

Local Business Taxes in Developing Countries

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In recent years a good deal of attention has been paid to the questions of designing and implementing suitable tax systems for local and regional governments in developing countries, particularly those in which decentralization has been an important policy issue.²

What Taxes for Local Governments?

One way to summarize some of the ensuing discussion is by considering a policy matrix like that sketched in Table 1.

As the top row of Table 1 suggests, a wide range of possible local revenue sources other than intergovernmental transfers has been considered, ranging from user charges and property taxes – both traditional local revenues almost everywhere -- to such more exotic sources as payroll and income taxes and excises and sales taxes. For the most part, all except the two traditional revenue sources already mentioned are often considered to be suitable only for larger regional (or metropolitan) governments as indicated by the symbol (R) in the top row of the table. Note, however, that business taxes, the main focus of the present note, can be and indeed are used both by smaller local and larger regional governments.

The left-hand column of Table 1 lists several criteria that have been used to assess the relative desirability and/or feasibility of each of the revenue sources shown. As usual in policy analysis, it is usually difficult to find good numbers on most of these matters or to make clear and uncontroversial qualitative judgments in order to make entries in the cells of such an instrument-objective matrix. Inevitably, therefore, just as the particular instruments and objectives shown in the table reflect subjective views -- albeit informed to the extent possible by experience -- so do the illustrative entries in the cells.³ Nonetheless, it is an interesting and useful exercise for anyone thinking about local finances in any country not only to try to “fill in the blanks” themselves but also to realize that (1) they would likely do so differently for different subnational governments (local, regional; urban, rural; big, small; rich, poor) and that (2) different people relevant to the policy process (local mayors, central ministers of finance, citizens, businesses) would also likely wait the different criteria differently.

In short, the main lesson to be learned from Table 1 is probably simply that, while many local revenue packages are conceivable, the ‘best’ package for any particular

¹ Professor Emeritus, University of Toronto. This note was prepared on the basis of remarks made at the Workshop on *Raising Taxes Through Regulation?* held by the Investment Climate Department of the World Bank Group on February 25, 2009. Those who wish to understand what is said in this very condensed note in more depth may perhaps find the (excessive) self-references in the notes of some use.

² This note does not discuss the (strong) case for ensuring that subnational governments have adequate “own” revenue sources: see e.g. Bahl and Bird (2008)

³ For a more detailed discussion of the subnational revenues and criteria listed in Table 1, see Bird (2006).

country or local government is likely to be both very context-specific (and, in all likelihood, path-dependent) and sensitive to the prevailing balance of political forces and interests. The appropriate answer to the question of subnational taxation lies at the heart of the complex and conflicting political, social, administrative, and economic issues that underlies the resolution of both the taxation and the decentralization puzzles: it is thus not something that may be quickly or easily discerned, let alone resolved, in any country.

If we add to the complexity of the local finance question the additionally complex task of designing an appropriate regulatory system that will both serve socially desirable ends and at the same time facilitate rather than hamper the sound expansion of private business activity in the formal economy of developing countries, the issues facing those charged with policy design let alone policy implementation become even more opaque and difficult. Unfortunately, the question of the extent to which and the way in which local governments can or should impose business taxes, licenses, and fees plunges us into precisely this complex area.

What Local Business Taxes?

Nonetheless, we have no choice: not only do local governments in many countries already impose a variety of such taxes, licenses and fees, but there are a number of understandable reasons, both good and less good, why they do so and are likely to continue doing so.⁴ When, as is often the case with respect to more urbanized areas in particular, local governments have to meet expanding expenditure needs from their “own” revenue sources, they generally need a more elastic source of general revenue than is usually provided by property taxation.⁵ In practice in both developed and developing countries, some form of business taxation is generally the most elastic (and locally controllable) source of revenue at the subnational level. Moreover, as many have argued (for example, under the name of “market-facilitating federalism”), when local governments gain directly from encouraging economic growth, as they do when their tax revenues expand more or less automatically with increased economic activity, they are more likely to follow ‘market-facilitating’ policies. Finally, when decentralization results from (or is accompanied by) increased responsiveness to local citizens, local governments are inevitably tempted to impose taxes on ‘business’ – that is, ‘someone else’ – when they can rather than directly confronting their citizen-voters. (This may not be “good” policy when it is usually good politics.) Budgetary needs, growth objectives, and political realities thus all often point in the direction of taxing business.

