

A New Look at Local Business Taxes

by *Richard M. Bird*

Richard M. Bird, International Tax Program, Rotman School of Management, University of Toronto, and PetroCanada Scholar, C.D. Howe Institute. The author is grateful to Francois Vaillancourt for helpful comments on an earlier draft and to the Canadian International Development Agency (CIDA) and the World Bank Institute for sponsoring the work underlying this paper.

Cynics have sometimes said that economists cannot agree about anything. An important issue, on which many economists do agree, however, is that, although it is obviously convenient to collect revenues through taxing businesses, there is little justification for taxing them. In the end, all taxes affect people in economic terms. There is little to gain, and potentially much to lose, by confusing the issue and pretending to tax companies, and not people. Of course, it is not always clear exactly which people — owners, workers, or consumers — end up paying business taxes, but somebody definitely will pay. Hiding who really pays the bills is not a good way to ensure accountable public sector decisions.

In addition, most forms of business taxation impose economic costs by distorting decisions on such matters as whether to incorporate, the debt-equity ratio, dividend policy, and where and how much to invest. Business taxes also may impose significant costs and barriers to the expansion of new and small firms. Those arguments sometimes may be overstated, for example, when the untaxed allocation of resources is clearly distorted by monopoly or externalities. On the whole, however, they are sufficiently well-founded to persuade many economists that there is little, if anything, to be said on efficiency grounds for taxing corporations in particular and indeed not much to be said for business taxes in general. Moreover, as discussed further in section I, the economic case against those taxes seems even stronger at the local level, than at the national level.

The virtual unanimity of professional economic advice on this issue is more than matched, however, by the unanimity with which governments at all levels ignore the advice and impose taxes on businesses. There are many reasons why they do so — some specious, some perhaps justifiable in certain circumstances, and some more generally compelling.

Contrary to the conventional economic wisdom sketched above, section II concludes that there often are good reasons why local governments in many instances should impose some form of taxation on businesses operating within their jurisdictions.¹

That decided, the balance of this article turns to the difficult practical question of just how local governments should tax business. Section III first sketches the surprisingly broad panorama of local business taxes found around the world by providing thumbnail sketches of practices in a number of countries. Against that background, section IV sets out some criteria by which local business taxes may be evaluated, and evaluates the various taxes against those criteria. Finally, section V sketches briefly what seem to be the two most promising forms of local business taxation. A brief section VI concludes.

I. The Costs of Local Business Taxation

Most economic costs from taxing business are larger the more mobile the capital. Capital generally is more mobile within, than between countries.² The argument that taxes on business are economically distorting would therefore seem to be even stronger for *local* business taxes.

On the other hand, the so-called “basic tax competition model” (Wilson, 1999) implies that local competition for the tax base may lead to an inefficiently low tax rate on capital, and a correspondingly low level of public goods provision. The idea behind that “basic” result is simple. If the total amount of capital in a country is fixed, but capital is mobile between regions, and there are only two regions, then an outflow of capital from one region is an inflow to the other. An

¹For an argument supporting national corporation income taxes, for quite different reasons, see Bird (2002).

²Helliwell and McKittrick (1999), for example, show that inter-provincial capital mobility is much higher than international mobility in Canada, with the correlation between savings and investment for individual provinces being statistically indistinguishable from zero. As Dahlby (2000) shows, however, one must be cautious in interpreting correlations between saving and investment as reflecting capital mobility. In a simple endogenous growth model for a small, open economy, a higher savings rate results in more investment in human capital and, because human capital is complementary to physical capital, also in an increase in the investment rate.

increase in the tax on capital in one region creates a positive externality in the other region because the outflow of capital benefits the residents of the other region. Because each regional government is assumed to be concerned only with the welfare of its own residents, it will not consider that external effect when setting its tax rates. Both regions will set their tax rates — and therefore their levels of public goods provision — inefficiently low. In this model, local tax competition produces what has been called a “race to the bottom” and business taxes are more likely to be set too high than too low in efficiency terms.

The argument that taxes on business are economically distorting would therefore seem to be even stronger for local business taxes.

From some perspectives, of course, competition that keeps local taxes on business down may be considered to be a “good thing” rather than a “bad thing.” One example is the so-called “commitment” problem. Fewer investments will be made because governments with limited political lives cannot commit credibly to not increase taxes in the future on investments once made (Kehoe, 1989). Competition that tends to keep local tax rates down may lead to increased private investment and, presumably, a higher rate of growth.

Similarly, the “public choice” model suggests that in the absence of tax competition, governments may be inefficiently large (Edwards and Keen, 1996). For example, often local governments can to some extent “export” taxes by shifting the tax burden to nonresidents — for example, by taxing nonresident owners. In those cases, not only will local business taxes often be inefficiently high, but by severing the connection between those who are taxed — whether in the end those who ultimately bear the tax are consumers or capital owners — and those who benefit from the services financed by taxes, local business taxation also may reduce local accountability.

In the real world, of course, the degree and nature of competition for capital between governments is generally even less straightforward than the most complex formal analysis suggests. “No Man is an Island Unto Himself,” the English poet John Donne once wrote. Similarly, no regional or local government is an island in economic terms. Each is affected by what happens outside its borders and, especially in the case of the larger localities, the actions of each in turn will exert some influence on the constraints facing others. Tax competition matters.

Local and regional taxes on business capital therefore seem likely, on balance, to be economically costly. The international and intra-national mobility of the tax base, the ease with which businesses can shift

income across boundaries, and the difficulty that small governments may have in enforcing taxes in those circumstances all point in the same direction. It is not easy to say exactly how much those taxes cost, however. The answer to that question depends on many things that are not easy to measure, such as the effect of taxes on economic growth and investment and the size of the associated distortions in capital allocation. Despite the difficulty of measurement, however, there appears to be a growing consensus in the literature that taxes on business capital both depress investment, and affect location decisions.³ Although it is hard to know precisely how important those effects might be in total in any country, in a recent survey of efficiency considerations in corporate tax reform, Whalley (1997) concluded that most studies estimated the efficiency cost of national taxes on capital to be from 0.75 to 1.0 percent of GDP. Those numbers may seem small, but of course they persist from year to year and imply a substantial cumulative effect on growth and well being. At the subnational level, because local economies are generally more open than national economies, the costs would presumably be even greater.

Theory, empirical evidence, and common sense all suggest that it makes economic sense in most circumstances to keep local and regional taxes on business, especially those impinging on capital investment, as low as possible. Those taxes depress investment and distort economic decisions. They reduce economic output and the potential standard of living. Moreover, by breaking the connection between those who pay taxes and those who benefit from the expenditures financed, business taxes reduce local accountability and weaken the critical “hard budget constraint” needed to ensure that decentralized public sector decisions are efficient (Bird, 2001).

II. The Case for Local Business Taxes

Despite the argument set out in section I, however, virtually every country has some form of local business taxation. Why? There are at least three arguments supporting local taxes on business — an efficiency argument, an equity argument, and a political argument.

In economic terms, the most convincing case for taxing business derives from one of the oldest principles of taxation, the *benefit principle*. To the extent that particular public activities result in identifiable cost-reducing benefits being received by particular firms, those firms can and should be charged for the

³A few recent studies along those lines may be cited, for example: Devereux and Griffith (1998); Cummins, Hassett, and Hubbard (1998); Chrinko, Fazzari, and Meyer (1999).

cost of providing the benefits. Whenever feasible, direct user charges should be applied to business firms, as to any other direct beneficiaries (Bird and Tsiopoulos, 1997). For example, if business waste is more toxic and more costly to remove and dispose of than household waste, an additional charge on those businesses is clearly warranted. Similarly, if large trucks impose heavier costs in terms of wear and tear on roads and highways, they should be charged accordingly.

In addition to services provided directly to specific identifiable private firms by the public sector, for which user charges can and should be levied, a significant fraction of general public expenditure, particularly at the local government level, directly benefits businesses. In the case of Canada, for instance, Kitchen and Slack (1993) estimated that, on average, close to 40 percent of the (noneducational) municipal expenditures in eight Ontario cities benefited commercial and industrial activities, although the share was less than 20 percent if education is considered. Similarly, Oakland and Testa (1995) estimated that the “business share” of state and local expenditures, including those on education, in the United States was 13 percent. Although both those studies make the very strong assumption that business received no benefits from educational expenditures, both concluded that the taxes levied on business actually constituted a higher share of the taxes levied by the respective governments than the benefits received by business. A solid efficiency case can be made for levying some form of “generalized benefit tax” on business to cover the “unattributable” benefits to productive activities.⁴

Indeed, benefit taxation has both an efficiency and an equity rationale. It is efficient because it ensures that — assuming local taxes are freely chosen by local people — someone is willing to pay (give up other resources) an amount at least equal to the marginal cost of providing a particular service. At the same time, it is equitable as it is fair for everyone, whether rich or poor, to pay the same price for services received, whether from the public sector (refuse removal, for example) or from a private seller (for example, bread or clothing).

