Local and Regional Revenues: Realities and Prospects
by
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1. Introduction

The traditional theory of fiscal federalism prescribes a very limited tax base for subnational governments. The only good local taxes are said to be those that are easy to administer locally, are imposed solely (or mainly) on local residents, and do not raise problems of harmonization or competition between subnational – local or regional - governments or between subnational and national governments. The only major revenue source that usually passes these stringent tests is the property tax, with perhaps a secondary role for taxes on vehicles and user charges and fees. Since central governments are in any case generally reluctant to provide subnational governments access to more lucrative sales or income taxes, it is not surprising that this conclusion has become conventional wisdom. Subnational governments almost everywhere are thus urged to make more use of property taxes and user charges, and are criticized when they do not do so enthusiastically.

Up to a point, there is much to be said for this view. Unfortunately, that point falls far short of the task facing subnational governments in many countries for a number of reasons. First, as discussed further in sections 2 and 3 below, the conventional case for user charges and property taxes is to some extent flawed. Property taxes, for example, are often costly and difficult to administer well, and such problems are greatly exacerbated as the tax burden increases. Moreover, in practice political realities mean that increases in property taxes are often concentrated primarily on those nonresidential properties that most readily permit “tax exporting” (the shifting of taxes to non-residents), thus undercutting one of the principal arguments for local use of property taxes in the first place.

Second, even a well-administered local property tax cannot finance major social expenditures (education, health, social assistance) except perhaps to a limited extent in the richest (and usually largest) communities. Since, as discussed further later, it is desirable to the

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2 The classic tax assignment arguments are set out in Musgrave (1983). Recent restatements may be found in Oates (1998) and McLure (1999). Much of this section of the present paper is based on a more detailed review of the tax assignment issue in Bird (2000).

3 User charges should be used only with caution in such social areas: for further discussion, see
extent possible for governments to finance from their own revenues the services they provide, either local governments that are dependent on property taxes are essentially confined to providing "local" services (street cleaning, refuse removal, etc.), or they are inevitably heavily dependent on transfers from higher levels of government. Even in developed countries, this pattern holds.4

Third, the conventional argument does not take adequately into account the existence in many countries of important regional or intermediate levels of government and especially the fact that these governments often play a major role in financing social expenditures. Local governments may to a considerable extent be able to finance purely local services through property taxes and user fees on residents. Regional governments responsible for social services, however, cannot rely solely on this narrow base for financial support. The conventional approach to tax assignment has traditionally held that perhaps the best additional source of finance for regional governments would be retail sales taxes. Such taxes are usually assumed to fall mainly on residents – a desirable feature in a subnational tax.5 Moreover, as the United States and Canada have long demonstrated, retail sales taxes can be administered at the regional level, at least in developed countries although this argument can obviously not simply be carried over to developing countries, which have universally found it impossible to administer such taxes even at the national level.

Given the recent move towards decentralization in many countries around the world (Litvack et al., 1998) and the concerns frequently expressed about the resulting strain on intergovernmental fiscal relations and the possibility of irresponsible behavior by subnational governments (Tanzi, 1996), some rethinking of the appropriate revenue structure for regional and local governments seems needed.6

Both theory and international experience suggest that governments are more likely to

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4 Relatively few developed countries have significant local property taxes. In most OECD countries, to the extent local governments are not dependent on national transfers, they either impose significant direct taxes on business or levy surcharges on national income taxes (Bird and Slack, 1991). Bahl (2002) shows that property taxes are even less important in developing and transitional countries.

5 In reality, most "retail" sales taxes even in developed countries fall to a considerable extent on business inputs: one Canadian study, for example, found that between one-third to one-half of the retail sales tax base in different provinces consisted of such inputs (Kuo, McGirr, and Poddar, 1988). The situation in the United States appears to be broadly similar (Ring, 1999).

6 Of course, in many countries, local and regional governments do not in fact utilize fully all the revenue sources at their disposal. While this question cannot be explored in detail here, this reluctance is sometimes understandable, given the political problems they may face in doing so and the relatively easier recourse they often have to transfer revenues. For a recent careful examination in one country (Colombia) of the disincentive to local revenue effort that may be created by poorly-designed transfers, see Sánchez, Smart and Zapata (2002).
spend responsibly the more they are responsible for raising the revenues they spend. While there will obviously always remain an important role for intergovernmental transfers, especially in countries with wide regional economic disparities, there seems no reason in principle why at least the wealthier regions (for example, larger urban areas) should not be able to raise and spend most of their budgets themselves.\footnote{For an earlier statement of this argument, see Bird (1993). An important implication of strengthening subnational “own revenues” is that the resources accruing to different states or provinces will obviously differ greatly, depending upon their access to the tax base in question. While transfer systems can in principle be adjusted as desired to prevent unduly penalizing poorer regions, the extent to which such adjustments will in fact be made is always country-specific -- compare, for example, the cases of Canada and the United States, and Germany and Switzerland (Bird, 1986) -- and the incentive effects of transfer design need to be considered with care. Although the critical interdependence of tax assignment and the design of transfer systems cannot be further discussed in this paper, some aspects of this problem are discussed further in Bird and Smart (2002).} There are thus good reasons to strengthen subnational tax regimes. The balance of this paper reviews the various sources usually considered for this purpose.

In principle, multi-tiered governments work best when taxes and the benefits of public spending are as closely related as possible — when, that is, citizen-voter-consumers residing in a particular political jurisdiction both pay for what they get from the public sector and get what they pay for (that is, benefit from the expenditures financed by the taxes they pay). Obviously, when citizens reside in several overlapping jurisdictions (local-region-nation) this so-called "principle of fiscal equivalence" (Olson, 1969) suggests that they should pay taxes to each level corresponding to the benefits they receive from each jurisdiction.

In this framework, the only rationale for intergovernmental transfers is to restore this equivalence, for example, by providing a compensatory payment when some benefits flow from one jurisdiction to another or (negatively) when some taxes levied by one jurisdiction are in fact paid by persons residing in another jurisdiction. Such transfers would, of course, be horizontal, between regions or municipalities, and not between levels of government. In addition, however, considerations of administrative efficiency and feasibility may require that higher (or lower) levels of government impose certain taxes or carry out certain expenditures, even when it is not appropriate to do on equivalence grounds. The vertical intergovernmental fiscal transfers found in most countries are motivated largely by this consideration. However, if as suggested here, more adequate subnational taxes are made available, this “fiscal gap” (Boadway and Hobson, 1993) argument for transfers disappears with respect to richer jurisdictions since the richer units of government at subnational levels should be essentially self-sufficient. Any grants from higher levels of government that are made to the poorer subnational units for reasons of regional equalization should be clearly infra-marginal, so that, as McLure (1999) notes, all subnational governments, rich and poor alike, will face the full marginal tax price of the spending decisions for which they are responsible. Only in this way can the “hard budget...
constraint” critical to good intergovernmental fiscal and financial policy be achieved.\textsuperscript{8}

Good subnational taxes should thus in principle satisfy two main criteria. First, they should provide sufficient revenue for the richest subnational units to be essentially fiscally autonomous.\textsuperscript{9} Second, they should clearly impose fiscal responsibility at the margin on subnational governments. The simplest and probably best way to achieve this goal is by allowing those governments to establish their own tax rates with respect to at least some major taxes.

The most immediately important issue facing many larger countries, for example, is undoubtedly the need to develop a satisfactory revenue base for regional governments, that is, one for which those governments are politically responsible. As noted in section 5 below, one possibility is to permit regional surcharges on personal income taxes. Another potentially promising approach may be to establish subnational value-added taxes. Such a tax already exists and works well in Canada (Bird and Gendron, 1998), and, as suggested in section 7 below, it now seems that it may be feasible to implement it in some circumstances even in countries with less well-developed tax administrations.

