2021 Research report summary

Local Taxation and Economic Incentives

Thomas Aronsson
Magnus Wikström

SNS

Summary

THE SWEDISH PUBLIC sector is characterized by far-reaching decentralization. Income taxation constitutes the main source of funds for municipalities and regions, but they are also financed via significant funds from the central government in the form of income and cost equalization as well as specific grants. Some problems linked to the incentives facing decision-makers follow from municipal taxation in combination with central government funding of municipal activities. Efficiency problems arise as different parts of the public organization interact with each other in different ways. Other problems follow from the fact that municipalities and regions differ in terms of resources and conditions, as well as from the central government's ambition to even out these differences in order to achieve a fair distribution of resources. Is the current system of local income taxation and equalization satisfactory? Are there alternative solutions that can handle the existing problems in a better way? These are two key issues studied in the report. The overall purpose is to discuss how taxation and equalization should be organized in order to reach objectives concerning efficiency and equity. The starting point of our analysis is a public sector of the same size and type of organization as the present Swedish public sector.

Which taxes are appropriate to use at the local level and which taxes should be decided nationally? We approach this issue by discussing basic principles and objectives for taxation at subnational levels. In addition to generating tax revenues that are sufficiently large and stable over time, local taxation must be economically efficient, comply with principles of equity, give local authorities the opportunity to make independent decisions, and be easy to administer. We also point out some conflicting goals in connection with local taxation, which imply that trade-offs have to be made.

An international overview of local taxation shows that the most common tax bases are earned income and property values. Countries with large local public sectors tend to use income taxation, whereas countries with relatively small local public sectors often use property taxation as their main source of revenue. The Swedish local public sector exhibits a high degree of decentralization by international comparison. There is a clear pattern where countries having decided on a high degree of local autonomy and having a large local public sector use tax bases that can provide significant tax revenues. It is therefore logical that Sweden, which has a large local public sector combined with a high degree of autonomy, uses income taxation to finance local public expenditure. When comparing potential tax bases that could be relevant in Sweden, it also turns out that only taxation of earned income is sufficient for financing a large local public sector. Taxation of, for example, capital income or real estate is not capable of financing current local public expenditure. Thus, as long as local tax autonomy prevails, income taxation must be the main source of revenue. Other potential tax bases are not only too small to finance the local public sectors, they are also too unevenly distributed to finance public sector services while maintaining autonomy.

From an international perspective, Sweden is characterized by strong local tax autonomy where the municipalities and regions themselves make decisions on tax rates. Since inhabitants of different municipalities may have diverse preferences and to the extent that local economic decision-makers have better knowledge of these preferences than decision-makers at the central level, there are efficiency arguments to support this. However, there are also efficiency arguments against decentralized taxation. Tax interaction, both vertical and horizontal, gives rise to fiscal external effects. Vertical external effects arise when taxation at one level (e.g., the municipal level) has a direct effect on the tax revenues at the other levels of government (e.g., the regions and the central government). Even if an individual municipality takes into account that its decision regarding tax rate affects its own tax base, it generally neglects that the tax bases of the region and the national government will also be affected. Vertical externalities therefore imply that municipalities and regions tend to underestimate the marginal cost of public funds (i.e., the cost of generating additional tax revenue, which also includes tax base responses to changes in tax policy). This, in turn, means that municipalities and regions tend to set higher tax rates than what is desirable from society's point of view.

There are several ways of internalizing vertical external effects and thus eliminating the efficiency cost they give rise to. One is to limit the right to tax to a single decision-making level (e.g., the central government) in combination with a redistribution of tax revenue between different levels. Another is an intergovernmental transfer system designed to correct economic policy incentives at the local level. Empirical research based on data from the 1980s shows that the vertical external effects arising because municipalities and regions share the same tax base were not internalized. We do not know of any similar test based on more recent data. As the system of transfers to the municipalities is currently not designed to correct incentives, there is reason to believe that these effects remain.

