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

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INTRODUCTION

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

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

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

Part D examines a number of issues in local taxation; specifically, what should local government be expected to fund from their limited tax base? Is one tax preferred over another? Who should set local tax rates? Should these rates be uniform or differentiated across a taxing jurisdiction? Should local tax rates be regulated? Should local government tax businesses? Are local taxes currently sufficient to ensure local fiscal sustainability? Part E summarizes the paper.

LOCAL TAXATION – AN INTERNATIONAL COMPARISON

Since most locally generated revenues come from local taxes (user fees are the other major source of locally generated revenue), the following two sections provide data on a number of features of local taxation in federal (three levels of government) and unitary (two levels of government) OECD countries. The next section briefly outlines the taxes that are available to local government along with their relative importance. This is followed by a section that comments on the fiscal autonomy and discretion that local governments have over their tax base and rate structure.

Pattern of local taxation

Table 1 illustrates the relative importance of a range of local taxes in OECD countries. From this table, the following may be noted.

1. Income taxation (corporate and personal) is the most important source of local tax revenues in fourteen countries (column 2). In Denmark, Finland, Norway, Sweden, Luxembourg, and the Czech Republic, it accounts for more than ninety percent of local revenue. In Australia, Canada, Mexico, France, Greece, Hungary, Ireland, Netherlands, New Zealand and the United Kingdom, by comparison, local governments do not have direct access to income tax revenue.

2. Local sales taxes (in various forms but referring generally to taxes on goods and services that are sold) generate between 20 percent and 76 percent of total local tax revenue in ten countries (column 3). At the other extreme, local sales taxes are non-existent in five countries and produce less than ten percent of local revenue in another twelve countries.

3. Property taxes (column 4) account for more than ninety percent of all local tax revenue in five countries (Australia, Canada, Ireland,

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

Table 1: Relative Importance of Local Taxes in Selected OECD Countries, 2001

Countries (1)	Tax sources as a percent of total local tax revenues: Income[1] (2)	Sales[2] (3)	Property[3] (4)	Other[4] (5)	Local taxes as a percent of GDP (6)	Local Taxes as a percent of all taxes[5] (7)
Federal:						
Australia	0.0	0.0	100.0	0.0	1.0	3.0
Austria	55.3	29.7	9.9	5.1	4.4	10.1
Belgium	86.5	13.2	0.0	0.3	2.1	4.7
Canada	0.0	1.9	91.3	6.8	2.9	8.1
Germany	78.0	6.0	15.8	0.2	2.6	7.5
Mexico	0.0	2.6	86.7	10.8	0.1	0.8
Switzerland	84.4	0.3	15.3	0.0	5.0	14.0
United States	6.5	21.8	71.8	0.0	3.5	11.5
Unweighted average	38.8	9.3	48.8	2.9	2.9	7.5
Unitary:						
Czech Republic	90.8	4.2	4.6	0.4	4.8	12.4
Denmark	93.4	0.1	6.5	0.0	15.9	32.9
Finland	95.4	0.0	4.4	0.1	9.9	21.2
France	0.0	11.5	48.2	40.4	4.4	9.7
Greece	0.0	46.3	0.0	53.8	0.4	1.0
Hungary	0.8	76.2	22.5	0.4	2.0	5.2
Iceland	78.0	7.6	14.3	0.0	8.3	22.4
Ireland	0.0	0.0	100.0	0.0	0.6	1.8
Italy	12.2	8.6	18.6	60.6	4.8	11.4
Japan	47.4	20.7	30.9	1.0	7.0	25.6
Korea	16.6	26.5	53.3	3.6	3.9	15.1
Luxembourg	92.9	1.3	5.6	0.3	2.4	5.9
Netherlands	0.0	44.0	56.0	0.0	1.4	3.4
New Zealand	0.0	9.7	90.3	0.0	1.8	5.8
Norway	89.9	2.2	7.9	0.0	6.5	16.3
Poland	78.4	1.8	19.8	0.0	5.7	16.3
Portugal	21.6	33.7	44.5	0.2	2.3	6.3
Slovak Republic	59.9	11.8	28.2	0.1	1.5	4.0
Spain	25.2	36.1	37.3	1.4	5.9	16.9
Sweden	100.0	0.0	0.0	0.0	16.0	29.8
Turkey	24.7	31.5	6.5	37.3	4.3	13.0
United Kingdom	0.0	0.0	99.5	0.5	1.5	4.1
Unweighted average	38.0	16.8	31.6	9.1	4.8	12.7

[1] Includes individual and corporate income tax plus payroll tax.
[2] Includes general consumption taxes, taxes on goods and services (fuel taxes, hotel and motel occupancy) and taxes on use on goods or on permission to use goods or perform activities.
[3] Taxes on property including recurring taxes on net wealth.
[4] Includes social security contributions in Austria and some residual taxes mainly on business (Austria, Canada, and Germany) and miscellaneous taxes everywhere.
[5] Total includes central government, state government, local government and social security funds.

Source: OECD, *Revenue Statistics 1965-2001* (Paris: OECD, 2002), Tables 135 to 168.

4. Local governments in France, Italy, Greece, and Turkey rely fairly heavily on other local taxes (column 5), mainly on businesses.

5. Column 6 of Table 1 provides information on the relative importance of local taxes by calculating local taxes as a percent of gross domestic product (a measure of the level of national income generated in each country). In federal countries, local government taxes varied from a low of 0.1 percent of GDP in Mexico to a high of 5.0 percent in Switzerland with the unweighted average for federal countries being 2.9 percent. For unitary countries, local government's tax share of GDP ranged from a low of 0.4 percent in Greece to a high of 16 percent in Sweden and 15.9 percent in Denmark with the unweighted average for unitary countries being 4.8 percent.

6. Column 7 looks at the relative importance of local taxes in the entire tax system in each country. When local taxes are calculated as a percent of total taxes (central government, state government, local government and social security funds), they range widely in relative importance. For example, in federal countries, local taxes account for less than 1 percent of all taxes in Mexico (the lowest) and 14 percent in Switzerland (the highest) with the unweighted average being 7.5 percent. For unitary countries, the range extends from a low of 1 percent in Greece to a high of almost 33 percent in Denmark with the unweighted average being 12.7 percent.

The above points lead to a number of observations including the following.

1. Since the level of local taxation is primarily driven by expenditures, local governments in those countries (federal and unitary) where local taxes are a relatively small percentage of total taxes generally have fewer expenditure responsibilities.

2. The relative importance of local taxes in a country's tax system is generally less in federal countries than in unitary countries – federal countries have a middle (state) level of government that collects taxes, some of which are in the domain of local government in unitary countries.

3. Local property taxes play a more important revenue role (almost 50 percent of all taxes on average) in federal countries than in unitary countries (almost 32 percent of total local taxes, on average). By comparison, local income taxes, on average, are equally important in both unitary and federal countries – around 38 to 39 percent of all revenues. Local sales taxes are relatively less important in federal countries (slightly more than 9 percent) than they are in unitary countries (almost 17 percent). This difference generally exists because the state level of government collects considerable sales tax revenue in federal systems; whereas, this source of revenue is more likely to be available to local governments in unitary countries.

4. At the local government level, there is heavy reliance on income taxes in the Nordic countries whereas heavy reliance is placed on property taxes in countries that, in the past, were part of the British Commonwealth or significantly influenced by it.

5. Where local taxes are a comparatively higher percentage of total tax revenue and GDP, local governments tend to rely more heavily on local income taxes.