As discussed in section 8, another key problem facing many countries is how to replace the various unsatisfactory state and local taxes on business that exist in most countries by some less distortionary form of taxation. Recently, a “business value tax” – in essence, a relatively low rate flat tax levied on an income-type value-added base -- has been suggested for this purpose.\textsuperscript{10} In contrast to the proposal mentioned in the previous paragraph, which is motivated mainly by the desire to provide more adequate “own” revenues to regional governments and hence to encourage greater fiscal responsibility and accountability, this proposal is aimed primarily at improving the allocative efficiency of subnational revenue systems. Given the obviously lesser attraction of efficiency than of revenue as a political goal, better local business taxation may be less likely to find a welcoming political audience. Nonetheless, since revenue pressures may soon produce a proliferation of increasing, and increasingly distorting, subnational business taxes many developing and transitional countries, it seems important to at least begin to think of some better alternatives.

The following sections review in turn the major tax sources usually suggested for local and regional governments in developing countries, more or less in order of preference -- user

\textsuperscript{8} Bird (2001) spells out this argument in some detail. For a useful recent review of experience with hard budget constraints in a variety of countries, see Rodden, Eskeland and Litvack (2003).

\textsuperscript{9} Of course this objective does not preclude intergovernmental fiscal transfers not only to achieve the usual “spillover” objectives but also, in some circumstances, in order to ensure the adequate provision of certain services to “national standards”: for a suggested design for such a system in Colombia, for instance, see Bird and Fiszbein (1998).

\textsuperscript{10} The history of this idea, and various examples found around the world, are discussed in Bird (2003). An empirical application of this approach to Canada may be found in Bird and Mintz (2000) and Bird and McKenzie (2001).
charges, property taxes, excises, personal income taxes, payroll taxes, general sales taxes, and business taxes.

2. User Charges

Perhaps the most obvious, and in many ways the most sensible, recommendation that can be made with respect to revenue at any level of government is that appropriate user charges should be employed whenever possible. Local (and to some extent regional) governments from an economic point of view may be viewed in effect as firms delivering packages of local public services to residents. As with any economic activity, people should want what they deliver enough to be willing to pay for it. From this perspective, the first rule of subnational finance should therefore be: "Wherever possible, charge." While user charges are likely to be viewed by officials solely as a potential additional source of revenue, their main economic values are, first, to ensure that what the public sector supplies is valued at least at (marginal) cost by citizens, and, second, to promote economic efficiency by providing demand information to public sector suppliers. This efficiency objective is particularly important at the subnational level since the main economic rationale for subnational government in the first place is to improve efficiency. Whenever possible, local public services should therefore be charged for properly rather than given away.

At least three types of user charges, broadly defined, exist in most countries: (1) service fees, (2) public prices, and (3) specific benefit charges.

- **Service fees** include such items as license fees (marriage, business, dog, vehicle) and various small charges levied by local governments for performing specific services -- registering this or providing a copy of that -- for identifiable individuals (or businesses). In effect, such fees constitute cost reimbursement from the private to the public sector. Charging people for something they are required by law to do may not always be sensible -- for example, if the benefit of (say) registration is general and the cost is specific -- but on the whole there is seldom much harm, or much revenue, in thus recovering the cost of providing the service in question.\(^{11}\)

- In contrast, as used here **public prices** cover the revenues received by local governments from the sale of private goods and services (other than the cost-reimbursement just described). All sales of locally-provided services to identifiable private agents -- from public utility charges to admission charges to recreation facilities -- fall under this general heading. In principle, such prices should be set at the competitive private level,

\(^{11}\) Note, however, that there may be considerable harm in imposing unnecessary regulatory requirements (whether accompanied by a fee or not), both through imposing additional obstacles to, and costs on, new business activities and also by providing more opportunities for corrupt practices.
with no tax or subsidy element included -- unless doing so is the most efficient way of achieving public policy goals, and even then it is best if the tax-subsidy element is accounted for separately.

- A third category of charge revenue may be called *specific benefit taxes*. Such revenues are distinct from service fees and public prices because they do not arise from the provision or sale of a specific good or service to an identifiable private agent. Unlike prices that are paid voluntarily by those who obtain services -- although like fees that must be paid for services that are legally required -- taxes are compulsory. Nonetheless, specific benefit taxes are (at least in theory) related in some way to benefits received by a specific taxpayer, in contrast to such general benefit taxes as fuel taxes levied on road users as a class or local general business or property taxes viewed as a price paid for local collective goods (as discussed further in later sections of this paper). Examples of such specific benefit taxes abound in local finance, under many different names: special assessments, land value increment taxes, improvement taxes, front footage levies, supplementary property taxes related to the provision of sewers or street-lighting, development exactions and charges, delineation levies, and so on. Most such charges are imposed either on the assessed value of real property or on some characteristic of that property -- its area, its frontage, its location.

The importance of user charges is greater in principle than the relatively small amounts of money that most countries collect from this source. The appropriate policy in setting user charges is simply to charge the correct (roughly, marginal cost) price. Only thus will the correct amounts and types of service be provided to the right people, that is, those willing to pay for them. As already mentioned, such user charges should be levied wherever feasible in order to ensure that scarce public resources are as efficiently utilized as possible. It is often suggested, however, that equity considerations argue against user charges. Although in principle the incidence of user charges -- the price of services obtained by someone from the public sector -- is no more relevant than the ultimate incidence of the price of something obtained by someone from the private sector, a number of studies in different countries suggest that in many instances the distributive consequences of charging for local public services may even be progressive (Bird and Miller, 1989). The rich, for example, use more water (for washing cars, watering lawns, and swimming pools) than the poor. In any case, attempting to rectify fundamental distributional problems through inefficiently pricing scarce local resources is almost always a bad idea, resulting in little, if any, improvement in equity and a high price in efficiency terms.

Most countries make much less use is made of charging at the local level than seems desirable, and many of the charges that are levied are poorly-designed from an efficiency point of view. In the province of San Juan, Argentina, for example, a wide range of charges is levied for an enormous number of specific services rendered by the judiciary, the registry of commerce, the registry of real property, the inspection of juridical persons, the civil registry, the mining department, the transport directorate, the bus station, local transport enterprises, the police, the irrigation department, the general administration, and even the tax department. Many of these

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12 Ley No. 6775 of December 19, 1996 lists six newspaper-sized pages of fees and charges.
charges probably cost more to administer than they yield and are little more than nuisance levies impeding normal transactions, while none of the rates imposed appear to be based on any rational principle.

As this example suggests, while there is much to be said for the rational use of user charges in subnational finance, it is hard to find much rationality in the current system in most jurisdictions. Probably 90 percent of the levies now existing in San Juan -- and, in all likelihood, in many other subnational governments throughout the world -- could be abolished with little loss in revenue and some gain in efficiency. The remaining 10 percent generally need to be revised to accord with appropriate charging policy.

The sad truth in most countries is that user charges are seldom employed to the extent that is both possible and desirable, and that those charges that do exist are seldom well designed and consequently seldom produce any significant economic benefits. Unfortunately, even in developed countries, it is often surprisingly difficult to design and implement good user charges, and as a rule even good charges are not very popular with either administrators or citizens. In short, user charges are a good idea in principle, but one that appears from experience to be surprisingly difficult to implement well in practice. Such charges thus seem unlikely to provide anything close to adequate finance for subnational activities in any country.

3. Property Taxes

For decades, local governments around the world have been told that the only appropriate general tax source for them is the real property tax. A property tax is indeed an excellent local tax. Unfortunately, such advice is often not very helpful in the circumstances of many countries. Land and buildings cannot easily run away and hide from tax officials; nonetheless, a standard market-value property tax can be sometimes difficult and costly to administer well. Valuation is an art, not a science, and there is much room for discretion and argument with respect to the determination of the base of the tax. Moreover, although the assessment and collection of property taxes can and should be improved in most developing and transitional countries, it is difficult to administer this tax equitably in a rapidly changing environment, and it is always difficult to increase revenues from this source very much or very quickly.

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13 For further discussion of the theory and practice of user charges, with extensive examples from Canadian experience, see Bird and Tsiopoulos (1997).

