# The State of Taxing

Almost like Ralph Waldo Emerson’s famous about the “shot heard round the world,” so too the bankruptcy of Detroit last year has focused countries on every continent to examine if their cities are at risk—or, as a draft German study queries, is it a “Race to the debt trap?”—“*The insolvency of Detroit in 2013 put municipality debt into the spotlight.*”[[1]](#footnote-1)But it also cast a light on distinct state or province tax policies, so that it appears that we could learn, especially from our neighbour Canada to the north, and from Germany, options to avert the fiscal catastrophes of U.S. chapter 9 municipal bankruptcies—but not from our neighbour across the Pacific, China, which today has the largest and fastest growing number of cities in the world, but where, in 1994, worried about the central government’s rapidly declining share of the nation’s total revenue, the Communist Party reorganized the country’s tax system to increase the share going to the central government—leaving China’s local governments in receipt of half the revenues collected—but responsible for 80 percent of all governmental spending.[[2]](#footnote-2)

A key lesson appears to be the roles of shared revenues and implicit state responsibility for municipal debt in each of these nations in alleviating the downward spiral of eroding fiscal disparities – that is both the institutional mechanisms that take into account fiscal disparities at the municipal level, and provide for a significantly greater stake for the respective countries’ states in the fiscal health of their localities. The combination of a much broader tax base, which alleviates this disproportionate reliance of U.S. municipalities and school districts on the property tax, and a greater stake in avoiding municipal debt spirals seems to explain the absence of municipal bankruptcies comparable to Jefferson County, San Bernardino, or Detroit—and healthier local governments across the board.

In contrast, the fractured and unshared tax bases of most state and local governments in the U.S. can add revenue insult to injury. Cities and counties with disproportionate levels of poverty have disproportionately weaker tax bases—producing much lower revenues, even as the municipality confronts significantly greater demands and needs for public services.[[3]](#footnote-3)

Or, as Alan Berube, a senior official at Brookings notes: “Cities just don’t have the tax and trade policy and tools to rein back inequality in a significant way…They can’t really redistribute income in the way the federal government can, so they are reaching for the levers they have.” Cities including Atlanta, Boston, San Francisco and Los Angeles are also considering proposals to tackle inequality, such as bolstering programs for public education, transportation, affordable housing and wages.[[4]](#footnote-4) This patchwork effort comes as the fortunes of the haves have diverged even more from those of the have-nots across the country. The top 1 percent of households has captured about 95 percent of the income gains eked out during the tepid recovery from the Great Recession.[[5]](#footnote-5) And inequality has increased in 94 of the country’s 100 biggest metropolitan areas since 1990, growing especially wide in the last few years.[[6]](#footnote-6)

**The Canuck Taxing Experience**

In Canada, one of the most decentralized countries in the world, provinces are responsible for most major social expenditures, but also receive large unconditional transfers[[7]](#footnote-7) from the federal government, so much so, in fact, that in some provinces such transfers are more important sources of revenue than their own taxes. In contrast, Canadian municipalities are essentially agents of provincial governments: they confront explicit hierarchical budget and debt constraints which restrict their revenues, direct their expenditures, and control access to capital markets. But, if a local government gets into financial trouble, the province generally comes to the rescue in a variety of ways -- adjusting municipal boundaries, taking over functions, and, in the extreme, taking control of its finances. The restrictive provincial control of local finances appears to create a double-edged sword for local fiscal stability: because there is a strong, implicit provincial guarantee that municipal obligations will be met by the province, it creates significant incentives for the province to make sure the municipality is both fiscally healthy—and has affordable access to the credit markets. That is, in contrast to California, Alabama, or Michigan; German states and Canadian provinces provide much greater fiscal resources to municipalities and have a much greater stake in their fiscal health.