From an efficiency perspective, it is economically necessary to levy taxes on firms and individuals that benefit from public services. Doing so will, for example, minimize the horizontal spillovers that would

otherwise arise from those expenditures (Mintz and Tulken, 1986). If local governments impose nonbenefit taxes that are paid by nonresidents rather than residents, as noted earlier they are likely to spend more than they should in terms of efficient resource allocation. Government size will then be excessive because nonresidents (nonvoters) pay through tax exportation for services enjoyed by residents (voters). An additional horizontal spillover arises from competition for the tax base. In that case, however, a jurisdiction may choose tax levels that are too low, for fear of losing the tax base to other jurisdictions. The result of local fiscal competition may be too much, or too little, local spending in aggregate. However, in either case, the efficient allocation of resources is distorted. To avoid that outcome, taxes should, where possible, be allocated in accordance with a reasonable measure of benefits received.

Theory, empirical evidence, and common sense all suggest that it makes economic sense in most circumstances to keep local and regional taxes on business as low as possible.

In many countries, as already noted for the United States and Canada, local and regional taxes levied on business already may be higher than can be justified on the efficiency arguments. That situation reflects the obvious political feasibility — perhaps even the political necessity (Sorensen, 1995) — of taxing business. It is often as politically attractive as it is economically undesirable to tax business heavily, both because of the common belief that the rich pay those taxes, and the real possibility that nonresidents may do so.

Moreover, there also seems to be a widespread belief that jurisdictions in which economic activities take place are in some sense “entitled” to part of the proceeds, regardless of whether the services provided by their governments contribute anything to production, or whether any of the output is consumed within the jurisdiction. The common conflicts between central and regional governments over natural resource revenues, for example, arise in part at least from those

⁴Feehan (1998), who argues that much government spending produces services that enhance the productive capacities of firms, provides an interesting theoretical rationale for such a tax under certain conditions. As Bird (2002) notes, the benefit argument for imposing “tax-prices” in the form of a generalized business benefit tax should not be confused with some of the less tenable versions of the benefit rationale for taxing corporations that may be found in the literature.

⁵The “entitlement” principle has recently been articulated in the international context by McLure (2000). It is equally observable at the subnational level in most countries, notably for resource taxes (McLure and Mieszkowski, 1983). The last aspect is discussed more carefully in McKenzie (2001). That argument, of course, should be distinguished from the case for adequate compensatory payments to local residents for, for example, environmental damage due to mining or similar activities.

deeply held, if seldom articulated, beliefs.⁵ That *entitlement principle* can be extended to encompass business taxes more generally. Of course, the extent to which one accepts that argument may rest largely on personal preference and the prevailing local interpretation of history. Still, some version of the entitlement concept, when combined with the benefit argument, appears to constitute the strongest logical case that can be made in support of local taxes on business.

From an efficiency perspective, it is economically necessary to levy taxes on firms and individuals that benefit from public services.

Many politicians, and indeed the public in most countries, appear to think that business taxes, especially those on large corporations, are not among the worst, but rather the best of all taxes. One naive version of that argument is that because corporations are separate legal “persons,” and some of them have a lot of money, they must have substantial “ability” to pay taxes and should do so. Popular as those arguments are, they are clearly fallacious. Only people, not things, can “pay” taxes in the sense of having their private real incomes decreased. Indeed, as noted above, a major problem with most business taxes — although of course also one of the political attractions — is that no one can be very certain who is actually paying them. The burden of corporate taxes may fall on labor, land, equity owners, consumers, or some combination thereof, and it is surprisingly difficult to assess exactly how the burden is likely to be distributed (Whalley, 1997).

Taxation is as much or more a political as an economic phenomenon. Governments go against popular perceptions of who should pay how much, and in what way, only at their peril. If popular feeling, despite strong economic argument to the contrary, is that businesses in general, and large corporations in particular, should pay much larger taxes than can possibly be justified on benefit grounds, then any government that wishes to stay in power has to bow to those winds — at least to some extent.⁶ If the *political* cost of raising taxes from corporations is low, even if the *economic* cost is high, it may be perfectly rational to impose those taxes. From a government’s perspective, both costs are real, and the optimal tax policy will

⁶As the Ontario Fair Tax Commission (1993, p. 399) said, “for many of those who appeared at our hearings, declining revenue shares from corporate income and capital taxation stood as a symbol of increasing unfairness in our overall system of taxation.” That symbolic aspect of taxation is developed further in Bird (1991).

equate total economic and political costs at the margin with total benefits (Gillespie 1991, Hettich and Winer 1999).

Corporate income taxes and other taxes on business may be economically irrational, but nonetheless make perfect sense from the perspective of the political-economic picture. Such arguments need to be used with caution, of course, lest all things that exist end up being justified simply because they exist. Most forms of business taxation induce significant economic distortions. Even though usually hidden from public and political eyes, the associated costs in terms of output forgone must be explicitly weighed against possible political benefits owing to greater public acceptability. Nonetheless, the political realities of governing, certainly in democratic countries, seem to mean that business taxes are going to be imposed, despite what economists may say (Pola, 1991).

In the circumstances, it is perhaps just as well that arguments such as those in this section also can be found to support the taxes to some extent. For example, in some instances, local business taxes may provide the only significant source of elasticity in local revenues and, therefore, may be a critical source of financing to expand local infrastructure and service needs. Moreover, despite the danger that such taxes may reduce accountability by severing the connection between payers and beneficiaries, in some instances, local business taxes may play a critical role in improving accountability. That is, those taxes are sometimes the only revenues for which local governments have any significant discretionary authority, and for which they therefore may be held accountable.

Just how well local taxes on business serve any of those purposes in practice will depend largely on exactly how they are structured and administered. The more important question is not *whether* countries will impose local and regional taxes on business — they are going to do so in most cases — but rather precisely *how* they should impose the taxes. That is the subject of the balance of this article.

III. Local Business Taxation Around the World

Many forms of local and regional business taxation exist around the world. Among the most common are corporate or enterprise income taxes, taxes on internal trade (such as octroi), gross receipts taxes, fixed or proportional taxes varying by type of business and location (such as patente), local sales taxes (which often fall to a considerable extent on intermediate business activities rather than on final consumers), and nonresidential real property taxes. A variety of licenses and fees unrelated to any services provided by the public sector also may be imposed. Some countries impose several of those forms of business tax at the same level of government, some impose different types

of taxes at different levels, and some impose different taxes on different sizes and types of business.

Unfortunately, information on the precise characteristics of those taxes, the variations from jurisdiction to jurisdiction within countries, how those taxes are administered, and their economic effects, is sporadic and incomplete. The present section simply summarizes some aspects of some taxes in some countries. It does not aim to provide a full picture of the situation in any country, but rather to illustrate something of the variety and complexity of the local business tax universe.⁷

Canada

Canada's provinces impose (1) corporate income taxes, (2) capital taxes, and (3) payroll taxes on businesses, usually excluding smaller enterprises.⁸ In addition, about half of the 10 provinces impose retail sales taxes that derive, on the whole, one-third or more of their revenue from taxing business capital investment and intermediate activities (Kuo, McGirr, and Poddar, 1988). Four provinces impose conventional "consumer" VATs (invoice-credit, destination-basis levies) that do not tax either investment or intermediate activities (Bird and Gendron, 1998). In total, these taxes constitute a substantial burden on capital investment, and on production in general. Bird and McKenzie (2001) estimate that in some provinces, such taxes are twice as high as in others on manufacturing investment, and in general, are much higher on investment in the (labor-intensive) service sector than in manufacturing.

In addition to provincial business taxes, Canadian municipalities impose the biggest (as a share of GDP) property taxes in the world, and about half of the yield from that tax comes from taxes on commercial and industrial property. In some instances, that property is subject to higher rates. In many cases, it is assessed at higher ratios of market value. In Canada, the heavy dependence of the property tax on the business tax base has been argued to be one reason why the property tax, so often seen as the main "accountability" link between local spending and taxing decisions, is in fact one of the main ways that link is severed (Thirsk, 1982).

⁷The text discusses formal taxes. As Prud'homme (1992) noted in a case study of Zaire, there are also many "informal" local taxes imposed on business in many developing countries, ranging from simple theft and extortion by local officials to systems of requisitions and contributions that are virtually "formalized" and in some ways reminiscent of the role played by (state) enterprises in providing public sector services in most central-planning countries.