14 One important economic argument for local property taxation, for instance, is a sort of generalized “user charge” financing activities that benefit local residents. The classic arguments for the property tax as a “user charge” may be found in Vickrey (1965) and Netzer (1973). For a modern view, see Fischel (1992).

15 As with the other very condensed reviews of alternative subnational revenue sources in this paper, such statements may appear to be unsupported assertions. For the most part, however, they are grounded in
Despite such problems, however, a low-rate uniform property tax almost always has an important role to play in financing local governments in most countries.\textsuperscript{16} Moreover, other "land-based" subnational taxes -- for example, betterment levies (\textit{valorización}) and even transfer taxes -- are both feasible and, within limits, desirable in certain circumstances.\textsuperscript{17} In general, however, subnational governments in most countries will do well if they can finance "hard" (property-related) services such as local roads and refuse removal and disposal out of property taxes. If such governments are expected to play any significant role in financing soft" services (education, health), as a rule they will need to have access to more elastic revenue sources.

The present state of land and property taxes in most countries leaves much to be desired. More local revenue usually can and should be collected from this source. In Argentina, as an example, the system a few years ago imposed \textit{maximum} property tax rates (differentiated by rural and urban) and further decreed that the tax base in no case can exceed 80 percent of market value. The maximum nominal rates that can be established are little more than 1 percent of market value.\textsuperscript{18} The nominal property tax rates currently in force in most of Argentina are well below these limits, and the effective rates even lower, given the high degree of undervaluation of even those properties recorded on the rolls.\textsuperscript{19} Moreover, the structure of the tax is, as a rule, too complicated, economically perverse, and basically unenforceable. In San Juan Province, for example, urban properties are taxed at nominal rates from 0.55 to 0.75 percent depending on the fiscal value; rural properties are subject to a similar scale ranging from 0.90 to 1.3 percent; and vacant land is allegedly taxed at 3 percent. Every aspect of this tax is both structurally wrong and complicates administration unduly. For example, progressive rates make no sense (Bird, 1974). Nor does the differentiation between the different classes of property or the attempt to penalize vacant land through very high tax rates (Bird and Slack, 2002).

Of course, much can and should be done to strengthen such deficient property taxes. Ideally, the tax should be simplified and applied uniformly. Cadastral maps should be updated, and valuations made more consistently and currently. Improved use should be made of flows of information from property registries, local building license authorities, public utilities, etc. As decades of experience and dozens of specific examples: see, for example, Bird and Slack (2002) and references cited there. This study also discusses alternative forms of property tax (e.g. area-based taxes) and many other aspects that cannot be covered here.

\textsuperscript{16} This is especially true in rural areas, in which land is often the only possible tax base. Rural land taxes are discussed in detail in Bird (1974).

\textsuperscript{17} For further discussion of such levies, see Bird and Slack (2002).

\textsuperscript{18} In principle, there is no reason why any maximum needs to be established with respect to residential properties -- though there may be a case for a maximum (to restrain tax exporting) as well as a minimum (to restrain tax base competition, if desired) with respect to industrial and commercial properties.

\textsuperscript{19} See, for example, the data on under-valuation in the cities of Santa Fé, Mendoza, and Buenos Aires reported in World Bank (1996).
Dillinger (1991) has argued, from a revenue perspective, in upgrading property taxes most attention should be paid to improving the "sharp end" -- collection and enforcement -- rather than the technically more costly (and less immediately productive in terms of revenue) mapping and surveying of the traditional cadastral approach.

In general, however, property taxes are not easy to administer well, especially in countries where inflation is endemic, and they appear never to be politically popular, perhaps owing to their visibility as well as to a certain inherent arbitrariness in the process of assigning values to individual properties. Even in the most sophisticated countries, local property taxes can seldom yield enough to finance local services. No developed country which depends significantly upon property taxes for local fiscal resources has a local government sector that accounts for more than 10 percent of total public spending (Bird and Slack, 1991). Similarly, despite substantial efforts in some countries and considerable foreign assistance, property taxes seldom account for more than 20 percent of local current revenues -- or less than 1 percent of total public spending - - in developing countries (Bird, 1995).

In short, although the property tax is a useful, even a necessary, source of local revenue, it cannot easily provide sufficient resources to finance a significant expansion of local public services in the circumstances of most countries. Indeed, many countries are often been hard-pressed even to maintain the present low relative importance of property tax revenues in the face of varying price levels and political difficulties. These facts reflect both the political and the administrative realities of property taxation.

- One reason for widespread resistance to the property tax, for example, is simply because it is a very visible tax. The tax generally has to be paid directly by taxpayers in periodic lump sum payments. Taxpayers who pay taxes directly to government tend to be more aware of the size of their tax bill than those whose take-home pay is reduced by weekly or monthly tax deductions or those who pay small amounts of tax on each purchase. The need to make such periodic large payments may increase the accountability and responsibility of governments; but it also greatly increases the sensitivity of taxpayers to even nominal increases in taxes.

- The inelasticity of the property tax has a similar effect. Since the base of this tax does not increase automatically over time, the periodic nominal increases in property tax bills needed to maintain real revenues when price levels rise require increased tax rates. In terms of political accountability, the need to confront the people with the cost of government represents a virtue of the property tax. However, the downside, at least from the government's point of view, is the heightened visibility of nominal tax increases and the accompanying political resistance.

- Finally, property taxes finance such services as roads and garbage collection. The quantity and quality of these services (or their absence) is thus readily linked to the property tax. When potholes develop in their street, taxpayers are understandably quick to question the taxes that supposedly finance street repair. Again, the very features that make the property tax a good source of local government revenue in principle make it especially vulnerable to political resistance in practice.
Other problems result from property tax administration. As a rule, for example, property is supposed to be assessed on the basis of its market value, usually defined as the price struck between a willing buyer and a willing seller in an arm's length transaction. Substantial technical efforts are therefore needed before much revenue can be expected from property taxes. Even in countries with well-developed property tax systems, discrepancies arise between assessed values and market values within classes of property, between classes of property, and across municipalities for both political and technical reasons (Bird and Slack, 1993). Since taxpayers can easily compare their property taxes with those of similar properties in their neighbourhood, such discrepancies lead both to specific assessment appeals and to general pressure for tax relief.

For such reasons, experience around the world suggests that the political costs of reliance on the property tax are so high that no government with access to "cheaper" sources of finance will willingly increase property taxes. It is not surprising that academics tend to be fonder of recommending increased use of the property tax than the politicians who actually have to do it.

Both unconditional intergovernmental transfers (which can be spent as local governments wish) and access to taxes on business (which can be exported to a substantial degree) must generally be curtailed if property taxes are to become a relatively more attractive source of local finance and if local decision-makers are to be made to confront the true economic (and political) costs of their decisions. Even if this essential structural pre-condition is met, a number of other policy reforms are also needed to turn the property tax into a responsive instrument of local fiscal policy.

- First, and importantly, local governments must be allowed to set their own tax rates. Few developing or transitional countries currently give their local governments much freedom in this respect.

- Secondly, the tax base must be maintained adequately. In countries with inflation, some form of index adjustment may be advisable. In other countries, the assessing agency must sometimes be provided direct financial incentives to keep the tax base up to date.

- Finally, as mentioned earlier, a series of procedural reforms is often needed to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base.

None of these steps is easy, but countries that want to have local governments that are both responsive and responsible must follow this hard road. There are no short cuts to successful local property taxation.

Property tax revenues are low in many developing and transitional economies in part because of the way in which the tax is administered. The coverage of the tax is not comprehensive, assessments are low, as are nominal tax rates, and collection rates are also often low. Low tax rates are sometimes imposed by higher-level governments and sometimes by local governments themselves, which find rate increases in this most visible of taxes very difficult to sell politically.
Simply raising the legal tax rate would seldom be appropriate, however, because it would place the burden of the increase on “those few individuals whose properties are on the tax rolls, accurately valued, and from whom taxes are actually collected” (Dillinger, 1991). Increased nominal rates are likely to be acceptable only along with improvements in tax administration such as more comprehensive coverage, better assessments, more frequent assessment revaluations, and enforced penalties for late payment. In general, revenues from this source are higher if the property tax were based on the value of land and buildings (instead of just on land), if there are few exemptions and no favorable treatment of particular property classes, and if the scope for local tax competition is limited.

