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2004

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Acknowledgements
The author is grateful for helpful comments on earlier versions of this paper from participants of the conference of the Tax Research Network, Faculty of Law, University of Cambridge, September 2002 those attending presentations at the Australian Taxation Studies Programme, Faculty of Law, University of New South Wales, Sydney, in April 2001, Ministerstwo Gospodarki, Warsaw in November 2000, Jayne Clancy and two anonymous referees.

Abstract
The topic of multi-level taxation is currently highly relevant to two issues – European tax harmonisation and local government taxation in the UK. This paper presents a general economic analysis of multi-level government and taxation and the characteristics that might make a particular tax appropriate as a regional or local tax. In applying this analysis to European tax harmonisation it is clear that there is little harmony in the meaning of the term and a classification is presented. The main driving force for EU tax harmonisation has been the promotion of economic efficiency in the form of free trade in order to achieve the establishment and functioning of the European internal market. Differing regional needs and preferences regarding public sector expenditure and taxation may not always be properly recognised. It is suggested that a greater emphasis be placed on equity as an economic criteria in developing European tax harmonisation. Applying the analysis specifically to local government in the UK, it is clear that taxes on property meet most of the criteria relating both to taxes in general and lower level taxes in particular. However as in the case of European tax harmonisation, there seems to have been insufficient account taken of matters of equity as compared to economic efficiency. It has been the issue of equity that caused the demise of local authority domestic rates and the community charge in turn and continues to raise difficulties with the present council tax. It is therefore suggested that coverage of the income tax feature of council tax – council tax rebates – be extended. The experience to date suggests equity as well as economic efficiency is important in the successful development of both European tax harmonisation and UK local government finance and perhaps should be given greater prominence in the development of systems of multi-level taxation more generally.

Introduction
In the last resort the public sector can only spend what taxpayers will let it have. This means that tax systems have to be acceptable to taxpayers and a dimension that may have received less attention than it deserves is *multi-level taxation*. The two topics of tax harmonisation in the European Union (EU) and local government finance in the UK are different aspects of this issue. Alexis de Toqueville (1838) suggested that ‘The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations’. In the European context authority and influence are shared across multiple levels of government – subnational, national and supranational (Marks, *et al.*, 1996). Although there are clearly pressures towards centralisation there are also some moves towards devolution, for example with respect to Scotland and Wales, which add to the complexity of relations within EU (Bulmer *et al.*, 2002). Furthermore there are different interactions between different Member States and the EU (Borzel, 2002) and different types of multi-level governance are possible (Hooghe and Marks, 2003).

The nature of the development of multi-level governance is therefore an interactive and iterative process and an important aspect is how multi-level government should best be financed. The topic of ‘fiscal federalism’ has developed many important insights and more can be gained by examining two current examples of the developing tax arrangements within the EU and what appears to be increasing stress associated with local government finance in the UK.

The analysis of taxation with respect to multi-level government involves the usual economic considerations but with some important extensions. One is the economic role and degree of autonomy permitted to lower levels of government. The second is the issue of which taxes are most suitable for which levels of government. This has been referred to as the ‘tax-assignment problem’ (see, for example, McLure, 1983). In terms of the UK these topics have been a long term issue. As Foster *et al.* (1980 p600) suggested:

> The recurrent crises, so called, in local finance which have been a feature of the last hundred years have sometimes led to modification of the system. But though very often there has been much talk about more fundamental changes, the ending of the crisis has usually meant the shelving of the talk.

For example, the implementation of the ill-fated local community charge introduced in 1989 in Scotland and 1990 in England and Wales led to civil disobedience including rioting in London. It was even a contributory factor in the events leading to the resignation of Mrs Margaret Thatcher as Prime Minister (see, for example, Gibson, 1990). At a European level the current manifestation of these issues has been the slow and uncertain progress towards ‘tax harmonisation’ and, as in the UK local government case, there seems to be a long way to go before a satisfactory long-term solution is achieved.

Internationally there are different arrangements with respect to multi-level taxation. For instance, in the USA the different levels of fiscal responsibility include the federal government, fifty state governments, the District of Columbia and about 80,000 local jurisdictions. Australia, Canada and Germany provide further examples of three-level arrangements. The UK basically has a two-tier system with parishes no longer having a significant financial role in local government.

The UK is a unitary not a federal state and the only power local authorities have is based on what the central government will let them have. In federal countries lower tiers have constitutionally established roles. However, in both types of arrangement similar questions arise regarding multi-level government and taxation. Another interesting situation at the other extreme is that of the European Union where there is a ‘bottom-up’ approach as Member States move in fits and starts towards more ‘harmonised’ tax arrangements.