⁸Capital taxes are usually especially heavy on financial enterprises (McQuillan and Cochrane, 1996). On provincial payroll taxes, see Dahlby (1993).

United States

In general, subnational business taxation in the United States is similar to that in Canada. Most states impose corporate income taxes, most also impose retail sales taxes that fall to a considerable extent on business (Ring, 1999), and most local governments rely heavily on nonresidential property taxes. State business taxation probably has more distorting effects than in Canada for two reasons. First, unlike Canada, which has an agreed uniform formula for apportioning tax base between provinces, there are substantial differences in the definition of the taxable corporate base in different states.⁹ Second, no U.S. states have followed the path taken by some Canadian provinces and eliminated the "business" element of sales taxes by moving to a consumption-type VAT. Two states, however, have experimented with income-type, VAT-type taxes.

Corporate income taxes and other taxes on business may be economically irrational, but nonetheless make perfect sense from the perspective of the political-economic picture.

The state of Michigan first introduced a modified income-type of VAT, called the Business Activities Tax (BAT), in 1953 (Ebel, 1972). Although the BAT was abolished in 1967, it flew much the same idea again when it introduced the Single Business Tax (SBT) in 1976 (Brazer, 1977). The SBT was basically a modified VAT computed through the addition method and measured on the income side as the sum of payments to labor and capital, but with a number of important deductions and limits that moved it closer to a consumption base (ACIR, 1978).

Originally intended to replace the state CIT (corporate income tax) and some other taxes on business, the main virtues of the tax were considered to be increased revenue stability and the extension of taxation to noncorporate forms of business. Both of those virtues were, of course, seen by some as vices, and business (perhaps in part reflecting deeply imbedded views about the "correctness" of taxing income) bitterly resented paying SBT when there would be no CIT liability. Some said that SBT stood for "Small Business Tax." The SBT came to be excessively complex and unpopular (Kenyon, 1996) in part simply because there is a tendency for tax bases to erode over

⁹There is a huge volume of literature on the workings, and defects, of state corporate income taxes in the U.S. A classic assessment is McLure (1981); for a more positive perspective, see McIntyre (2002).

time, and to become more complex — especially when, as in Michigan, the state increasingly uses a tax to provide investment incentives.

Responding to those pressures, it was not a total surprise when, in 1999, Michigan once again drew back from its pioneering attempt to introduce a state VAT. Although the SBT still exists at a fairly significant 2.3 percent rate, it is supposed to be phased out on a prolonged 23-year time schedule. Judging by past events, however, it would not be surprising to see yet another reversal within that period.

The political realities of governing, certainly in democratic countries, seem to mean that business taxes are going to be imposed, despite what economists may say.

The second attempt at a state VAT in the United States is much more recent. In 1993, the state of New Hampshire introduced a Business Enterprise Tax (BET), which differed from Michigan's SBT in a number of important respects. First, the BET base is essentially net income (Kenyon, 1996). Second, the tax is levied at a much lower rate — 0.25 percent compared to the current rate of 2.3 percent in Michigan. Third, unlike Michigan, the BET did not replace the CIT in New Hampshire, but was instead a complement to it. Despite those differences, the two taxes also are alike in some important respects. Both are levied on value added by the addition method, and both were intended to provide a more stable, efficient, and simple source of state revenues. Kenyon (1996) argues that the BET has indeed increased stability, that it is less distorting than an equivalent increased CIT would have been, and that it is a relatively simple tax.

The main technical problem that governments seem to have encountered with income-type, origin-based state VATs in the United States concern their application to multistate (or multinational) businesses. Michigan, for example, used the same apportionment rule as many states do for the income tax — an equally weighted three-factor allocation formula (payroll, profits, and sales in the state), ignoring the illogic of using destination-based sales in this tax base. Recent moves in many states to “double-weight” the sales in the formula would of course accentuate that problem. On the other hand, although New Hampshire, unlike Michigan, actually has a CIT, it does not use the same apportionment rule for the BET. Instead, it applies different factors to each element of the tax base, thereby, substantially complicating what is otherwise a very simple tax. Of course, those problems obviously would be greatly simplified if, as in Canada, a simple uniform apportionment formula were applied throughout the country.

Germany

The grandfather of all “value-added” local business taxes is probably the German trade tax, or *gewerbesteuer*.¹⁰ As originally conceived, that tax was levied on the income of all factors of production, although not in a very coherent fashion. As is so often the way with fiscal institutions, however, over the years the scope of the tax base has been substantially eroded. For example, the payroll component of the base was abolished in 1980 and, since 1984, 50 percent of interest on “long-term” debts has been deducted from the base. That not only creates an incentive to use more debt financing that varies across localities (Gropp, 2002), but also reduces the relatively logical initial coherence of the tax. Moreover, Germany, in practice, has essentially removed the tax from all but larger enterprises.

Although local authorities in Germany still have considerable discretion about tax rates, base changes decreed from above have substantially reduced their revenue autonomy. It, therefore, is not surprising that most local governments appear to have supported a federal proposal in 1982 to introduce an explicit local VAT, at an estimated rate of about 3 percent, on top of the federal VAT. The tax was to be imposed on a net income origin basis and, preferably, to be collected by the addition method (that is, on the sum of payroll, interest, rents, and net profits). In the end, however, that proposal was not accepted, owing largely — as in the Michigan case mentioned earlier — to business opposition to paying taxes when firms had no profits. At the present time, however, a Commission for Reform of Municipal Finances again is considering possible revisions of the tax. One reason for doing so, reportedly, is because the trade tax is considered to be overly dependent on economic cycles. Therefore, it is rather curious that one proposal has been to replace it by a surcharge on the national personal and corporate income taxes, which clearly are considerably more cyclically sensitive.

At present, larger cities generally impose higher rates. Recent analysis suggests that the higher tax rates may reflect both the greater market power and urban externalities to be found in larger population centers, and their lesser concern with attracting mobile capital. At the same time, the rates imposed in one area clearly are affected by those imposed in neighboring jurisdictions (Buttner, 1999, 2001).

Italy

A particularly interesting approach to the ancient problem of how best to tax local business may be found

¹⁰This brief account is based largely on Bennett and Krebs (1987).

in Italy. In 1998, the *imposta regionale sulle attivita produttive* (IRAP), a new business tax, replaced an existing regional income tax levied essentially on business income (at about 16 percent), a tax on dividend distributions by corporations, a small net worth tax, and payroll contributions levied to finance a national health scheme (Maisto, 1997; Dell'Anse, 1997).¹¹ The IRAP is essentially a net income-type VAT on an origin basis. Most firms, including all types of business and self-employed activities, are subject to IRAP at 4.25 percent, although regional governments may choose to levy an additional percentage point.

The IRAP appears to be the closest approximation to a good local business tax that now exists. The tax base is calculated annually by a direct subtraction method, as the difference between gross receipts (sales revenues) and the cost of intermediate goods and services (purchases from other firms plus depreciation). There are specific rules for different types of financial institutions. Neither wages and salaries, nor interest payments, are deductible from the tax base. Outlays for capital goods are deducted in accordance with normal income tax depreciation schedules. Revenues are allocated among regions in proportion to labor costs incurred in each region. That tax now finances about one-quarter of all regional spending in Italy.

A recent assessment stressed IRAP's neutrality both for choice of organizational form, and between equity and debt financing. The assessment noted that it probably, on balance, favored capital over labor because tax depreciation exceeded economic depreciation (Bordignon, Giannini, and Panteghini, 2001). Commentators thought that the major virtue of that regional tax, however, was that it permitted a significant reduction of taxes on profits and brought Italian profit taxes closer to those in other European Union (EU) countries. In addition, the U.S. Internal Revenue Service agreed that a "portion" of the IRAP would be creditable for U.S. income tax purposes (Smith and Gann, 1998), which on its face would appear to be a factor encouraging (or at least permitting) other countries to adopt that form of tax. Given the circumstances, it seems unfortunate that the national government has recently decided to eliminate the tax, beginning with the exclusion of 20 percent of labor costs from the base in 2003. As Keen (2003) notes, it is not at all clear why the government has decided to do this, and it is even less clear how this essential source of regional finance will be replaced. This move does not

appear to augur well for the future of rational business taxation in Italy.

Other EU Countries

The United Kingdom does not impose real estate tax (council tax) on enterprises, but two other EU countries (Ireland and Denmark) actually impose real estate taxes only on enterprises. Messere (1993) reports that taxes on business constituted as much as 71 percent of total property taxes in Austria, 65 percent in Iceland, 60 percent in Germany, 50 percent in Finland, and 32 percent in France. The problem of possible tax exporting noted above for Canada clearly is not unique to that country.

The rates imposed in one area clearly are affected by those imposed in neighboring jurisdictions.

