CHAPTER TWO

Revenue Sources for Local Government

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Why local governments need resources

Local governments need resources in order to finance the services and activities for which they are responsible. This may include the direct provision of goods and services where the market fails to provide satisfactorily (e.g. 'public goods' and 'merit goods', such as health and education), or contracting or subsidising the private sector to provide them. Local governments also have a variety of regulatory roles, such as building and development control and consumer protection, which have to be financed. Moreover, local governments may need to subsidise certain services for low-income groups, even though redistribution is generally regarded as primarily a function of central government.

Locally generated resources are also essential for another reason. One of the principal justifications for decentralisation is that the decisions made about local services will reflect the needs, priorities and willingness to pay of local citizens. Decisions about how much to tax local citizens, and how to use those tax revenues to provide services, are core elements of local democracy and critical to local accountability. This requires that local governments have under their control a range of local taxes and charges, borne by residents of the jurisdiction, to fund at least part of the cost of services which benefit those residents. It also requires that local decision-makers have a degree of discretion about the level of taxation.

However, the reality in most countries is that local revenue sources meet only part – sometimes quite a small part – of local expenditure needs. There are two reasons for this. Firstly, the most significant taxes (such as income tax, corporate profits tax, VAT, customs duties, excises) are usually assigned to central government. This is because central government is much better placed to collect such taxes uniformly, efficiently and equitably, particularly where tax revenues are collected in only certain locations (e.g. ports, in the case of customs duties). As a result, the taxes left for local government are generally small and often problematic (as will be discussed below). Secondly, the tax base is unevenly distributed within countries. While large cities may be able to generate substantial tax revenues, smaller, more remote and rural jurisdictions may have little scope for levying taxes. Therefore, local revenue raising needs to be accompanied by a system of fiscal transfers from the centre to ensure that local governments have sufficient resources to carry out their mandated functions, and to ensure that financial resources are equitably distributed between local governments.

In the Commonwealth, the dependence of local governments on intergovernmental transfers varies widely, ranging from 10 per cent in South Africa, 15 per cent in Malaysia, 20 per cent in Australia, 40 per cent in Canada, 70 per cent in Ghana, 78 per cent in Uganda and up to to 90 per cent in Lesotho, 98 per cent in Trinidad and Tobago and 100 per cent in Seychelles (CLGF, 2005). However, these averages disguise big differences within countries, typically between urban and rural local governments.

Thus, local revenue sources remain important as a way of financing part of local expenditure and to establish a degree of accountability to citizens for the expenditure decisions made by the local government. In most countries, much could be done to improve local revenues, through more efficient administration and assigning new revenue sources, as well as improving expenditure management so that the limited resources go further.

Revenue sources for local governments

The following are the main revenue sources for local governments.

a) *Local taxes* are in principle the main source of revenue for local governments, with the choice about tax rates to fund local services being the key annual decision made by local elected representatives. There are many types of local tax (see below), of which property tax is the most common internationally.

b) *Charges* for services provided, where a service is provided directly and exclusively to the payer; charges are normally related to the cost of providing the service.

c) *Fees for permits and licences*, where the prime purpose is to regulate an activity, rather than to raise revenue; the costs are normally (but not always) limited to the cost of administration/enforcement.

d) *Profits from local enterprises* – where the local government owns an enterprise, any profits from that enterprise would accrue to the local government (but so would any losses). This is still a significant revenue source for local governments in China but not in many other countries, although local governments in many countries, such as Pakistan and Uganda, own markets which are operated as commercial enterprises, and some countries also have municipal water enterprises.

e) *Central government revenue sharing* – shares of taxes (and other revenues) collected by central government and allocated (partly or wholly) to local government, either based on their origin (where they were collected) or by formula (see chapter 6).

f) *Intergovernmental grants* of various types to finance some of the costs of local government services, as well as equalising (to some extent) resources between local governments (see chapter 6).

g) *Borrowing* to finance capital expenditure, from various sources – banks, government, donors, bonds, etc. (see chapter 4). However, strictly speaking, borrowing is not a revenue source but a financing mechanism, since the money has to be repaid.

The principal sources of revenue in various local governments are shown in Box 2.1.

