

# PERSONAL AND CORPORATE INCOME TAXES AS SOURCES OF LOCAL REVENUES - OPPORTUNITIES AND CHALLENGES

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**Abstract:** *The policy of expanding the tax powers of local authorities leads to the optimisation of vertical financial relations in the public sector and improved economic efficiency and public well-being. Within the context of decentralization (administrative and fiscal one, in particular), regional structures should be equipped with access to profitable revenue-generating tax sources. The paper focuses on the applicability of personal income taxes and corporate taxes at a local level. The pros and cons of using the two types of taxes as sources of revenues to municipalities are analysed, the practice of different countries around the world in the sphere is reviewed, and, based on those, the author proposes the thesis that taxes on labour incomes should be approached as local or parallel taxes, while there are no grounds for including corporate taxes in the category of local or parallel taxes.*

**Keywords:** *local revenue; local government autonomy; personal income tax; corporate income tax.*

**JEL:** H71, H72.

## Introduction

The effectiveness of financial decentralization is a consequence of having competences and financial resources reasonably shared by central and local governments and directly depends on the own revenues of territorial structures (Zahariev, 2012; Krastev, 2018). 'Therefore, the dependence (or independence) of a local government on (from) the central one is largely determined by the ability of each municipality to accumulate sufficient own revenues to be expended freely for public benefits in public interest' (Pavlova-

Bunova, 2018, p. 5). The choice of a specific form of local taxation is essential for designing a decentralized tax system that is based on the principles of regional revenue autonomy and therefore requires an in-depth analysis.

Issues related to the well-grounded attribution of a tax to the powers of the central government or to the responsibilities of local government bodies determine *the relevance* of this paper. The *object* of the analysis is to examine personal and corporate income taxes as potential sources of local revenue, while its subject relates to the effects which the revenues from those taxes would have on the financial autonomy of local authorities. The main *objective* of the paper is to determine which level of the budget system personal and corporate taxes correspond to. Based on the defined object, subject and objective of the research, the following research *thesis* is formulated: The analysis of the practical and theoretical aspects of personal income taxes leads to the conclusion that in contrast to corporate taxes, they can be approached as an adequate source of local revenue<sup>1</sup>.

## 1. An Optimistic Approach to Using Personal Income Taxes at a Local Level

The personal and corporate income taxes are a source of significant revenue to the budget. Provided that property taxes are not profitable, the question of the possibility of using income taxes as a local source of income is of paramount importance<sup>2</sup>.

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<sup>1</sup> **Note:** Issues related to the comparative analysis (through data provided by the statistics) of current tax efficiency and profitability (respectively, the benefits and costs) of the existing model of financing different administrative units are not included within the scope of this paper. Such an analysis and testing of simulation models for financial modeling of the effects which the tax reforms are expected to have on Bulgarian municipalities are clearly needed *next* steps (after justified attribution of a tax to the powers of the central government or to the responsibilities of local governments) in the process of designing an efficient decentralized tax system.

<sup>2</sup> **Note:** The basic characteristics of personal and corporate income taxes are: 1) they are neutral in terms of price levels since they are not included in the prices of goods and services; 2) they are personal and therefore taxation can be organized in a way that takes into account the individual characteristics of the taxpayers; 3) they are an instrument of the discretionary fiscal policy; 4) they can be used for specific purposes, for example, to encourage employment in certain regions; to promote (or limit) certain costs incurred by businesses; to encourage savings in certain assets; to affect the activity of monopolistic and oligopolistic structures; 5) progressive taxation renders personal income taxes a typical example of the operation of built-in budget stabilizers. See. Prof. Brusarski, R., A. Zahariev, G. Manliev. (2015); *Financial theory*, Veliko Turnovo: Faber; Milinov, V. and M. Marinov (2017); *Taxation Technique*. Svishtov: Tsenov Academic Publishing House.

*Personal income taxes* are levied on labour incomes and capital gains from trading in securities, currency, rental income, interest, dividends, etc. In light of the objective of this paper, our analysis is focused on the possibility to use revenues generated from personal income taxes at the level of municipality. We should note, though, that this is an adequate source of local revenue since it meets fully or partially the optimality criteria (See Table 1).