Several EU countries, in addition to Italy and Germany, impose special local taxes on business in addition to the property tax. France, for example, has a local tax that is essentially on payroll and fixed assets. Belgium has one that is based on the number of persons employed and "motive power." Portugal taxes based on profits, and Spain on the number of persons employed, as well as on other factors such as area, sector of activity, and power usage.

Hungary

Hungarian local governments in 1998 collected 86 percent of their own-source revenues from a local business tax. In addition, they levy a small "communal" tax at a fixed amount (HUF 2,000) per employee based on the average number of employees of businesses with permanent establishments in the municipality.¹² They levy the business tax, which has been called "the curiosity of the Hungarian local taxation system," (Szalai and Tassonyi, 2002), at a locally determined rate of up to a maximum of 2 percent on a base that seems to be value-added (sales revenue, excluding VAT, less the cost of goods sold, materials costs, and the cost of subcontractors). If a taxpayer has permanent commercial activities in more than one jurisdiction, the base is divided. Smaller taxpayers (those with turnover of less than HUF 100 million) may choose to divide it either by the proportion

¹¹This change was part of a broader reform of business taxation, including at the national level, as discussed in Bordignon, Giannini, and Panteghini (2001).

¹²Like many countries, Hungary also makes it easy for local governments to impose special taxes on nonresidents, specifically tourists, in the form of a tax of HUF 300 per person per night. For a review of tourism taxes, see Bird (1992). Many countries also have special local taxes on entertainment of various sorts. As with tourist taxes, those taxes appear to be highly politically acceptable.

of net assets or by personnel payments. Larger taxpayers have to use the weighted average of those two factors.

This tax is much more important in larger than in smaller localities. On a per capita basis, for example, revenues are 27 times greater in Budapest than in villages, and 8-9 times greater than in towns (OECD, 2000). There appears to be no serious audit of tax returns in most localities. A recent assessment (Szalai and Tassonyi, 2002) noted that that tax was expensive to administer because the base was calculated on a very different basis than the corporate income tax. It also was economically inefficient and likely engendered tax competition (for example, localities can grant exemptions), tax exporting, tax avoidance, and reduced accountability. Nonetheless, the business tax has been unquestionably the mainstay of local taxation in Hungary since its inception in 1990, although levied at a maximum rate of only 0.3 percent.

Many countries have (at least) two levels of subnational government, one at the regional level and one at the local level.

Ukraine

Like other transitional countries, Ukraine has for some time been wrestling with the problem of how to tax small business. Recently, it introduced a “simplified” system, consisting of (1) fixed rates imposed on different activities by sole proprietorships, (2) a 10 percent sales tax on gross sales by enterprises, or (3) an optional 6 percent sales tax, plus 20 percent VAT, for enterprises. Although a share of the enterprise taxes imposed under this system goes to local governments, this part of the new system is clearly a national tax.¹³ On the other hand, local councils not only receive all the revenues from the tax on individuals engaged in business, but may vary the rate of the low “simplified” tax on individuals engaged in a variety of business activities within fairly narrow limits — between approximately US \$50 to US \$500 a year. This levy is imposed in addition to a related system of local business taxation (the patent) that imposes similar “patent fees” ranging from US \$50 to US \$250 annually on individuals engaged in trading. These levies may not amount to much in revenue terms, but they are nonetheless significant in terms of local accountability.

¹³A similar national levy is imposed (at low rates varying by types of land) on agriculture, with a share to local budgets. All taxes in Ukraine are administered by the State Tax Administration. For a description of the Ukrainian system, see World Bank (2002).

Local governments have more discretion in applying them than they do for other revenue sources.

The current system has been under review for some time and seems likely to be changed in some way shortly. A proposal introduced in late 2002, for example, introduced a single corporate tax of 5 percent on small and medium enterprises, although it would require them to pay both VAT and social security contributions. As yet, however, it is not clear how, if at all, the system will be changed. There are very different views about its virtues and problems. On one side, the national office responsible for “entrepreneurship” has argued that the simplified system on the whole has been a major success at promoting small and medium-size business because it greatly reduced the complexity of the tax system with which businesses must grapple. That report also suggests that adopting what is essentially a “fixed tax” system for most firms has greatly increased the number of persons in the formal tax system, and, therefore, increased tax revenues.¹⁴ On the other hand, the State Tax Administration considers the simplified system to be ineffective and producing no revenues. Its reported solution is simply to exempt small businesses from tax completely (Lungu, 2002). At the same time, the World Bank (2002) has expressed considerable reservations about the whole system. It suggests that over time, it may “erode” the whole tax system because it provides incentives for firms to masquerade as small, and it is difficult for the Ukrainian tax administration to uncover the truth. Although the current discussion is focused largely on national tax issues, there are obviously serious implications for the future of local business taxation in how those issues will be resolved.¹⁵

Japan

In Japan, both regional (prefectural) and municipal governments levy taxes not only on property, but also on both personal and enterprise incomes. Corporations, for example, are subject to a municipal tax assessed on the basis of the national corporation tax paid the previous year. The tax base is allocated among jurisdictions in proportion to the number of employees. That tax is both assessed and collected locally.

¹⁴Those and other arguments may be found in Ukraine (2002).

¹⁵Other countries emerging from the former Soviet Union seem to have encountered similar difficulties in working out how best to tax small business. At one point, for example, legislation intended to simplify small business taxation in both Russia and Kyrgyzstan required those businesses to calculate tax liabilities using both the simplified system and the standard system: how forcing anyone to calculate taxes using two different methods simplifies anything is a mystery.

The same is true of the business fixed assets tax, which is imposed not only on land and buildings, but also on business assets that are depreciable for income tax purposes. Although the local governments assess that tax, a uniform system of assessment is applied throughout the country. Local governments must impose at least a “standard” tax of 1.4 percent of taxable value, but may increase the rate up to 2.1 percent. About 10 percent of municipalities impose higher rates (Kitazato, 2002). In addition to this municipal tax, prefectures can levy a separate tax on certain assets held by larger businesses (those exceeding limits specified by national law).

India

The most striking form of local business taxation in India is octroi. It is a local “customs duty” on goods entering a locality, enforced by physical inspection at the “border” — for example, at the state level. Uttar Pradesh reportedly had 105 “check posts” at its borders in 2002.

Octroi also is (or has been) important elsewhere in the South Asian region. For example, Zimmerman (1998) reports that 87 percent of local revenue in Nepal came from octroi. GTZ (1999) notes that octroi is supposed to be replaced by a “local development fee” of 1.5 percent on imports by customs, and distributed to municipalities by the central government. Bangladesh abolished octroi and replaced it by a central grant, which turned out to be a much less productive, reliable, and elastic source of revenue. In Pakistan, urban local governments collected octroi until 1999, and then Pakistan replaced it by a transfer, based on 2.5 percent of General Sales Tax revenue.

Within India, the rates of octroi vary widely from place to place and also by product. It sometimes is levied on a specific basis, but more frequently, as a percentage of value. Much of the revenue — over 40 percent in Gujarat according to one estimate (Rao, 1984) — comes from taxing intermediate and capital goods.

Octroi is supposed to be collected only from goods that are destined for use in the taxing locality. Goods that are “passing through” are supposed to get a transit pass exempting them. In some cases, they are charged octroi and payors have to seek reimbursement on proof of exit. Zimmerman (1998) notes that they seek in vain for the most part in Nepal. Others have noted that in many instances, octroi amounts to a tax on exports. Commentators agree that octroi obstructed the free movement of trade within the country and was assessed and collected in an arbitrary, costly, and corrupt fashion. To illustrate the scale of the problem, at one time there were as many as 10,000 local octroi “checkpoints” in Maharashtra. The cost of collection in Karnataka was estimated to be very high, varying between 6 and 18 percent of collections. As one observer noted with respect to the corruption of the

system, “. . . a facilitation fee is considered as the way of life when there is an octroi post” (Rao, 1998).

Octroi is complex in structure, nontransparent, induces cascading, encourages vertical integration, and greatly increases transportation costs. Border procedures are said to take between an hour and several days at the state level, implying economic costs of over 1 percent of GDP and perhaps much higher (Das Gupta, 2002). For all these reasons, although it is clearly both the most important and most buoyant source of a locality’s “own” revenue, especially in urban areas, economists have frequently characterized octroi as “obnoxious, vexatious, wasteful and distorting” (Rao, 1984). Indeed, almost everyone who has looked at how this tax works in the subcontinent has agreed that Napoleon was quite right when he abolished similar levies 200 years ago in France.

Octroi is complex in structure, nontransparent, induces cascading, encourages vertical integration, and greatly increases transportation costs.