Box 2.1. Principal revenue sources for local government

1. Property tax (rates) on land and/or buildings
2. Tax on the transfer of immovable property
3. Tax on motor vehicles
4. Local sales tax and/or tax on the sale of local products
5. Tax on local businesses and services
6. Tax on electricity consumption
7. Tax on non-motorised vehicles
8. Tax on tourism, hotels, restaurants and entertainments
9. Tolls on roads, bridges, etc. within the limits of the local government
10. Charges for public works and public utilities like waste collection, drainage, sewerage and water supply
11. Charges for markets and rents for market stalls
12. Charges for the use of bus stations and taxi parks
13. Fees for approval of building plans, and erection and re-erection of buildings
14. Fees for fairs, agricultural shows, cattle fairs, industrial exhibitions, tournaments and other public events
15. Fees for licensing of businesses, professions and vocations
16. Fees for other licences or permits, and penalties or fines for violations
17. Fees for advertisements
18. Fees on sale of animals in cattle markets
19. Fees for registration and certification of births, marriages and deaths
20. Fees in respect of education and health facilities established or maintained by the local government
21. Fees for other specific services rendered by the local government
22. Rent for land, buildings, equipment, machinery and vehicles
23. Surpluses from local commercial enterprises
24. Interest on bank deposits or other funds

Closing the 'fiscal gap'

Local governments in most countries are seriously short of money to meet their expenditure needs. In order to bridge the 'fiscal gap', they need to examine a number of options:

a) *Reducing expenditure*

- Abandoning activities that are no longer necessary
- Privatising or contracting out some activities
- Operating more efficiently
- Improving budgeting and financial management.

b) *Improving revenue collection* (see chapter 3)

- Improving the identification of taxpayers and assessment of tax liabilities
- More effective collection and enforcement mechanisms
- Improving record keeping, accounting and checking arrangements
- More effective pursuit of arrears
- Reducing collection and compliance costs.

c) *Increasing charges for services*

- Charging for some services that are now free
- Reviewing charges in relation to service costs.

d) *Increased local tax revenues*

- Increasing tax rates
- Moving rates fixed in monetary amounts to *ad valorem* rates (i.e. rates based on the value of the taxed object)
- Identifying new local taxes (subject to central government approval).

e) *Negotiating for increased intergovernmental transfers*

f) *Borrowing*

- For investments that generate revenues, directly or indirectly
- Subject to local government borrowing capacity.

See Blore *et al.* (2004) for examples of improved financial performance by municipal governments.

Selecting local revenue sources

The choice of revenue sources for local government generally lies with central government (although it may be specified in the constitution). Decentralisation of functions should be accompanied by decentralisation of revenue sources. However, due account must be taken of the suitability of revenue sources for levy and collection at the local level. There are a number of criteria for selecting local tax instruments: the first five sets of criteria are general tax criteria, the sixth relates specifically to local taxes.

a) *Yield*

- The tax should be capable of generating a substantial revenue; in many developing countries, local governments have multiple small revenues that are little more than nuisance taxes.
- The yield should be stable and predictable year on year (the yield of some local taxes, e.g. on agricultural products, may be quite unstable, depending on local harvest conditions and world market prices).
- The yield should be elastic – that is, increasing automatically with inflation, increases in real incomes and population growth; *ad valorem* taxes are preferable to fixed monetary amounts; many local taxes, e.g. property taxes, are relatively inelastic, so that the real value of the revenue can fall over time.

b) *Collection costs*

- The proportion of the tax yield that is used up in collection costs should be low; some local taxes cost more to collect than they yield, which is obviously pointless and economically damaging. This situation may arise because the cost of collection is seldom examined against the revenue collected.

c) *Equity*

- The tax basis and liability should be clear, not arbitrary, thereby minimising risks of exploitation by tax collectors.
- Those in similar economic situations should be treated equally ('horizontal equity'); that is, someone earning $100 in agriculture should face the same tax bill as someone earning $100 in a shop. All too often, local taxes impinge only on particular sectors.
- The rich should pay more than the poor ('vertical equity' or 'ability to pay'); again, many local taxes impinge mainly on the (relatively) poor.
- Where a revenue is related to a particular service, those who benefit most should pay most ('the benefit principle of equity'); this provides the justification for benefit taxes (such as vehicle licences) and charging for services which not everyone receives.