*In the first place*, individuals, in most cases, reside and work on territories that are subject to the same jurisdiction. Personal income taxes can therefore be approached as a payment for the 'common benefits' provided by local governments. Applying this tax at a local level helps avoid exporting the tax burden and make sure that the taxpayers are also the users of public benefits, which is essential for economic efficiency.<sup>3</sup> It is precisely from the perspective of efficiency that another point should be made - income taxes (including from labour) are usually visible to payers, which forces local governments to improve their expenditure accountability. In order to be objective in our analysis, though, we should acknowledge the fact that personal income taxes are not as visible as property taxes. This statement takes into account the fact that all due taxes on wages and salaries are usually deducted by employers, while the payments due for ownership rights (or change of ownership rights, etc.) on property are made in person.

A fair approach to the regional applicability of the analyzed tax requires that we take into account the fact that gained receipts reflect the dynamics of the economic situation within a region relatively accurately, i.e. the tax base is elastic. During an economic upsurge, labour incomes tend to increase due to the growing demand for labour force (i.e. in real terms) and due to inflationary dynamics which is typical of periods of economic growth (i.e. in nominal terms). Positive changes in personal incomes result in increased revenue generated from personal income taxes and thus encourage local governments to manage their own regional resources in a responsible manner. In contrast, transfers from the central government that are not related to the economic situation in the municipality or, more often than not, are inversely dependent on the situation, create conditions for unreasonable expending of resources due to fiscal illusions. This is another argument in favour of the economic efficiency of local taxes on labour income.

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<sup>3</sup> **Note:** For further reference about the relation between fiscal decentralization and cost-effectiveness, see: Tanzi, V. (1995). Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects. Annual World Bank Conference on Development Economics, pp. 295-316. For further reference about the effects of introducing changes in tax practice in different regions worldwide, see: Naydenov, L. (2012). Tax autonomy of local authorities - theoretical arguments and national practice, Varna: Steno.

*Table 1*  
*Local use of personal income taxes*

Optimality criteria for local taxation	Comments
The tax burden is borne by the residents of the region	Most often, individuals live and work in the same municipality. Therefore, the local use of personal income tax prevents tax exporting.
Easy administration of taxes	In most cases, individuals live and work in the same municipality, and the tax liability is withheld at work. The local administration of personal income tax is therefore a realistic option.
Taxes do not impede the functioning of the domestic market	Labour income taxes do not affect the performance of the domestic market and pose no barriers to international trade.

*In the second place*, the administration of the tax in question at a regional level can be defined as a realistic and achievable goal. Such a statement takes into account the fact that personal income taxes are deducted by employers and is based on the assumption that tax-payers live and work in the same jurisdiction. The taxation of freelancers' incomes and other sources of income outside payrolls is probably more difficult, but 'it is no more problematic to local authorities than it is to the central government, and therefore there is no reason to believe that the percentage of the funds collected through a decentralized tax systems would be lower than the percentage of funds collected through a centralized one' (Bahl and Cyan, 2010, p.6). The issues discussed so far can be approached from another perspective. In comparative terms, the costs incurred for the regional administration of *property taxes* are lower than the costs incurred for the collection and control of *direct personal income taxes*. This argument is commonly used against the practice of local administration of taxes. Nevertheless, a similar argument should be approached with certain criticism for at least two reasons. On the one hand, it does not take into account the recurrent expenditures incurred by administrative tax offices on the tax revaluation of property (due to changes in market prices or in other circumstances). Those expenditures should not be underestimated, since including them in the analysis will render the administration of income taxes similar to that of property taxes. On the other hand, revenues generated from income taxes are much higher than the revenues generated from property taxes, therefore, the ratios between

administrative expenditures and the nominal revenues generated from the two types of taxes are similar<sup>4</sup>.

*Parallel taxation* is another solution to potential administrative problems in the collection and control of income taxes (including those on labour income). There are two options for organising this type of distribution of powers and they are quite similar in content. The application of the first one implies that income taxes are levied both at a local and at a national level. In this situation, local governments apply a uniform (proportional) rate to the tax base which the central government has defined and proceeds are collected by the central government. The second option refers to levying a surcharge on the fixed national income tax rate. The specific amount of the surcharge may vary in the different jurisdictions within the limits set by the central government or it may be fixed by the regions. It is recommended that the percentage of the surcharge be proportionate and not progressive in order to avoid possible tax exportation.