To analyse the economics of taxation at different levels of jurisdiction, this paper starts with the economics of multi-level government in Section 1 followed by the economics of multi-level taxation in Section 2. Section 3 discusses the criteria that might be helpful in considering which taxes are appropriate for lower level jurisdictions. Sections 4 and 5 then discuss two cases – that of European Union and the United Kingdom. Finally Section 6 draws some conclusions.

1. The Economics of Multi-level Government

The economic justification for government intervention in a market economy is that there are some activities where the public sector might provide a more appropriate economic solution than the private sector is likely to achieve. The theoretical justification for this approach is described for example by Musgrave (1959) and Oates (1999). Some of these economic activities are best dealt with at the highest level of government, others at lower levels. Policies relating to the economy as a whole, such as those involving aggregate levels of demand and supply, the issues of unemployment, inflation and the balance of payments, are generally best dealt with at the highest level of national government. This is also because such policies should be co-ordinated with the policies of the monetary authority. Policies relating to the desired distribution of income and wealth are also often best dealt with at the highest level partly because they are likely to affect the whole population and partly because income and wealth are unlikely to be distributed evenly across a country. The provision of some public or ‘social’ goods might, depending on their nature, be best supplied at national level, for example defence, or at a local level, for example parks and other public amenities.

The existence of public goods has long been recognised, for example by Adam Smith in the Eighteenth Century. Although his work is more usually quoted by free-market enthusiasts, Smith (1776 p185) was also very clear that the government has the:

> duty of erecting and maintaining certain public works and certain public institutions which it can never be in the interest of any individual or small number of individuals to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

In contemporary economic analysis, the technical definition of a pure public good has two aspects. One is that it is non-excludable, that is individuals cannot be charged directly for consuming a public good such as national defence or public health and so it has to be provided collectively. The other is that, once it is provided, everyone can benefit at no extra cost so it is not economically efficient to charge for its consumption, even if this were possible. There are very few pure public goods, but many have elements of one or both of these characteristics.

Furthermore the public sector often supplies, or encourages the supply of, goods and services that do not necessarily fit the public good definition but which are considered to have sufficient merit to deserve a higher level of provision than might otherwise be available, particularly to those on modest incomes. Examples of such ‘merit goods’ include education, health and some cultural activities such as the arts.

The demand for public and merit goods may not be the same in all areas of a political entity. For instance, areas with a large proportion of retired inhabitants or one with a large proportion of children might well have very different demands on the public sector than one with a more even distribution across age groups. It is just as possible for varying demands for public goods to exist between groups with different regional and cultural traditions. The economic argument is therefore that communities might be better served if there is an element of choice as regards the level of consumption of public and merit goods in different areas. Another argument for lower tiers of government is that local administration might be better informed than central government about the best ways to meet local needs. There is also an accountability argument for lower tier taxation. Local public spenders might be more careful in their expenditure if they are accountable to local taxpayers than if the money simply came as grants from national funds.

The seminal work analysing how economic welfare might be increased by different local tax and public spending regimes was produced by Tiebout (1956). A great deal more has been done since then. For example, Inman and Rubinfeld (1996) reviewed the literature on the design of tax policy in federalist economies and consider different constitutional rules. Prudhomme (1995) examines some of the drawbacks of fiscal decentralisation and Alesina *et al.* (1995) discuss some possible reconciliations between the gains from large fiscal units and an empirical observation of a tendency towards political separation. Several aspects of fiscal decentralisation are examined by Bird (1993) and particular issues include the deductibility of lower-level taxes from higher level liabilities, (Kaplow, 1996) the effects on the overall size of the public sector (Persson and Tabellini, 1994) and tax competition (Bucovetsky, 1995). Fiscal federalism also has implications for macroeconomic policy (Allsopp, *et al*., 1995) and optimal tax design (Gordon, 1983) but these will not be addressed in this paper. James and Alley (2002) have already addressed issues of tax compliance in this journal and an important related area that has also perhaps received less attention than it deserves is multi-level taxation.

2. The Economics of Multi-level Taxation

In considering the economics of multi-level taxation, it should be pointed out, as Hagemann *et al*. (1988) have, that tax systems often do not even meet the basic economic criteria of *efficiency* and *equity* against which taxes may be judged. Nevertheless it still helpful to consider the main criteria that can be used to assess the economic merits of a particular tax and how these might be modified to take account of multi-level taxation. These criteria are examined more comprehensively in James and Nobes (2003) which forms the basis for the following analysis.