There may often be a conflict between vertical equity and the benefit principle, since those who benefit from a service may well be those least able to pay.

d) *Economic efficiency/neutrality*

- Taxes should be neutral in their impact, not distorting relative prices more than necessary (unless the aim is to regulate consumption – e.g. taxes on cigarettes). Price distortions occur where certain commodities or activities are taxed and not others; some local taxes are levied on only certain commodities, e.g. certain agricultural products or goods entering a market or a jurisdiction, causing producers and consumers to alter their behaviour in an economically damaging way.
- Similarly, taxes should be designed to avoid creating unintended incentives or disincentives (again, unless the incentive/disincentive effect is intended). Taxes on incomes and profits create disincentives to work, savings and investment, while local toll barriers on roads may cause diversion of traffic to less suitable routes.

e) *Ability to implement*

- Taxes require political will to implement; this will be easier if the tax is not too 'visible' to the taxpayer. A local tax on electricity can be 'disguised' in the bill for electricity and so is less visible than a property tax demand; on the other hand, visibility is important for accountability, so that people know what they are paying in local taxes for what services.
- Taxes should be simple enough to be administered within the administrative capacity of local government; some taxes are easier to administer than others, and local governments generally have limited capacity to implement complex taxes.

f) *Is the tax suitable for local government?*

- Is it clear which local government should receive the tax? In the case of a property tax, it is clear in which jurisdiction the property is located, but with an income tax, should the tax be paid to the local government where taxpayers work or where they live? Since income taxes are generally collected through employers, assigning the revenue to the jurisdiction where the employee lives requires an elaborate administrative arrangement.
- Is the tax collected within the local jurisdiction? For example, a sales tax may be collected from the headquarters of the retail company, and thereby benefit a local government far from where the purchase was made or where the purchaser lives.
- Will the tax be paid solely or mainly by residents within the jurisdiction, rather than being 'exported' to those living elsewhere? A profits or turnover tax on a

business which sells goods throughout the country could effectively be 'exported' to residents of many other local governments, thereby breaking the link between those who benefit from the tax-funded expenditure and those who bear the burden of the tax.

- Can all local authorities benefit from the tax or will the tax exaggerate economic differences between regions? For example, customs duties would benefit only those places where ports and airports are located, while a local tourism tax only benefits tourist areas.
- Is some local discretion over tax rates possible without causing locational distortions? For example, it would be difficult to have differential local taxes on petrol, since some motorists would simply drive to the lower tax jurisdiction.

From this last set of considerations, it is apparent that the main taxes, notably VAT or sales tax, profits tax and customs duties cannot realistically be levied at the local level, and that the most suitable *local* taxes are those where the tax base is wholly confined within a jurisdiction, is immobile and is relatively similar in all jurisdictions. This is why property tax is the most common form of local taxation.

There are, of course, inherent conflicts between some of these criteria. For example, making a tax more vertically equitable may also make it less neutral (e.g. higher taxes on luxuries), as well as making it more complex to administer. No tax is perfect: the aim should be to select those that perform best overall, or do least damage.

Ideally, local governments should have a combination of local taxes – some which score well on certain criteria and others which score well on others; however, they should not have too many taxes – say three to four – to avoid perceptions of 'nuisance taxation'.

Principal forms of local taxation

As already noted, property taxation (in various forms) is the most common form of local taxation around the world. This will be discussed in more detail below.

There are many other local taxes used in different countries with varying degrees of success.

Local income tax: Potentially the most equitable form of taxation and used in several European countries. But progressive income taxes are generally administered more equitably and efficiently at national level, especially where the formal sector is small and largely concentrated in the capital city, as is the case in many developing countries. However, a few African countries (notably Uganda) have developed forms of *mass personal taxation* for local government. These apply a graduated tax scale on incomes below the national income tax threshold. Incomes, especially from agriculture and the informal sector, are assessed on a presumptive basis (i.e. the likely income from a particular activity or piece of land) rather than on actual incomes, which may be hard to determine. This can be expensive to administer, given the numbers involved. It can also involve inequities if not well co-ordinated with the national income tax system, especially since there is usually a flat-rate minimum for all (so making it effectively a poll tax for the poorest).