In Canada, the federal government makes transfers to the seven poorest provinces, which are intended to bring provincial revenues up to the level they would have received had they levied the national average (provincial) tax rate on a share of the national tax base equal to their share of national population. In addition, the federal government makes a separate and larger transfer to *all* provinces. Third, although provinces—like states—have almost complete freedom to choose their own tax bases and rates, in practice most provincial income taxes are collected by the federal government under tax collection agreements, under the condition that the same base is taxed as for the federal income tax. Moreover, the Canadian federal government collects corporation income taxes for seven provinces and personal income taxes for nine provinces under such arrangements. Thus, instead of the tax competition between states and between states and the federal government of the U.S., the Canadian federal and provincial governments essentially tax the same bases, and the federal government collects more from its taxes than its direct spending, so that, for many years, it has transferred much of the surplus through two large unconditional transfer programs described to the provinces – even as direct income maintenance programs for the elderly, children, and the unemployed are largely federal.[[8]](#footnote-8)

In contrast to the relative fiscal freedom enjoyed by Canadian provinces, Canadian municipalities face very explicit, hard debt and budget constraints: as a rule, for example, local borrowing requires prior provincial approval and is severely limited; moreover, both local revenue and expenditure decisions are tightly controlled, and the important transfers received by local governments from the provinces are generally highly conditional. These fierce fiscal constraints are a product of both the implicit provincial responsibility for bailing out any municipal default―so that acting early on to avoid spiralling costs and potential default, but also the experience of the Great Depression, which, in Canada led to a wave of local defaults amounting to about 10 percent of total municipal debt. By late 1934, over forty Ontario municipalities and school boards had defaulted on their obligations. In response to such experiences, over the next few years Ontario established both a regulatory framework for municipal finance and the capacity to regulate, audit, investigate, and inspect municipal administration.[[9]](#footnote-9) In addition, the province was also given extensive powers of supervision over defaulting municipalities, exercisable either at the request of council or, when in default or with high probability of default, by creditors who represented not less than twenty per cent of the indebtedness. Finally, even as these changes have enhanced local tax stability, unlike in the U.S., Canada has continued to expand the size (relative to GDP) of provincial transfers to municipalities, so that today such transfers as a proportion of total local revenues remain close to half. You might say that Germany and Canada appear to be models of shared dependency and fiscal responsibility, unlike the more difficult relationships between the three layers of government in this country. For while the world watched as Michigan property-tax revenues fell faster than the rest of the U.S. from 2006 to 2009, according to a September report by Moody’s, Eric Scorsone, an economist at Michigan State University, noted: “It’s hard to be a city in Michigan because state policy is very negative toward cities in general.”

**The Canadian Taxing Experience**

Canadian provinces are responsible for most major social expenditures and have a virtually free hand in levying taxes. They face essentially no constitutional restraints on tax rates, bases, or collection systems and no requirement to harmonize either with each other or with the federal government. Up to the early 1970s, the federal government reaped a revenue bonanza by maintaining an unindexed progressive income tax through the largest economic expansion in Canadian history. Rather than cut taxes, it chose to channel a substantial share of this revenue inflow to the provinces through several large transfer programs. The first big federal transfer was equalization, which was clearly unconditional.[[10]](#footnote-10)

Of the three levels of government in Canada, the municipal level is most visibly a provider of services to its inhabitants. The services for which municipalities are responsible vary from those which require considerable capital investment (water supply) to those that are highly labour-intensive (social services). Since most Canadians live in cities, it is not surprising that provincial politicians, despite some continuing rural bias in constituencies, often act in ways that imply that there is a strong implicit provincial “guarantee” of the services nominally financed through local budgets.[[11]](#footnote-11) Modern urban economies are especially dependent on services that are highly capital-intensive, such as water supply, sewage treatment and transportation. When municipal capacity to finance both capital and operating costs is threatened, either by the demands placed on the municipal fiscal system by competing expenditure pressures to fund redistributive services, or by the inability of the existing political structure to cope with spillover effects among adjacent municipalities or simply to establish an adequate fiscal base, a policy response from the province has generally been forthcoming.