As with public spending, there may be cultural and regional differences regarding taxation in different areas. For instance, in the European context, different countries have different views about the level of taxation on tobacco. Similarly Northern European countries tend to tax alcoholic beverages more heavily than the European Union average and the main wine-producing countries tend to tax wine relatively lightly. This may result partly from different views of the best combination of taxes in terms of direct and indirect taxation, but it might include a deliberate policy of discouraging the consumption of alcohol and tobacco by this means. Furthermore national interest might be involved. For example the European Court has had to intervene in a range of such cases as in the so-called 'spirits cases'. Several countries were found to have discriminatory taxes in breach of Article 95 of the Treaty of European Union - France for having favourable tax rates for cognac over whisky, Italy for grappa over rum and Denmark for aquavit compared with other spirits (Weatherill and Beaumont, 1999 p480).

The main economic criteria for analysing taxes or possible tax reforms in general are efficiency, equity, stabilisation and some economists have also taken administrative considerations into account. These will be summarised in turn.

Efficiency

For a tax to be considered economically efficient, it should not distort economic behaviour of consumers and producers. This includes possible disincentives to work, save and invest as well as decisions about buying and selling particular items. Economic efficiency is about maximising economic output given the resources available to the community. This is not just maximising production but also producing the goods and services that consumers value most. There are countless examples throughout an economy of distortionary behaviour caused by taxation and a great deal of economic tax research has been undertaken into this area relating to the effects of different taxes in different circumstances.

Some of the economic research in this area is very technical but general conclusions can be drawn, subject to a number of limitations and exceptions. In *efficient* markets, taxes that have a wider base are less likely to create distortions than those with a narrower base. Thus a tax on all goods and services is likely to be less distortionary than taxes on only a limited number of goods and services. With *inefficient* markets, there may be scope to use taxation to guide economic behaviour in the right direction. For example, some economic activities, such as those causing pollution, impose costs on the wider community and a possible remedy might be some form of tax designed to give incentives to avoid such costs.

In terms of multi-level taxation, in efficient markets economic activity might be distorted by different rates of tax in different local jurisdictions. Thus local sales taxes might divert trade to lower tax areas. This might not matter so much in geographically large countries such as the USA or Australia but it could be a major consideration for much smaller ones such as the UK. It might also be important in Europe as a whole where there are many countries very close to each other and such tax avoidance has become a major activity. Possibly the best known example are 'booze cruises' undertaken mainly to allow UK consumers to benefit from lower continental taxes on alcohol and tobacco.

However, where there are inefficient markets in which some forms of corrective taxation might be more appropriately levied at lower levels of government. For instance, there is the growing awareness of the possible benefits of the use of congestion charges to ration scarce road space. As the circumstances relating to such a tax vary from area to area, in this respect congestion charges might be a suitable tax for local rather than national levels of government.

Equity

Although this topic covers a number of dimensions, the main area of interest in the present context, is what constitutes a 'fair' tax. The definition of 'fair' is, of course, at least partly a matter of opinion. However, some progress has been made using concepts such as horizontal equity which suggests that people in similar circumstances and with the same taxable capacity should be taxed in the same way. Another concept is vertical equity which suggests that those with differing taxable capacities should contribute different amounts. This overall 'ability to pay' approach includes the 'sacrifice approach' to taxation discussed by earlier economists such as Mill (1871) and Pigou (1932). According to the sacrifice approach, individuals' tax liabilities should be arranged according to the sacrifice of utility involved. Those who derive a lower amount of economic utility from income should pay more in taxation than those who gain greater utility. Although it might be thought that those on higher incomes would have a lower marginal utility of income than those on lower incomes, this is not necessarily true. There is therefore no single scientific prescription as to how this approach would translate, for example, into the most desirable degree of progressivity of a tax system – see for instance Blum and Calven (1953). Other relevant concepts include the 'benefit approach' to taxation - that individuals should pay tax in line with the benefits they receive from public expenditure. This has also been discussed by earlier economists such as Smith and Mill but this approach has a number of limitations. Not the least of these is the difficulty of estimating such benefits.

With respect to multi-level taxation there are several considerations. One is that the level of per capita income and wealth usually varies significantly in different regions within any country. A policy of redistribution therefore has to involve the highest level of government and taxation in order to channel resources from areas with the highest resources to those with the highest needs. However the benefit approach suggests that regions choosing a higher level of public spending should contribute in the form of higher taxation. If there are clear regional differences in views regarding redistribution then there is a case for part of this policy to be determined at a regional level.

Stabilisation Policy

There is a clear case for the government to promote macroeconomic policy objectives relating to variables such as the levels of employment and inflation (for example, see HM Treasury, 2002). There are several considerations as to the optimum level at which such policies should be developed and implemented, and some controversy. It seems reasonably clear that in the UK such policies should not be devolved below the national level. In contrast the European Union might still be too diverse economically for such policies to be successfully managed centrally.