Despite its problems, the property tax remains the predominant option for raising local revenues in most developing and transitional countries. The potential yield of land and property taxes is unlikely to be huge, revenues from this source will not be very elastic, and administrative costs are substantial. Nonetheless, an expanded property tax is indeed both a logical and a desirable objective for many countries, particularly those in which local governments are expected to play an increasing role in allocating public sector resources. But significant additional revenues from this source can seldom be expected in the short run, and, although property taxes are often relatively more important in smaller communities, most additional revenues will likely be found in, and accrue to, the larger urban areas. A good property tax is a good thing; but it is seldom enough to do the whole job.

4. Excise Taxes

The property tax is undoubtedly the pre-eminent local tax. Among the taxes that might be considered as regional sources of funds are excises, payroll taxes, corporate income taxes, personal income taxes, payroll taxes, retail sales taxes, and value-added taxes (VATs). McLure (1997), for example, suggests that excise taxes are a potentially significant source of regional revenue, largely on administrative and efficiency grounds. Such taxes, he argues, are both easily administered by regional governments and lend themselves to regionally-differentiated rate determination. Moreover, in terms of efficiency, such taxes, applied on a destination basis, should have little distortionary effect. Finally, it is sometimes argued that there is a general “benefit” argument that can be made for regional excises -- for example, on alcohol and tobacco to the extent regional governments are responsible for health expenditures and on vehicles and fuel to the extent they are responsible for roads.

There is of course something in all these arguments, although in some instances not all that much. The benefit case for “sin” taxes, for example, is weak in general (Bird, 1998), and it is not always that easy to impose regionally differential taxes without serious distortions, as well as

20 In most developing and transitional countries, none of the taxes mentioned are likely to be sensible as local taxes, except perhaps in large metropolitan areas.
substantial administrative and compliance costs and dangers of evasion.\textsuperscript{21} Indeed, although it is true that in countries such as the United States and Canada a significant proportion of regional government revenue comes from excises, in principle it does not seem particularly desirable to tie regional finances to such inelastic levies when the pressure on those finances for the most part comes from very elastic expenditure demands for health and education.\textsuperscript{22}

Undoubtedly, the strongest economic and administrative case for regional excises is with respect to vehicle-related taxes (Bahl and Linn, 1992). Such taxes should certainly be exploited as fully as possible. The most important tax on automobiles from a revenue perspective is the fuel tax, which is also the simplest and cheapest form of automotive taxation from an administrative perspective. Fuel taxes can be levied at the regional level. Different regions could impose different taxes, if they chose to do so, subject of course to the constraint that they would not likely be able to differ much from the rates imposed by their neighbors given the mobility of the tax base. Administratively, differential regional fuel taxes could easily be imposed at the refinery or wholesale level, with the refiner or wholesaler acting a collection agent for the regional governments, remitting taxes in accordance with fuel shipments.

Fuel taxes are, of course, also related both to road usage and to such external effects of vehicles as accidents, pollution and congestion, although not in any very precise way. To the extent automotive taxation is intended to "price" either the utilization of publicly-provided services or externalities, fuel taxes are at best a very crude instrument. Toll roads -- privatization, as it were -- and an appropriate set of annual automobile (and driver) license fees can in principle serve this benefit tax function much better. For example, such fees might be based on such features as the age and engine size of vehicle (older and larger cars generally contribute more to pollution), location of vehicle (cars in cities add more to pollution and to congestion), driver records (20 percent of drivers are responsible for 80 percent of accidents), and especially the axle-weight of the vehicle (heavier vehicles do exponentially more damage to roads and require roads that are more costly to build).

To the extent that it is desired to achieve some redistributional goal through automotive taxation, this can best be done by a national excise tax at the time of initial sale. In contrast the present situation in Argentina, for instance, in which every province levies an array of annual taxes that vary with the year and model of the vehicle, apparently largely in an attempt to levy a "progressive" tax, makes little sense. In San Juan Province, where it takes three (newspaper sized) pages to set out the details of vehicle tax rates, the tax in principle is imposed at a rate of 3 percent on automobiles, but the values to which this rate is applied vary with the make and model, age, and weight of the vehicle. This approach is administratively complex and costly; it is not related in any consistent way to any distributional objective; it unduly penalizes newer

\textsuperscript{21}Consider, for example, Canada’s recent experiences with cross-border smuggling and provincial tobacco taxes (Bird, Perry, and Wilson, 1998).

\textsuperscript{22}This “mismatch” of revenue and expenditure elasticity is a serious problem in Colombia, for example, where the revenues of the departmental (regional) governments depend largely on excise taxes (Acosta and Bird, 2003).
(and more efficient) vehicles; and it does not price public services or externalities in any meaningful way. As with most provincial taxes and charges in Argentina, the automobile tax suffers from undue refinement in terms of fine discrimination between very similar bases. The result is essentially arbitrary differentiation with consequent economic distortion, and considerable leeway for administrative and compliance slippage. A commendable desire to make fine distinctions for social purposes may underlie this complex system. But the reality is that such complexity makes the system both economically undesirable and fundamentally unadministrable.

Subnational taxation of automobiles is fundamentally a good idea. Careful study of the appropriate design of the automobile tax system is needed, however (Smith, 1991). In most countries, both more revenue and better economic effects could be achieved through a revised system of automotive taxation. Subnational revenues could be still further boosted by giving regions access to the fuel tax (perhaps through regionally-determined surcharges). Indeed, automotive (and fuel) taxation appears to be the only commonly available subnational revenue source that, in principle at least, should demonstrate more than unitary income-elasticity, thus matching this aspect of some of the key services (education, health) for which regional (and sometimes perhaps local) governments are increasingly responsible in many countries. Nonetheless, even when most fully exploited, automobile taxation alone seems unlikely to do the job of financing social services such as education and health to any significant degree. Moreover, as with most of the potential tax sources discussed in the following sections, fuel and vehicle taxes obviously are much greater potential revenue sources in large urban areas than in poor rural areas. Consequently, to the extent regional finances rely on such levies, regional fiscal inequalities are likely to be exacerbated unless offset by an adequate system of equalization transfers.

5. Personal Income Taxes

Since property taxes can only be pushed so far, and user charges and taxes on vehicles and fuels seem unlikely to be too productive in most regions, if more "own-source" revenue is desired -- either to expand the size of subnational activities or to make subnational governments more self-reliant -- OECD experience suggests there is much to be said for supplementary ("piggybacked") local income taxes (Bird and Slack, 1991). Like the property tax, such a tax would be visible and hence in principle satisfy the criteria of political responsibility and accountability.23 Many such taxes exist in developed countries:

- Among the few countries in which subnational governments both have large expenditure roles and are largely fiscally autonomous are the Nordic countries. It is no coincidence

23 On the other hand, the fact that income tax revenues tend to grow with less political fuss, while presumably good news for local officials, suggests that increased reliance on local income taxes ought perhaps to be viewed with mixed feelings.
that the best-known examples of local income taxes are in those same countries (Soderstrom, 1991). These local income taxes are basically levied at a flat, locally-established rate on the same tax base as the national income tax and collected by the central government.

- In contrast, in Belgium (and, until recently, in most Canadian provinces) the local surcharge is levied as a percentage of the national tax liability rather than the national tax base. A similar system exists in Switzerland, where most cantons -- the intermediate level of government -- allow local governments (communes) to levy surcharges at locally-established rates on the cantonal income taxes -- taxes which are, incidentally, like most U.S. state income taxes, in no way harmonized with the federal income tax (Bird, 1986).