In Canada, only the municipal level of government has a clearly separate tax source in most provinces -- the property tax. Despite recent provincial encroachments on property tax revenues in a number of provinces (usually as part of a realignment of provincial-local responsibilities for education), this situation seems unlikely to change drastically in the near future. Nonetheless, even with respect to their “own” property tax, assessment― the determination of the tax base ― is carried out by provinces,[[12]](#footnote-12) and, although local governments may generally set their own tax rates, even this freedom is often limited, for instance with respect to the extent of variation in the structure of rates between residential and other properties.[[13]](#footnote-13)

More generally, local governments in Canada are controlled by the provinces in all important fiscal respects: as a general rule they cannot tax, charge, borrow, or spend without explicit provincial approval. Although they can set property tax rates, on the whole municipalities receive only those tax revenues which a province permits them to levy. In current fiscal circumstances, therefore, it appears unlikely that any province will allow municipalities to tap such potential revenue sources as income and sales taxes, so the stability of local taxes seems likely to continue in the future.[[14]](#footnote-14)

This local tax stability has been coupled with an inevitably greater role for local expenditures in an increasingly urbanized Canada largely by expanding the size (relative to GDP) of provincial transfers to municipalities. From 1955 to 1975, such transfers as a proportion of total local revenues almost doubled. Since then, this proportion has remained close to half. At the same time, however, transfers to municipalities actually constituted a *decreasing* share of provincial revenues, reflecting the more rapid rise of the latter. Local governments have actually received sufficient provincial funds through transfers to enable them to expand expenditures substantially, albeit most such funds came with restrictions and controls aimed at implementing provincial wishes at the local level.[[15]](#footnote-15) At the end of the day, what Canadian local governments can do and how they can do it, and even whether they may continue to exist and retain their boundaries, are issues largely in the hands of the provincial governments, which have not been reluctant to exercise these powers.[[16]](#footnote-16)

Thus, Canadian provinces keep local governments under tight check by restricting their revenues, directing their expenditures, and in various ways controlling their access to capital markets. If, however, a local government experiences severe fiscal distress, the province generally comes to the rescue in a variety of ways, such as adjusting municipal boundaries, taking over functions, and, in the extreme, taking control of its finances. Very much unlike U.S. states, the Canadian strict provincial control of local finances, as evidenced by the proliferation of rules and restraints to which local budgets are subjected, means that, in effect, there is a strong implicit provincial guarantee that municipal obligations will, in the end, be met.

On the other hand, municipalities are subject to formally hard hierarchical budget constraints, in part because the institutional incentives to behave well are less strong. Although local governments are also subject to credit market discipline, creditors can reasonably expect to be bailed out by the province. Local citizens may have to bear the cost of such bail-outs but the non-partisan weak mayor systems general in Canada mean that local institutional incentives to behave are weaker than at the provincial level. While, as suggested earlier, the generally prudent behaviour – “borrowing in a cold climate” – of Canadian municipalities is striking, at some level since provincial control of municipal action means that the province is ultimately responsible, these hierarchical constraints are somewhat offset. All in all, it seems that the very different approaches followed in the “two worlds” of Canadian public end up at a rather similar destination.

**Across the Pond**

# While municipalities in Germany have constitutionally guaranteed rights to manage their own affairs, they too face little risk of insolvency, as both municipalities and investors ultimately expect complete bail outs by state governments in cases of fiscal distress. In Germany, which has 16 states, about 450 counties, and about 12,500 municipalities; municipalities have responsibilities for public order, infrastructure, cultural institutions, and public transport―but, together with other levels of government, they also administer expenditures for child care, schooling, and social security—and often supervise basic services such as water, energy supply, and waste disposal. To finance these essential services, German municipalities draw not only upon three local taxes (2 property and a local business tax), but also allocated tax revenue from income taxes and federal VAT or value added taxes, as well as state-allocated grants.[[17]](#footnote-17) The shared tax base eliminates both the kind of over dependence on a property tax, but also serves to balance disparities in both resources and needs at the local level.

# As in Canada, that more comprehensive fiscal safety net is counterbalanced through the grant to state authorities of extensive oversight rights on local borrowing—including approval authority when a municipality seeks to issue debt to finance public infrastructure. Moreover, again like Canada, German states implicitly guarantee public debt incurred by municipalities, with investors guaranteed full compensation when a state bails out a municipality—an important provision, because it means municipalities with greater fiscal distress in Germany do not experience the kinds of interest rate spreads or disparities experienced in this country. German state regulators can take over a municipality in the event of looming insolvency—and may mandate what is called a Haushaltssicherungskonzept[[18]](#footnote-18)—or a budget consolidation plan, not dissimilar from a chapter 9 plan of adjustment, to demonstrate how the municipality can return to a balanced budget within 10 years.