Administrative Considerations

Much of the economic work on the administration of tax has been empirical studies of administrative and compliance costs. Generally the term administrative costs has been applied to the costs to the public sector of operating a tax and compliance costs to the expenses the private sector incurs in complying or not complying with the tax. Relatively high administrative and compliance costs do not necessarily offset all the benefits of a particular tax but they should also be taken into account.

3. Criteria for Choosing an Appropriate Lower Level Tax

In addition to the general criteria summarised above concerning the design of a tax system, to take account of the issues raised relating to multi-level government, there are several additional criteria that might apply to a good local tax. These are all based on the idea that local jurisdictions should have a significant degree of autonomy over local decisions regarding public spending and taxation. A tax that is suitable for lower level should therefore have the following three characteristics:

1. There should be a substantial tax base so that local jurisdictions can raise sufficient funds.
2. The tax base should be reasonably distributed across jurisdictions to avoid revenue sharing arrangements that might reduce the benefits of tax and spending decisions being made at a local level.
3. The tax should be capable of being levied at different rates in different jurisdictions according to local decisions.

4. Multi-level taxation and European Tax Harmonisation

Political considerations are always, of course, important in the design of multi-level taxation and tax harmonisation is part of a much wider political movement towards European integration. For some countries, emerging from the horrors of the Second World War, it was considered to be the only certain way of avoiding a further European conflagration. For some individuals it is seen as a visionary development in political organisation, for example, Moussis (1994 p14) wrote:

> The beauty of the European edifice which has been under construction since the middle of the twentieth century lies in its originality and simplicity. The method of construction chosen, namely the voluntary integration of different nations, had never before been tested in human history.

This might be considered something of an exaggeration but it gives a flavour of some of the hopes pinned on such developments. More generally the preamble to the EEC Treaty of 1957 expressed a determination 'to lay the foundations of an ever closer union of the peoples of Europe'. Some other countries, including the UK, have rather different aims, mainly viewing European co-operation primarily as a way to create a free trade area rather than as a 'United States of Europe'. Even among those countries most enthusiastically in support of European integration there have been difficulties. For example, the EU Stability Pact of 1997 was set up to restrict the size of national fiscal deficits, but unravelled in 2003 with great publicity when it was breached by both France and Germany.

In terms of the analysis in Sections 1 and 2 regarding regional diversity, it is clear that the levels of public spending and taxation are considerably different across the EU. Table 1 shows considerable differences in general government expenditure as a percentage of gross domestic product (GDP) between different Member States. For instance in 2000 the big spenders included Sweden at 58.1 per cent, Denmark at 53.5 per cent and France on 52.8 per cent. The lowest spenders by this measure were the UK at 40.2 per cent, Luxembourg with 40.1 per cent and Spain on 40.0 per cent.

Table 1 Total General Government Expenditure as a Percentage of Gross Domestic Product

	1996	2000
Belgium	53.0	49.9
Denmark	59.8	53.5
Germany	50.3	45.9
Greece	49.2	-
Spain	43.7	40.0
France	55.5	52.8
Ireland	39.6	32.0
Italy	53.2	46.5
Luxembourg	45.4	40.1
Netherlands	49.6	45.4
Austria	56.6	51.9
Portugal	45.6	44.6
Finland	59.9	48.7
Sweden	65.3	58.1
United Kingdom	44.2	40.2
EU 15	51.2	47.0

Source: *Eurostat Yearbook 2002: The Statistical Guide to Europe*, Central Statistical Office of the European Communities, Luxembourg, 2002.

Different countries' requirements for revenue necessarily mean that demands on their tax systems are also very different. For example Table 2 shows that in 2000 general government revenue amounted to 62.5 per cent of GDP in Sweden, 56.3 per cent in Denmark and 55.6 per cent in Finland. At the other end of the scale it amounted to 43.2 per cent in Portugal, 42.1 per cent in the UK and 39.7 per cent in Spain. It is clear that tax harmonisation will have to accommodate considerable regional diversity in public spending.

Table 2
Total General Government Revenue as a Percentage of Gross Domestic Product

	1996	2000
Belgium	49.3	50.0
Denmark	58.8	56.3
Germany	46.8	47.1
Greece	41.8	-
Spain	38.8	39.7
France	51.4	51.4
Ireland	39.4	36.5
Italy	46.1	46.1
Luxembourg	47.3	46.2
Netherlands	47.8	47.6
Austria	52.8	50.8
Portugal	41.6	43.2
Finland	56.8	55.6
Sweden	62.2	62.5
United Kingdom	39.8	42.1
EU 15	47.0	46.2

Source: *Eurostat Yearbook 2002: The Statistical Guide to Europe*, Central Statistical Office of the European Communities, Luxembourg, 2002.