Poll tax: Flat rate taxes on every adult (or every working adult) were common in colonial times in Africa. While relatively easy to administer, they are clearly regressive and are consequently unpopular and difficult to enforce. As a result, they have largely been abandoned. An experiment with poll tax (called the community charge) in Britain in the 1990s was abandoned because of perceived unfairness, high evasion rates and high collection costs, but above all because of its unpopularity.

Taxes on agricultural land are widely used in Asia to fund local government in rural areas, but are of declining importance. They require an elaborate system of valuation of land, and the yield may be relatively small if the land and/or the people are poor. They also tend to be strongly resisted by landowners (who may often have powerful influence over policy).

Taxes on local products, notably agricultural produce, are easy and cheap to administer where there is a state monopoly produce marketing organisation, but where such arrangements have been abandoned (as is now usually the case) they can be difficult to administer and are wide open to corruption. Such taxes can create serious disincentives to production and marketing of produce, and incentives to smuggling between local government areas if tax rates differ. They also create problems of horizontal equity (e.g. between producers of taxed and untaxed products) and of inter-regional equity (e.g. between regions with a high output of taxable products and other regions).

Taxes (royalties) on extraction of minerals and materials: While minerals and other natural resources are usually taxed by central government (not always in a transparent manner), there may be scope for local governments to benefit. This could be through local taxes or charges, or shares of national taxes (as in the case of oil revenues in Indonesia). It is common for local governments to levy charges for the extraction of sand, gravel, timber and other building materials from the local area. In Sierra Leone, chiefdoms have rights to revenues from diamond mining and local governments are supposed to get a share of this. The obvious problem is how to monitor extraction and assess the value of the materials extracted from (usually) remote locations; the greater the value of the materials, the greater the risks of collusion and smuggling.

Local sales tax can be used for large jurisdictions (e.g. states in the USA and India), but differences in local sales tax rates can have undesirable effects on the pattern of economic activity (e.g. cross-boundary transactions). In most countries sales taxes are best administered nationally. Where VAT is adopted, local administration is not really possible because of the integrated nature of the tax (i.e. problems of differential rates between jurisdictions and how to share revenue between jurisdictions – problems that are apparent with state-levied VAT in Brazil).

Octroi: A tax on the movement of goods into a jurisdiction (effectively, a local customs duty) which has been an important source of municipal revenue in some states of India (and of Pakistan in the past). However, it has hugely damaging effects on internal trade and economic efficiency, and cannot be recommended.

Local taxes on businesses: Many countries (e.g. Germany, France, Hungary, Brazil, Philippines and South Africa) have some form of tax on local businesses, particularly on services. These may be levied on turnover or profits – either presumed or actual. Such taxes can generate substantial revenues, but there are problems in making correct assessments. There are also possible overlaps with national taxes or a local property tax, as well as issues of tax exporting and disincentives to local economic development.

Businesses licences are the commonest form of local business taxation, particularly in Africa. They were originally a form of regulation, but in practice are now a significant source of local revenue in many countries. They are relatively easy to assess and collect, if kept simple, but they can have a negative effect on the local economy if they are set too high and the equity effects are uncertain (depending on who bears the ultimate burden of the tax). In order to generate more revenue without impinging unduly on small businesses or the poor, there is a need to relate in some way the amounts paid to turnover or profitability: this creates assessment problems, with risks of corruption and collusion. The single business permit system in Kenya has been successful in increasing revenue from this source through a progressive tariff scale based on relatively crude but easily verified indicators (Kelly and Devas, 2001). (See Box 2.2.)

Taxes on tourism and entertainments, e.g. hotels, restaurants, cinemas and sports events. These taxes are common in Europe and several other parts of the world, and can produce a reasonable yield in the main urban centres and tourist areas. They are relatively easy to administer and crudely equitable, since they fall mainly on the rich, as well as visitors who use local services, but are somewhat non-neutral since they fall on certain sectors only.

Taxes on utilities, notably electricity, are a local tax that is increasingly used because of the ease and cheapness of administration. It is levied as a surcharge on the utility bill and collected by the utility company on behalf of the local government. It is relatively equitable, since the rich consume far more electricity than the poor. However, it can have an adverse effect on economic efficiency by distorting utility prices, and can only be applied in regions that have electricity.

