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Subnational Personal Income Tax Autonomy in Selected OECD Countries: a comparative perspective*

by

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Introduction

The purpose of this paper is to summarize the findings of a conference held in Madrid in January 2010. That conference can be seen as a twin[1] to the one whose papers are presented in this book. This will give the reader of this book, which focuses mainly on transaction taxes, a broader view of the use of subnational tax powers. The conference examined the well-established use of subnational personal income tax (PIT) powers in three countries-Canada, Switzerland and the United States , the fairly recent (2009-2011) choice to require the exercise of such autonomy in three other countries-Belgium, Spain and the United Kingdom(Scotland), and the lack of interest in such autonomy in Germany. The focus on PIT is justified by both the importance of this tax as a revenue source, in some of these countries, for sub national governments (SNGs) and by the fact that it was the main object of the increased SNGs tax powers in others

Before turning to the findings of the Madrid conference, it is useful to recall a few principles and practices of sub national taxation to better appreciate the policies discusses hereafter. To minimize administrative and compliance costs, as well as tax avoidance activities, it is recommended that the PIT tax base be defined the same way across all constituent units in a country. That settled, there is no specific recommendation as to what level of government should collect the PITs. Should tax collection with centrally set rates be carried out by SNGs, increasing or reducing its intensity is an indirect way of varying effective tax burdens between SNGs. But this is not a clear indication of the cost of providing public goods and services. Thus, economists argue that subnational tax autonomy is best implemented by giving SNGs the power to set tax rates, with or without limits.

[1] Albeit not identical and first born

There are three broad ways of sharing of the income tax field between the central government and SNGs in federal and quasi-federal countries:

1. *Full tax powers*. Both levels of governments have the power to access a given tax field; they can define the base, set the rates, and collect the taxes themselves. In practice, they may choose to use the tax base already set by another level (usually the central one) and to have the tax collected on their behalf. But they must set their own rate; otherwise it defaults to zero. In other words, there must be an explicit tax decision by SNGs.
2. *Optional tax powers*. Both levels of governments have the power to access a given tax field. However, the subnational governments must use the tax base of the central government which also collects the tax. If they do nothing, the central government rate is the default one for their portion of any shared tax. There is no need for an explicit tax decision by SNGs.
3. *No tax powers*. One level of government sets the base as well as the rates and collects the taxes. Tax revenue is then shared between the two levels of governments according to a formula that may or may not give some weight to where the tax was collected. In this case, there is no possibility of explicit tax decisions by SNGs.

We present the countries in decreasing order of the use of SNG tax autonomy. Consequently, we start with the USA, follow with Switzerland and Canada, which are very similar, continue with Belgium then Spain and finally, we conclude with the UK .We do not present Germany save to note here that Länders (, German states), do not set the base or rates of the PIT though they are responsible for collecting it.

United States

The American states have the power to set their own PIT bases, rates and brackets and to collect it. In a few states, local governments also collect their own PIT. There has never been federal collection of state taxes in the USA though for the PITs, this was

offered from 1972 to 1990 (see Stolz and Purdy (1977) for a discussion of this proposal). Table 1 summarizes the use of PITs by American states. We find:

1. The use by forty-three states of a PIT with forty-one levying it on a broad base and two (New Hampshire and Tennessee) only on interest and dividend income (Cordes and Juffras 2012);

2. The non-use by seven American states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) of the PIT;

3. The wide use, by the forty-one broad base states, of federal Adjusted Gross Income (Cordes and Juffras 2012); out of these forty-one, only five start off using their own definition of income. This de facto base harmonization is particularly noteworthy since, as discussed above, there has never been federal collection of state PITs in the USA (see the Canadian case) or a legal framework promoting harmonization (see the Switzerland case);

4. The use by seven states of a flat tax rate on a broad income base and a wide variation in the number, from one to ten, and limits of their tax brackets;