6. Local governments in some countries only have access to one tax (property or income) whereas local governments in other countries have access to two or three local taxes.

7. Where local taxes account for more than 10 percent of all tax revenue, there is no common pattern. Local governments in some of these countries have access to a wide range of taxes (Austria, some states in the United States, Italy, Iceland, Japan, Korea, Spain, and Turkey). In other countries where local government taxes are equally important, (Nordic countries and the Czech Republic), local governments are

restricted to only one tax of any significance.

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

Fiscal autonomy in local taxation

International experience tells us that an essential ingredient in creating a good local public sector is a responsive and responsible local government. A necessary condition for such a government is that it possesses the fiscal capacity to provide required and desired levels of public infrastructure and services.[2] In other words, local governments carrying out their expenditure responsibilities are likely to be more efficient, responsible and accountable if they are required to raise the revenue that they spend.[3] Furthermore, this is dependent on the fiscal autonomy or fiscal discretion that local governments have in determining their tax base and setting their tax rates. Fiscal autonomy, in theory, is greatest when local governments are free to determine both the tax base and tax rates without senior governments imposing limits on either of these. Fiscal autonomy is least when both the tax base and tax rate are set or controlled by senior levels of government. Of these two possibilities, permitting local governments to control their own tax base is often administratively costly and can give rise to innumerable economic inefficiencies when local government deliberately distorts its tax base to satisfy some constituency or other. A preferred option is one where local governments simply piggyback onto an existing state tax base with locally determined rates – this is administratively inexpensive and minimizes the potential for inter-municipal distortions in the tax base.

Tax sharing arrangements between different levels of government also lead to different levels of tax autonomy. Here, the degree of autonomy will depend on whether or not local government consent is required before any change can be made in the tax sharing formula.[4]

Table 2 offers a thumbnail sketch of the kinds of autonomy and its relative importance in a number of OECD countries. As with reliance on local taxes, there is considerable variation across countries. In particular, the following may be observed.

1. Local governments set both the tax base and tax rate in very few countries (column 3). Furthermore, where both are at the discretion of local governments, local taxes tend to be a very small percentage of overall taxes. For example, in New Zealand, local taxes account for less than 6 percent of all taxes and almost all of this is from the property tax where local governments have the power to control both the base and rate. Similar comments may be made for local governments in Portugal and Spain where local governments also rely heavily on property taxes.

2. Local governments in every country, except for Mexico, have some control over local tax rates. In countries such as Belgium, Switzerland, Denmark, Finland, Iceland, Japan, Netherlands, Sweden and United Kingdom, 84 percent or more of local tax revenue is obtained from local taxes where local governments have control over local tax rates. While not included in Table 2, it could also be noted that local governments

[2] Jonathan A. Rodden, Gunnar Eskeland, and Jennie Litvack, eds, (2003), *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, (Cambridge: MIT Press).

[3] Richard Bird (2001), "Subnational Revenues: Realities and Prospects", (Washington: World Bank Institute), p. 3.

[4] OECD, (1999) *Taxes Powers of State and Local Government*, OECD Tax Policy Studies No. 1, (Paris: OECD), p. 10.

in Canada, the United States and Australia have considerable control over local tax rates and in a few cases over the local tax base. At the other extreme, less than 45 percent of local tax revenue comes from local government's ability to set tax rates in Austria, the Czech Republic, Hungary, Norway, and Poland (and Mexico, as noted above).

3. In many countries, there exists a form of revenue sharing between local and state (federal), or local and central (unitary) governments for a portion of local tax revenues. In none of the countries is the revenue sharing split determined by local governments.

4. In four countries, the split set out in the revenue sharing arrangement may be changed only if local governments consent to it; for example, in Austria, this revenue sharing arrangement accounts for over 80 percent of local tax revenue; in Germany and Poland, for around 50 percent; and in Spain, for 16 percent.

5. The split in the revenue sharing arrangement is fixed in legislation in seven countries but the fixed portion is really only significant in the Czech Republic (90 percent of local tax revenues) and Mexico (74 percent of local tax revenues).

6. The central government is responsible for determining the central-local split in revenue sharing arrangements in Hungary and Norway. In the former country, this split accounts for 70 percent of local tax revenue and in the latter country, for 95 percent.

7. The central government solely determines the tax base and sets the tax rate for some local taxation in four countries but in only two of them does it amount to anything of substance. In Portugal, 37 percent of all local tax revenues come from taxes of this type and in Mexico, the comparable percentage is 26 percent.

This broad brush summary illustrates the range of local taxes and the extent to which local governments have some control over rates and base. To expand on the local tax system and fiscal autonomy in slightly more detail, the following section describes the local tax system in a few countries.

Local tax systems in more detail

The discussion here includes one country (Canada) where local governments have direct access to only one tax (property) and one country (United States) where local governments may have access to as many as three local taxes. As well, it describes some potentially interesting features of local tax systems in a few other countries. The discussion is not intended to be comprehensive (this would require a much more voluminous paper); rather, it is designed to highlight some of the nuances of local tax systems in a few countries.

Canada: Local governments are creatures of the province and as such, are permitted to use only one tax – the property tax.[5] Although free to set their general property tax rate, municipal governments face a significant number of provincial rules and regulations with respect to their tax base and rates. While some of these restrictions and constraints may be necessary to satisfy a variety of broader social and economic objectives, the point is they do restrict municipal fiscal autonomy. Examples of these restrictions and controls are described here.

In all ten provinces and the three territories, real property is the tax base. Its principal components include land, buildings and structures and in some provinces, machinery and equipment. Provincial government's legislation/regulations exempt certain properties from property taxation, however. These include colleges and universities, churches and cemeteries, public hospitals, charitable

[5] In some provinces, the provincial government also imposes a property tax.

Table 2: Local Government Taxes by Type of Tax Autonomy in Selected OECD Countries								
	Extent of Tax Autonomy							
	Local government sets			Revenue split under tax sharing arrangements				Senior govt. sets local rate and base (10)
Country (1)	tax rate and base (3)	tax rate only (4)	tax base only (5)	Set by local govt. (6)	Only changed with consent of local govt. (7)	Fixed in legislation (8)	Determined by central govt. (9)	
	Percentage distribution of local taxes							
Federal:								
Austria	9	11			81			
Belgium	13	84				2	1	
Germany	1	52			47			
Switzerland		97				3		
Unitary:								
Czech Republic	2	5	3			90		
Denmark		96				4		
Finland		89				11		
Hungary		30					70	
Iceland	8	92						
Japan		94						6
Mexico						74		26
Netherlands		100						
New Zealand	98							2
Norway		5				1	94	
Poland		45	1		54			
Portugal	49	14						37
Spain	33	51			16			
Sweden	4	96						
United Kingdom		100						

Source: OECD (1999) *Taxing Powers of State and Local Government*, (OECD: Paris), Table 1.

organizations, and so on. Under the Constitution, provincial and federal owned properties are also exempt from property taxation. For federal and provincial properties including colleges, universities and public hospitals, grants-in-lieu of taxes (based on number of students or number of beds) are paid to the municipality. As well, provincial legislation/regulations require special treatment for other types of property – agricultural land and managed forest properties receive favourable property tax treatment in every province. Favourable treatment takes the form of exemptions, lower property tax rates, or assessment on the basis of the land’s current use rather than its market value.