Taxes on motor vehicles: Annual vehicle taxes (and transfer taxes) can generate a substantial yield, especially in larger cities. They are relatively easy to administer and can be regarded as equitable and politically acceptable. However, central governments are often reluctant to surrender this revenue source, even though local governments may be responsible for the maintenance of local roads and streets.

They are more appropriate to large jurisdictions (e.g. provinces, as in Indonesia), since vehicles tend to be registered in the urban centres, but use roads beyond the urban jurisdiction.

Tax on vehicle fuel (usually levied as a surcharge on a national fuel tax) is very easy and cheap to collect (centrally, through the oil companies). The tax is borne mainly by the rich, and it may have a marginal effect on reducing fuel use. However, it is likely to benefit mainly the developed regions and urban centres, where fuel stations are located. Revenue sharing by formula of a centrally administered tax (such as the fuel levy introduced in a number of African countries) is more appropriate than a directly collected local tax.

Betterment taxes or valorisation charges: These taxes seek to capture from land owners or developers some of the increase in land values that results from urban development and the provision of infrastructure. They are widely used in Latin America to finance urban infrastructure. Depending on how they are implemented, they are usually equitable, but they may be complex to administer, may create unintended inequities and are likely to be politically sensitive.

Market charges, bus/taxi park charges and car parking charges: Technically these are charges (or fees), not taxes, but in practice the charge is often raised well above the costs of the service, making it effectively a tax on the particular activity. In many African countries, market charges are the principal revenue sources for small and rural local governments as they are relatively easy to collect (and collection is often contracted out). The impact of market and bus/taxi park charges is generally regressive, and high charges create incentives for activities to be shifted away from the designated location. By contrast, car parking charges can be regarded as relatively equitable and ensure more efficient use of available space, but they are only feasible in major urban centres.

Other local taxes: Around the world one can find numerous other local taxes – on radios, bicycles, dogs, outdoor advertising, alcohol and particular local products, as well as road tolls. Few of these raise any significant amount of revenue and they may cost more to collect than they yield; they are often regressive and may be economically damaging.

Property taxation

Property taxation is the most common form of local taxation worldwide. In many countries it contributes more than half of local government revenue.

Strengths of property tax: The property tax has several merits as a local tax:

- It has a substantial, stable and predictable yield;
- It is crudely equitable, in that rich people generally occupy more valuable properties than the poor;

Box 2.2. Raising more local revenue from business taxation in Kenya

Business licences can be costly to business

Business licences are imposed at local level in many countries, both rich and poor. Licensing was originally seen as a regulatory instrument to protect customers, workers or competitors. The fee imposed for the licence is often small, but the red tape involved may impose high compliance costs on businesses, especially where they are required to have multiple licences for the different aspects of their business.

In Kenya, by the late 1990s, the business licensing system had become very unsatisfactory. The licence fee schedule was determined for each municipality through negotiation with central government, but the fees set for different businesses bore no relation to their ability to pay. In order to obtain a licence, businesses had to meet a number of pre-conditions, such as obtaining a health clearance certificate. This could be a time-consuming process, with ample opportunity for rent-seeking on the part of the officials concerned. Moreover, businesses were often required to have multiple licences, including in many cases licences from both the local and the central government. There was huge dissatisfaction with the system among businesses.

Licensing may generate declining revenues

In Kenya, business licences did not cover all businesses and the inefficiencies of the system meant that many were not included. Because of the limited variation in tariffs, the amount of revenue which could be generated was constrained by the ability to pay of the smallest informal sector business. Increases in tariffs rarely kept pace with inflation, so that revenue declined in real terms. By the 1990s the system had ossified. It neither regulated businesses well nor raised significant revenues for local government.

Simplifying the system

Instead of abolition, the system was changed into a purely revenue function under the title of single business permit (SBP). This required central government policy and legal change to:

- De-link the payment of the fee from regulatory ‘clearances’
- Broaden the base to include all businesses
- Simplify the tariff structure and make it significantly more progressive by relating it to indicators of size or profitability
- Establish ‘one stop shops’ to issue the new permits

- Require the purchase of only one permit for each business premises
- Remove the business licensing function from central government.