One way forward in developing a model for multi-level government in the EU is the concept of subsidiarity. The principle of subsidiarity was not explicitly described in either the Treaty of Rome or the Single European Act. However, it appeared implicitly in a provision inserted by the Single European Act, namely that the 'Community shall take action relating to the environment to the extent to which the objectives...can be attained better at Community level than at the level of the individual Member States' (Article 130r(4) EC). The Treaty on European Union broadened the provision so that it stated:

> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community (Article 3b EC).

The concept of subsidiarity allows for regional diversity within a Unified Europe. Bernard (1996) suggested that 'subsidiarity provides us with a framework for the understanding of the relationship between the Community and its Member States'. González's (1995) view was that 'subsidiarity is not proportionality' but possibly a different way of doing things. Although the term 'subsidiarity' has been used to challenge the expansion of Community activity, as Weatherill (1996 p509) points out, Article 3b cited above is concerned with the appropriate level at which things should be done. Brittan (1992) described it as a 'best level' test. Taxation could be one area in which some actions can be 'sufficiently achieved' by the Member States particularly if their public sector needs and choices are different.

There is a view that subsidiarity might impede unification. Toth (1992) for example concluded that it will 'weaken the Community and slow down the integration process' and Green (1994) argued that subsidiarity is a concept which promises much and delivers little and is not therefore of much consequence to developments in the Community. Yet such arguments appear to discount the stresses and strains between central organisation and local circumstances. The peoples of Europe may wish for a greater degree of unification than has existed historically, but may not find complete unification of everything acceptable. As Cass (1992) suggests, subsidiarity is a principle which is still maturing but it can help clarify the relationship between the Community and Member States and it has the potential to defuse conflict. It may make it easier for states to operate with a degree of autonomy within a co-operative framework. In other words, it might provide the flexibility to make a closer union possible because it can accommodate a degree of heterogeneity. As Bernard (1996) concludes, the 'Union cannot avoid answering the calls for more decentralised decision-making. Subsidiarity permits this without calling into question the integrity of the Community legal order'. This dimension has to be taken into account in the progress towards tax harmonisation.

The Development of EU tax harmonisation

In Europe the main economic theme of tax harmonisation has been the economic efficiency of free trade required to sustain an integrated internal market. The first significant step towards tax harmonisation was therefore the elimination of customs duties between Member States and this was incorporated in the Messina resolution of 1955 and the Treaty of Rome of 1957. However, initial moves towards harmonisation were very cautious. It began with provisions only for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation 'to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market' (Article 99 EEC as replaced by Article 17 SEA). Since that time there has been a series of reports, reviews and initiatives. An early initiative by the European Commission in 1960 was a committee of tax and financial experts under the chairmanship of Professor Fritz Neumark. This committee was asked to examine taxation and public expenditure with particular regard to those aspects that might distort the achievement of a common market. The Neumark Committee (1963) recommended at least some harmonisation of income tax, capital gains tax, corporate taxation and indirect taxes. It proposed a three stage timetable for harmonisation. The first stage included turnover taxes as the area in need of the most urgent attention and this led to the development of VAT as a European tax. This stage was also to cover withholding taxes on dividends and interest, double taxation agreements and, if possible, excise duty structures. The second stage was the harmonisation of personal income taxes and corporate taxation. The third stage would have completed the implementation of the recommendations by including a common information system and the establishment of a Community tax court. The Neumark Committee produced a fundamental set of proposals but, four decades later, they are still a long way from implementation.

In 1967 the European Commission produced a tax harmonisation programme relating mainly to direct taxation but only part of that has made significant progress. Further initiatives came with the plan for economic and monetary union at the beginning of the 1970s but few of the tax proposals were adopted. In the 1980s fresh proposals for achieving a single internal market emerged and some progress was made, particularly with respect to VAT but much less in relation to other taxes. A few more modest moves followed in the 1990s but progress generally has been slow and not always forwards.

At the Nice summit of European leaders in December 2000, there were clear differences in views, for example, between smaller and larger Member States, and a whole range of difficulties in achieving agreement (for example see the *Economist*, 2000 pp25-30). With respect to taxation, although EU decision-making in more areas became subject to majority voting, decisions with respect to taxation remained subject to national veto. More recently the failure to adopt the draft European Constitution in 2003 was primarily due to more general political disagreements which overshadowed fundamental differences over tax harmonisation.