For all taxable properties, every province has legislation that calls for the assessment of real property at some value. In some provinces, this is called "real and true value", "current value", or "fair value". In practice, these terms refer to market value. To avoid unintended variation in provincial assessment practices and to achieve intended variation, every province has established a central assessment authority and has moved recently to more updated and frequent reassessments.

Although municipal governments are responsible for setting their general property tax rate without restriction, provincial rules and regulations control the rate structure across all properties. For example, some provinces permit municipalities to apply a single general tax rate to all classes of property; others permit the application of different rates to different property classes with lower rates assigned to residential and farm properties and higher rates to commercial and industrial properties. In one province (Prince Edward Island), property tax rates are lower for residents of the province than for non-residents of the province.

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

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

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

Also, in the U.S., local governments in thirty-one states and the District of Columbia levy general sales taxes. Across these states, a relatively low rate of 0.25 percent is imposed in a number of transit districts to subsidize public transportation. In other states, the rates may be as high as five percent with revenues not earmarked for specific expenditures.[9] In some states, such as Virginnia and California, the local sales tax is universal. In others, it is used by some municipalities and not others. Regardless of the locality there are two common features. First, virtually, all general sales taxes are ad valorem (fixed percent of selling price) rather than per unit taxes; and second, the tax is levied on retail purchasers.[10]

All municipalities impose a property tax, with two minor exceptions. These are in Oklahoma where cities use the property tax to secure bonds and not to fund services and the City of Springfield, Ohio where a local income tax is used instead of the property tax. Issues around setting local property tax rates, determining the tax base, and state restrictions on local taxation authority are similar to those described for Canada.

All local taxes in the United States are permissive taxes. As noted, the property tax is used almost everywhere. Nearly all cities impose a sales tax if given the authority, but this is not

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

7 For a discussion of local income tax structures and issues in the United States, see Robert L. Bland (1989), *A Revenue Guide for Local Government* (Washington, D.C.: International City Management Association), at 89-101.

8 Rodgers and Temple (1996), supra footnote 5, at 242-245.

9 Ibid, at 232-234.

10 Bland (1989), supra footnote 6, at 51-67.

Table 3: United States City (over 125,000 population) Personal Income Tax Rates for 1999 – (percent)			
Akron	2.0	Louisville - residents	2.2
Baltimore	2.5	- non-residents	1.45
Birmingham	1.0	Newark	1.0
Cincinnati	2.1	New York2	2.675 to 3.3575
Cleveland	2.0	Philadelphia – residents	4.79
Columbus	2.0	- non-residents	4.2082
Dayton	2.25	Pittsburgh (city)	1.0
Detroit – residents1	3.0	Pittsburgh (school district)	1.875
- non-residents	1.5	Portland, OR	1.45
Flint – residents	1.0	St. Louis	1.0
- non-residents	0.5	San Francisco	1.0 to 1.5
Grand Rapids – residents	1.3	Toledo	2.25
- non-residents	0.65	Yonkers- residents	10% surtax
Kansas city, MO	1.0	- non-residents	0.5
Lansing – residents	1.0	Youngstown	1.0
- non-residents	0.5		

1 For each tax year following July 1, 1999, the rate on residents is reduced by 0.1% until it reaches a rate of 2% after June 30, 2008.
2 For tax years after 1999, tax rates ranged from 2.65% to 3.315%; for tax years after 2000, tax rates ranged from 2.55% to 3.2%; after 2001, 1.29% to 1.61%; after 2002, 1.18% to 1.48%. Non-residents – 0.25% of wages; 0.375% of net earnings from self-employment. Unincorporated business, 4%.

Source: *State Tax Guide* (Toronto: CCH Canadian Limited, 2000)

true for the income tax. For example, all cities in Georgia and Michigan have the option to use an income tax, but only about 20 cities in Michigan have adopted it. Georgia is a different case. The state law says that a city can impose an income tax only if a majority of the registered voters (not the actual voters) approve it. With voter turnout generally less than 50 percent, approval is unlikely to be forthcoming.

Property taxes are administered and collected at either the county level (most common) or by cities. Local governments are free to set their tax rates but the tax base is essentially controlled by state policy (legislation) and practice (similar to Canada). Most sales taxes are piggybacked onto the state tax with the state collecting the revenue and remitting it to the originating municipality. Income taxes are collected by the municipality in Pennsylvania, Ohio, Kentucky, and Michigan. Yonkers and New York City's income tax is piggybacked onto the state income tax. For income and sales taxes, the state frequently regulates the tax rate or range of tax rates that can be used.

Nordic countries: The best known examples of local income taxes are in these countries (Sweden, Norway, Finland, Denmark) where it is the only local tax of any significance (Table 1). 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. The progressive part of the rate structure is the central income tax. After the local income tax is collected by the central government, these revenues are then remitted to each local jurisdiction.

Belgium: Local governments in Belgium rely almost entirely on local income taxes. Here, the local tax is not a surcharge on the central tax base (as in the Nordic countries); rather, it is a surcharge levied as a percentage of the national tax liability.

Switzerland: In most cantons (middle level of government), local governments are permitted to levy surcharges at locally established rates on cantonal income taxes, not on the income tax of the central government. Local taxes are levied on both income and assets (a tax on personal wealth and a tax on corporate net worth - net wealth tax).

Japan: Local governments rely on all three taxes but the local income tax system is rather unique. Municipal governments may tax corporations. Each year, the rate is set locally and it applies largely to national corporate taxes paid in the previous year with the tax base in each jurisdiction determined by the proportion of employees working in that jurisdiction. Corporations are also subject to a progressive municipal enterprise tax based directly on income – here, the rate varies with the category of business activity (France also has a local tax of this type).

Individuals also pay a local income tax at progressive rates on the same base as the national tax. Non-residents working in a municipality are subject to a poll tax levied at a nationally determined per capita rate that varies with the size of the municipality. Finally, all taxes are assessed and collected locally.[11]

Germany: Local government revenues in Germany come from a variety of sources. The business tax (primarily a tax on corporate profits whose base is determined by the central government with the local rate set by individual municipal governments) accounts for about 40% of local tax revenue after sharing. Personal income taxes are next in order of importance. They represent the local share of the national income and wage tax that is determined by the state and federal governments. Overall, local governments receive 15 percent of these revenues (this is stipulated in the Constitution) but the share for each municipality may vary. Revenues are distributed by state governments to local governments in originating municipalities (that is, where the taxpayer resides) up to a limit approximating 15 percent of national GDP per capita. This limits the amounts distributed to high-income communities and introduces an equalizing effect. Local property taxes also exist but are considerably less important than the business tax. In many municipalities, the property tax raises about 1/6 of the revenue generated by the business tax. Fees and charges are another important source of local funds, generally accounting for considerably more revenue than the property tax.[12]

FINANCING MODEL FOR LOCAL GOVERNMENT

A major observation from the international experience cited above is that there is no consistent or uniform approach to local government taxation. Some countries have only one tax at the local level; others have two taxes, and still others have three taxes. What is known from this experience, however, is that the more revenues that local governments are required to raise on their own (from taxes, user fees, charges, and so on), the more responsible, efficient and accountable they will be in managing their operations.

Such variation in the use of local government taxes raises the question of whether or not there is a theory of local government finance that can be used to answer two important questions. First, what is the appropriate role for local taxes vis-à-vis other own source revenues including user fees, permits and special charges in funding local services? Second, of all taxes that are available, is there one that is more desirable or appropriate than others in funding local services or should there be a mix of taxes?