There are several different sources of horizontal tax interaction, where the choice of tax rate in one municipality directly affects the choice of tax rate in other municipalities. Tax competition is a plausible explanation and is based on the notion that the tax base is mobile between municipalities and regions. If a higher tax rate in an individual municipality leads to a tax base inflow in other municipalities, there is a positive horizontal external effect. In this example, local economic policymakers overestimate society's marginal cost of public funds and tend to choose tax rates that are too low from society's point of view. This, in turn, leads to less public consumption.

Another source of horizontal tax interaction is yardstick competition, which is based on the idea that voters evaluate their own municipality's economic policy by comparing it to the economic policies of other municipalities and, in turn, that this evaluation affects the likelihood of decision-makers being re-elected. Here, tax interaction can instead help eliminate inefficiencies in the political system. A possible effect of both tax competition and yardstick competition is that neighboring municipalities tend to change their tax rates in the same direction. Empirical evidence on horizontal tax interaction varies across studies. However, several studies (based on data for different countries) find that local policymakers choose higher tax rates when the tax rate increases in other localities, and vice versa. Since this correlation in tax rates may be related to several underlying factors and cannot be linked to a particular type of interaction, the policy implications for a central government are not obvious.

Since the tax base is unevenly distributed between municipalities and regions, an extensive fiscal redistribution takes place via the municipal income equalization system. We focus on two key issues in particular. The first refers to the importance of strategic leadership for economic efficiency, i.e., which level of government (local or central) can commit to maintaining its policy in the long run and which level eventually adapts its policy. We analyze the importance of strategic leadership within the framework of a theoretical model in combination with results from empirical research on the effects of discretionary intergovernmental grants. An important result is that if the redistribution system is designed in such a way that local economic policymakers are given the opportunity to act as strategic leaders vis-à-vis the central government, this creates incentives for local decision-makers to adjust their own policies in order to obtain more resources from the central government. This, in turn, undermines the local incentive to tax.

The second question refers to the current municipal income equalization system in Sweden (which is based on a formula and is thus not discretionary) and how this system affects tax policy at the municipal level. We show that income equalization induces municipalities to underestimate society's marginal cost of public funds, thereby implying an incentive to choose a tax rate that is too high from society's point of view. The intuition is that the subsidy received by the municipality increases when the municipality's own tax base decreases. The municipal income equalization system therefore exacerbates the efficiency problems created by vertical external effects.

The most important conclusions in the report are summarized below:

› To finance local public expenditure, we need tax bases capable of generating significant revenue. In addition, tax bases must not be too unevenly distributed between municipalities (or between regions). Out of the potential tax bases we have discussed, only the taxation of earned income can meet these conditions.
› The central government should be responsible for the redistribution of income between individuals/households. As a result, municipalities do not need a more flexible income tax instrument than they currently have. Any new property taxation should be national. The reason is that the distribution of assessed values across municipalities is very uneven and that a national property tax would have redistributive effects between as well as within municipalities.
› Vertical external effects and the current fiscal equalization system tend to give municipalities and regions incentives to raise tax rates beyond what is optimal from society's point of view. To reduce (or eliminate) this distortion, one can either limit the right to tax to one level of government, introduce a ceiling on the income tax rate, or give municipalities and regions financial incentives to keep the level of local tax rates at a socially efficient level.
› A restriction on the local power to tax means reduced autonomy for the subnational levels. The municipalities have a larger number of tasks to perform than the regions, which is why it is more valuable to let the municipalities determine their own tax rates and instead limit the regions' right to tax.
› The national government should avoid so-called discretionary grants, and it should design grants aiming to redistribute resources or steer municipalities in the desired direction based on clear rules.

- The mechanisms behind the measured correlations between municipal tax rates are not fully understood. Here, we want to highlight an important area for future research.

About the authors

Thomas Aronsson and *Magnus Wikström* are professors of economics at Umeå School of Business, Economics and Statistics, Umeå University.