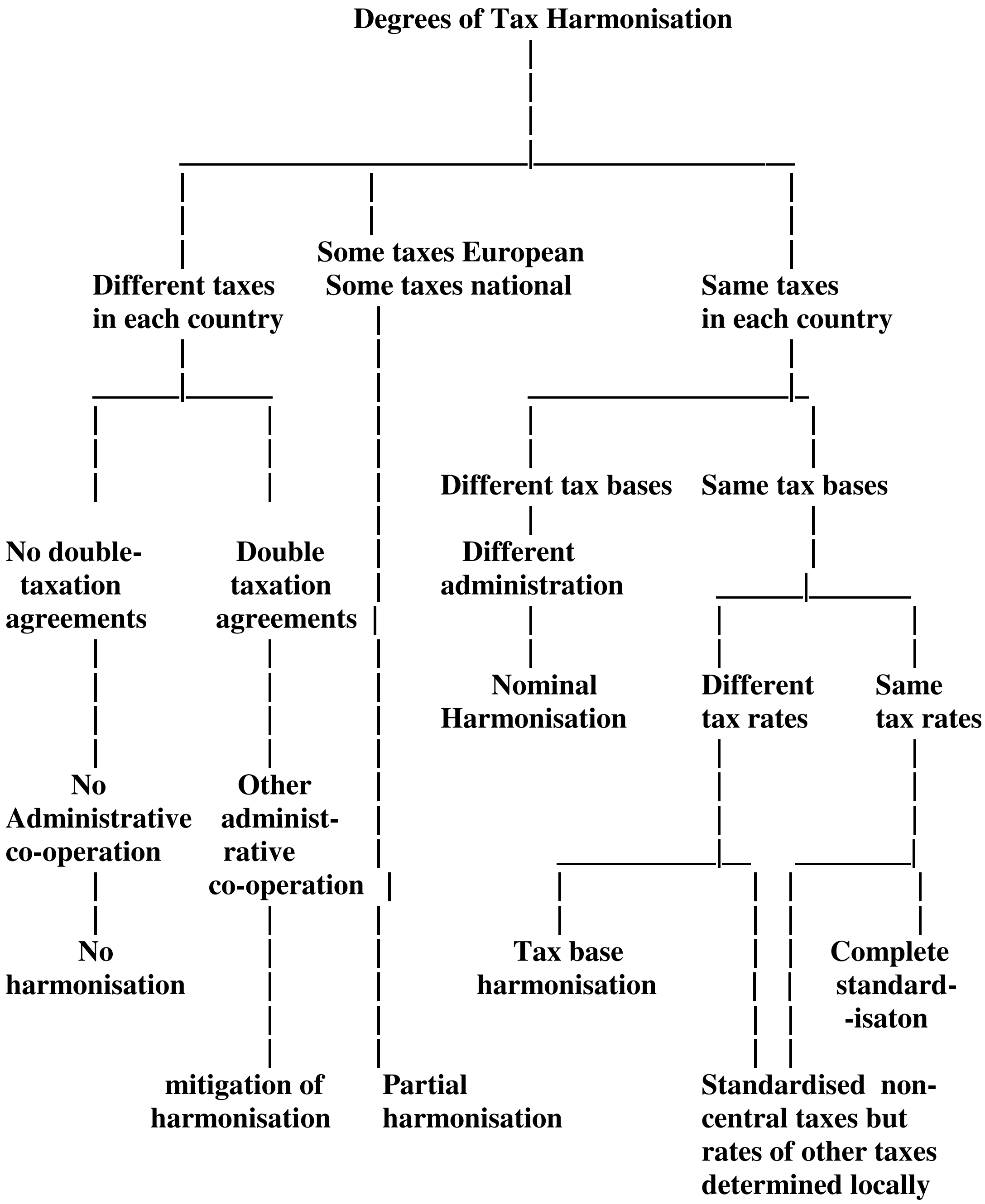
The Economics of Tax Harmonisation

One of the main difficulties in progress is a lack of clarity of the meaning of 'tax harmonisation'. For example, Dosser (1973) restricted tax harmonisation to 'tax co-ordination among nations in the process of integration in a customs union or economic union'. However, Prest (1979 p76) argued that 'co-ordination' is essentially a low-level meaning of harmonisation because it could be interpreted as no more than some sort of consultation process about organising tax systems in a similar sort of way. Rounds (1992 p92) suggests that harmonisation 'refers to any situation where differences in taxation between the states (or provinces) are reduced either by co-operation among the states or by a federal government policy' but acknowledges that a completely uniform tax system may 'not be optimal or practical.' Peggy Musgrave (1967 p210) suggested a more open definition, based on ends rather than on precise institutional arrangements, namely: 'Fiscal harmonisation may be viewed as the process of adjusting national fiscal systems to conform with a set of common economic aims'. Hitiris (1994) took a wider view of the term and describes two approaches to tax harmonisation. The *equalisations* approach, suggests essentially that each country ends up with the same tax system and the *differentials* or *fiscal diversity* approach which allows each country to use its tax system as a tool of policy in achieving major economic aims.