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Whereas the General Revenue Sharing program enacted under former President Richard Nixon recognized that U.S. cities had significant disparities in human needs—where the greater the needs and local tax effort, the greater the demand for municipal services, but the more distressed the city[[19]](#footnote-19)—the federal program, and most state revenue sharing programs no longer exist. Nor, as in Germany or Canada, does the federal government or states share their tax bases. If anything, tax competition rules. Thus, even as we experience greater and greater income disparities, the U.S. federal government—and, increasingly U.S. states, no longer offer balance. In contrast, both Canada and Germany have revenue equalization systems.

While states, too, have in many instances phased out or down state revenue sharing programs, 19 states have intervention programs for distressed municipalities, but the potential level of involvement varies. The most assertive state appears to be North Carolina, where, in a program that dates back to the Great Depression when more than 400 local governments and public authorities in the state defaulted on debt, the state’s Local Government Commission (LGC) was created to sign off on all local debt issuance. Today it still monitors local property tax intake and will not allow localities to issue debt if fund balances drop below a certain point. Officials in North Carolina claim LGC oversight is the key reason the state’s municipalities have strong credit ratings.[[20]](#footnote-20)

However, Alabama may indicative of the obverse—a state which refused to grant Jefferson County the authority to raise its own taxes in order to avoid insolvency in what became the largest municipal bankruptcy in American history[[21]](#footnote-21)—or at least until Detroit filed last year. Rather than sharing a state’s or national tax base, over the last century, city revenue streams have been strictly circumscribed by states. Absent sharing of state or federal tax bases—especially with the onset of the Great Recession—driven by the collapse of the mortgage market, cities and counties have sought, increasingly, to shift to greater reliance on charges and fees―a shift that as Dr. Michael Pagano has noted has contributed to increased state-local tension as municipalities have sought to rebalance their fiscal footing: “States continue to restrict the authority of municipals to create a lasting revenue structure…We can point our fingers at the state because they do have enormous amounts of discretionary control over what cities do.”[[22]](#footnote-22)

1. “Race to the debt trap?” Frank Fossen, Ronny Freier, and Thorsten Martin, draft, January, 2014, Deutsches Institut for Wirtschaftsforschung. [↑](#footnote-ref-1)
2. “Building the dream,” Special Report, *The Economist*, April 19, 2014. [↑](#footnote-ref-2)
3. # See, viz.: “Perry County, Ky., Downgraded to Baa3 by Moodys, *Bond Buyer*, April 25, 2014: “The downgrade reflects the county's very narrow financial position, reliance on economically sensitive revenues, and below average socioeconomic profile.”

   [↑](#footnote-ref-3)
4. # Annie Lowrey, “Cities Advance Their Fight Against Rising Inequality,” *New York Times*, April 6, 2014.