[11] Bird (2001), supra note 2, at 18-19.

[12] Harry Kitchen, (2002), “Municipalities: Status and Responsibilities, Budgeting and Accounting”, a paper prepared for CEPRA I Project, at 15-16.

What is the role for local taxes?

To answer the first question, let us turn to the constitutional place of local governments in most countries, especially in federal jurisdictions.[13] Local governments are generally ‘creatures of the state’. Because of this, it is appropriate to examine their fiscal roles and responsibilities within the principal-agent model[14] of state-local fiscal arrangements. In this model, local governments are the agents while the state is the principal. The latter has the power to alter jurisdictional boundaries, to change revenue and expenditure responsibilities of the agent, and to change intergovernmental fiscal arrangements to overcome differing objectives between the principal and the agent. Within this context, the role of the agent is to provide and fund services that benefit local constituents; hence, financing of each service is best addressed on the basis of benefits received from local services.

In principle

The underlying principle of the benefits received model of local finance is straight-forward: those who benefit from local public services should pay for them. *Economic (allocative) efficiency*[15] is achieved when the user fee or tax per unit of output equals the extra cost of the last unit consumed. This is the well-known marginal cost pricing principle. The price or fee, by definition, indicates what consumers are willing to pay for this good and marginal cost, by definition, measures the cost of resources used up in producing that unit. Perhaps this could be illustrated by reference to a simple example. Suppose the extra (marginal) cost of producing the last litre of water is 10 cents and customers are willing to pay 15 cents for it. This is not an efficient level of output because the value that customers place on this litre is greater than the cost of producing it. In other words society is the beneficiary of a net gain of 5 cents for this unit. Collectively, society would be better off if water consumption increased as long as the price paid for each additional unit exceeded the cost of producing that unit; that is, for each of these units, marginal benefit would exceed marginal cost - a net gain. If, on the other hand, the marginal cost of producing the last litre is 10 cents and customers are only willing to pay 5 cents for it, this is not an efficient level of output either. The benefit that customers get from this unit is less than the cost of the resources used up in producing it and society is worse off – worse off by 5 cents for this unit. As long as the extra cost of producing the unit is less than its price, society is devoting too many resources to its production. It follows, then, that resource efficiency is achieved where marginal cost equals price because this is the point where society secures the greatest net gain from the consumption of this service.

The preceding paragraph makes it clear that the main economic reason for imposing correctly designed fees or taxes on recipients (individuals or businesses) of local government services is to provide local government with incentives for using its resources in the most efficient manner possible. The goal of maximizing efficiency in a local government’s provision of services is not an objective dreamed up by some economist. It is simply common sense. Surely any society should

13 Harry Kitchen (2001), “Models of Decision-Making and Collaboration (for Local Government) in Federal Systems”, Mimeograph.

14 For a discussion in the provincial-municipal context, see Richard M. Bird and Duan-jie Chen (1998), “Federal Finance and Fiscal Federalism: The Two Worlds of Canadian Public Finance”, *Canadian Public Administration,* 1 (Spring): 50-74.

15 Economic efficiency is more than technical efficiency- the latter is a necessary but not sufficient condition for economic efficiency. Technical efficiency exists when a producing unit (firm, government, commission) operates in a way such that it is not possible to secure any additional output given the available inputs (labour, material and capital) and level of technology. In other words, technical efficiency is achieved when the output per unit of input is maximized or the cost per unit of output is minimized. This, it should be noted, is not concerned with whether one good or service generates more or fewer net benefits than another good or service. It simply concentrates on the efficient employment of inputs in the production of a specific good or service. Finally, as the level of technology advances, a technically efficient production process leads to increased output with the same inputs.

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

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

Accountability is enhanced when the design of a tax, user fee or expenditure is clear to taxpayers. Furthermore, the closer the link between the beneficiaries of a government service and payment for that service, the greater is the degree of accountability. When taxes and user fees are directly matched to beneficiaries, the latter can determine whether the benefit from the last unit consumed is worth the price or tax paid for its consumption. They are then in a position to apply pressure on politicians to improve the efficiency with which services are provided.

Transparency is an extension of the accountability argument. Transparency is enhanced when citizens/taxpayers have access to information and decision-making forums so that the general public is familiar with the way in which local tax bases are determined and local tax rates set. Emphasis on transparency is intended to mitigate the risk of corruption by making information available.[18]

16 For a more detailed discussion of this, see Richard M. Bird (2001), "User Charges in Local Government Finance", in *The Challenge of Urban Government: Policies and Practices*, edited by Mila Freire and Richard Stren (Washington, D.C.: The World Bank), 171-182; and Richard M. Bird and Thomas Tsiopoulos, (1997) "User Charges for Public Services: Potential and Problems" *Canadian Tax Journal*, Vol. 45, Number 1, p. 35-37.

17 Bird and Tsiopoulos, (1997), supra footnote 15.

18 This corresponds to the "Code of Good Practices on Fiscal Transparency" (March 23, 2001), (Washington, D.C.: International Monetary Fund).

Fairness within the benefits model is achieved because those who consume public services pay for them, just as someone who benefits from a private good pays for it. Concerns about the tax burden on low-income individuals should be addressed through income transfers from state or central governments and social assistance programs targeted to individuals in need. It is far more equitable and efficient to handle income distribution issues through income transfers or targeting[19] than to tamper with charging or taxing mechanisms to accommodate these concerns.

Finally, the *easiest local tax system to administer* is one that is not confusing for taxpayers to understand and does not require an unnecessary amount of time, effort and money in administering it.

In practice

Application of the benefits based model to the municipal sector steers us in certain directions. At the outset, it should be noted that local governments in developed countries supply a range of services – from those that exhibit mainly private goods characteristics (water, sewers, solid waste collection and disposal, public transit, public recreation and so) to those that exhibit mainly public goods characteristics[20] (local streets and roads, street lighting, fire and police protection, neighbourhod parks, etc.).

For services with mainly private good characteristics, individual beneficiaries can be identified, income redistribution is not a goal, spillovers are unlikely to exist, and operating and capital costs can be measured and recorded. Here, a user fee would be relatively easy to administer and would be the best financing instrument for satisfying the principles of

19. For a discussion of these programs, see Robin Boadway and Harry Kitchen (1999), *Canadian Tax Policy*, third edition (Toronto: Canadian Tax Foundation), chapters 8 and 9.

20 For a discussion of 'public' versus 'private' goods, see Harvey S. Rosen, Paul Boothe, Bev Dahlby and Roger S. Smith (1999), *Public Finance in Canada*, (McGraw-Hill Ryerson), chapter 7.

efficiency, accountability, transparency, and fairness.

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

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

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

In summary, within this benefits based model of local finance, there is a very clear role for local taxes, just as there is a role for user fees and grants from senior levels of government.

Which local tax or taxes?

The role for local taxes is to fund those services whose collective benefits are enjoyed by the residents of the local community. The question, then, is 'which tax' or 'which taxes'?

The strongest economic and fiscal arguments for assigning a tax or taxes to local governments come from the literature on fiscal federalism where there is wide spread agreement on general principles that should be followed. In short, this theory prescribes a limited tax base for local governments.[23] The best taxes are those that are based on an immobile tax base and therefore, borne primarily by local residents (not exported); that do not create problems with harmonization or harmful competition between local governments or local governments and more senior levels of government; and are easy to administer locally.[24]

Here, there is a strong defense for using property taxes.[25] First, the tax base is largely

[21] Under this view, user fees or charges are retained for funding those services whose costs and benefits can be assigned to specific properties or individuals (water and sewers, and a portion of transit and recreation, for example). For an excellent discussion of the benefit model of local finance, see Richard M. Bird, "Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization" (1993), vol. XLVI, no. 2, *National Tax Journal*, 207-227.