Some states have abolished octroi, and others are considering its abolition. Still, even at the end of the century, that form of tax still existed in at least six states, although sometimes in the form of an “entry tax” (as in West Bengal). Karnataka, for example, abolished octroi in 1979 — 197 of the state’s 226 municipalities were levying the tax — and replaced it by a state entry tax on a similar base (although, of course, the local governments did not administer the tax). At the time octroi was abolished, it accounted for 40 percent of the revenue of Bangalore and up to 60 percent of the revenue of other urban areas in the state. The “octroi compensation grant” introduced to make up for that loss did not demonstrate the same buoyancy (or responsiveness to local wishes) as the old tax. By the late 1990s, the need for local revenues, particularly in urban areas, actually led the state to consider its reintroduction (Rao, 1998). Indeed, a recent study of the border check posts used to enforce state sales taxes suggests that, in the absence of other decent subnational taxes and competent tax administration, even such costly and distorting tax enforcement techniques as check posts may be better than the available alternatives (Das Gupta, 2002).

Brazil

Local business taxes in Brazil have a long history, dating back to the early 19th century (Silveira, 1989). The present tax, the ISS (*Imposto sobre Serviços*), established in 1966, is basically levied on the gross receipts of independent professionals and firms in the service sector. Brazil excludes some important services, such as communications, finance, and transport, from its scope. Originally, 79 specific

services were subject to tax, but that number has been extended over time. The municipality in which the service is provided charges the tax. Initially, the national law limited both the base and the rates of the ISS, but for some years local governments have had full rate autonomy within the maximum rate fixed by federal law. There are wide variations in how the tax is applied and enforced around the country, with the more developed cities generally doing better and, as usual, collecting relatively more. In Brazil as a whole, the ISS yielded 0.57 percent of GDP in 2001 — almost 2 percent of total taxes collected — compared to 0.45 percent for the property tax, the other main source of local tax revenue (Wiesner, 2002).

The patente is simple to administer because it is based on visible indicators, such as size of premises, type of business, and number of employees.

Silveira (1989) suggests that, although the tax is probably regressive and its effects on economic efficiency questionable, to some extent those defects are not as bad as they seem because the tax extends into the informal sector in a way that state and federal taxes do not. The existence of a large sector of the economy that is effectively not subject to direct taxation may substantially affect how one assesses the effects of different taxes on equity. For example, the real progressivity of a nominally progressive personal income tax (PIT), which mainly affects wage earners, and which many high-income recipients seem largely to escape, may be low. In countries like Brazil, an indirect tax on the service sector like the ISS may be in the end as or more progressive than a tax like PIT, which essentially burdens only a limited group of wage-earners. The name of a tax is not necessarily a good guide to its incidence or effects.

Other Latin American Countries

Many other countries in Latin America have special local taxes on business. Broadly, those taxes take two forms — taxes on gross receipts, or some form of patente (fixed tax). In Argentina, for example, there is a 1 to 12 percent provincial tax on gross receipts. In Nicaragua, there is a 1 percent tax on gross receipts. In Colombia, the rate of the gross receipts tax (*industria y comercio*) ranges from 0.2 to 1 percent. In practice, most of these taxes are levied on an annual basis, that is, at a fixed amount calculated as the tax rate times the estimated tax base for the previous year — often as estimated by the taxpayer. Much of the revenue from such taxes generally comes from a few sectors, such as financial enterprises. The second common form of local business tax in Latin America is some form of tax on some measure of “wealth,” often called a “patente.”

Chile, for example, imposes that tax at rates of 2.5 and 5 percent, depending on the estimated net wealth (*patrimonio*) of the enterprise. Ecuador imposes a similar tax at a 1 percent rate. Venezuela levies at a rate of 0.5 percent of “social capital.”

South Africa

An interesting local (regional) tax imposed in South Africa is the so-called Regional Services Council (RSC) Levy (Bahl and Solomon, 2000). Like many local taxes around the world, this tax functions mainly in urban areas, and it accounts for about one-third of Cape-town’s revenues, for example. The central government establishes the rates and the base. The RSC levy has two components. Two-thirds of the revenue comes from a flat tax imposed on gross sales, and the balance from a similar tax on payrolls.¹⁶ A recent study criticized almost every aspect of the tax, but somewhat paradoxically concluded that the combination of low rates and weak administration probably made it more or less acceptable (Bahl and Solomon, 2000). The future of the RSC levy is currently a matter of considerable discussion in South Africa.

Kenya

Kenya has recently undertaken a major reform of its local business tax system. In Kenya, the major local taxes levied specifically on business take the form of “license fees.” Such fees or charges, found in various forms in many countries, are intended in principle to serve both regulatory and revenue purposes — although there is often conflict between those two objectives. Sometimes they are levied as flat lump sum charges, sometimes as charges that vary by the type, size, and location of the business, and sometimes as a proportion of sales, turnover, or income. In principle, as Kelly and Devas (2001) note, the latter approach is likely best in principle. It is also, however, the most complex to administer and the most likely to lead to problems of competition, not only between localities but between levels of government, because higher-level governments generally already impose taxes on sales and income. For that reason, the Kenyan reform in 1999 followed the second path, establishing a matrix of fixed charges varying with business type and size.

The pre-existing license fees were said to be out of date, burdensome to business, and conducive to substantial corruption. To reduce those problems, the

¹⁶As mentioned earlier, provinces in Canada, like states in Mexico and Australia, also can levy taxes on payrolls. While some portion of those taxes undoubtedly falls on business, at least in the short run, as a rule, economists think those taxes are borne largely by workers in the long run. In the Canadian case, for example, Dahlby (1993) estimated that two-thirds of the tax was ultimately borne by workers.

reform introduced a Single Business Permit system. That system was intended to achieve several purposes:

- to reduce compliance costs by streamlining business licensing procedures and eliminating multiple licensing of the same business;
- to establish a more rational rate structure; and
- to allow local authorities to exercise some discretion over rates by choosing from a range of permitted rate schedules.

Under the previous system, fees had varied from place to place on a completely discretionary basis, and they had varied also from business to business, with no apparent rationale. The result was that the fee for a butcher might be twice that of a baker in one town, while the opposite was true in the next town. To reduce those unnecessary distortions, the new schedules classify businesses into easily distinguishable broad categories — for example, traders operating in the open are taxed differently than those in temporary structures, and the latter, in turn, are distinguished from those with premises in permanent buildings. Traders are then further classified by number of employees and size of premises. Local rates are set by choosing a local base level value — for example, 100 shillings — and then applying the established relative rate factors, ranging from 2 (for example, for small informal traders) to 100 (for example, for a large five-star hotel or a manufacturer employing more than 50 people). Localities can choose among 16 “base levels.” The system reportedly is working well.

Francophone Africa

As in most African countries that were formerly ruled by France, the major form of local business tax in Côte d’Ivoire is the *patente*, a differentiated set of fixed taxes varied by type, size, and location of business. (That tax now is replaced in France by the *taxe professionnelle*.) The Ivorian *patente* was based on the French tax that existed in the preindependence period. It produces substantial revenue for local governments — about one-third of total revenues in Abidjan, for example. But it is not particularly elastic, in part, because the tax schedules are not indexed, making the effective rate fall with inflation (World Bank, 1989). The tax is based in part on fixed amounts differentiated by type of activity, number of employees, and so on, and in part takes the form of a property tax, based on the rental value of premises.

Morocco has a similar tax. It applies six tax rates to several hundred categories of businesses, classified by rental value, type of business, and nature and quantity of inputs used (Vaillancourt, 1998). For example, Morocco taxes a dentist’s office at different rates, depending on the number of chairs. In contrast, Tunisia levies the business tax at a rate of one-fifth of 1 percent on gross business income (up to a maximum).

A problem with this tax was that businesses do not provide a breakdown of their activities by locality, so cities with head offices obtain most revenues. To deal with that problem, in 1997, revenues were allocated on the basis of the square meters of premises used. In both countries, as is common in Francophone Africa, all tax rates are set nationally.

Local governments, particularly the smaller ones, have fewer avenues for taxation open to them than do larger regional governments.

In principle, the *patente* is simple to administer because it is based on visible indicators, such as size of premises, type of business, and number of employees.¹⁷ In practice, however, it is cumbersome because of its complex structure, the need to update the taxpayer register yearly, and the fragmentation of administration between several different agencies. Although it is a local tax in the sense that all the revenues go to the local government, the central government administers the *patente*. The *patente* is supplemented by other, less important, forms of local business taxation, such as a tax on small craftsmen and traders, and professional and business license fees. The latter two are differentiated by activity, being higher, for example, on businesses selling alcohol.