- Less well-known is the unique system of local income taxation in Japan. Corporations are subjected to a municipal tax assessed largely on the basis of national corporate taxes paid in the previous year, with the tax base being allocated to the different jurisdictions in proportion to the number of employees. In addition, corporations are subject to a progressive municipal "enterprise" tax based directly on income. When this enterprise tax is applied to individuals operating businesses, its rate varies with the category of business activity (as is also true with the local taxe professionelle in France). Individuals are also subject to both a progressive local income tax on the same base as the national income tax and a poll tax (like the former British "community charge") levied at a nationally-determined per capita rate which varies with the size of the municipality. Only the latter, however, is levied on nonresidents working in the municipality. All these taxes are assessed and collected locally.

Although local income taxes have occasionally been levied in developing countries (Bahl and Linn, 1992), they are not common. In contrast, in many transitional economies, subnational governments have been assigned significant shares of income tax revenues. For example, in Russia a few years ago such governments received all of personal income tax revenues, in Bulgaria, 50 percent, in Poland, 30 percent, and in Hungary, 25 percent (Bird and Wallich, 1993). In none of these countries, however, did local governments have any freedom in establishing the tax rate. The resulting distribution of revenues is therefore better considered as an intergovernmental fiscal transfer based on locally-collected national tax revenues rather than as a truly "local" source of revenue. If local governments are not politically responsible for the revenues they receive, it stretches reality to consider such revenues as local taxes (Ebel and Yilmaz, 2001). In contrast, locally-determined surcharges are clearly local "own taxes" in that the accountability both for imposing the taxes and for spending the revenues is placed squarely on the local government.  

24 In Canada, for instance, where the central government assesses and collects the income tax, the provinces can set different rates and therefore affect through their own actions the amount of revenue accruing to them. Note, however, that Canadian local governments cannot levy income taxes of any description: as Bird and Chen (1998) note, there are two very distinct worlds (federal-provincial vs. provincial-local) of intergovernmental finance in Canada.
One reason local governments have seldom been given access to income taxes in developed countries is because of the reliance of central governments on this source of revenue. In developing countries, of course, even central governments often have trouble collecting much from the income tax. Shome (1999), for example, has recently depicted the weak, and weakening, state of personal income taxes in a number of Latin American countries. The combination of weak personal income taxes at the central level, the apparent difficulty of strengthening these taxes in the near future, and the reluctance of central governments as a rule to share productive taxes with local governments makes it seem unlikely that any quick fix can found for subnational revenues in this quarter.

Nonetheless, local surcharges on a central personal income tax (PIT) have recently been proposed in several developing and transitional countries, such as South Africa and Hungary (Bird, Wallich, and Peteri, 1995) and this revenue source has been reviewed favorably in other recent writings (e.g. McLure, 1999). The possibility of imposing regional (and perhaps in some instances even local) surcharges on personal income taxes should thus certainly be explored further in most countries, but it seems unlikely that subnational revenues from this source will loom very large in the near future.

6. Payroll Taxes

A closely related question concerns regional payroll taxes. Payroll taxes have been important sources of regional government finance in Australia and, to a considerably lesser degree, in some other countries such as Mexico and South Africa. Such taxes have several merits, and at least two demerits. Their merits are that they are easily administrable, at least when imposed on large enterprises and relatively productive at relatively low rates. Their demerits are, first, that they act as a tax barrier to employment in the modern sector and introduce distortions into the factor mix decision (Bird, 1992) and, second, that in most countries the payroll tax basis is already heavily exploited to finance (central) social security systems.

To the extent that payroll taxes can be made effective on a regional basis, so can (flat-rate) personal income taxes, which are in practice likely levied on much the same base, without -- at least in principle -- the factor bias inherent in payroll taxes. Moreover, again in principle, if not so clearly in practice, such subnational PITs can more easily be levied on a destination (resident) than origin (employment) basis (Bird and Wallich, 1992), an important factor in considering the potential distortionary aspects of subnational factor taxes (as discussed further in section 8 below). On the whole, therefore, surcharges on a nationally uniform personal income

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25 To avoid administrative problems and economic distortions, it would seem best to impose such surcharges at a uniform (flat) rate, although of course the particular rate applied might vary from region to region.

26 In some countries, the payroll tax base is used for many additional purposes: see, for example, the discussion of the Colombian system in Alm and López-Castaño (2002).
tax base would seem a more appropriate way in economic terms than payroll taxes for subnational governments to tax wages in most developing and transitional countries. In administrative terms, however, there is no doubt that a payroll tax – levied as a “final” tax on payrolls at the enterprise level – is considerably simpler, unless (as is sometimes the case) the so-called “personal income tax” is itself levied in much the same way in practice, on total wages and salaries at the enterprise level and not aggregated with other forms of income on an individual basis.

7. General Consumption Taxes

In many countries, the search for a regional revenue source that is both economically respectable and administratively viable, as well as reasonably elastic, comes down to a general sales tax. Excises, yes...to some extent; but there is not always that much money, and even less elasticity, in this revenue source. Much the same can be said with respect to user charges and local property taxes: use them sensibly and as fully as possible, but do not expect large (and certainly not easily expansible) revenues from these sources. Payroll taxes are in most countries already more than adequately exploited by social insurance funds and in any case are not always appropriate for regional taxation. Regional -- and perhaps even local in some circumstances-- surtaxes on the central personal income tax are sensible in principle, but are often not very promising in the immediate future, given the poorly developed nature of that tax in the context of most developing and transitional countries. The only “big” tax that remains – apart from the business taxes discussed in section 8 – is the general sales tax.

The general sales tax now found in most countries is of course a value-added tax (VAT). The retail sales tax once favored as a regional tax (Musgrave, 1983), though still in place in most U.S. states, is now an aberration in world perspective. Its future seems dim. The dominance of the VAT poses a serious problem for the finance of regional governments, however. Most tax analysts have long thought that, so to speak, the only good VAT is a central VAT. The reasons why independent subnational VATs were considered to be either infeasible or undesirable were varied (Bird, 1993a). Some emphasized high administrative and compliance costs. Others stressed the possible loss of macroeconomic control and the general reluctance of central governments to share VAT room. Still others emphasized the problems arising from cross-border (interstate) trade. Broadly, the argument with respect to such trade was that subnational VATs were, if levied on an origin basis, distortionary, and if levied on a destination basis, unworkable. Experience in Brazil was generally taken to support this negative appraisal.

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27 Ebrill et al. (2001) report that 123 countries had a VAT in that year.

28 Interestingly, Poddar (1990) in the most thorough early discussion of this issue had demonstrated that the destination base was technically feasible, although the particular approach he discusses in that paper seems unlikely to work well in developing countries.
Brazil was the first country to introduce a full-fledged VAT (Guérard, 1973). Indeed, Brazil liked the idea of a VAT so much that it introduced not one VAT but several—one for the federal government (IPI) and one for each of the state governments (ICMS).²⁹ It soon became clear, however, that Brazil’s enthusiastic adoption of this new tax had resulted in a series of complex technical and administrative problems with respect to how to apply different VATs in different states (although all are levied at a uniform rate) in addition to a federal VAT. Over the years, these problems were partly resolved in various (and ultimately unsatisfactory) ways. For example, the overlap in taxes was reduced by confining the federal IPI essentially to the manufacturing stage. In part, the problems were simply ignored, perhaps because the resulting distortions in resource allocation seemed unimportant compared to those resulting from inflation. And in part, the issue was fudged by various unsatisfactory administrative fixes such as the introduction of some border controls between states.³⁰ Nonetheless, the resulting patchwork quilt—perhaps a better analogy would be a blimp precariously patched with chewing gum—has become increasingly unsatisfactory, and sales tax reform has again risen high on the fiscal agenda in Brazil in recent years, although as yet no reform has proved possible.³¹

Fear of difficulties similar to those encountered in Brazil has perhaps been one reason for delaying desirable sales tax reforms in neighboring Argentina, where a 1993 federal-provincial agreement (the Pacto Fiscal) required the abolition of the provincial gross receipts taxes and their replacement by a retail sales tax by 1996 (World Bank, 1996). Although in the end the process was postponed, the ensuing debate led to proposals from the most important province (Buenos Aires) for a provincial-level VAT and to considerable discussion on the merits and demerits of this approach.