[22] Robin W. Boadway and Paul A.R. Hobson (1993), *Intergovernmental Fiscal Relations in Canada* (Toronto: Canadian Tax Foundation), chapter 3.

[23] Charles, E. McClure Jr. (2001), "The Tax Assignment Problem: Ruminations on How Theory and Practice Depend on History." *National Tax Journal*, Vol. LIV, No. 2, 339-363.

[24] Bird (2001), supra footnote 2; Richard Bird (1999), "Rethinking Tax Assignment: The Need for Better Subnational Taxes", draft paper, Fiscal Affairs Department, (Washington: International Monetary Fund); Wallace E. Oates (1998), "Federalism and Government Finance", in Wallace E. Oates (ed.), *The Economics of Fiscal Federalism and Local Finance* (Cheltenham, UK: An Elgar Reference Collection).

[25] A discussion in support of property tax funding for local public services that provide benefits of a collective nature to the local community is found in John Bossons, Harry Kitchen, and Enid Slack (1993), "Local Government Finance: Principles and Issues", an unpublished paper for the Ontario Fair Tax Commission, Toronto; Almos Tassonyi (1993), "The Benefits Rationale and the Services Provided by Local Governments", an unpublished paper for the Ontario Fair Tax Commission, Toronto; Paul A.R. Hobson (1997), "Efficiency,

immobile and therefore, relatively efficient because distortions in economic behaviour are minimized.[26] Second, it is effective in funding, partially at least, those services whose collective benefits accrue to the local community; hence, it satisfies the benefits received criteria. Third, given that no single tax or two taxes are deemed to be entirely fair and distortion free, there is considerable merit in a state or national tax system that employs a mix of taxes including a local property tax.

The property tax that is most frequently defended, because it is used in this way in most developed countries, is one that is based on market values. But this need not be the case. It is just as defensible to support a local property tax that is based on unit-value or area assessment. Here, the tax base consists of a combination of building area and lot area. For each property, assessed value is the sum of lot area times an assessment rate per square metre plus the building area times an assessment rate per square metre of building area.[27]

Unit value has been used in Israel and in Rotterdam. It is also used in some economies in transition[28] (Poland and Ukraine, for example) where the absence of developed property or real estate markets makes it difficult to determine market value.[29] Similarly, it may make sense to use it in isolated hamlets or communities where there is no clearly functional market for property values because the government owns most of the housing and rents it to occupants.[30]

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

First, it is more progressive than the property tax in its distributional impact on local taxpayers. Second, its use would permit local governments to cast a wider net in capturing revenues from those who benefit from municipal services - residents, commuters and visitors. As noted above, a key tenet of the benefits model of local government finance is that those who enjoy the benefits of local services should pay for them. Recent U.S. evidence suggests that the cost of inner city services used by people who live in the suburbs and commute to work (in the city centre) exceeds, sometimes substantially, the taxes they pay for inner city services.[31] For these services, an income tax and even a sales taxes could be more effective at linking the costs and benefits of services than the property tax. Third, it is more revenue elastic than the property tax – a useful

Equity and Accountability Issues in Local Taxation" in *Urban Governance and Finance: A Question of Who does What*, edited by Paul A.R. Hobson and France St-Hilaire (Montreal: The Institute for Research on Public Policy), 113-131 at 117-118; and see Harry M. Kitchen (2002), *Municipal Revenue and Expenditure Issues in Canada* (Toronto: Canadian Tax Foundation), chapters 3 to 5.

26 McClure (2001), supra footnote 22.

27 Harry Kitchen (August 1989), "Alternative Methods of Taxation and Assessment", a report prepared for the Task Force on Reassessment in Metropolitan Toronto (mimeograph, Toronto), part VII.

28 Jane Malme and Joan Youngman (2001), *The Development of Property Taxation in Economies in Transition*, (Lincoln Institute of Land Policy).

29 Estonia, Poland, Czech Republic, Slovakia, Russia, and Armenia, for example. See Joan Youngman and Jane Malme (2000), *An International Survey of Taxes on Land and Buildings* (Netherlands: Kluwer Law and Taxation Publishers), p. 18.

30 Harry Kitchen and Enid Slack (Dec. 18, 2001), “Providing Public Services in Remote Areas”, a paper prepared for the World Bank Institute, Washington, D.C., p. 9.

31 Howard Chernick and Olesya Tkacheva (August 5, 2002), “The Commuter Tax and the Fiscal Cost of Commuters in New York City” *State Tax Notes*, Vol. 25, No. 6, August 5, 2002, at 451-456; and Howard Chernick, “The Effect of Commuters on the Fiscal Costs of the District of Columbia” (December 2002), mimeograph, 36 pages.

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

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

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

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

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

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

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

Are there other theories of local taxation?

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

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

Issues in Local Taxation

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

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

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

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

What public services should local taxes fund?

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

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

[34] Ibid.

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

Redistribution of Income: In general, the central or state level of government should pay for programs whose primary purpose is the redistribution of income.[35] The reasons for this are twofold: first, the more senior levels of government have access to a broader mix of taxes, some of which are more closely related to ability to pay: the income tax, for example. Second, specific income redistribution programs are more effective if administered across larger geographical areas, where there is a greater opportunity to redistribute income from rich to poor. This does not, however, suggest that these services need to be delivered by federal or provincial governments. Their delivery might be more appropriate if handled locally where administrators are familiar with local circumstances and in a better position to accommodate specific circumstances. Also, local delivery might be preferred if it generates cost savings although a potential downside of this may be a loss in accountability that often surfaces when one level of government spends the money that is raised by another level of government.

Local Preferences: For those services where spillovers are not prevalent and income redistribution is not an objective, a strong case

[35] While some elements of income distribution are inherent in most public services, income distribution services here include welfare payments, children's aid, social housing and income transfer, to name the most obvious.

exists for local responsibility (sometimes, referred to as satisfying the subsidiarity principle). A major advantage of this is that local preferences can be reflected in service levels and quality – an important consideration in securing efficient and accountable local government. In addition, if each municipality is responsible for a given service, a competitive environment will arise, in the sense that neighbouring municipalities will be able to benchmark the cost of providing the service with each other; the result will be stronger incentives for efficient and effective service provision. The same argument may be made for permitting neighbourhoods within municipalities to have different service levels; that is why some large cities have a number of separate tax areas where different levels of taxation fund different levels of service.[36]

Other considerations: In addition to spillovers and redistribution, some observers cite the supposed advantages of uniform state-wide or country-wide standards and economies of scale as reasons for assigning the responsibility for particular services to senior governments rather than local governments. Senior government responsibility is required, the argument goes, to achieve a minimum uniform standard across the state or country. State or central government responsibility is also appropriate if state-wide or country-wide service delivery results in economies of scale.

Neither of these arguments for assigning expenditure responsibility and hence, funding these services from locally generated revenues is accepted here. State or provincial governments in most countries already set standards for many locally provided and locally funded services including safety standards for building codes, police and fire protection; planning and zoning regulations; environmental controls and requirements for water supply, sewage treatment and solid waste; quality standards for roads; and so on. If uniformity in service standards were a criterion, the preponderance of state standards or regulations suggest that it should be responsible for almost all services currently provided by local government. As long as there is a local government, this should not happen.