Although the shape of the new SBP has been centrally designed, local authorities have discretion to select an appropriate set of tariffs from a range of pre-approved and internally consistent tariff sets. This has secured municipal engagement. The SBP was also launched as a business-friendly initiative as part of wider deregulation reform.

Capacity building to support the change

The SBP registration forms are simple and are based on self-assessment by the business. Municipalities have been helped to survey businesses and initiate a registration drive. This has helped to increase coverage. Training was provided to assist municipalities to work closely with local businesses and to select the appropriate tariff set. This, together with the removal of the requirement for multiple licences and the de-linking of SBP from subjective regulatory clearances, has improved compliance.

Initial results and lessons

By 2000 all municipalities had introduced the SBP. Within two years revenues had increased by over 30 per cent and in some municipalities had doubled, although collection is still a problem in many places. Revenue improvements have stemmed partly from increased coverage and partly from enhanced tariffs, although some local authorities were forced by their local business community to reduce the high tariffs that they had adopted in the first round. But collection efforts are now based on a more acceptable form of business taxation, revenues have increased and businesses are benefiting from reduced compliance costs.

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- It has no serious effects on relative prices or incentives, and hence on economic efficiency (although there may be a certain disincentive to development, but there is also a positive incentive to more efficient use of land and buildings);
- The basis is reasonably clear and understandable to taxpayers;
- Property is immovable, so the tax object cannot be hidden;
- It is relatively easy to administer;
- There are no problems in assigning the revenue to the correct local government;
- Local governments can have discretion over tax rates;

- It can benefit all local governments, since land and property exist everywhere, although it tends to benefit urban areas more than rural areas.

Weaknesses: Property taxation has certain disadvantages:

- The yield is relatively inelastic – in particular, yields only increase in line with inflation if properties are revalued or if the tariff is increased, and doing this involves difficult political decisions;
- The relationship between the tax bill and ability to pay is crude: there may be serious inequities, e.g. where poor people live in relatively expensive property;
- The payment is highly visible and cannot be disguised, so that there is a reluctance to pay and a reluctance by decision-makers to increase the tariff;
- There has to be a system of property valuation which requires skills, and revaluation has to take place regularly. In rural areas, property may not be titled or recorded on a cadastre, and so is not captured in a valuation roll, while in urban areas informal settlements are often not included;
- The potentially large number of taxpayers means that there is a substantial administrative task;
- Enforcement can be difficult, especially against big property owners and politicians;
- High tax rates can be a disincentive to development, and can encourage people and businesses to move to lower tax jurisdictions.

Property tax assessment: The calculation of the property tax bill has three elements:

- Valuation of the property;
- Tax rate or tariff, expressed as a percentage of the valuation;
- Assessment for a particular property, which is the product of the valuation multiplied by the tax rate.

Exemptions: There may be various categories of exemption – low-value properties (see below); government properties (but it is normal for governments to make a payment in lieu of tax, since local governments still have to provide services to government buildings); places of worship; charities; and social facilities. There is a risk that the range of exemptions will become large, while exempt buildings still require the local government to provide services.

Property tax registers need to be updated regularly. It is common to find that large amounts of property have never been included in the register. Aerial surveys and GIS (geographic information systems) can be used to produce and update property cadastres, but these need to be supplemented by on-the-ground inspection.

Valuation may be done by the local government or by central government. The tariff rate may be set at the discretion of the local government, or central government may specify the tariff (or more commonly specify a range or a ceiling). Worldwide, the tariffs for property tax vary considerably, but typically tariffs are in the range 0.2–2 per cent of capital value.

Valuations may be based on:

- Annual value method (the annual rental income which is obtained from renting that property, or which could be obtained from renting it if it were rented);
- Capital value method (the actual – or potential – sale price of the property on the market).

The method chosen will partly depend on what data are available. In either case, not every property may be valued individually: if there are many similar properties, valuations may be made on a sample basis. Valuations should take account of differences between properties in terms of location, size of land, quality of land, permitted land use, size of building, type of construction, etc.

Valuation rolls should be published in order to discourage collusion between assessors and taxpayers.