IV. An Appraisal of Local Business Taxes

As section III illustrates, local business taxation around the world is characterized by great variety. Some countries rely mainly on taxes on profits and property; some on various forms of sales taxation; some on a variety of specific charges and fees. How can one appraise that diverse variety of levies? As Table 1 suggests, there are a number of criteria by which to appraise those taxes.¹⁸ Although the entries in the cells of that table are obviously essentially subjective — and readers may well wish to fill in the blanks differently for their own country — it is difficult to avoid the conclusion that most local taxes on business found

¹⁷It is worth noting that that is very similar to the structure of some forms of imputed and presumptive national taxes. Other such taxes amount to gross receipts taxes. For a recent review of those taxes, see Wallace (2002). The similarity between presumptive taxation and many of the issues arising with respect to local business taxes — for example, the extent to which those taxes really tax the “indicators” (number of employees, size of premises) — deserves more attention.

¹⁸Many of those criteria were suggested by Bahl and Solomon (2000).

Table 1
Evaluation of Local Business Taxes

Criterion	Property Tax (higher than on residential)	Income Tax	Gross Sales Tax	VAT	Taxes on Trade	Patente/ Licenses
Revenue adequacy	Potentially yes	Unlikely	Yes	Yes, at regional level	Yes	Perhaps at local level
Revenue buoyancy	No	Yes	Yes	Yes	Yes	Perhaps, if indexed
Correspondence of payers and beneficiaries	Not high	Not high	Not high	Potentially satisfactory	Not high	Potentially satisfactory
Progressivity	Not likely to be high	Largely unknown	No	No	No	Unknown
Administrative cost	Relatively high (if done well)	Not usually feasible locally (but regional surcharge possible)	Not high	Perhaps reasonable regionally	Feasible, but high cost	Feasible but not cheap to set up properly
Compliance costs	Not high	Medium	Low	Higher than sales tax	Very high	Probably moderate if well designed
Latitude for Corruption	Moderate	Probably high in most countries	Moderate	Moderate	Very high	High
Political acceptability	Moderate	Low	Fairly high	Unknown	Moderate	High
Local accountability	Low	Low (depends on rate discretion)	Low	Moderate	Low	High
Reduces regional disparities	No	No	No	No	No	No
Distortionary impact	Moderate	Moderate	High	Low	High	Low

around the world do not appear to score well on many of those criteria. Few such taxes are equitable. Almost none are neutral. All accentuate rather than reduce disparities between localities, giving most to those who have most. Most also lend themselves to tax exporting, thereby violating the “correspondence principle” that those who pay should be those who benefit. Finally, most are costly to administer, especially if one takes into account, as one should, the cost of compliance and the facility with which the tax can serve as the basis for corrupt transactions.

On the other hand, local business taxes thrive around the world precisely because many of them score high on some of the other criteria mentioned. These taxes are, for example, highly politically acceptable, in part because no one quite knows who really pays them but many people think someone else pays. Local business taxes also provide an important, and relatively elastic, source of revenue, particularly for larger cities. And, finally, in many countries, local business taxes, defective as they often are in design and

execution, provide one of the few ways in which local governments have any degree of fiscal autonomy.¹⁹

The question is therefore to what extent the virtues of local business taxation — essentially money and autonomy — can be realized while minimizing such vices as economic distortions, high administrative costs, and breaking the correspondence principle. The low rates of most of such taxes lessen those problems, but two possible systematic approaches to local business taxation aimed at that goal — one primarily for the local level and one primarily for the regional level of subnational government — are sketched in section V below.

¹⁹It should perhaps be noted that user charges are not considered in Table 1. As mentioned earlier, those charges are almost always the most desirable possible way for local governments to raise revenue, whenever feasible: for further discussion, see Bird (2001a).

Regardless of how well-designed, however, no form of local business taxation can overcome two fundamental problems. First, any tax on business will give more revenues to those who have more tax base. It therefore will accentuate fiscal disparities between regions and localities.²⁰ Second, although one of the virtues of local business taxation is that it is politically acceptable, that virtue is almost inescapably accompanied by two potential vices — some weakening of the correspondence principle, and a consequent increase in the lack of clarity about the equity of local taxation.

The first of these weaknesses is much more important, although in principle it is simple to overcome. All that is needed to overcome it is to introduce clear political responsibility at the local level for the taxes imposed. That can be done, for example, simply by allowing local governments some degree of discretion with respect to tax rates. Even when taxes are collected by central governments, on bases determined by those governments, political accountability can be achieved as long as the subnational government that receives and spends the revenues is clearly responsible to its citizens for setting the tax rates. In some instances, local rate discretion may need to be limited, however, especially for business taxes. To check tax exporting and maintain the correspondence principle, it may be desirable to impose a maximum rate. At the same time, however, when there are great differences in the tax base from locality to locality, as is common with business taxes, it also might be advisable to impose a minimum rate to restrict the ease with which richer areas (with larger tax bases) may be able to attract the tax base from other areas by imposing lower tax rates.

Regarding the second weakness, although most local business taxes are likely to be regressive, the equity of local taxation is a much less important question than some think. From many perspectives, local governments can be considered to be entities that provide services to residents, so that the appropriate equity perspective is the benefit principle, rather than the ability-to-pay principle, as has been argued in detail elsewhere (Bird, 1993). Even from the latter perspective, the equity issue may be approached at two different levels. First, one can consider the details of the relative treatment, in law and in practice, of the tax burdens imposed on taxpayers in the same and different economic circumstances. Secondly, one may instead focus on the overall taxation effects on people's income and level of well-being. Economists generally

take the second approach, while much of the popular discussion of taxation takes the first approach.

The policy implications of those two different approaches to the equity of taxation may be quite different. Focusing on the implications for equity of details of particular taxes tends to result in proposals to alter the rates and structures of particular taxes. Those proposals, while they may improve horizontal and vertical equity within the limited group who are actually subject to the full legal burden of the tax in question, may at the same time actually exacerbate inequity more broadly considered. From the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income. The precise incidence of specific local government taxes seldom has much importance in that context, and it would be a mistake to complicate the system excessively in terms of economic, administrative, and compliance costs in an attempt to achieve miniscule, if any, gains in equity terms.

V. Two Approaches to Local Business Taxation

Many countries have (at least) two levels of subnational government, one at the regional level and one at the local level. Each of those levels may want to impose taxes on business, but the best way to do so may be quite different. Local governments, for example, particularly the smaller ones, have fewer avenues for such taxation open to them than do larger regional governments. Although each country's circumstances are different, it may be useful to sketch briefly two "ideal" approaches to subnational business taxation, one most applicable to smaller, lower-level subnational governments — "local" — and one more suitable for larger "regional" (or metropolitan area) governments.

On the whole, the smaller the government, the more closely it is likely to adhere to the benefit model mentioned earlier, so it is not surprising that the ideal form of business taxation for those governments would appear to be as benefit-related a system as possible. In addition to imposing properly designed user charges whenever possible, those governments might consider a system of "business licenses," such as those recently introduced in Kenya (Kelly and Devas, 2001). In some instances, it might be advisable to supplement, or perhaps even replace, that system by a low-rate gross receipts levy, as in Tunisia (Vaillancourt, 1998).

The advantage of the Kenyan system is that it is based on "objective" evidence, information that should readily be visible to the tax assessor. The disadvantage is the same. The need for direct contact between assessor and taxpayer opens the process to corruption. Another disadvantage is that such taxes often become irrationally differentiated between different activities and different size businesses, again opening the door to

²⁰In part to offset that effect, many countries have introduced some "equalization" component in intergovernmental transfers, as discussed in Bird and Smart (2002).

complexity and corruption. Although the differentiation may be an advantage, provided the tax is differentiated in accordance with rational economic factors, which may be difficult to work out in some instances, the Tunisian system's advantage is that it is less distortionary because it is not a tax on specific inputs. The disadvantage is that it is essentially self-assessed and open to evasion. Low-rate gross receipts taxes also may create problems of interjurisdictional apportionment. Like the business license approach, they may turn over time (as in Argentina) into highly differentiated, and in all likelihood, distorting systems. While neither of these approaches should be pressed too far in terms of rates — because economic distortions rise with the square of the tax rate — either may be acceptable at relatively low rates. Which path, if either, is best for any specific country would of course require careful study and assessment.

The bottom line is that subnational governments around the world do, and probably always will, tax business.