It makes a big difference just how one does so, however. As the second policy matrix set out in Table 2 shows, several distinct forms of business taxation may be found around the world (Bird 2005). All of these approaches may “work” to varying degrees in the sense of producing some revenues for local governments, and some of them may even be buoyant enough to keep up with expenditure needs. However, most do so at the

⁴ For some discussion of the rationale(s) for local business taxation, see Bird (2005).

⁵ User charges are not discussed here: for a brief introduction, see Bird (2001). As with regulatory fees, the theory of what should be done in this area is not difficult; but, or so it seems, good practice is rare. Like user fees, property taxes are not further discussed here: for the argument that as a rule effective property taxes on business should not be any higher than those on residences, see Bird and Slack (2004).

expense of introducing new (and unneeded) distortions into production and allocative decisions and are hence not desirable ways to foster economic activity and growth. Some such as octroi (domestic trade taxes) and gross receipts taxes are particularly unpalatable to the economist in terms of their distorting effects.⁶ Others, like business (corporate) income taxes are hard to administer and also (both because of their compliance cost and because they penalize success rather than stimulate it) discourage rather than encourage the growth of the formal economy.

While the matrix of local business taxes shown in Table 2 is of course as inherently subjective and as open to controversy as the broader matrix of Table 1, on the whole it appears to suggest that local governments in developing countries wishing to tax business activities in principle have the choice of a (relatively good) “modern” business tax or a (generally not very good) set of presumptive levies.

In practice, most countries today have understandably followed the more familiar presumptive path with such variously named levies as the “patente”, the “professional tax”, “industria y comercio”, the “single business fee”, the “simplified tax”, etc. The greater elasticity and reduced distortion of an alternative “modern” approach to taxing local business, however, suggests that this as yet unexplored alternative may be worth more detailed examination, perhaps particularly with respect to the large and rapidly growing metropolitan areas found in many developing countries. Such areas should and could do much more to finance their own growth in a way that would make them politically responsible to those whom they govern (Bird and Slack 2007), and adopting a simple flat-rate tax imposed on an accounts basis on (essentially) the costs of the factors of production employed by a business appears to be a potentially promising path to pursue.⁷

A “Modern” Local Business Tax

The problem is how to realize the potential virtues of local business taxation – essentially an elastic revenue source and increased autonomy – while minimizing such vices as economic distortions, high administrative costs, and breaking the “correspondence principle” by permitting local governments to ‘export’ (non-benefit) taxes to non-residents.

One way to achieve this aim is to impose what has been called a ‘business value tax’.⁸ Businesses add value by combining labour and capital with other purchased inputs. The value added by labour is the cost of labour (wages and salaries) while the value added by capital is the cost of capital (both debt and equity). The base of such a local

⁶ Personal income tax surcharges at the regional level are workable, however, provided there is a good national tax to serve as a base which is seldom true in developing countries (Bird and Zolt 2005). Regional sales taxes may in some instances also be viable and, if carefully designed and implemented – which is by no means easy – not too distorting; however, this path can and should be pursued only by a relatively few, more advanced developing countries (see Bird forthcoming).

⁷ As Bird and Slack (2008) note, the problems in small rural areas are quite different: as a rule, the only fiscal basis acceptable to local governments in such cases is some form of tax based on property.

⁸ This concept was introduced in Bird and Mintz (2000) and spelled out (for Canada) in Bird and McKenzie (2001): see also Bird (2005).

business tax would thus consist of revenues less purchases of inputs (except labour). From an administrative perspective, such a tax base could be calculated in three broad ways. The first is simply to add back appropriate amounts of interest and wages to the base of a business income tax as usually calculated. A second approach might be to impose, in effect, a payroll tax and an appropriate tax on capital. The third and probably easiest approach in most countries might be to tax essentially the same base as a value-added tax.

Compared to a conventional value-added tax (VAT), a BVT has three important distinguishing features. First, it is a tax on income, not consumption: that is, it is imposed on profits as well as wages or, to put it another way, on investment as well as consumption. Second, as a tax on production, rather than consumption, it is imposed on an origin rather than a destination basis, and thus in effect taxes exports but not imports. A third distinction is administrative: the tax would be assessed on the basis of accounting records (or equivalent estimates) rather than on a transaction basis and collected annually (or by periodic payments based on an annual assessment).