   [↑](#footnote-ref-4)
5. Emmanuel Saez, “Striking it Richer: The Evolution of Top Incomes in the United States,” UC Berkeley, September 3, 2013. [↑](#footnote-ref-5)
6. Jeff Kolko, “America’s Most Unequal Metros,” *Trulia Trends, March 12, 2014.*  [↑](#footnote-ref-6)
7. Second, there is a separate and larger transfer to *all* provinces. Despite its name – it is called the Canada Health and Social Transfer -- it is basically unconditional in nature. This transfer was introduced recently to replace two previous transfers -- a conditional transfer in support of social assistance and another basically unconditional transfer which had itself been introduced in 1977 to replace earlier conditional transfers supporting health and post-secondary education (Bird, 1987). The total amount transferred is based on the amount of the transfers replaced in 1996-97, escalated by a moving average of GDP growth. Only part of this transfer is actually made in cash. The rest is a notional transfer of what are called “(equalized) tax points,” that is, the estimated yield of federal “tax room” turned over to the provinces in earlier years. [↑](#footnote-ref-7)
8. Richard m. Bird and Almos Tassonyi, “Constraining Subnational Fiscal Behavior in Canada: Different Approaches, Similar Results?” 2003. [↑](#footnote-ref-8)
9. Ibid. [↑](#footnote-ref-9)
10. Indeed, it could even have been used to finance a tax reduction -- although in Canada, as in every country, what evidence there is demonstrates that the last thing most governments that receive transfers do is to reduce taxes – an illustration of what has been called the “flypaper effect” – namely, that money sticks where it hits. [↑](#footnote-ref-10)
11. Although primary and secondary education is delivered at the local level in Canada, it is not the responsibility of municipal governments but of separately-elected school boards. These boards may in most provinces impose a tax on real property which is collected for them by municipal governments which have no role in determining in determining the education rate. In Ontario and some other provinces, the provincial government in recent years has become the main player in both financing and controlling education. For further discussion of the complex system of education finance, see Auld and Kitchen (1995). [↑](#footnote-ref-11)
12. In consequence, municipalities have only very limited input into the process of assessment reform as inequities in the base arise. [↑](#footnote-ref-12)
13. In addition, at least in the case of Ontario, where only lower-tier municipal governments impose property taxes, but where they must also impose such taxes on behalf not only of school boards but also of upper-tier (regional) governments, the “Wicksellian connection” (Breton, 1996) between local responsibility for taxes and for expenditures is largely breached (Locke and Tassonyi, 1993; Tassonyi and Locke, 1993). [↑](#footnote-ref-13)
14. Although some provinces (for example, Alberta and Ontario) have in recent years increasingly encroached on the property tax base, largely as part of the on-going reform of educational finance, it might be argued that this may actually make it easier for municipal governments to raise their own property taxes as a result of the reduction in interlocal tax competition owing to the provincialization of education finance. This theme cannot, however, be further explored here. [↑](#footnote-ref-14)
15. “Most provincial-municipal grants in Canada are conditional, closed-ended, matching grants that do not seem appropriate for achieving either allocative efficiency or fiscal equity. Provincial-municipal transfers in Canada thus appear to be designed to allow provincial governments to maintain a fair amount of control over the expenditure and taxing decisions of local governments while appearing to let local governments provide their own services. In effect, local governments in Canada, to a considerable extent, are really acting as agents, spending provincial funds on provincially designated activities.” (Bird and Slack, 1993, p. 138). [↑](#footnote-ref-15)
16. Provinces, unsurprisingly, appear—like U.S. states, less than welcoming of direct federal relations with local governments, as the federal government found out in the early 1970s when it attempted to establish a federal department of urban affairs and was soon told, in effect, to cease and desist from interfering in provincial business. It did. [↑](#footnote-ref-16)
17. Fossen, op. cit. [↑](#footnote-ref-17)
18. Ibid. [↑](#footnote-ref-18)
19. The State and Local Fiscal Assistance Act of 1972, P.L. 92412, established a new type of Federal program to provide financial

    assistance to State and local governments-the general revenue sharing program, using a formula to determine the allocations to local governments which included the following three factors: population; per capita income, used to measure a government's need; and adjusted taxes, used to measure a government's effort to meet its needs. The intrastate allocation process began by a tiering process of dividing funds among geographic county areas. Once the county area allocationwas established, separate amounts were set aside for Indian tribes and Alaskan native villages, the county government, municipalities, and townships located in the county area.  [↑](#footnote-ref-19)
20. # Liz Farmer, “Bankrupt Cities? What About Distressed Cities?” *Governing*, March, 2014.

    ### \*All those who attribute Jefferson County’s bankruptcy case and Cooper Green’s (the emergency hospital in Jefferson County) plight only to conduct and actions by the county are ill-informed…The State of Alabama and its legislature are a significant, precipitating cause….” ~ U.S. Bankruptcy Judge Thomas Bennett, *IN RE JEFFERSON COUNTY*, ALA., No. 11-05736-TBB, United States Bankruptcy Court, N.D. Alabama, Southern District, December 12, 2012.

    [↑](#footnote-ref-20)
21. [↑](#footnote-ref-21)
22. Ibid. [↑](#footnote-ref-22)