5. The variability in tax rates – either minimum or maximum, with a coefficient of variance (CV) of 0.64 and 0.63.

Table 1 Some characteristics of American states PIT, 2008

State	No. of Brackets	First tax rate (%)	Highest tax rate (%)	Highest rate for income over	State	No.of Brackets	First tax rate (%)	Highest tax rate (%)	Highest rate for income over
Alabama	3	2.00	5.00	$3,000	Montana	7	1.00	6.90	$14,899
Alaska	n.a.	no PIT		n.a.	Nebraska	4	2.56	6.84	$27,000
Arizona	5	2.59	4.54	$150,000	Nevada	n.a.	no PIT		n.a.
Arkansas	6	1.00	7.00	$30,000	New Hampshire	1	5.00		n.a.
California	7	1.00	10.30	$1,000,000	New Jersey	6	1.40	8.97	$500,000
Colorado	1	4.63		n.a.	New Mexico	4	1.70	4.90	$16,000
Connecticut	2	3.00	5.00	$10,000	New York	5	4.00	6.85	$20,000
Delaware	7	2.20	5.95	$60,000	North Carolina	4	6.00	7.75	$120,000
Florida	n.a.	no PIT		n.a.	North Dakota	5	2.10	5.54	$349,700
Georgia	6	1.00	6.00	$7,000	Ohio	9	0.649	6.555	$200,000

Hawaii	9	1.40	8.25	$48,000	Oklahoma	7	0.50	5.50	$8,700
Idaho	8	1.60	7.80	$23,963	Oregon	3	5.00	9.00	$7,150
Illinois	1	3.00		n.a.	Pennsylvania	1	3.07		n.a.
Indiana	1	3.40		n.a.	Rhode Island	5	3.75	9.90	$349,700
Iowa	9	0.36	8.98	$60,435	South Carolina	6	0.00	7.00	$13,150
Kansas	3	3.50	6.45	$30,000	South Dakota	n.a.	no PIT		n.a.
Kentucky	6	2.00	6.00	$75,000	Tennessee	1	6.00		n.a.
Louisiana	3	2.00	6.00	$50,000	Texas	n.a.	no PIT		n.a.
Maine	4	2.00	8.50	$18,950	Utah	1	5.00		n.a.
Maryland	7	2.00	5.75	$200,000	Vermont	5	3.60	9.50	$349,700
Massachusetts	1	5.30		n.a.	Virginia	4	2.00	5.75	$17,000
Michigan	1	4.35		n.a.	Washington	n.a.	no PIT		n.a.
Minnesota	3	5.35	7.85	$69,990	West Virginia	5	3.00	6.50	$60,000

Mississippi	3	3.00	5.00	$10,000	Wisconsin	4	4.60	6.75	$142,650
Missouri	10	1.50	6.00	$9,000	Wyoming	n.a.	no PIT		n.a.
D.C.	3	4.00	8.50	$40,000	Average (%) 50 states	4.93	2.96	7.72	$118,606.58
Federal	6	10.00	35.00	$178,850	Std Dev 50 states	2.28	1.90	4.85	$190,956.94

Source Table 5 Vaillancourt (2012)

Switzerland

Swiss cantons must set their PIT base taking into account federal legislation that came into force in 2000[2] following the adoption of article 129 of the Constitution. . Thus, the confederation and the cantons use a common list of tax exemptions/ deductions. However, the amount of each deduction/exemption is set independently by each canton. Swiss cantons can set their PIT rates as they wish subject to a provision in the federal constitution stipulating that the tax burden on the taxpayer should be commensurate with his or her economic capacity. This, along with a 2006 federal court decision prohibiting a regressive personal income tax schedule which had been put forth by the canton of Obwalden, precludes a declining tax rate schedule. .. Cantons collect the Confederal PIT, their own PIT and often the PIT of communes (set as piggyback rates on cantonal rates) located within their boundaries.