Economies of scale is likewise dismissed as a criterion, primarily because it is generally associated with service production and delivery and not decision-making and funding responsibility. Distinguishing between decision-making and funding from actual production and delivery is important. The latter may be handled in a number of ways – by the governing unit itself, by contracting out to the private sector, or by buying from another governing unit. Decision-making and funding responsibility is different. It must be left with the local government which, in turn, must have the appropriate funding tools for financing local decisions.

Although these principles are easily described, the actual task of assigning policy setting responsibility and funding to either the state or municipality on the basis of these criteria is not as clear-cut as it may appear. Some individuals might perceive significant spillovers in certain services while others do not. Some might view some services as being entirely driven by local preferences while others might not. The allocation of service responsibility to a particular level of government, then, partially reflects the views of the individual(s) determining the allocation. In spite of the difficulties in assigning unequivocal responsibility for services such as land ambulance, police, public transit, to name three, there are many on which most analysts, policy makers, municipal officials and local citizens could likely agree. In particular, these include state or provincial responsibility for all income redistributional services such as social services, care for the aged and day nurseries, and social housing. As well, there is general agreement that the local sector should be responsible for local streets and roads, water, sewer and solid waste, public parks and recreation, sidewalks and street lighting, fire protection and so on. In general, application of these principles in assigning service responsibility generally results in a

[36] The City of Halifax in Nova Scotia, Canada has over 60 sub areas where tax differentials fund similar services of differing levels - see the *Annual Budget* of the City of Halifax.

provincial/municipal allocation of major services that is similar to that in Table 4. Given that local governments ought to be responsible for services that benefit local residents either directly or collectively, it follows that they ought to have access to revenue sources permitting them to cover costs. Some of these revenue issues are discussed next.

Is one tax preferred over other taxes?

The information in Table 1 illustrated the different taxes on which local governments rely to finance local government services in a number of countries. Clearly, as discussed above, there is no obvious tax that stands out as the best or ideal tax in every instance. The property tax has often been defended as the best local tax because its base is immobile; the residential portion cannot be exported; it permits local governments to tax those residents who benefit collectively from local services;[37] and its high visibility helps to ensure that local governments work in an accountable, transparent, and efficient manner. Critics of the property tax have argued that it is difficult to administer,[38] especially if the tax base is property value and a proper functioning real estate market does not exist.[39] As well, it is a poor tax when it comes to taxing commuters and visitors, and it is not revenue elastic. In some countries where property taxes have been the backbone of local finance, there is increasing concern as to whether or not it can continue as the only major tax available to local governments if the latter are to be fiscally sustainable.

Local income and sales taxes are also used in a number of countries. While neither of these adhere to the benefits based model of local taxation as closely as the property tax, they may be designed to capture benefits in a more round about way and both can be useful components of a local tax system – either alone or as a supplement to the property tax. If sales or income taxes fall on local residents, their incidence may be more progressive than the property tax (injecting some elements of ability to pay into the local tax system). In addition, their use would permit local governments to collect revenue from commuters and visitors. They are more revenue elastic than the property tax and will almost certainly be easier to administer if they are piggybacked onto the state tax with tax rates set locally. A major problem with these taxes is that they may be exported which has the potential to reduce local accountability and lead to inefficiencies in the allocation of local resources.

In summary, there is no single local tax that is unequivocally preferred over other taxes. Where the local public sector is well developed and plays an important role in financing a number of expenditure responsibilities, there are solid arguments for giving local government access to a range of taxes. Where the local public sector is less well developed and expenditure responsibilities minimal, access to one local tax may be sufficient. In deciding which tax or taxes are appropriate for local governments, a number of factors come into play, not the least of which is the local government's ability or capacity to administer local taxes, the kinds of public services funded by local taxes, and the tax culture of a country (are taxpayers inclined to support taxes on the basis of benefits received or are they more inclined to support taxes based on ability to pay).

Who should set local tax rates?

International experience tells us that local governments are more responsible, efficient and accountable if they are required to fund their expenditures from locally generated revenues. This includes setting local tax rates. Additional autonomy could also be achieved if local governments were free to establish and determine their local tax base, however, high administrative costs of doing so generally argue against it. For income and consumption based taxes, it is far less expensive to piggyback onto an existing state

[37] User charges should be used for those services that benefit to specific individuals.

[38] See the property tax paper by Harry kitchen in this series of papers.

[39] One way around this would be to ignore market value and to tax the square metre of land and buildings. One could even have a different tax per metre for buildings and for land.

Table 4: State versus Local Government Responsibility for Policy Setting and Funding of Major Public Services

Major Service	Municipal	State
Municipal government administration	XX	---
Protection:		
Police	XX	---
Fire	XX	---
Emergency planning	XX	---
Roads:		
Provincial highways	---	XX
Local roads	XX	---
Sidewalks	XX	---
Street lights	XX	---
Parking	XX	---
Public Transit	XX	---
Health:		
Hospital care	---	XX
Preventive care or public health	XX	XX
Ambulance service	---	XX
Social Services:		
Welfare assistance	---	XX
Day care services	---	XX
Children's assistance	---	XX
Homes for the aged	---	XX
Social housing	---	XX
Education:		
Elementary and secondary	---	XX
Post secondary education	---	XX
Environment:		
Water supply and distribution	XX	---
Sewage collection and treatment	XX	---
Solid waste management	XX	---
Recreation and Culture		
Community parks and recreation programs	XX	---
Local libraries	XX	---
Community centres, theatres and auditoriums	XX	---
Convention facilities	XX	---
Planning and Development:		
Local planning, zoning, severances and approvals	XX	---
Local economic development	XX	---

Note: Allocation of responsibilities as generally supported by reference to a set of principles discussed in this paper.

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

For single tier local governments, local tax rates should be set by the governing council of the jurisdiction responsible for spending the money. For two-tier local governments where the lower tier is responsible for a range of services and the upper tier (that encompasses a number of lower tiers) is responsible for services that spill over the lower tier boundaries,[40] the lower tier should set its own tax rates and the upper tier should set its tax rates. This practice follows the principle that those who spend the money should be responsible for raising it.

The practice of having each tier of local government in a two-tier structure set its own property tax rate on the same property tax base is common in Canada. In some U.S. states, the application of a local sales tax or income tax to the same tax base as used by the state is common practice. These examples suggest that it is not uncommon for different levels of government to impose different tax rates on the same tax base. Nor does it follow that the level of government that sets the tax rate need collect the tax revenue. Returning to the Canadian experience, let us consider the province of Ontario. Here, all regional and county governments (upper tier) set their own taxes independently of the tax rates set by the local municipalities (lower tier). The local municipalities then send out combined tax bills and collect both upper and lower tier taxes. This practice has been around for years and has been fiercely defended in the presence of a number of proposals to migrate billing and collection to the upper tier where cost savings could be achieved because of distinct economies of scale that are present in this operation.[41] Billing and collection is an administrative function and has nothing to do with policy setting or decision-making; hence, there is no reason why billing and collection needs to rest with the taxing jurisdiction that sets the tax rate.

Should local tax rates be uniform or differentiated across a municipality?

Given that local governments should be responsible for setting their own tax rates, there is the question of whether or not these rates should be uniform throughout the entire jurisdiction or whether they should be differentiated across property types and geographical areas within the jurisdiction. Whether a tax should be differentiated or not may also depend on the type of tax or the way it is administered.