*In the third place*, the use of personal income taxes as a local source of revenues does not impede the functioning of the domestic market and is not related to international trade.

## **2. Potential Disadvantages of Using Personal Income Taxes at a Local Level**

The arguments in favour of the local administration of personal income taxes are not generally accepted. *There are several points of criticism* to such sharing of powers.

*On the one hand*, it should be borne in mind that the personal income tax is a typical instrument of a national stabilization and redistribution policy and is therefore inappropriate for use by local governments. Stancho Cholakov, for example, notes: 'It is advisable that personal income taxes be collected by central governments, since income is one of the most appropriate objects of taxation, not only in terms of yield ... but also because it is recognized as being the most comprehensive tool for measuring the economic and social status of income holders. The personal income tax is therefore A GOOD instance of fair taxation' (Cholakov, 1936, p. 156). This view is logical (and in accordance with the tradition established by R. Musgrave, it is accepted as an axiom in the theory of fiscal federalism), but should nevertheless be approached with more skepticism. Beyond a strictly dogmatic interpretation, the statement that local authorities cannot be expected to be involved in stabilisation raises certain objections. As a

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<sup>4</sup> **Note:** The practice of the United Kingdom proves the validity of the considerations above since the relative costs (i.e. the cost/income ratio) of administering income taxes in the country are lower than those of collecting and controlling property taxes. In addition, the property tax rate is one of the highest in the world. See Chartered Institute of Public Finance and Accountancy (CIPFA). (2004). *Reviewing the Case for a Local Income Tax*. London.

matter of fact, in the presence of regionally asymmetric shocks or in the context of small open economies with a floating exchange rate, a central fiscal policy is hardly effective and there is definitely room for territorially constrained growth incentives<sup>5</sup>. The issue of social policy can also be considered from a position that differs from the commonly accepted one.

Redistribution through progressive income taxation is clearly within the prerogatives of central governments, but the administration and control of the appropriate targeting of social assistance for the disadvantaged may be implemented by local authorities since they have more accurate and adequate information on their real needs. Provided that governments levy a progressive income tax while local authorities apply proportional taxes, there is no reason to believe that regional intervention limits the effectiveness of the stabilisation and redistribution policy which is implemented by the central government. A similar manner of organizing taxation may be advisable as it does not compromise the impact of built-in automatic fiscal stabilizers.

*Another reasonable argument* against the use of personal income tax by local authorities is the statement that the place where a tax is paid is not always the place where public goods financed through that tax are consumed. Of course, people can work and live in different regions (McLure, 1999). If tax revenues are accumulated locally (i.e. by employers), there will certainly be a discrepancy between incurred costs and received benefits. We need to emphasise again that some locally provided public goods (education, healthcare) generate 'common benefits' and it is therefore necessary to ensure that the consumption of those benefits is pegged to income taxes. That would be difficult if personal income taxes are collected by employers. What is more, this type of taxation creates conditions for exporting the tax burden, thus reducing further the efficiency of the distribution of scarce resources. In theory, revenues generated through income taxes that are collected by employers may be expended by the regions where people live. The administration of such a mechanism, however, raises other issues, such as the lack of incentives for efficient collection of receipts and potential delays in the payment of amounts due. On the other hand, taxes collected through income tax forms may take into account the residence of taxpayers. Such an option (used in conjunction with the collection of income taxes by employers) is in compliance with the principle that paid taxes must

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<sup>5</sup> **Note:** In a situation of regionally asymmetric shocks (for example, the impact of oil prices on two districts – one being an importer and the other one – an exporter), there is no harmonized *national* economic cycle. In this situation, one of the regions might be subject to inflationary pressures, while at the same time the other jurisdiction might be facing unemployment. Clearly, a central fiscal policy is ineffective in this case. The same conclusion may apply to small countries with open economies and a floating exchange rate, because in such cases the central fiscal policy will affect the price of the national currency. Thus, during a recession, the value of the national currency will rise, which will result in lower exports and increasing imports. A local fiscal policy is possible and even advisable provided that it bears no effect to the exchange rate.

correspond to received benefits. Hence the conclusion that when the tax collection process is appropriately organized, personal income taxes may be expended locally. This is further supported by the fact that individuals are more likely to live and work within the same jurisdiction.