The major revenue source of Argentine provinces has long been an antiquated gross receipts tax levied at various rates on different activities (and an even more antiquated stamp tax). To return to the example of San Juan Province, for example, the basic rate of the gross receipts tax was 3%, with rates of 0.83% on fuel production, 1.67% on fuel sales, 2% on construction, 4% on tourist services and certain financial activities, 5% on certain other financial activities (e.g., insurance companies), lotteries and gaming, sales of tobacco, and advertising agencies, 10% on pubs, night clubs and similar activities, and 15% on electronic games, pool, cabarets, and places that rent rooms by the hour. In addition, minimum fixed taxes were established for certain activities, including cabarets, parking lots per space (depending on the size of the space!) as well as for places rented by the hour (depending upon the rate they charge).

²⁹ IPI (Imposto sobre Productos Industrializados) is levied by the federal government on industry and ICMS (Imposto sobre operacoes relativas a Circulação de Mercadorias e Servicos) is levied by the states on agriculture, industry, and many services. In addition, another tax, the ISS (Imposto Sobre Servicios) is levied on a gross receipts basis by municipalities on a variety of industrial, commercial, and professional services, and there are also a number of other taxes on financial transactions, retail sales of fuel and so on that are not discussed here.

³⁰ For further discussion, see Purohit (1994) and Shome and Spahn (1996).

³¹ See the useful discussion in Varsano (2000).
This tax provides an excellent illustration of what is wrong with existing provincial consumption taxes in Argentina, and similar taxes found in other countries around the world. It taxes a significant number of intermediate business activities (fuel, construction, advertising, insurance, finance). It creates a variety of totally unenforceable distinctions between "disfavored" activities -- ranging from cabarets vs. night clubs to the sizes of parking spaces -- and imposes ridiculous rates on these activities. Such provisions may make legislators feel good, but they create a nightmare for tax administrators, are not effectively enforced, and serve no useful economic or social purpose.

It is thus quite understandable that the 1993 Pacto Fiscal mentioned above required the gross receipts tax to be changed to a "retail" sales tax. Some steps were indeed taken in this direction. As early as 1995, for example, taxes on primary production had been eliminated completely in 6 of the 24 provinces and reduced to rates of 1 percent or less in most of the rest, while the tax on industry had generally been lowered to 1.5 percent (compared to the general rates of 2.5 percent on wholesale trade, and 3.5 percent or so on retail trade and services). From the point of view of reducing the economic distortion due to the tax system, the need to go all the way and replace these antiquated taxes with a more modern retail sales tax seemed obviously desirable. From the point of view of strengthening provincial revenues, however, the effects of replacing the existing stamp and gross receipts tax seemed less obviously desirable to most provincial governments. Estimates of the revenue-neutral rate of a retail sales tax ranged from 3.5 percent to 10 percent. Adding a retail sales tax at these rates to the then existing federal VAT of 21 percent was clearly not a politically attractive alternative.

Some commentators (e.g. Gómez Sabaini and Gaggero, 1997) suggested that it would be better to impose either independent provincial VATs or a more uniform joint federal-provincial VAT (subject to an overall 20 percent rate limit). Such subnational VATs, they suggested, could be imposed like any national VAT essentially on a destination basis, with the problem of interprovincial sales dealt with by allocating revenues in accordance with macro-level consumption indicators. Such an approach would clearly be more feasible with the joint version of the tax. It would also require a high degree of agreement between the federal and various

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32 The effects of the proposed change to a “retail” tax were muted because it was proposed that the new tax would largely be collected at the pre-retail stage. A manufacturer or wholesaler selling a product for 100 pesos to a retailer will actually charge, say, 103 pesos, with the additional 3 pesos being remitted to the government as a sort of "withholding" against the 6 pesos (or whatever) the retailer is in principle supposed to charge when he sells to a final consumer, at, say, a 100% markup for an ex-tax price of 200, or 206 tax-inclusive. The retailer will then owe the government 6 pesos less the 3 pesos already withheld for a net tax due of 3 pesos. If, as is all too likely, the retail sale does not come to the notice of the authorities, they would at least have the 3 pesos. The mechanics of this system are similar to a value added tax and, as with a VAT, one reason for adopting this approach is to avoid losing all the revenue by making the only taxable act the hardest to control, namely, the final sale. The end result, however, is that in fact the new system will not be very different from the old in the sense that most revenue would continue to be collected from established larger pre-retail firms.

33 This version would be similar to the so-called "Harmonized Sales Tax" (HST) currently in force in three small Canadian provinces (Bird and Gendron, 1998).
provincial governments. In contrast, the CVAT proposal discussed briefly below both requires less such agreement and affords more provincial revenue autonomy.34

The only functioning destination-base subnational VAT now in existence is that in the province of Québec in Canada (Bird and Gendron, 1998). The Québec Sales Tax (QST) and the federal VAT (Goods and Services Tax, or GST) as they now exist in Canada constitute an operational “dual VAT” system with essentially none of the problems usually associated with such systems. The rates of the two taxes are set quite independently by the respective governments. The tax bases are also determined independently, although they are essentially the same.35 From the beginning, both taxes have been collected by a single administration (the Québec Department of Revenue).36 Taxes on interprovincial sales from one business to another are basically handled by a deferred-payment system very similar to that now applied with respect to sales between member countries in the European Union. Exports from Québec, whether to another province or another country, are zero-rated. Imports into the province from other provinces, or from abroad, are taxable, but the tax is assessed on interprovincial imports only when there is a sale by a registered trader to an unregistered trader or consumer in the province. Although special regimes apply to automobiles and a few other cases, in general no attempt is made to collect tax on interprovincial purchases made directly by final consumers.37

What makes this system work, Bird and Gendron (1998) argue, is the existence of the overriding federal GST as an enforcement mechanism. Audit priorities for GST are established by the federal government, but a final audit plan is agreed with the Québec government, with the latter actually carrying out the audit and reporting the results to Revenue Canada. Since the QST

34It should be noted that with any change to a destination-base consumption tax “producing” provinces would clearly lose revenue. A credible “revenue guarantee”would likely be needed to make any approach acceptable. Revenue gains (or losses) to particular jurisdictions from tax substitutions are unlikely to have the same magnitude--and may even have different signs--than real economic changes, but it is clearly the visible revenue effects that dominate discussion of these issues even in developed countries (Keen and Smith, 1996), although this important question is not discussed in detail here.

35It is perhaps not unimportant that a precedent existed for this under the long-standing Québec personal income tax, the base for which is also almost identical to the federal PIT -- although in this case, unlike the QST/GST case, the two taxes are collected independently.

36The federal share is turned over to the federal government after deducting an agreed (per registrant) administrative cost. No problems have arisen from such intergovernmental collection arrangements, which are quite common in Canada (although the revenue flow has invariably been the other way in the past, that is, from the federal to the provincial governments.)

37Apart from a very few cases, Canadian provinces have traditionally not worried too much about this problem since geography ensures that most major population centres are not close to borders with other provinces. The advent of electronic commerce, however, has increased concern with this issue.
is applied to a GST-inclusive base, Québec has some direct incentive to monitor the GST as well as the QST. On the other hand, although Quebec cannot directly monitor the other end of interprovincial sales, the normal process of GST audit (carried out interprovincially by Revenue Canada) serves as a cross-check to ensure that QST has not been evaded. In effect, the existence of a federal sales tax on a more or less uniform base provides some control over interjurisdictional sales for purposes of both provincial and federal taxes. Reportedly, the system is working quite well.