Mass appraisal: Where valuation skills are limited, mass appraisal should be used. This system categorises properties roughly by type, location and size, and assigns approximate relative values to each category, either per property or per square metre of property. Once the basic classification is done, valuations of groups of property can be done quickly and cheaply by unskilled staff using a table of values. Valuations do not need to be accurate in an absolute sense, only fair relative to each other. (The UK's council tax banding system is a form of mass appraisal.)

Site value or improved site tax? Assessments may be based on site value only, or on improved site value (i.e. land plus buildings). The former (used in Commonwealth countries such as Kenya, South Africa and Jamaica) has the advantages of stimulating development, encouraging efficient use of land and discouraging speculative land holding. The disadvantages are that site value rating may be seen as being less fair (since the owner of a high-rise building would pay the same as the owner of a single storey building on a similar-sized and adjacent plot), and may raise less revenue. It may encourage overdevelopment of land and may be more complex to administer (since it requires the maximum permitted use to be determined for every plot). A compromise approach is to tax both land and buildings, but to levy a higher rate of tax on land than on buildings.

Owner or occupier? The property tax may be levied on the owner or the occupier. In the case of tenanted property, the tax burden will ultimately be shared between owner and occupier through adjustments to the rent payable; the relative shares will depend on the elasticity of the supply of and demand for rented property. The advantage of levying the tax on the occupier is that the occupier is resident, whereas the owner may be difficult to trace. The disadvantage of levying the tax on the occupier is that they may leave, obliging the local government to pursue them, whereas a liability on the owner can become a charge on the property, such that the property cannot be sold without the tax being paid. The ideal arrangement may be to levy the tax initially on the occupier, with a residual liability on the owner if the occupier fails to pay.

Exemption of low value properties: In some countries (e.g. Indonesia), low-value properties are exempt. This reduces the administrative burden of assessment and collection of small amounts of tax. It may also help to protect the poor, although where such properties are rented, the main beneficiary may be the landlord, who can charge a higher rent in the absence of the tax.

Other assessments: Property tax assessments may also provide the basis for special assessments, for example charges for water (as historically in the UK) or for waste collection. They may also be used as a basis for charging property owners for contributions towards infrastructure improvements, such as new or improved roads in their vicinity.

Local choices over local taxation

As already noted, one of the principles of decentralised governance is a degree of local choice over the amount of tax raised from local citizens to finance local services. This does not mean that all local expenditures have to be financed from local revenues (i.e. financial self-sufficiency of local governments). Rather, what matters is 'discretion at the margin': that is, that local governments should have sufficient choice over a sufficient amount of local taxes to be able to make decisions about marginal differences in local expenditure. Since the bulk of expenditure is largely pre-determined (by statutory requirements, central regulation, historical conditions, etc.), in practice local governments only have a real choice over quite a small proportion of their expenditure budget – perhaps 10–20 per cent. Therefore, discretion over local taxation needs to reflect at least that range of expenditure choice.

It is normal for central governments to determine the range of taxes to be assigned to local government, and the definition of the bases for those taxes. In some systems, local governments have some discretion about introducing new local taxes, but that is highly problematic, since new taxes may overlap with existing national or local taxes, may be non-neutral and inequitable in their impact, and may undermine national fiscal stability.

Local governments may have discretion over assessments and exemptions. Again, there is a case for central assessment of some taxes, in order that the basis for taxation is uniform across the country. Differences in assessments and exemptions between jurisdictions can lead to an undesirable shifting of tax objects between jurisdictions. On the other hand, exemptions can be used by local governments to stimulate local economic development, although they may also be used to give favourable treatment corruptly.

The important area for local discretion is over the tax rate. This should be the main political choice that the local government makes each year, to set the rate so as to generate sufficient revenue to meet its expenditures. Central governments often seek to limit this choice, e.g. by setting ceilings on tax rates. Apart form the negative effect on local autonomy, which may already be quite limited, such limits can seriously constrain local revenues where the ceilings on tax rates are not adjusted for inflation. For example, in the case of property tax, local governments may soon reach the ceiling rate, after which no increase in revenue is possible.