As we know, in the budgeting process (central or local), the revenue side is based on projected, expected revenues. Therefore, *tax revenue predictability* is essential for building a realistic budget. Revenues from personal income taxes, however, are difficult to forecast because of the highly resilient base. The problem is further exacerbated when local authorities have broad tax powers and the proceeds from personal income taxes constitute a significant share of those revenues. In this context, an unexpected decline in regional economic activity poses a risk to the funding of basic local public goods. Central government support is therefore essential for expanding the tax powers of local governments in terms of collecting personal income taxes. The specific organization of relations between the central government and regional authorities must prevent any moral hazards that could undermine local responsibility or accountability. Practice in Scandinavian countries shows that ambitious as it could be, this goal is still achievable<sup>6</sup>.

The difficulty of accurately forecasting revenues from personal income taxes should not be exaggerated. This thesis is supported by the general macroeconomic fact that, in the short term, wages are not flexible in terms of declining, i.e. a sharp decrease in the revenues from collected personal income taxes is not very likely. Undoubtedly, the existence of minimum wages, the presence of trade unions and medium and long-term employment contracts reduce the elasticity of the tax base. On the other hand, there is no obvious reason to define regional forecasts as wrong *by default*.

In the context of fiscal autonomy and local freedom in defining tax rates, there is always the risk of unfair tax competition *and tax-driven migration*. We need to emphasize that high tax rates, when coupled with high quality local public goods, ensure fiscal equivalence and do not encourage migration<sup>7</sup>.

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<sup>6</sup> **Note:** In Denmark and Sweden, central governments collect revenues from personal income taxes and subsequently distribute accumulated funds to local authorities in accordance with the budget forecast (rather than on the basis of real amounts collected). In Danish practice, any difference between planned and actually collected revenues on the territory of a region is approached as a loan from the government to the province or vice versa. This loan is repayable within two years, with due interests. In Sweden, the difference between estimated and real revenues is added to or respectively, deducted from the subsidy paid off in two years.

<sup>7</sup> **Note:** Clearly, in terms of tax base mobility, property taxation is less risky than income taxation. This issue is analyzed by *J. Spry*. The author suggests that a number of US states prefer property taxes to income taxes because the latter motivate the migration of one particular group of households. These are households whose incomes are high enough, but the value of real estate owned is relatively low, i.e. the cited author points out the importance of the nominal income / price index of the property as a factor for migration. See: Spry, J. (2005). The Effects of Fiscal Competition on Local Property and Income Tax Reliance. Topics in Economic Analysis and Policy. Vol. 5. No. 1. pp.1-19.

*There are further arguments that raise doubt about the efficiency of using personal income taxes at a local level. For example, it is an indisputable fact that taxable bases vary widely on different territories and therefore local fiscal autonomy results in growing regional fiscal imbalances. To support the thesis of our research, we should note that the issues of horizontal imbalances:*

- 1) are in the prerogatives of the central government and
- 2) may be resolved through transfer policy instruments.

*Another tax-related issue that deserves more attention refers to the scope of local taxation. It is recommended that the tax base should include any incomes of individuals, and not just those from labour. The administration of *capital gains* faces considerable difficulties, mainly in terms of the control on the fair and true declaration of incomes (for example, from trading in securities, currencies and other taxable assets). Furthermore, capital income is often generated from a source operating outside the region and, therefore, a local tax on such income does not comply with the principle of levying taxes that are commensurate with received benefits. It is therefore worth considering the possibility to levy different taxes on different types of income. Such a solution has two major aspects: Firstly, taxes which are easy to administer on a 'local' basis (for example, real estate rental tax, property tax on commercial real estate, or taxes levied on sole proprietorships) are decentralized by providing extensive powers to regions, i.e. tax rates are defined locally. Secondly, taxes on income generated from dividends, interest, trading in securities, currencies, precious metals, etc. are collected centrally (by applying a common tax base and tax rates). We should note that a similar approach to collecting taxes on income that is not generated from wages or salaries would be in conflict with the principle of equal taxation of income from different sources (in practice, this principle is often violated by tax legislation, both in developed and developing countries) and incur additional (including transaction) costs on taxpayers.*