One way of clarifying the issue is to classify possible degrees of harmonisation and this is done in Figure 1. The extreme left hand situation is no harmonisation at all, followed by administrative co-operation. A middle solution of partial harmonisation is to have some European taxes and some national taxes. It is then possible to have the same taxes in each country but different choices about tax bases and tax rates which is roughly the current situation in the EU with respect to the major taxes. The next possibility is to have the same tax bases but some local discretion regarding tax rates. In the UK, Council tax is assessed on the same property tax base throughout the country but local tax jurisdictions have the power to vary the rate at which it is levied. Property is used in many countries as a tax base for local tax jurisdictions, partly because it cannot be moved to areas with lower taxes. However, some countries use a local income tax, sales tax or other taxes on a decentralised basis. Some countries have more than one local tax.

The final extreme is complete standardisation with the same taxes levied at the same rates everywhere in the EU. This does not seem to be the solution sought by most parties, not least because it is unlikely to meet basic equity criteria. The question therefore is to identify an acceptable harmonisation arrangement. The economic analysis summarised in Sections 2 and 3 above would clearly be helpful in guiding political movement towards harmonisation. Possibly the most important factor in the acceptability of such multi-level tax system is equity as the experience of local government finance in the UK illustrates.

Figure 1
Possible Classification of Degrees of Harmonisation



5. Multi-level Taxation and Local Government Finance in the UK

A more fundamental review of local authority finance should also take account of the analysis in Section 1 regarding the appropriate economic roles of different levels of government. In such an analysis the use of the concept of subsidiarity in the UK context might possibly be helpful. However that is beyond the scope of the present paper which examines local authority finance given existing local responsibilities.

The main problem with local taxation in the UK in recent years has been perceptions of *equity* and *fairness*. With the brief exception of the community charge, more popularly known as the poll tax, the main basis for local government taxation over the last four centuries has been property. Such a basis was very suitable in earlier centuries and currently scores very well in terms of the criteria for a lower level tax outlined in Section 3 – there is a substantial tax base distributed across jurisdictions which are able to levy the tax at different rates without major adverse economic effects. Property also scores well in terms of the more general criteria for taxation outlined in Section 2 with the major exception of fairness since it is not linked to 'ability-to-pay'. Similarly the community charge scored well on all the main criteria in Sections 2 and 3 except equity and it was this aspect that caused it to fail. It was replaced by the Council Tax which reverted to property as the primary tax base but this tax is also subject to criticism on grounds of equity. The Council Tax is levied on the basis of domestic property modified by whether there are one or more adult residents and, at the lower levels, by the income of the residents.

Traditionally the most important local tax was rates on occupiers of land and buildings. This tax has an ancient ancestry and can be traced back to the compulsory poor rate raised under the Elizabethan Poor Relief Act of 1601 and indirectly to even earlier taxes. In their modern manifestation local rates were a property tax levied on the 'rateable value' of property. Domestic ratepayers were charged at a lower rate than non-domestic taxpayers and there were also rebates for individuals on low incomes.

Although local authority rates aroused considerable opposition from some ratepayers, in terms of the criteria discussed above, this tax scored quite highly. The efficiency criteria was more successfully met than it would have been by many other potential local taxes because, of course, existing property cannot be moved to lower taxed areas. The administrative and compliance costs were also low and rates were not considered to provide significant disincentives to work, save and invest. In terms of equity it has been argued that the amount spent on housing is (at least loosely) linked to income and wealth and rate rebates were available to those on lower incomes. It has also been argued that a tax system may be progressive overall without every tax individually also having to be progressive. Finally, to the extent that rates were levied on housing, their impact might have been partly offset by income tax and capital gains tax concessions to owner-occupiers.

Nevertheless, local authority rates were subject to considerable criticism over the years. The issue of fairness was frequently raised and it was said that rates did not take an individual's ability to pay into account and were regressive. Other criticisms came from local authorities themselves, who complained that rates were not a buoyant source of revenue and that they were too unpopular to raise the increasing income they needed. Such criticisms were recorded in the reports of successive government enquiries into local government finance (Layfield, 1976).

An additional dimension has been attempts to control public spending. From the time of its original election in 1979 the Conservative Government had struggled to control the level of public expenditure of which, of course, local government expenditure is a substantial part. It was felt therefore that a tax was needed that would make it clear to local electors how much of their money local government was spending. Although rates were acknowledged as a highly perceptible tax, they were actually paid by only a proportion of the local electorate.

