The Personal Income Tax as a Municipal Revenue

Tony Levitas
Anthony_Levitas@Brown.edu
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A Stylized take on Anglo-Saxon Fiscal Federalism

- Municipalities should pay for most of their responsibilities through ‘benefit taxes’ (own taxes in proportion to wealth/use).
- The ad valorem property tax –imposed at flat rates-- is the best municipal tax because it ‘captures use’ while the immobility of its base limits fiscal competition.
- Following Musgrave, the Personal Income Tax is thought of as a national tax whose progressive yield is most appropriate for redistribution.
- As a local own-revenue it would encourage fiscal competition. Not much thought about it as a shared tax.
- USAID and IFI-supported decentralization projects invest heavily in local property taxation as the sine non qua of municipal revenue generation – typically with little effect.

Really Existing European Fiscal Federalism

- Makes little use of the property tax which typically yields little more the 1% of GDP and mostly as a tax on businesses, not residents.

- Instead, PIT is often the single largest source of municipal revenue.
  - In Sweden, Denmark, Iceland as an own revenue, with cities setting rates within base and rate limits prescribed by the national government. (In Sweden, 100% of the yield goes to municipalities.)
  - In Germany, Poland, Norway, Latvia, Estonia, Lithuania, Serbia, Belgium, Spain, Italy, Bosnia-Hercegovina, Croatia, Romania and Ukraine as a shared tax (both through local surcharges; problematically by place of work)

- Where municipalities have significant functions, they are typically assigned 40% to 60% of the PIT generated on their territories.

- The most important national government revenue is VAT not PIT, meaning redistribution is largely funded through 'regressive taxes.'

Two Questions

1. What explains the popularity of municipal PIT sharing in Europe in general, and in post communist Europe in particular?

2. Why has this European reality been largely ignored in the mainstream discussion of decentralization and development?

I could say a lot about both questions but will leave the second for discussion.

- During the 1980s, Scandinavians consolidate jurisdictions to decentralize their welfare states. (Some German *lander* do the same.)

- Consolidation facilitates the assignment of ECCE, K-12 schooling, and elderly care to municipalities, functions too costly to be funded by the property tax.

- Consolidation also facilitates the use of PIT as a local own revenue by limiting fiscal competition (The suburbs are now too far to move to for the rich).

PIT Sharing in Post-Communist Europe

- During the 1980s, and thinking about what to do after the fall, a group of Polish administrative lawyers watch what the Scandinavians are doing.
- In 1989, they see municipalities (not regions) as the best way to break up the single-party state, and to build –from the bottom up– the political parties they don't have.
- For the national government, PIT sharing is a technically easy way to fill the 'vertical gaps' they know decentralization will create.
  - True, so long as PIT payments can be linked to place of residency --admittedly not always the case (e.g. Ukraine, Columbia, Albania, Romania etc.)
- For municipalities, shared PIT feels like an own revenue --"we get what's ours"– without the political burden of rate setting or the 'indignities' of grant dependency.
- Stimulates economic development without unleashing fiscal competition.

PIT Sharing in Post-Communist Europe

- IMF requirement that everybody develop/impose a VAT relieves pressure on the national government to lean on PIT for revenue.
- Paradoxically, sharing large amounts of PIT with municipalities makes equalization both technically easy and politically less contentious.
- Technically easy and less contentious because a single measure –not a proxy– is being used both to assess relative wealth and to calculate equalization grants:
  - All municipalities whose per capita revenues from PIT are less than 90% of the national average are entitled to equalization to grants equal 90% of the difference between their per capita PIT revenue and the 90% threshold.
- The Polish ‘model’ of municipalization can be seen as the poor man’s version of Scandinavia.

PIT Sharing in Post-Communist Europe

- Model goes ‘viral’ through emulation and export.
- Can be, and has been, expanded in places by allowing local PIT surcharges (Croatia).
- In general, has provided municipalities with both stable general revenues while encouraging mayors to take job creation seriously.
- It has also made equalization both politically and technically less contentious, preventing the bottom from dropping out.

So again, why hasn’t PIT sharing become a more central part of the discourse about decentralization and development elsewhere?