D. King (2007) suggests a different solution, its primary advantage being ensuring the fiscal autonomy of the regions. The author recommends that local authorities levy capital income with one and the same tax rate that is equal to the average tax rate levied locally on incomes (this implies that local authorities will define independently the tax rate on labour income and employ a uniform tax rate for capital income) and then distribute the revenue generated from taxes on capital income among regions according to the size of their population. The objective is to ensure equal receipts per capita. Applying King's solution, however, would complicate the tax system and requires cooperation between regions which, in some cases, is not possible.

The issues arising from the central regulation of payments are not impossible to resolve. They refer to formulating adequate and straightforward legislative provisions that are based on the principles that labours earned through labour should be negotiated and that capital incomes should be regulated by the market.

Hence, we could make the following conclusions and recommendations about the possibility to collect taxes on personal incomes at a local level:



- Taxes on incomes earned from labour meet the requirements for using them at a regional level. As a rule, they do not encourage tax export or impede the functioning of the single domestic market and can be administered at a reasonable cost;
- Taxes on capital income are not relevant to the domestic or the international trade of the country, but their collection and exercising control on the fair payment of debts are difficult. At the same time, some of those taxes are not in compliance with the principle that collected taxes correspond to the benefits gained from the consumption of public goods.

### **3. Using Personal Income Taxes at a Local Level - the Practice**

The findings of the research provide some guidelines for designing a decentralized tax system and define its characteristics (in terms of personal income taxes). Nevertheless, it would be impossible to make a definitive judgement without studying *the practice of other countries* (Bahl and Cyan, 2010). It is worth noting that the use of personal income taxes as a source of local revenue is a typical feature of the tax systems in countries with developed market economies. The models through which regional authorities have access to the receipts from personal income taxes range from full local autonomy to sharing of receipts between the government and the territorial units.

In the USA, regional (state) governments are authorised to decide whether to expend revenues from personal income taxes and to define the tax base and the tax rates. In terms of the tax base, most states adopt the definition of gross income that is used by the federal government and subsequently formulate their own tax base. In general, the tax is proportional, but some regions apply progressive taxation. An interesting fact is that in 11 states, third-level public authority may levy surcharges on the regional (state) basis. Canadian provinces are also authorised to collect personal income taxes (including the right to determine the tax rates), but the administration and scope of the tax base are within the prerogatives of the central government (except in Quebec, where the tax base and the administration of taxes are a local responsibility). In Switzerland, regional authorities (cantons) charge a personal income tax within the limits prescribed by the constitution and define the tax rate. Similar to the USA, taxes can be proportional or progressive, and third-level public sector units (the communes) can set surcharges on the tax rate defined for a particular canton. We should note that regions in Switzerland receive as subsidies a share of the revenues generated at the federal level from the central personal income tax.

Table 2

Options for using the personal income tax as a local source of revenue

Characteristics of the tax system	Local autonomy	Mixed approach		Centralized allocation	
	The USA & Switzerland	Scandinavian countries	Spain	Germany	CEE (Central and Eastern Europe)
Regional tax rates	YES	YES	YES	NO	NO
Regional tax base	YES	NO	In some regions	NO	NO
Regional administration	YES	NO	In some regions	YES	In some countries
Regional or local tax surcharges	YES	YES	-	NO	YES
Shared taxes	YES (Switzerland)	YES	NO	YES	YES

According to the so-called *Scandinavian model*, the administration of taxes is the responsibility of a single central administration (there are no local ones), and the rate of personal income taxes is defined by the regions. In principle, the rules for determining the tax base are formulated by the government, and the latter may also set limits on the amount of the tax base. In *Norway*, for example, there is an upper tax threshold and most provinces apply that maximum. In *Sweden* and *Denmark*, the courts define the taxable rate independently. The practice is different in Germany- the regions (*länder*) are fully responsible for the administration of personal income taxes, but are not authorized to define tax rates or the tax base. Generated revenues, however, are shared between the provinces and the central government. The shared tax system is also used in the administration of personal income taxes in *Austria*, *Belgium*, *Portugal* and some other countries.