In contrast, at the regional level — and perhaps also for larger metropolitan local governments that might, for example, impose surcharges on regional levies — in theory the best form of business taxation is a broad-based levy neutral to factor mix, such as a tax on value-added. Interestingly, as Sullivan (1965) has documented, the original conception of the VAT was as a business benefit tax. More precisely, the most appropriate form of VAT for that purpose is a “value added income tax” or a VAT levied on the basis of income (production, origin) rather than the usual consumption (destination) VAT set out in, for example, Ebrill et al. (2001).²¹

Businesses add value by combining labor and capital with other purchased inputs. The value added by labor is the cost of labor (wages and salaries), while the value added by capital is the cost of capital (both debt and equity). The form of local business tax called the Business Value Tax (BVT) by Bird and Mintz (2000) consists of revenues, less purchases of current inputs except labor, less depreciation allowances.²² From an administrative perspective, that tax base could be calculated in two ways. The first is simply to add back the appropriate amounts of interest and wages to the base of a business income tax as usually calculated. A second approach might be to impose, in

effect, a payroll tax and an appropriate tax on capital. In most countries, the easiest way to do that would be, in effect, to tax the same base as a VAT.²³

Compared to a conventional VAT, a BVT has two important distinguishing features. First, it is a tax on income, not consumption: that is, it is imposed on profits as well as wages or, to put it another way, on investment as well as consumption.²⁴ Second, as a tax on production, rather than consumption, it is imposed on an origin rather than a destination basis, and in effect taxes exports but not imports. A third distinction might be in the way the tax is assessed (for example, by the subtraction or addition method rather than by the more familiar invoice-credit system) or collected (for example, on an accounts rather than transaction basis), but that is less fundamental than the differences in tax base noted above.²⁵

As a replacement for many existing local and regional business taxes, which in effect tax capital to a substantial extent, an income-based BVT would improve the tax system in at least two ways. First, such a tax would be more neutral than income and capital taxes, which discriminate against capital investment. Second, a BVT would be less susceptible to base erosion. The tax rate would be lower, and the base larger and unaffected by the degree of debt financing. Economic distortion costs, therefore, would be lower. BVT-type taxes are sometimes criticized (see the German and Michigan taxes discussed in section III) because they do not sufficiently resemble income taxes. They have to be paid whether a company makes profits or not. Of course, that is precisely one reason why they are much more efficient taxes. Moreover, to the extent the rationale for

²³Although the two approaches are effectively identical for a fully tax-paying firm, they may differ for non-tax-paying firms, depending on the nature of loss offsetting. Under the second approach, all firms will pay taxes regardless of their profitability. Under the first approach firms could be in a loss position and, therefore, not pay BVT in a particular year.

²⁴Note that if capital is expensed rather than depreciated, the BVT becomes a consumption-based, rather than income-based, tax. Financial income would not be included in the BVT tax base and interest on borrowed funds would not be deductible. A special regime, therefore, would be necessary for financial institutions and insurance companies, because most of their value-added would not be included in the tax base. Presumably, one would need to levy a combination of capital and payroll taxes on that sector (as Israel does for its VAT, for example).

²⁵From one perspective, a system in which, in effect, two different types of value added tax are imposed simultaneously might seem odd — as indeed it did to many when Meade (1978) first proposed a similar approach. But the apparent oddity resides largely in the similarity of the names. If it makes sense to levy taxes on both consumption and income in terms of base, it may equally make sense to levy one or both (or parts of each) indirectly in the value-added form at the business level, as well as directly on income and/or consumption at the personal level.

²¹A similar conclusion has been reached at various times by many analysts in the United States: for two recent examples, see Ebel (2000) and Papke (2000).

²²This discussion follows Bird and McKenzie (2001).

taxing business rests on benefit or entitlement grounds, a BVT is more equitable than an income tax.

Although in principle, the efficiency gains from switching to a BVT at the local or regional level may be substantial, there would, of course, be many difficulties in implementing such a proposal in many countries. For instance, there are many detailed definitional issues that would have to be resolved. However, for low-rate local business taxes, the need for adjustments is reduced and any rules introduced for those purposes could be highly simplified.

An important coordination issue would need to be resolved. Ideally, the tax base should be identical everywhere to facilitate BVT compliance and administration. Even if it is, one also must determine the allocation formula for business value added. Businesses that operate in only one region (province, state) or one locality (municipality, district) would be taxed solely by that jurisdiction. In principle, value-added earned in more than one jurisdiction would be allocated according to formula weights based on such factors as payroll, sales (on an *origin* basis) or capital, or some combination.²⁶ As Smith (1998) documents for the provincial business taxes in Canada, negotiations about who gets what tax base are never easy, but they can be successful. Indeed, as Bird and McKenzie (2001) argue for the Canadian case, while there are a number of difficult points that have to be decided in designing a BVT, none of them seem unsolvable in either principle or practice. Moreover, as mentioned a number of times in section III, the status quo in many countries seems increasingly unsatisfactory. Adequate solutions may be found more readily with the BVT than by tinkering further with the existing imperfect taxes.

In any case, the bottom line is that subnational governments around the world do, and probably always will, tax business. BVT would be less distorting than most other possible local business taxes and deserves consideration for that reason.

VI. Conclusion

Local business taxes, like the weather, are always with us and always, it seems, a matter for discussion and, often, dissatisfaction. Unlike the weather, however, commentators and governments can do more than deplore unfortunate outcomes. Both the design and the implementation of local business taxation can be substantially improved in most countries. Two broad paths toward those improvements are suggested in section V — toward a more strictly “benefit” system of business licenses and fees on one hand, and toward a more neutral and uniform variety of VAT (the BVT) on

the other hand. As Table 1 suggests, neither of those approaches is without flaws, but together or separately they appear more likely to yield satisfactory results than most of the many forms of local and regional business taxation now found around the world. ♦

References

Advisory Commission on Intergovernmental Relations (ACIR) (1978) *The Michigan Single Business Tax* (Washington).

Roy Bahl and David Solomon (2000) “The Regional Services Council Levy: Evaluation and Reform Options,” November.

Robert Bennett and Gunter Krebs, eds. (1988) *Local Business Taxes in Britain and Germany* (Baden-Baden: Nomos Verlagsgesellschaft).

Richard M. Bird (1991) “Tax Structure and the Growth of Government,” in Lorraine Eden, ed., *Retropectives on Public Finance* (Durham, NC: Duke University Press), pp. 263-75.

Richard M. Bird (1992) “Taxing Tourism in Developing Countries,” *World Development*, 20 (August): 1145-58.

Richard M. Bird (1993) “Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization,” *National Tax Journal*, 46 (June): 207-27.

Richard M. Bird (2001) *Intergovernmental Fiscal Relations in Latin America: Policy Designs and Policy Outcomes* (Washington: Inter-American Development Bank, Sustainable Development Department).

Richard M. Bird (2001a) “User Charges in Local Government Finance,” in Richard Stren and Maria Emilia Freire, eds., *The Challenge of Urban Government* (Washington: World Bank Institute), pp. 171-82.

Richard M. Bird (2002) “Why Tax Corporations?” *Bulletin for International Fiscal Documentation*, 56 (No. 5, May): 194-203.

Richard M. Bird and Pierre-Pascal Gendron (1998) “Dual VATs and Cross-Border Trade: Two Problems, One Solution?” *International Tax and Public Finance*, 5 (no. 3): 429-42.

Richard M. Bird and Kenneth J. McKenzie (2001) *Taxing Business: A Provincial Affair?* Commentary No. 154, C.D. Howe Institute, Toronto, November.

Richard M. Bird and Jack M. Mintz (2000) “Tax Assignment in Canada: A Modest Proposal,” in Harvey Lazar, ed., *Canada: The State and the Federation 1999/2000. Toward a Mission Statement for Canadian Fiscal Federalism* (Kingston: Institute of Intergovernmental Relations), pp. 263-92.

Richard M. Bird and Michael Smart (2002) “Intergovernmental Fiscal Transfers: International Lessons for Developing Countries,” *World Development*, 30 (no. 6): 899-912.

²⁶Gordon (1986) discusses this apportionment problem with state origin-based VATs briefly.

Richard M. Bird and Thomas Tsiopoulos (1997) "User Charges for Public Services: Potentials and Problems," *Canadian Tax Journal*, 45: 25-86.

Massimo Bordignon, Silvia Gianni, and Paolo Panteghini (2001) "Reforming Business Taxation: Lessons from Italy?" *International Tax and Public Finance*, 8: 191-210.

Harvey E. Brazer (1977) "Michigan's Single Business Tax — Theory and Background," in *Proceedings of the 69th Annual Conference on Taxation* (National Tax Association-Tax Institute of America).

Thiess Buttner (1999) "Determinants of Tax Rates in Local Capital Income Taxation: A Theoretical Model and Evidence from Germany," CESifo Working Paper No. 194, September.

Theiss Buttner (2001) "Local Business Taxation and Competition for Capital: The Choice of the Tax Rate," CESifo Working Paper No. 440, March.