Canada has thus demonstrated that with good tax administration it is feasible to operate a VAT at the subnational level on a destination basis, at least for large regional governments. In principle, it is immaterial whether there are two separate administrations or one; or, if there is one, which level operates it. Clearly, a single central administration and a common base (as in Canada's personal income tax system) would probably be most efficient, but this degree of convergence is not essential. What seems critical is either a unified audit or a very high level of information exchange. Most importantly, from the perspective of improving accountability, each taxing government should be able independently to determine its own VAT rate.

But what can be done when there is no realistic prospect of “good” tax administration at the subnational level in the near future? As Varsano (2000) demonstrates, a promising approach is to impose what is in effect a supplemental central VAT, which McLure (2000) labels the “compensating” VAT or CVAT. This approach has the major virtue of protecting the revenue when tax administration (at all levels of government) is far from well-developed. Specifically, it reduces the risk that households (and unregistered traders) in any state can dodge state VAT by pretending to be registered traders located in other states.

How might such a CVAT work? Briefly, states would zero-rate not only international but interstate sales, but the latter would be subject to the central CVAT (as well as the central VAT, of course). Domestic sales would thus be subject to central VAT and either state VAT or central CVAT. There would be no need for any state to deal explicitly with any other state nor, generally, would there be any need for interstate clearing of tax credits. Registered purchasers in the other state would of course be able to credit CVAT against central VAT. The results of this procedure are twofold. First, the central government, which first levies CVAT and then

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38 As described in Bird and Gendron (1998), the case of Canada also demonstrates that it is perfectly feasible to have several different types of relationship (or non-relationship) between central and subnational sales taxes, but this point is not pursued here.

39 Bird and Gendron (2001) discuss and compare CVAT and several other approaches to subnational VATs in much more detail.

40 This assumes that the state VAT rates are lower than the central rate. If, as in Brazil, the state rates are substantially higher, there might be some residual need for a “clearing house” -- though on an aggregate, not transaction basis -- but this would not seem to be a very difficult problem if, as would seem generally advisable, there is central administration of state VATs.
credits it, would gain no net revenue from it. Second, the state VAT applied to resale by the purchaser would be that of the destination state. In other words, the results are exactly the same as in the GST/QST case described above -- a destination subnational VAT is applied -- but the CVAT now acts to protect state revenues from some obvious frauds. This approach – like several others currently under discussion -- appears to make subnational VATs potentially feasible at least in large countries in which states have major expenditure roles, the VAT is the principal source of actual and potential revenue, and tax administration is not up to Canadian standards.

As Bird and Gendron (2001) note in a recent review of experience around the world, however, the debate on how best to design and implement a subnational VAT is far from settled. The final answer may turn out to be—not too surprisingly—that different contexts call for different solutions. What a country can, should, and will do obviously depends on many factors. Trade patterns, the location and size of the country and its subnational jurisdictions, the relative importance of “Business to Business” (B2B) versus “Business to Consumer” (B2C) transactions in the tax base, the quality of administration, the degree of trust and feasible coordination, the desire for local autonomy, the tolerance for asymmetry, the offsetting nature of equalization, the extent and nature of revenue shifts, and, not least, the existing sales tax structure—all these things will determine what happens. The road to feasible subnational VATs may be long and winding in many countries. But, as has often been noted, the longest journey starts with a single step and, with respect to subnational VATs, countries such as Canada, India, and Brazil are already much further down this path than a few steps.

8. Business Taxes

Those familiar with subnational tax systems around the world will have noted one conspicuous omission from the preceding discussion -- taxes on business. Regional and local business taxes in such forms as corporate income taxes, capital taxes, nonresidential property taxes, and such ancient levies as octroi, patente, and various forms of “industry and commerce” tax are found in most countries. Whether or not there is an economic case for such taxes, the

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41 Presumably, as in Canada, the central government would receive an agreed -- per registrant? -- fee for its services.

42 As emphasized earlier, on the whole more homogeneous or smaller countries would likely be better advised on the whole to follow what was called earlier, the HST approach to sharing VAT revenues. As Canadian experience suggests, it may be possible to apply both HST and CVAT approaches simultaneously in different states.

43 Bird (2003) reviews local business taxes in more depth, both in general and with respect to practices in a number of countries.
political realities of governing in a democratic society are such that virtually any subnational government will in any case wish to impose such a tax. Subnational business taxes are not only widespread, they are also generally popular with officials and citizens alike, for at least two reasons. First, they often produce substantial revenue and in particular tend to be much more elastic than, for example, property taxes. Second, since no one is quite sure of the incidence of such taxes, it is easy to assume, or assert, that they are paid by someone other than local residents.

As a rule, experts have looked at the distortions and problems arising from such taxes,\(^{44}\) shuddered, uttered some homily such as “don’t do it,” and passed on to things of more interest. Since local business taxes are likely to continue to exist, however, no matter what economists may say, it is important to consider whether the problem is with the very idea of subnational governments taxing business or rather with the way in which they now generally do so.

The economic case for local business taxation is simply as a form of generalized benefit tax. Such benefit taxes are not only allowable at the subnational level but are indeed essential to the attainment of efficiency. Where possible, specific public services benefiting specific business enterprises should of course be paid for by appropriate user charges, as argued in section 2 above. But where it is not feasible to recoup the marginal cost of cost-reducing public sector outlays through user charges, some form of broad-based general levy on business activity may well be warranted. It is difficult, however, to find any support along these lines for taxing any one input, however, whether labor (payroll tax) or capital (corporate income tax) Instead, what this line of reasoning suggests is that a broad-based levy neutral to factor mix should be imposed, such as a tax on value-added.\(^{45}\)

The most appropriate form of VAT for this purpose would appear to be a “value-added income tax” or a VAT levied on the basis of income (production, origin) rather than consumption (destination). Compared to a conventional VAT, such a tax -- which shall henceforth be referred to as a “business value tax” (BVT) -- has three important distinguishing features. First, it is levied on income, not consumption: that is, it is imposed on the sum of profits and wages, or to put it another way, on investment as well as on consumption.\(^{46}\) Second, it is imposed on production, not consumption: that is, it is imposed on an origin not destination basis and hence, in effect, taxes exports and not imports. And third, it is assessed by the subtraction (or addition) method on the basis of annual accounts rather than on a transaction or invoice-credit method.

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\(^{44}\)See, for examples, Thirsk (1982) and McLure (1994).

\(^{45}\)As Sullivan (1965) documents, the original conception of the VAT (by Adams (1918) was in fact as a business benefit tax.

\(^{46}\)Note that an “income” basis can be applied to gross income, net (of depreciation) income, or even consumption (add back depreciation and deduct capital expenditures). It is assumed here that the net income basis is the most logical.
Those, like many economists, who think the optimal subnational tax on business is no tax may reject this proposal out of hand. But those who think either that there is at least some justification for local business taxation or that, whether experts like it or not, there will in any case continue to be such taxes should not be so hasty. While the danger of tax exporting and, more importantly, beggar-my-neighbor tax competition suggest that it may be advisable to place a floor (and perhaps also a ceiling) on such taxes, a BVT-type levy is clearly much less distorting than such existing subnational business taxes.47

As a replacement for such taxes, a BVT would improve subnational tax systems in several ways. First, it would be more neutral than most existing local business taxes, which often discriminate against (certain forms of) investment. Second, it would likely be less susceptible to base erosion. Third, a BVT should nonetheless be more sensitive to cyclical realities than most other forms of business tax (e.g. capital taxes, property taxes). All these advantages would of course apply even if the rate of the BVT were set to produce the same revenue as existing business taxes. Of course, if the rate were set to match roughly the benefits-received basis suggested above, it would generally be lower, and the tax would have the additional important advantages of eliminating inefficient spillovers and encouraging more responsible and accountable subnational governments. As with the subnational VAT discussed in section 7, while there are many technical issues that need further thought and discussion, moving towards a BVT-type local business tax – as, for example, Italy did recently (Bordignon et al., 2001) would clearly be a substantial improvement in many countries.