*Spain* is an interesting case as no uniform approach is employed in terms of the powers of regional authorities. Some provinces have guaranteed tax autonomy (its parameters being close to those in the United States), while others are only authorised to determine the tax rate. A similar approach is quite reasonable, provided that not all provinces have the necessary administrative or financial resources to handle the responsibilities of tax decentralization. Two of the characteristics of the administration of personal income taxes in *CEE countries* are the surcharges on centrally defined tax rates and the tax base and/or the sharing of receipts. In *developing countries*, the practice of local

autonomy with respect to personal income tax is an exception, rather than a rule.

These practical and theoretical aspects of the issue of local personal income taxes provide the necessary basis for making a final assessment. Evidence from applied tax practices in different countries confirm the findings of the conducted theoretical analysis, hence we can make the following conclusions:

- Personal income taxes are treated as local taxes (and exclusively as local ones in the US and Switzerland). Nevertheless, there are certain restrictions on regional tax autonomy (predominantly in Canada and Norway) which are considered to be appropriate;
- Personal income tax can be used as a form of parallel taxation (as it is the case in Central and East European countries). Such a compromise is highly recommended for countries which are going through fiscal decentralization and substantial vertical fiscal imbalances at the same time. Personal income taxes may also be charged to generate revenues that are shared;
- It would be impossible to apply a uniform approach to the taxation of personal income. Some of these taxes (for instance, those levied on income generated from the rent of property) may be collected at a regional level. If this is the case, it would be appropriate to have the the tax base, the administration and the upper limit of tax rates defined by the central government. The latter implies parallel taxation or sharing of tax-generated revenues. Profit taxes collected from sole proprietorship may (under certain conditions) be administered at a regional level as typical local charges.

#### **4. Administration of Corporate Income Taxes at a Local Level - Opportunities and Disadvantages**

The issue of including *corporate income tax* within the scope of local tax powers does not raise any theoretical debate. The view that business taxes (i.e. taxes on corporate profit and/or on specific types of revenue) should not be used by regional authorities is generally accepted and justified by the fact that all *potential* negatives of taxes on personal incomes are thus *materialised*. In terms of the criteria adopted in the paper for the optimization of tax separation between the vertical levels of the public sector, there are a few points to emphasise.

*In the first place*, charging corporate income taxes is in conflict with the principle that the amount of payments made should correspond to received benefits. Clearly, legal entities that consume local public goods have to pay appropriate charges or prices for the services provided by the municipality. This is the case in all developed and developing countries. It is impossible, however, to consider the so-called 'public benefits' an argument in favour of corporate income taxes. This does not mean that companies do not benefit from the high

quality of locally funded goods such as primary and secondary education, emergency medical care or fire protection, rather, it emphasizes the fact that such benefits are indirect and largely affect the well-being of physical persons. The previous section of the paper therefore proposed that personal income taxes could be collected at a local level.

*Table 3*  
*Using corporate income taxes at a local level*

Optimality criteria for local taxation	Comments
The burden of taxation is borne by the residents of the region	The local administration of corporate income taxes allows the exportation of the tax burden.
Easy tax administration	Substantial administrative potential is required to control the correct accounting of company operations and to accurately identify the geographical source of income.
Taxes do not impede the functioning of the domestic market	Charging corporate income taxes, as a rule, does not affect the functioning of the domestic market and does not create barriers to international trade.

*In the second place*, the issue of local autonomy in the regulation of corporate taxes relates to the lack of a direct relation between the revenues generated from those taxes and the benefits that are consumed, as well as to the export of the tax burden. Taxes charged on corporate profit (all things being equal) lead to lower income of company owners, have a negative effect on wages and salaries, and result in higher prices. A major argument against the local administration of corporate profit taxes is that shareholders, workers and buyers often live and work outside the territory of the tax creditor (i.e. the municipality, in this case). It is therefore logical to conclude that regional powers on collecting corporate taxes result in exported tax burden.