Such a tax has several advantages: it discriminates less against investment than income or property taxes; it is also likely to be less susceptible to base erosion; because it has a larger base, lower rates are possible so that economic distortion costs are lower; revenues are more stable than income taxes but more responsive to changed economic conditions than property taxes. Moreover, to the extent the rationale for taxing business at the local level rests on benefit or entitlement grounds, a BVT can be argued to be more equitable than an income tax in any case.⁹

Although this is not the place to do so, much more obviously would need to be worked out about many details before introducing such a tax in any country. As yet, however, the very unfamiliarity of this idea appears to have discouraged its use: no one, it seems, wants to be a fiscal pioneer.¹⁰ Most countries are hence stuck with essentially “presumptive” forms of business levy: nonetheless, even such levies can and should be designed and implemented with much more care than is generally evident in practice in order to improve their elasticity and to reduce both their distorting effects and their vulnerability to abuse.¹¹

Conclusion

As indicated earlier in this note, there is no simple or general answer to the complex set of questions posed by the intersection of taxation, decentralization, regulation, and the development of the private sector. Each country poses a distinct and usually complex problem. Equally, however, there is no doubt that more attention should

⁹ To reduce corruption and evasion possibilities and to prevent abuse by ‘over-taxing’ exporting firms, a single rate tax should be imposed on all business.

¹⁰ South Africa recently considered such a tax but in the end decided not to adopt it. Italy and more recently Japan do, however, have such taxes. It was also proposed by a recent official commission on local business taxation in France. More limited forms of taxes along these lines may also be found in Hungary and in a few U.S. states.

¹¹ See Bird and Wallace (2004) for a general discussion of presumptive taxation.

be paid in most developing countries to the role played by local levies on business in affecting the development of both the local public sector -- "state capacity" at the front end, as it were¹² -- and the development of the formal private economy. What local governments do and how they do it is often a critical and unduly neglected component of both political and economic development. Getting the local taxation and regulation of business "right" from this perspective, while not a solution in itself, is undoubtedly one important ingredient in improving development outcomes in many countries.

¹² On this question, see Brautigam, Fjeldstad and Moore (2008) and Everest-Phillips (2008).

Table 1: A Preliminary Evaluation of Local Revenues

| <i>Criterion</i> | <i>User Charges (L, R)</i> | <i>Property tax (L)</i> | <i>Excises (R)</i> | <i>Personal Income Tax (R)</i> | <i>Payroll Tax (R)</i> | <i>Sales Tax (R)</i> | <i>Business Taxes (L, R)</i> |
|--|--|---------------------------------|--|---|-------------------------------|--------------------------|----------------------------------|
| Revenue adequacy | OK for some activities; not in general | OK for general local government | Unlikely to suffice | Unlikely | Yes, if industrial area | Yes | Not likely |
| Revenue buoyancy | No | Not much | Varies | Yes | Yes | Yes | May be OK |
| Correspondence of payers and beneficiaries | Excellent, if well designed | Fair, if properly done | Not too high | Not high | Depends on employment pattern | Depends on mobility | Depends on design |
| Local Accountability | Excellent | Low | Not too good, unless rate set regionally | Low (depends on rate discretion) | OK if have rate discretion | Can be OK | Usually low |
| Administrative cost | Sometimes high | Fairly high | Low | Not usually feasible unless as regional surcharge | Not high | Moderate | Sometimes high |
| Compliance costs | Irrelevant, in principle | Depends, but not high | Low, as a rule | Medium | Not high | Moderate | Often high |
| Latitude for Corruption | Low? | Moderate | Low | Probably high in most countries | Low | Moderate | High |
| Political Acceptability | Apparently not very high in most countries | Moderate | Very high in some instances | Low | High | Perhaps | High |
| Distortionary Impact | None | Moderate | Can be low | Moderate | Not too high | May be OK | Usually high |
| Progressivity | Irrelevant? | Possibly | Regressive in general, except fuel | Largely unknown | Not very | No | Usually unknown |
| Reduces regional disparities | May do so to some extent | No | No | No | No | No | No |

Table 2: Evaluating Local Business Taxes

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

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