Alternatively, in some countries it may prove simpler administratively and almost equally beneficial economically simply to “rationalize” the existing set of (often presumptive) levies imposed on business in many countries, as discussed in more detail in Bird (2003). Local business taxation around the world is characterized by great variety. Some countries rely mainly on taxes on profits and property; some on various forms of sales taxation; some on a variety of specific charges and fees. A recent study (Bahl and Solomon, 2000) suggested that the following criteria might be used to appraise local taxes: adequacy of revenue, elasticity of revenue, equity, administration, economic neutrality, political acceptability, correspondence principle, local autonomy, effects on disparities. Most of the existing local taxes on business found around the world would not score that high on many of these criteria. Very few are equitable. Almost none are neutral. Most accentuate rather than reduce disparities between localities, giving most to those who have most. Most also lend themselves to tax exporting, thus violating the “correspondence principle” that those who pay should be those who benefit. Finally, all too many are costly to administer, especially if one takes into account, as one should, the cost of compliance and the facility with which the tax can serve as the basis for corrupt

47These arguments are by no means solely theoretical, since there is already some important real-world experience with such taxes, both in the states of Michigan (the former BAT, or business activities tax, from 1953 to 1968, and, since 1976, the SBT, or single business tax) and New Hampshire (the business enterprise tax, or BET) as well as in Italy (the new regional business tax, the IRAP) and Germany (the old “local trade tax” or gewerbesteuer). For further discussion, see Bird (2003).
On the other hand, local business taxes thrive around the world precisely because they score very highly on some of the other criteria mentioned. They are, for example, obviously highly politically acceptable, in part because no one quite knows who really pays them but many people think someone else does. They also provide an important, and relatively elastic, source of revenue, particularly for larger cities. And, finally, in many countries, local business taxes, defective as they often are in design and execution, provide one of the few ways in which local governments have any degree of fiscal autonomy.

The question is therefore to what extent the virtues of local business taxation – money and autonomy – can be realized while minimizing such vices as economic distortions and administrative costs. While the low rates of most such taxes dampen these problems, a more systematic approach to the problem – the BVT -- was sketched above. It should be emphasized, however that that no form of local business taxation can overcome certain fundamental problems. First, any tax on business will obviously give more revenues to those who have more tax base. It will therefore accentuate fiscal disparities among regions and localities. Second, although one of the “virtues” of local business taxation is that it is politically acceptable, this “virtue” is inescapably accompanied by two potential vices – the weakening of the correspondence principle and a consequent increase in the lack of clarity about the equity of local taxation. The first of these weaknesses is much more important. Although most local business taxes are, in all likelihood, somewhat regressive, the equity of local taxation is in general, a less important question than some think. Indeed, as noted earlier, from many perspectives, local governments can be considered to be essentially entities that provide services to residents and the appropriate equity perspective is the benefit principle rather than the ability-to-pay principle (Bird, 1993).

9. Conclusion

To sum up, the general approach taken in this paper to subnational taxation in developing and transitional countries is based on three simple principles: (1) More attention should be paid to matching expenditure and revenue needs. (2) More effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. (3) Subnational taxes should not unduly distort the allocation of resources.

If regional governments have significant expenditure responsibilities, in most countries there appear to be only two ways these criteria can be satisfied -- through a surcharge on PIT or a surcharge on VAT. The possibility of local income tax surcharges now seems to be broadly accepted. Unfortunately, few developing countries have sufficiently robust central income taxes to offer much hope that subnational governments will soon be able to derive much revenue from this source. A potentially promising alternative answer for subnational revenues at least in the
larger countries, particularly those with federal features, may be, as developed in more detail in Bird and Gendron (2001), to rely on the VAT. At the very least, this path appears to be open, and should be further explored in at least a few important countries.

A second feature of subnational taxation that has been emphasized here is the importance of developing a less harmful form of subnational business taxation. Most forms of local and regional business taxes found in developing countries -- corporate income taxes, trade taxes, business taxes, differentially heavy nonresidential property taxes, and even so-called “retail” sales taxes introduce serious economic distortions in a variety of ways. Nonetheless, as noted in Bird (2003) there is both an economic (benefit) case for some regional and local taxation of business and, it seems, often an overwhelming political need for local leaders to impose such taxes. One approach to this problem that seems worth further exploration is to introduce what is in effect another form of value-added tax such as the BVT discussed briefly above (and in more detail in Bird (2003). Variants of such taxes already exist in some developed countries. The practical case for replacing the present mish-mash of taxes imposed on business by such a tax seems even stronger in the context of developing countries.

Suppose that both these "new" proposals for subnational revenue reform were to be accepted in any given country. The result would then be, in effect, a "family" of VATs, with a standard invoice-credit destination-principle consumption-type VAT imposed at the central government level, similar VATs imposed at varying rates on the same base by regional governments, and a BVT (essentially an income-type VAT imposed by the subtraction or the addition method) levied on all VAT registrants by regional (and perhaps even larger local) governments at relatively uniform rates. In addition, of course, all levels of government should apply appropriate user charges, some excise taxes -- particularly those related to vehicles -- might appropriately be levied at the regional level, there is a strong case in most developing countries for more effective local property taxation, especially of residential property, and the central government may of course continue to levy both a corporate and a (progressive) personal income tax, perhaps with regional governments imposing flat-rate PITs on the same base, if they so choose.

Much work of course needs to be done to develop the details of such a scheme in the concrete circumstances of any particular country. Myriad details of design and administration need to be settled, the relation between different levels of subnational government needs careful thought, the role and design of intergovernmental fiscal transfers needs to be carefully considered, as does the appropriate and tolerable level of asymmetry in the application of the

48Note that since the BVT is imposed on essentially the same base as the gross income that should be reported for income tax purposes, its introduction might also provide an appropriate occasion for the introduction of a uniform and unified tax administration encompassing both VAT and CIT plus business PIT at all levels of government. Such administrative elaboration must, however, be left for a later date.

49Devolving more taxing authority to subnational governments will of course mean most in revenue terms to those with the largest tax bases. As noted earlier, if a country is at all concerned with providing relatively equal opportunities for access to key public services, a more explicitly equalizing transfer system may therefore be required (Bird and Fiszbein, 1998). In addition, special problems
suggested principles to subnational governments of vastly differing size and competence. Nonetheless, it does appear that some long-accepted principles governing subnational taxation need to be rethought, and largely discarded:

First, the conventional model of tax assignment, which in effect assigns all significant revenue sources to central governments, is clearly inappropriate for countries in which subnational governments, for whatever reason, account for a significant proportion of public sector spending. If such governments are to be big spenders, they must, in the interests of fiscal responsibility and accountability, also become bigger taxers.50

Second, the VAT is the key to central government finance in most developing countries. Central governments are obviously most reluctant to lose any control over this tax, and this understandable reluctance has, until now, been supported by the conventional wisdom that subnational VATs are not technically feasible. Contrary to what has long been thought, however, such taxes are feasible. Subnational VATs may thus, over time, become the most important source of subnational revenue, at least in some larger federal countries.

Third, admirable as the user charge and property tax package that is commonly recommended for financing local governments is in many ways, forty years of experience has made it clear both that these proposals are very difficult to implement and that they are unlikely to provide an adequate fiscal base if local governments have major spending responsibilities in the social area. One result has been the proliferation of a variety of bad local (and regional) taxes on business. A partial answer in some countries may lie in the introduction of a “business value tax” (BVT) at a low and uniform rate. While such a tax might first be considered as a replacement for clearly undesirable subnational corporate income taxes, it might also be extended in some instances to replace local nonresidential property taxes, with local supplemental rates imposed on the same base as a regional BVT.51

Even major reforms along these lines would not, of course, solve all the problems of establishing sound and workable subnational tax regimes in all developing countries. Such reforms would, however, move matters in the right direction.

50 To repeat, it must also be emphasized that transfer systems need to be redesigned to accommodate different tax assignments since more access to tax bases means little to subnational governments with few bases to access: see e.g. Bird (2001) and Bird and Smart (2002) for further discussion.

51 For such a proposal for Canada, see Bird and Mintz (2000).
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