Under benefits based taxation, individuals and businesses that benefit from local public services should pay for them. Where these benefits vary by individual, by property type, or by area of the municipality, a case exists for charging differential taxes to the extent that it is possible.

For a local tax, such as the property tax, differential tax rates are justified on a number of grounds.[42] First, they are fair on the basis of benefits received as long as the tax rate is set to capture the cost of municipal services used up by different property types or property location. Second, they are efficient if they reflect differences in the cost (production, environmental and social) of delivering services to different property types. In other words, if some properties or property types are more expensive to service, a case can be made for differential property tax rates. Failure to correlate benefits from local government services, as they are reflected in effective property tax rates, with the extra cost of services consumed (or an approximation of it) leads to a redistribution of income that is not neutral. If the effective tax rate exceeds the extra cost of delivering the service, incentives exist for people or businesses to relocate to lower taxed areas unless they are willing to accept lower property values. Third, variable tax rates have a further advantage in that

[40] See Enid Slack's paper in this series of papers.

[41] W. Douglas Armstrong and Harry Kitchen (May, 1997), *Peterborough County/City Municipal Review: Final Report*, (Peterborough: Joint Restructuring Steering committee), pp. 125-127.

[42] Enid Slack (2002), "Property Tax Reform in Ontario: What Have We Learned?" *Canadian Tax Journal*, Vol. 50, No. 2, 576-585.

they could be used to distort decisions deliberately to achieve certain municipal land use objectives. For example, if higher tax rates slow development and lower tax rates speed up development, a deliberate policy to develop certain neighbourhoods instead of others might be achieved through different tax rates for different locations.

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

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

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

Should local tax rates be regulated?

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

If, however, local governments share the tax base with a senior level of government, yet have the power to set their own rates (which they should, as was argued earlier), there may be a case for regulation if the rate setting action of local government creates spillover or externality problems for senior governments. For example, if state or central and local governments have access to the same income tax or sales tax system and if the senior level of government lowers tax rates to achieve important state or national goals (to foster economic growth or to enhance competitiveness, for example), they may wish to regulate what local governments do to prevent the latter from increasing its tax rates to take up the vacated tax room. While regulation here would be justified, significant funding problems may still exist for local governments that need tax revenue to meet expenditure needs.

A further externality argument for regulation arises in instances where local governments tax businesses. If the local tax on business is set to

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

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

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

Should local government tax business?

Depending on the country, local government taxation of businesses may include a property tax on commercial and industrial properties, a tax on capital, a corporate income tax and a range of other industry and commerce taxes.[45] The strongest economic argument for local taxation of commercial and industrial properties is to tax them in order to recover the cost of local public services that they use. Where specific beneficiaries of these services can be identified, user charges are preferred. Where user charges are not possible because specific beneficiaries cannot be identified, some type of general tax levy may be appropriate. Under the benefits based model of local taxation, this approach fits with the model of a good local tax – immobile base and limited opportunity for exporting the tax to other jurisdictions.

Local government taxation of non-residential property is almost never efficient or fair. For example, in countries with a fully developed property tax system, higher taxes - either through assessment differentials or differential tax rates - are almost always imposed on non-residential properties when compared with residential properties. This practice is inefficient because property taxes from non-residential properties are used to subsidize services consumed by the residential sector. Since service levels in any municipality are driven primarily by the demands of the residential sector (they vote), their subsidization means that the residential tax rate will be less than it would be in the absence of the subsidy and an oversupply of municipal services could follow. Equity is not achieved either if those benefiting from the services are not paying full costs.

This heavy taxation of the non-residential sector has been addressed in two Canadian studies that compared the property tax paid by non-residential properties with the cost of municipal services consumed by these properties. Both studies[46] found that the residential sector when compared with the non-residential sector is the recipient of proportionately more benefits from local government services (social services, elementary and secondary education, libraries, recreational facilities, etc.). When combined with higher effective property tax rates paid by the non-residential sector, the studies concluded that the latter is over-taxed and the residential sector under-taxed. Beginning in 1995, this prompted the local council in the City of Vancouver to shift, over the ensuing five years, some of its tax burden from the commercial and industrial sector onto the residential sector. More recently, the provincial government in Ontario announced that tax increases beyond the range of fairness[47] (established as a standard that is defined by taking the ratio of commercial/industrial taxes to single dwelling residential property taxes) must

[44] Richard M. Bird and Thomas A. Wilson, (June 2003), "A Tax Strategy for Ontario", a paper prepared for the Panel on the Role of Government in Ontario.

[45] Giancarlo Pola, ed. (1991), Local Business Taxation: An International Overview (Milano: Vita e Pensiero)

[46] Harry M. Kitchen and Enid Slack (1993), *Business Property Taxation*, Government and Competitiveness Project Discussion Paper no. 93-24 (Kingston, Ont.: Queen's University, School of Policy Studies, 1993); and KPMG, "Study of Consumption of Tax Supported City Services", a report for the City of Vancouver, mimeograph, 1995.

[47] For a discussion of this, see Kitchen (2002), supra footnote 24, at 108-109.

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

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

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

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

[48] William H. Oakland and William A. Testa, "Community Development-Fiscal Interactions: Theory and Evidence from the Chicago Area", Working Paper Series No. 16 (Chicago, IL: Research Department: Federal Reserve Bank of Chicago.

[49] *Report of the Technical Committee on Business Taxation* (April 1998), (Ottawa: Department of Finance) at chapter 2.

While it is uniformly accepted that the cost of doing business is an important factor in location decisions, there is less consensus on the role played by property taxes in this decision. The evidence, most of which is drawn from the U.S., suggests that property tax differentials are relatively unimportant in inter-municipal or inter-regional location decisions but do play an important role in intra-municipal or intra-regional location decisions.[50] In other words, property tax differentials are unlikely to affect a firm's decision to locate in a specific city-region, but once it has decided to go there, property taxes may play a role in where it locates within that region. To this extent, higher effective tax rates on commercial and industrial properties in one municipality within a region or area when compared with neighbouring municipalities create an incentive for firms and businesses to locate in the lower taxed municipalities. In the extreme, one might expect these property tax differentials to produce a heavy (why not all) concentration of all firms and businesses in the lower taxed jurisdictions. In other words, intramunicipal tax competition[51] could be potentially destructive if it led to a race to have the lowest tax rates. A recent study on municipalities in British Columbia examined this issue and concluded that while there is some evidence that municipalities react to tax increases of their neighbours, there is no widespread destructive competition for capital.[52] Similar studies in the U.S., however, have concluded that property tax competition among neighbouring municipalities is much more prevalent and wide spread.[53]

[50] Kitchen and Slack (1993), supra footnote 45. Similar comments were made by officials of the Greater Toronto Marketing Agency in December of 2000.

[51] Tax competition is addressed in a paper by Francois Vaillaincourt in this series of papers.

[52] Craig Brett and Joris Pinkse (2000), "The determinants of municipal tax rates in British Columbia", *Canadian Journal of Economics*, vol. 33, no. 3, 695-714.

[53] Jan K. Brueckner and Luz A. Saavedra (2001), "Do Local Governments Engage in Strategic Property-Tax Competition?" *National Tax Journal*, Vol. LIV, No. 2, 203-229.