In addition to local collection of the revenue (where the effectiveness and efficiency of the revenue collection service will determine the resources available to the local government), the other main area of local discretion is in the use of the tax revenues. In principle, local governments have full discretion in the use of local revenues, in accordance with statutory obligations, although even here the central government may seek to direct or influence local government spending patterns.

Apart from local own revenues, local governments may benefit from the national tax base in other ways. One is surcharging national taxes (also called tax-base sharing). This is where the local government is empowered to add a percentage to a national tax, such as income tax. This model is common in Scandinavia. Although the tax base is set by central government and the revenue is collected by the centre, the local government has a choice (within limits) over the tax rate and over the use of the money. This then approximates to a local tax.

The other method is the sharing of nationally collected taxes. Where revenues are shared by origin, the revenue reflects the local tax base and the local government has a strong incentive to assist in revenue mobilisation. Where the revenue sharing is by formula, that incentive is greatly reduced and the outcome is much more like a grant than a local tax.

Charges and fees for services

Charges are normally made for local government services that are provided directly and exclusively to the beneficiary (i.e. 'private' goods), for example piped water and recreation facilities. By contrast, 'public goods' (e.g. police and street lighting, which are non-rival and non-excludable) should normally be financed by taxation. The problem is that many services that local governments provide have both 'public' and 'private' characteristics, e.g. education, health services, waste collection and public toilets, and require at least a degree of subsidy.

Justifications for charging for services: These include:

- The need to ration demand for a service and avoid waste;
- The need to provide the resources to maintain and increase the supply of the service;

- The 'benefit principle' of equity – where the benefits are private, those who benefit from a service should pay for the service, rather than those who do not benefit.

However, there are also arguments against charging:

- Administrative difficulties and costs in levying a charge, since non-payers have to be excluded and the amount consumed has to be measured. For example, water meters have to be installed, maintained and read, and illegal connections prevented;
- 'Externalities' – the fact that some services benefit the public at large, as well as the individual beneficiary (e.g. immunisation, waste collection);
- The poor cannot afford to pay for the necessary level of services (e.g. health, education).

A decision not to charge for a service is a decision to subsidise that service. Such a decision needs to be explicit, justified on the basis of externalities (public benefits) and/or poverty reduction (if it is certain that the poor – and only the poor – will benefit). All too often, services that are supposedly free (e.g. health services) do not exist in practice or are of a very low quality, because there are no resources to maintain or improve the service. Also, subsidised services intended for the poor may actually benefit mainly the better off (for example, piped water supplies benefit only those connected to the system, whereas the poor, who are not connected, receive no benefit), or are captured by those responsible for allocating the subsidised goods ('rent-seeking' by those who control access).

Pricing policy: It is normally advocated that charges for services should be set to recover the costs of the service, or – more correctly – to recover the marginal costs (that is, the additional cost of serving the particular consumer). However, there are problems in setting the price correctly, due to lack of disaggregated cost data and issues about short-run or long-run marginal costs. Again, there will be cases where subsidy is appropriate, where public benefits are significant or where the service is provided exclusively, or mainly, for the poor. This may require a form of product differentiation, to ensure that what is provided for the poor is not used by the better off; for example, public standpipes for water are likely to be of interest only to low-income groups.

Cross-subsidies: It may be possible to address the needs of the poor through internal cross-subsidies, at least up to a point. However, that depends on being able to differentiate customers according to income (at least approximately), and ensuring that the rich do not access the services designed for the poor. There will always be limits to the extent of cross-subsidy, since if the price to the rich is raised too high, they may seek alternative supplies (e.g. a private borehole for water) and opt out of the cross-subsidised public system.

Fees: In the case of fees for permits and licences, where the primary purpose is regulation, the costs involved may be small (administrative and inspection costs). It may be considered appropriate to set a fee higher than these costs on the grounds that: (a) the licence or permit is a rationing device; and (b) that the permit/licence holder may derive financial benefits from having the permit/licence. In some cases, fees can be used as a form of taxation, by setting the tariff well above costs (e.g. car parking), in which case consideration must be given to the equity effects on those who pay, as well as any disincentive effects. Where the primary purpose of the permit/licence is to control an activity, fee levels should not be set so high as to discourage people from applying, thereby defeating the main purpose of the permit/licence.

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