*In the third place*, a major feature of local tax autonomy is the right to determine tax rates. Within the context of competition between regions, that right can encourage the unjustified reduction of tax rates, thus leading to a decline in the volume of locally provided public goods below the demand for them.<sup>8</sup> It is worth noting that the freedom to charge autonomous tax rates renders the implementation of policies of the 'beggar-thy-neighbour' type highly attractive, and encourages business entities to have their economic activity relocated

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<sup>8</sup> **Note:** The negative effects of local powers in regulating corporate income taxes have been the subject of numerous research works. For a thorough theoretical analysis and empirical verification, see: Graham, E. and P. Krugman (1989). *Foreign Direct Investment in the United States*. Institute for International Economics. Washington.

somewhere else. Hence the conclusion that local tax autonomy, in terms of corporate profit taxes, results in inefficient allocation. Such a conclusion may not be fully applicable to situations in which a company strongly depends on its territorial location (for the extraction of raw materials, for example), yet this is rarely the case in practice (since although raw materials may be extracted on a specific territory, their processing and the production of final goods may take place somewhere else).

There is another aspect of the issue of efficiency. As we already stated in this paper, the principles of taxation need to be 'visible', so that consumers of public goods (voters) could be aware of the costs for having those goods provided to them. Hence, we need to emphasise that:

1. Corporate income taxes are charged anonymously with respect to average voters;

2. The exportation of the tax burden to other regions complicates the process of making an informed choice;

3. Cross-subsidization, which in this case is materialized through the taxes charged on businesses in order to provide benefits to individuals, further generates fiscal illusions;

4. Such behavior ensures political benefits and is therefore a strategy preferred by the authorities.

The above considerations prove that the lack of visibility in corporate income taxation discourages local accountability and responsibility.

*In the next place*, business taxation entails high administrative costs. There are two major aspects of arising problems. On the one hand, significant administrative capacity is required to control the correct accounting of company operations. On the other hand, the administration of local corporate taxes requires accurate identification of the geographic source of income. The latter is practically impossible in cases when the company operates in more than one region and applies transfer pricing. From a theoretical point of view, one can argue in favour of an approach in which corporate income is taxed on a formula basis. It is assumed that the formula may reflect variables that relate to the sources of income (e.g. property, sales volumes/production, etc.), or taxes may be calculated as the weighted index of three main factors: salaries, assets and sales (Martinez-Vazques, 2007). Applying either of the approaches would be inappropriate, since they turn the taxation of corporate income into taxation of the elements included in the formula. The accurate calculation of the value of sales/production volumes, the value of property or of assets gives rise to several other issues. Furthermore, the relationship between the territorial location of the factors included in the formula and the generation of company profits is controversial (or at least inaccurate). A local corporate tax that is based on the registration of legal entities is completely unacceptable. Such an approach, in the absence of a formula for the inter-regional distribution of receipts, would be both unfair and ineffective as it would be in favour of large, fiscally sound, jurisdictions and would put in a disadvantageous position the other jurisdictions, thus exacerbating existing horizontal imbalances.

*In the fifth place*, local powers in terms of corporate income taxes as a rule do not affect the functioning of the domestic market or create barriers to international trade. An alternative statement would be the assumption that a jurisdiction may organize the taxation system it applies so as to function as a 'tax haven' attracting corporate investment. Such a possibility should be considered unlikely, and in any case, the problem can be solved through legislative measures.

Using corporate income taxes at a local level also has *other disadvantages*, including the fact the analyzed taxes are an instrument of the government's fiscal policy, which is indirectly related to the redistribution of income; the revenue generated from them is rather cyclical and unstable; the progressive income tax acts as an automatic budget stabilizer; the tax base is different on the different territories. All these arguments in favour of waiving the regional corporate income tax are, to some extent, justified. At the same time, there is no explicit need for detailed comments since they have already been analyzed with reference to personal income taxes.

In terms of the three optimality criteria for the allocation of powers, the following conclusions can be made:

- Corporate income taxes do not meet the requirements for taxation in accordance with the accumulated benefits or for easy administration;
- Corporate income taxes are neutral in terms of the functioning of the domestic market, but they are an important element of the central fiscal policy.