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

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

There is at least one more positive effect that could arise from shifting the tax burden away from the non-residential sector.[55] Reducing the property tax burden on this sector would reduce the potential for exporting[56] the tax to non-residents, thus leading to an improved allocation of resources and an increase in local accountability. Tax exporting refers to situations in which some portion of the burden of a tax is borne by non-residents either through changes in relative commodity prices or in a change in the net return to foreign owned factors of production (inputs in the production process). For example, if higher effective tax rates on commercial and industrial properties lead to relatively higher prices charged on the sale of that community's exports (to other communities), the taxing jurisdiction will have effectively shifted part of its tax burden onto residents of other communities. If the non-residential tax in every jurisdiction is exported to some extent, those jurisdictions exporting relatively more of the non-residential property tax will be better off than those jurisdictions exporting relatively less. In particular, if the burden of this tax is shifted from residents of high income jurisdictions to those of low income jurisdictions, the distribution of income among jurisdictions is worsened. Furthermore, this may run counter to state equalization schemes that are aimed at redistributing resources (income) from relatively high income jurisdictions to relatively low income jurisdictions.

The limited evidence on tax exportation in Canada covers a sample of the larger municipalities in the province of Ontario.[57] The results suggest that the degree of exportation ranged from a low of 16% of the non-residential tax burden to a high of 106%. More than this, relatively rich municipalities had relatively high exporting rates whereas relatively poor municipalities had relatively low tax exporting rates. Here, the practice of exporting the property tax results in an implicit transfer from relatively low income municipalities to relatively high income municipalities.

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

55 Sylvester Damus, Paul Hobson and Wayne Thirsk (1987), *The Welfare Effects of the Property Tax in an Open Economy*, Discussion Paper No. 320 (Ottawa: Economic Council of Canada); and Shantayanan Devarajan, Don Fullerton, and Richard A. Musgrave (April 1980), "Estimating the Distribution of Tax burdens: A Comparison of Different Approaches," 13 *Journal of Public Economics*, 155-82.

56 Of course, the ability of a firm to export will depend on the elasticity of demand for the exported product.

57 For elaboration on this, see Wayne R. Thirsk, (1982) "Political Sensitivity Versus Economic Sensibility: A Tale of Two Property Taxes," in Wayne R. Thirsk and John Whalley, eds., *Tax Policy Options in the 1980s* Canadian Tax Paper no. 66 (Toronto: Canadian Tax Foundation) 384-40.

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

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

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

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

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

What are the conditions for local government fiscal sustainability?

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

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

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

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

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

2. The capacity of the local revenue base and local taxes to keep pace with expenditure responsibilities – is there enough revenue elasticity in the local tax base to permit revenues to rise and fall with expenditure requirements?

3. The ability of local governments to control their own destiny – do local governments have sufficient control over their expenditure responsibilities and revenue sources to meet changing fiscal circumstances?

The extent to which local governments and cities, in particular, meet these conditions varies. In general, one can state that local governments should only be responsible for funding those services that benefit residents of their local jurisdiction. All income redistributional services, services that generate spillovers and those in which there is a state or national interest should be funded by more senior levels of government. As well, local governments should have access to revenue sources that are elastic enough to provide them with the necessary revenues, without imposing undue tax burdens, to meet their local expenditure commitments. Finally, they should have the power and freedom to meet the demands of their constituents without unnecessary tax restrictions and regulations.

SUMMARY

There are no definitive conclusions that can be drawn about patterns of local taxation across countries nor can anything be concluded about the appropriateness of one local tax over another. Local governments in some countries rely on property taxes; in other countries, they rely on income taxes; and in still other countries, they rely on a mix of local taxes – property, sales and income. Reliance on a specific tax or taxes is dependent on a number of things including the traditional or historical pattern of taxation in that country; the local government's capacity to administer its own taxes; the types of expenditures that local government must fund; the willingness of state or central governments to assign taxes to local government; the constitutional and legislative requirements within which local governments operate; and a variety of other factors.

What we do know from international experience is that local governments carrying out their expenditure responsibilities are likely to be more efficient, responsible, accountable and transparent if they are required to raise the revenue that they spend. As well, these criteria are more likely to be met if local governments have the fiscal autonomy to determine both their tax base and tax rates without limits on revenue collected, tax base and tax rate. Fiscal autonomy is least when both the tax base and tax rate are set or controlled by senior levels of government. Tax sharing arrangements between local and sate government also lead to different levels of tax autonomy. Here, the degree of autonomy will depend on whether or not local government consent is required before any change can be made in the tax sharing formula.

Based on the countries surveyed, most local governments have some, if not considerable, autonomy in setting local tax rates and almost no control over their tax base. Where local tax sharing arrangements are in place, the tax split between state and local governments is generally fixed in legislation or determined by the senior level of government. Only in a handful of countries does the local sector have any say in the tax split in the revenue sharing formula.

Given that there is no single, consistent or uniform tax used by local governments around the world, the question that emerges is whether there is a theory of local government taxation that can be used to answer two important questions. First, what is the appropriate role for local taxes? Second, of all taxes that are available, is there one that is more desirable or appropriate than others in funding local services or should a mix of taxes be used?

The first question is probably best addressed by reference to the principal-agent model of state-local fiscal relations. Here the state is the principal and local government the agent. Within this model, local taxes fund local services that provide collective benefits to the local community. Local taxes are not used for services that are income redistributional in nature, that generate spillovers affecting neighbouring communities, and that are designed to satisfy state or national goals or objectives.

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

Other taxes have also been defended at the local level, even though they are generally less effective at satisfying the criteria for a good local tax. These include an income tax on individuals, some type of consumption based tax that could include a general sales tax, a hotel and motel occupancy tax, and an automobile fuel tax. The only one currently used alone in place of the property tax is a local income tax. Support for it is generally based on the following arguments. It is more progressive than the property tax in its distributional impact on local taxpayers. Its use permits local governments to cast a wider net in capturing revenues from those who benefit from municipal services - residents, commuters and visitors. It is more revenue elastic than the property tax.

There are also arguments in support of a mix of local taxes, especially for large cities and city-regions. Here, reliance on a single tax like the property tax is almost certain to create local distortions, some of which could be offset by other taxes. Additional tax sources would make the overall local tax structure more flexible, thus permitting local governments to choose taxes that fit local conditions and circumstances. Additional tax sources would increase the revenue elasticity of the local tax base and allow it to adapt more easily to rising costs and service demands.

Over the past decade or so, local governments, virtually everywhere, have faced a similar pattern – declining grants from senior governments, devolution of additional funding responsibilities, and a limited tax base that may not be sufficient to meet future fiscal challenges and objectives. This, in turn, has raised a number of issues around local taxes. In particular, there is ongoing debate over local tax funding of public services – what should local government be expected to fund from their limited tax base? Is one tax preferred over another? Who should set local tax rates? Should these rates be uniform or differentiated across a taxing jurisdiction? Should local tax rates be regulated? Should local government tax businesses? Are local taxes currently sufficient to ensure local fiscal sustainability?

While answers to the above questions are long and, at times, convoluted, there is a general consensus that local taxes should only fund those services that benefit the local community; that there is no single tax that is ideal or preferred everywhere – indeed, a mix of taxes may be desirable; that the governing unit that spends tax dollars should be responsible for raising it including setting local tax rates; that differential tax rates should be used to capture differences in the cost of delivering local services; that local tax rates, in general, should not be regulated; that local governments should not overtax businesses as they do in virtually every country; and that senior governments must ensure that local governments have the funding tools to ensure fiscal sustainability.