxes that may be levied by local governments, but more common is the use of ‘shared tax bases’—where more than one tier of government will levy a tax rate within a particular tax structure. Either way, the national tax regime is a key constraint on the room for manoeuvre available to local authorities.

Sources of revenue: innovation

We noted above that the fiscal landscape faced by local governments could give rise to incentives to develop particular sources of finance further. Local authorities’ activities in this regard are often influenced by ‘push factors’. If their revenue-raising power from one source is curbed, they will attempt to compensate by generating more revenue from an alternative source. Often, the attractiveness of such sources is that they are subject to fewer governmental or constitutional restrictions in their particular jurisdiction (Gelfand 1979). Clearly, the constitutional position of local government influences its ability to do this: it will be easier if local authorities have general powers to act unless prohibited from doing so, and harder where specific legal permission is needed for every act. Recent innovative approaches include:

- The United Kingdom has pioneered the use of social impact bonds (SIBs). These bring together investors, a public service commissioning body or bodies, and service providers in a contractual relationship. The investors provide capital at the outset of the project. The commissioning body or bodies then agree contractual terms and agreed outcomes for the service providers. The service providers are paid with the investors’ money. The investors will then receive a return on their investment, according to success criteria laid out in the contract. This is to be paid from savings arising from efficiencies in the provision of the service. The contract may also provide that a certain share of any savings is to be retained by the commissioning body.

  The performance of SIBs so far has been variable. The world’s first SIB, in Peterborough, showed some progress against metrics (RAND Europe 2015). An interim evaluation of the London rough sleepers SIB, in March 2015, found more mixed results (DCLG 2015). Many SIBs in the UK are underwritten by a pool of ‘soft money’, often supplied by a major charitable funder; this reflects in part that risk levels have been too great to attract large scale commercial funding (Corry 2016).

- The USA has dominated the use of tax increment financing (TIF). A TIF scheme borrows money for infrastructure development and uses as collateral the increased tax revenues that
Adapting to the fiscal environment

will arise when the development is complete. These can be property taxes, sales taxes, or revenues from a broad local deal. Allentown, Pennsylvania agreed a deal with state and other authorities for future local revenues from 14 taxes (controlled either locally or at state level) to be placed in a fund to repay bond finance (Urban Land Institute 2016: 21). TIFs may often make use of financial ‘special purpose vehicles’, which can allow state or central government borrowing controls to be circumvented (Briffault 2010).

TIFs are a form of ‘uplift’ or ‘betterment’ taxation. ‘Uplift’ refers to the idea that public investment – such as a new transport link or a regeneration scheme – often leads to rises in private property values. Normally these rises in value are retained entirely by property owners, even if they were driven by public funding. If uplift taxation is available to a local authority, this in itself may act as an incentive to pursue development policies, alongside or in place of other elements of its responsibility: ‘TIF exemplifies the fiscalization of local development policy. TIF enables local governments to pursue what is often the principal local development goal-increased tax base, while avoiding the political and legal limits on increased local taxation. . . . TIF programs are market-oriented, aimed at inducing or retaining investment by private entrepreneurs. Moreover, local governments use TIF to act as entrepreneurs, formulating and implementing development plans’ (Briffault 2010: 66–67).

• Some local authorities in Poland operate property leaseback schemes. They sell properties to private sector entities, with a requirement that the local authority must be permitted to lease the property back for an agreed number of years at an agreed rent. The local authority will then have an option to repurchase the property at the end of the period, with the minimum price set out in statute. These arrangements allow access to capital finance for authorities whose poor financial performance prevents them from accessing municipal bonds or conventional bank loans. The arrangements also do not need to be officially reported as a debt obligation (Kluza 2016).

The existence of these options does not mean that they are open to all local governments. Much depends on the organisational capacity and financial scale of a local authority and the strength of its local economy. For instance, seeking investment via a TIF amounts to participation in a competitive market. Some areas may be unable to find investors; equally, a TIF would fail – leaving substantial debt in the hands of the local authority – if economic growth does not occur and ‘uplift’ in value fails to materialise. Local authorities that cannot find customers for their properties would be unable to lease them. Social impact bonds that cannot reduce the costs of public services may increase local authority spending instead of reducing it.

A contrasting phenomenon is found in some developing countries. Where a state’s local taxation systems are under-developed or non-existent, there have been instances where aid agencies have set up parallel ‘taxation’ systems to manage the financial dimension of local development. Functionally these may be more effective than local administrative systems. But equally, their existence may undermine the chances of local systems developing (Devas and Delay 2006; Shah and Thompson 2004). ‘Tax farming’ – where central or regional authorities contract out tax collection privately in exchange for a fee or percentage of the revenue collected – is a distinct phenomenon but one that arises in similar socio-economic circumstances (Shah and Thompson 2004). Smoke (2015: 42) mentions ‘constituency development funds’, given to parliamentarians in some countries to spend on local matters that may overlap with, and detract from, local government functions.

A final mention should be made of a phenomenon termed ‘private government’ (Bailey 1999: 162). This phrase refers to the use of ‘business improvement districts’ and their more
common domestic counterpart, ‘residential community associations’. These are ad hoc areas established by a local business (or residents’) association, within which a tax supplement or a charge is collected and retained by the association for local use. ‘Private governments’ could be regarded as a further innovative method of raising revenues. They have some of the characteristics of private associations, but with compulsory membership within a particular geographical area. They represent a localised example of the principle of the ‘benefits model’. The services they provide are principally consumed by the residents (or businesses) in the geographical area, in their capacity as members.

Conclusion

Local authorities across the world have a broad range of tax and revenue raising capacities. These are normally sufficient to make them significant economic actors locally. This generates a relationship with central government; and it is common for central or state governments to try to minimise the independent fiscal powers and leverage of local authorities (Gelfand 1979). When this happens, local authorities in some areas have responded by being swift on their feet and exploiting previously unnoted opportunities within the financial ecosystem in which they operate.

But this reflects that authorities’ taxation powers, and their financial strategies, are expressions of the central-local relationship within which they operate. Some authorities gravitate towards funding sources over which they have greater freedom (using own assets, borrowing) and away from those in which they do not (tax raising). Some retain a strong purchase on a nationally agreed system of financing. In most cases, a broad range of access points to revenue is a good guarantee of local authority financial health. But it is national systems of government, rather than a universal approach of rationality, that explain the approach to sources of revenue that are available to local authorities. Central and state/regional governments are frequently ‘jealous gods’, and are rarely ready to tolerate the existence of autonomous local entities of the kind favoured by economic theory.

Acknowledgements

My thanks to Andrew Stevens for his assistance.

References


Adapting to the fiscal environment


Gelfand, M. D. (1979) Seeking Local Government Financial Integrity Through Debt Ceilings, Tax Limitations, and Expenditure Limits: The New York City Fiscal Crisis, the Taxpayers’ Revolt, and Beyond. Minnesota Law Review 63: 545–608.