## **5. The Use of Corporate Income Taxes at a Local Level in Practice**

Due to the considerations listed above, local governments would be expected to avoid the use of corporate income tax. *The practice*, however, is in serious conflict with a similar recommendation. As a matter of fact, corporate income taxes generate local revenue in a number of developing countries, incl. Mexico, China, the USA, Switzerland, Luxembourg, Italy, Japan, Canada, the Czech Republic, Belgium, etc. Different regions in these countries have different tax powers – they are wider in the USA and in Canada, while in Belgium, the Czech Republic, Denmark and Finland revenues from taxes are shared, yet the factors which govern the organisation of their tax systems are similar.

The main arguments in favour of applying corporate taxes locally can be summarized in three main groups. *Firstly*, personal property taxes and personal income taxes are visible, highly tangible and therefore unpopular. Central subsidies, on the other hand, are often insufficient to satisfy local demand for public goods (in terms of their quantity and quality). Regional authorities therefore give priority to corporate income taxes as a source of revenue. *Secondly*,

corporate income taxes generate significant revenue with higher elasticity to the economic environment, compared to the elasticity of the revenue generated from personal property taxes and personal income taxes. *Thirdly*, since 'no one is quite sure what the impact of those taxes is, it is easy to assume or claim that they are paid by non-residents' (Bahl and Bird, 2008, p.23). Hence, the factors that have been identified as underlying the practice using corporate taxes locally should be considered ungrounded, imposed by political considerations and being the consequence of the inoptimal organization of vertical financial relationships (for example, difficult access to capital markets or insufficient volumes of government subsidies).

The fact that the motives behind regional corporate taxation are subjective does not imply easily rejecting the implementation of such a practice. Provided that municipalities have access to the revenues generated from taxes on corporate profit, it would be more logical to levy taxes on production or sales growth rates (Bird, 1999). Some financial theorists also discuss the possibility to replace the corporate taxes which are currently levied at a regional level with specific taxes on corporate revenue. One of the proposals is to levy a *Value-Added Income Tax* (VAIT) on production (Bird, 2009). It is necessary to specify, though, that companies combine the production factors they purchase or lease to create a product or service whose utility is higher than the incurred costs. Therefore, provided that the value added by labour is the cost of labour (wages and other types of remuneration), and the value added by capital (own and borrowed) is expressed in the cost of capital, the taxable base of a value added income tax can be reduced to the positive difference between the revenues of a company and the costs it has made on purchasing labour and capital. This type of taxation is currently employed in Italian provinces and has three major advantages: 1) the tax is neutral and does not discriminate investment; 2) the tax base is less susceptible to erosion; 3) the tax is relatively sensitive to changes in the economic environment.<sup>9</sup>

The theoretical arguments, currently existing practices of local corporate taxation, and the conducted analysis of possible tax innovations through VAIT can be summarised into the following major findings:

- There are no grounds for assigning corporate income taxes to the groups of exclusively local, typically local or parallel taxes. Despite political and historical traditions, those taxes should either be charged by central governments only or be replaced with a Value Added Income Tax. In the second case, the value-added income tax can be interpreted as autonomous, but in order to limit the export of tax burden, central restrictions on tax bases and rates should be applied;
- It is possible to have the revenue generated from corporate taxes shared between the central and the regional governments. A similar

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<sup>9</sup> **Note:** It must be objectively acknowledged that, logically, the value-added income tax (sometimes referred to as BVT - business value tax) is based on the idea of value added tax (VAT) and can therefore be attributed to the group of consumption taxes.

practice requires using a formula that takes into account the differences in the tax bases and the expenditures of the different regions. The strong emphasis on the equalizing nature of the revenues thus generated renders it necessary to predominantly use transfers instead of shared receipts.

## Conclusion

In terms of Bulgarian practice, the analysis of the alternative sources of local revenue, as a basis of the financial autonomy of territorial units, leads to the following recommendations:

*First.* Local governments can increase their own revenues by introducing the practice of charging parallel taxes on personal income from employment.

*Second.* The organization of the taxes charged on personal income from employment should be improved to increase the powers of local authorities (minimum powers should include their right to determine the parallel tax surcharge within a centrally defined range).

*Third.* Corporate income taxes should be excluded as an alternative source of local revenue, including from shared revenue.

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