There was the possibility, therefore, that a majority of non-ratepayers might vote for a high level of local expenditure with no immediate concern about how it would be financed.

The government therefore looked for a tax that promoted local accountability more effectively. The argument was that 'a substantial proportion of electors [should] have a direct interest in the decisions of their authority' and 'there should be a clear link between changes in [local] expenditure and changes in the local tax bill' (Department of the Environment, 1986). It was therefore thought important that a local tax should be *perceptible* to local voters. On this basis a local sales tax was rejected, among other reasons, because it would not be perceived directly by those able to vote in local elections. Similarly the government rejected the possibility of a local income tax because, while there were over 35 million voters, there were only 20 million income taxpayers (though this counted married couples as one unit: at the time there were nearly 24 million individuals paying income tax). Instead, to try to ensure that as far as possible all voters contributed something to the costs of local expenditure, the government decided to introduce a 'community charge' levied at a flat rate per person. This charge applied to individuals only and, with some modifications, the system of business rates has continued.

The Community Charge or Poll Tax

A review of the arguments relating to a poll tax can be found in Smith (1988). Interestingly enough, like local authority rates, the poll tax meets most of the economic criteria for a good tax. Since such a tax is levied at a flat rate per person, it does not distort consumer choice nor incentives to work, save and invest. In principle at least, it has low administrative and compliance costs since essentially only the existence of the taxpayer has to be established. In terms of a local tax it also generally scores well. The tax base is well distributed since a local authority perhaps ought to be considered as the population rather than a geographical area. Also, as it later proved, it was highly perceptible.

However it failed on the criterion of equity and in its own turn had to be replaced. The historical precedent had not been encouraging. The Rising of 1381 originated from a hatred of the poll tax (Trevelyan, 1946). The Archbishop of Canterbury, who as Chancellor of the realm represented the government, was beheaded by Wat Tyler's men on Tower Hill and, quite remarkably, the rebels captured London itself. Clearly even in those times the poll tax scored highly on the criterion of perceptibility.

The modern version of the poll tax was not related to taxpayers' ability to pay. The lessons include not only that fairness is one of the most important characteristics of a tax but that one which is considered to be unfair becomes difficult to administer and therefore expensive to collect. Although the experience of 1381 was not repeated in quite the same way, the country faced a considerable anti-tax campaign that included civil disobedience and a major riot in London. Alternative forms of local taxation were quickly reviewed and proposals for the replacement of the community charge with a new council tax was introduced in 1993.

The Council Tax and Potential for Reform

The current council tax incorporates a discount of 25 per cent for single adult households and there is an offsetting council tax benefit for those on lower incomes.

Despite the differences between council tax and the old domestic rates, council tax has been the subject of increasing criticism. This is largely a result of substantial increases in the tax charged. In 2003 the council tax average for Britain as a whole was almost double the level of April 1993. In comparison prices had increased by about a third and average earnings by a half (Kenway and Pannell, 2003). However, of course, those not in employment, such as pensioners, have not benefited from increases in earnings and many have found the council tax increases a considerable economic burden. The pressure for reform has therefore been increasing in a similar way as it had for the former domestic rates.

Since the main problem in terms of taxpayer acceptance has been in terms of equity it is the perceived fairness of the tax that needs to be addressed. One suggestion has been the introduction of a local income tax which is used in some other countries. This would meet the equity criteria but would not be so good in terms of some of the other economic criteria. For example it may provide significant incentives for individuals to move to areas with lower rates of tax.

A more acceptable solution might be to extend the existing income tax feature – the council tax benefit. This benefit is payable to those on low incomes who are liable to council tax and is reduced as income rises. It is also limited to people with modest levels of saving. In 2000/01 there were 4.7 million people receiving this benefit to offset their council tax and half of them were pensioners (Kenway and Pannell, 2003). A straightforward solution, which would move towards an income tax in practice for those on lower incomes, would be to lift the upper income limits for council tax benefit further. This would produce the happy combination of an arrangement that went a considerable way to meeting the efficiency criteria outlined in Sections 2 and 3 while addressing the equity issue which carries most force when raised with respect to those on low incomes.

6. Conclusion

The role of multi-level taxation has been analysed previously but the importance of issues of equity do not seem to have been fully recognised. In the case of European tax harmonisation economic efficiency has been the main consideration and driving force behind developments. However, for the development of a successful European multi-level tax system considerations of equity should play a greater role and there should be more explicit provisions to allow for regional diversity. In terms of UK local government finance equity has been the major problem in recent years and has been a factor in all the main reforms – through domestic rates, the community charge and the present council tax. It is suggested that in this case the equity issue may be at least partly addressed through an extension of the council tax rebate system.

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