Robert Chirinko, Steven Fazzari, and Andrew Meyer (1999), "How Responsive Is Business Capital Formation to Its User Cost? An Exploration with Micro Data," *Journal of Public Economics* 74: 53-80

Jason Cummins, Kevin Hassett, and Glenn Hubbard (1998) "Tax Reforms and Investment: A Cross-Country Comparison," *Journal of Public Economics* 62: 237-73.

Bev Dahlby (1993) "Payroll Taxes," in Alan Maslove, ed., *Taxing Business* (Toronto: University of Toronto Press).

Bev Dahlby (2000) *Tax Reform and Economic Growth in Alberta* (Calgary: Canada West Foundation).

Arindam Das-Gupta (2002) "Internal Fiscal Barriers in India: Check Posts," Draft paper; December.

Luca Dell'Anese (1997) "Italy Introduces New Regional Tax," *Tax Notes International*, November 17, pp. 1589-90.

Michael Devereux and Rachel Griffith (1998) "Taxes and Location of Production: Evidence from a Panel of US Multinationals," *Journal of Public Economics* 68: 335-367.

Robert D. Ebel (1972) *The Michigan Business Activities Tax* (East Lansing, MI: MSU Business Studies, Division of Research, School of Business Administration, Michigan State University).

Robert D. Ebel (2000) "Robert Ebel on Tax Reform, Federalism, and Sound Tax Policy," *State Tax Notes*, May 29, pp. 1877-79.

Liam Ebrill et al. (2001) *The Modern VAT* (Washington: International Monetary Fund).

J.S.S. Edwards and Michael Keen (1996) "Tax Competition and Leviathan," *European Economic Review*, 40: 113-40.

James P. Feehan (1998) "Public Investment: Optimal Provision of Hicksian Public Inputs," *Canadian Journal of Economics*, 31: 693-707.

W. Irwin Gillespie (1991) *Tax, Borrow and Spend* (Ottawa: Carleton University Press).

Roger H. Gordon (1986) "A Critical Look at Formula Apportionment," in *Final Report of the Minnesota Tax Study Commission* (St. Paul, MN: Butterworths).

Reint E. Gropp (2002) "Local Taxes and Capital Structure Choice," *International Tax and Public Finance*, 9 (January): 51-71.

GTZ (German Technical Cooperation). (1999) *Urban Development Through Local Efforts*. Kathmandu.

John Helliwell and Ross McKittrick (1999) "Comparing Capital Mobility Across Provincial and National Borders," *Canadian Journal of Economics* 32: 1164-1173.

Walter Hettich and Stanley Winer (1999) *Democratic Choice and Taxation* (Cambridge: Cambridge University Press).

Michael Keen (2003) "Tax Reform in Italy," *Tax Notes International*, February 17, pp. 665-82.

Patrick Kehoe (1989), "Policy Cooperation Among Benevolent Governments May Be Undesirable," *Review of Economic Studies* 56: 289-296.

Roy Kelly and Nick Devas (2001) "Regulation or Revenues? An Analysis of Local Business Licensing, with a Case Study of the Single Business Permit in Kenya," *Public Administration and Development*, 21: 381-91.

Daphne Kenyon (1996) "A New State VAT? Lessons from New Hampshire," *State Tax Notes*, December 2, pp. 1605-15.

Toshi Kitazato (2002) "Japanese Fixed Property Tax," Paper prepared for World Bank.

Harry Kitchen and Enid Slack (1993) "Business Property Taxation," Government and Competitiveness Paper 93-24, School of Policy Studies, Queen's University, Kingston.

C.Y. Kuo, T. McGirr, and S. Poddar (1988) "Measuring the Non-neutralities of Sales and Excise Tax in Canada," *Canadian Tax Journal*, 36: 655-70.

Iurie Lungu (2002) "Official Proposes Exempting Small Businesses From Tax," *Tax Notes International*, October 21, p. 246.

Guglielmo Maisto (1997) "Italy Introduces Regional Tax on Productive Activities," *Tax Notes International*, March 31, pp. 1029-31.

Michael J. McIntyre (2002) "Thoughts on the Future of the State Corporate Income Tax," *State Tax Notes*, September 23, pp. 931-47.

Kenneth McKenzie (2001) "Fiscal Federalism and the Taxation of Non-Renewable Resources," World Bank Institute, Washington.

Charles E. McLure, Jr. (1981) "The Elusive Incidence of the Corporate Income Tax: The State Case," *Public Finance Quarterly*, 9 (October): 395-413.

Charles E. McLure, Jr. (2000) "Source-Based Taxation and Alternatives to the Concept of Permanent Establishment," in *2000 World Tax Conference Report* (Toronto: Canadian Tax Foundation).

Charles E. McLure, Jr. and Peter Mieszkowski, eds. (1983) *Fiscal Federalism and the Taxation of Natural Resources* (Lexington, MA: Lexington Books).

Peter E. McQuillan and E. Cal Cochrane (1996) "Capital Tax Issues," Working Paper No. 96-8, Technical Committee on Business Taxation, Department of Finance, Ottawa.

Meade Report (1978) Institute of Fiscal Studies, *The Structure and Reform of Direct Taxes* (London: Allen & Unwin).

Ken Messere (1993) *Tax Policy in OECD Countries* (Amsterdam: IBFD Publications).

Jack M. Mintz and Henry Tulkens (1986) "Commodity Tax Competition between Member States of a Federation: Equilibrium and Efficiency," *Journal of Public Economics*, 29: 133-72.

OECD (2000) *Economic Surveys — Hungary* (Paris)

William H. Oakland and William A. Testa (1995) "Community Development-Fiscal Interactions: Theory and Evidence from the Chicago Area," Working Paper Series, Research Department, Federal Reserve Bank of Chicago.

Ontario Fair Tax Commission (1993) *Fair Taxation in a Changing World* (Toronto: University of Toronto Press).

James A. Papke (2000) "Rethinking Local Business Taxation: Substituting a State Value Added Tax for the Local Ad Valorem Tax on Business Personal Property," *State Tax Notes*, February 28, pp. 669-82.

Giancarlo Pola, ed. (1991) *Local Business Taxation: An International Comparison* (Milano: Vita e Pensiero).

Remy Prud'homme (1992) "Informal Local Taxation in Developing Countries," *Environment and Planning C: Government and Policy*, 10: 1-17.

M. Govinda Rao (1984) *Entry Tax as an Alternative to Octroi* (New Delhi: National Institute of Public Finance and Policy).

M. Nageswara Rao, ed. (1998) *Octroi: Pros and Cons* (Bangalore: Asia Institute of Urban Development).

Raymond J. Ring (1999) "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, 52: 81-92.

Ricardo Silveira (1989) "The Local Tax on Services in Brazil," INURD Working Paper no. 7, Urban Development Division, Policy Planning and Research Staff, World Bank, Washington.

Ernest H. Smith (1998) *Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada* (Toronto: Canadian Tax Foundation).

Paul A. Smith and Jennifer Gann (1998) "U.S. IRS to Allow Partial Credit for New Italian Local Tax," *Tax Notes International*, April 13, pp. 1114-15.

Peter Birch Sorensen (1995) "Changing Views of the Corporate Income Tax," *National Tax Journal*, 48: 279-94.

Clara K. Sullivan (1965) *The Tax on Value Added* (New York: Columbia University Press).

Akos Szalai and Almos T. Tassonyi (2002) "Value Based Property Taxation: Options for Hungary," Unpublished paper; Toronto.

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* (Toronto: Canadian Tax Foundation).

Ukraine (2002) "Simplified Taxation Regimes: Application Practices and Development Trends," Department for Economic Development of Entrepreneurship, Kyiv.

Francois Vaillancourt (1998) "Morocco and Tunisia: Financing Local Governments — the Impact on Infrastructure Finance," in Richard M. Bird and Francois Vaillancourt, eds., *Fiscal Decentralization in Developing Countries* (Cambridge University Press).

Sally Wallace (2002) "Imputed and Presumptive Taxes: International Experiences and Lessons for Russia," Working Paper 02-03, International Studies Program, Andrew Young School of Public Policy, Georgia State University, Atlanta, March.

John Whalley (1997) "Efficiency Considerations in Business Tax Reform," Working Paper 97-08, Technical Committee on Business Taxation, Department of Finance, Ottawa.

Eduardo Wiesner (2002) "Bank Lending for Subnational Development: The Policy and Institutional Challenges," Office of Evaluation and Oversight, Inter-American Development Bank, Washington.

John Wilson (1999), "Theories of Tax Competition," *National Tax Journal* 52: 269-304.

World Bank (1989) "The Administration of the Patente in the Cote d'Ivoire," Washington.

World Bank 2002 "Ukraine: Tax Policy and Administration," Washington.

Horst Zimmermann (1998) *Strengthening Local Government Finance: Principles of Fiscal Decentralization and Nepal Case Study* (Escheim: GTZ).