Gilardi et al (2010) show that tax autonomy at the cantonal level is a defining aspect of Swiss federalism and that there are important differences between cantons in the use or not of specific tax instruments as well as in personal income taxes. Table 2, derived from Gilardi et al (2010), presents these differences as well as shows the result for the PIT for two income levels for 2007. As the table illustrates, effective marginal tax rates vary substantially within each income level. For married individuals with an income of 50,000 Swiss francs (CHF), tax rates range between 1% and 4%. Results not shown here indicate a tighter range at the 25,000 income level (0-2.1%). Moreover, the tax rates vary more widely for higher income levels. For individuals with annual incomes of CHF 200,000, the tax rate was, in 2007, slightly more than 4% in Schwyz, Zug, and Obwalden, but the rate was more than 12% in Glarus, Geneva, and Neuchâtel.[3]

Cantons also differ greatly in the progressivity levels of their tax rates. The last column of Table 2 displays the ratio of the tax rates for annual incomes of CHF 200,000 and CHF

[2] Cantons were given a transitory period of eight years beginning in 1992 to adapt their tax laws

[3] Wealthy foreigners with residency but no occupation in Switzerland can apply for lump-sum taxation, which is typically very advantageous and also varies between cantons. In February 2009, the electorate of the canton of Zurich abandoned this tax practice in a referendum. Other cantons might follow.

50,000, again from Gilardi et al (2010). On average, the tax rate for an annual income of CHF 200,000 is 3.43 times higher than the tax rate for an annual income of CHF 50,000. Basle-Country, Ticino and Geneva have the most progressive tax systems with a ratio above 6:1. Obwalden is the canton with the lowest progressivity with a ratio of just 1.68:1.

Table 2 Cantonal effective marginal PIT rates for a married childless individual, two income levels (CHF), Switzerland, 2007

Canton	**50 000 CHF annual income**	**200 000 CHF annual income**	**Ratio of the two rates/progressivity indicator**
Zurich	1.93	5.74	2.97
Berne	3.78	11.15	2.95
Lucerne	2.70	6.70	2.48
Uri	2.64	11.34	4.29
Schwyz	1.81	4.24	2.35
Obwalden	2.57	4.31	1.68
Nidwalden	1.90	5.41	2.84
Glarus	5.34	12.46	2.34
Zug	1.20	4.30	3.58
Fribourg	3.74	9.48	2.54

Solothurn	2.67	7.71	2.89
Basle-City	3.21	8.94	2.78
Basle-Country	1.58	9.51	6.01
Schaffhouse	2.84	7.16	2.52
Appenzell Outer-Rhodes	2.76	6.28	2.28
Appenzell Inner-Rhodes	2.11	5.32	2.52
St. Gall	2.23	7.01	3.15
Grisons	2.12	7.64	3.60
Aargau	1.81	7.25	4.00
Thurgau	1.68	6.62	3.93
Ticino	1.23	7.83	6.35
Vaud	2.97	11.21	3.78
Valais	2.91	7.54	2.59
Neuchâtel	3.66	13.33	3.64
Geneva	1.61	13.17	8.17
Jura	3.71	10.71	2.88
Mean	2.58	8.17	3.43
C.V.	0,37	0,34	

Source: table 4 Vaillancourt (2012)

Gilardi et al (2010) then examine how PIT rates changed from 1990 to 2007. They find a decline for all four income categories, but this decline is much more pronounced for the lowest income than for the highest. Hence, if there is a race to the bottom, it benefits the lower income groups and not the higher ones, an admittedly unexpected result. Gilardi et al (2012) indicate that various factors explain this outcome: the co-operative nature of Swiss federalism, the fact that it is not only taxes but public services that matter, the direct democracy mechanism that makes it hard to push through measures benefiting only a small group (the rich), and the fact that, following a tax cut, large cantons may lose more from the reduction of revenues from existing taxpayers than they gain from new taxpayers attracted by this tax cut. In addition, tax rate differences are capitalized into property values, making a move less appealing.

Canada

Canadian provinces can set the base, the rates and brackets of their PIT and collect it which they did, albeit sparingly, until World War II. In 1942, the provinces signed the Wartime Tax Agreements (the so-called “tax rental” agreements) by which they surrendered to the federal government (“rented”) all rights to impose three taxes, including the PIT, in exchange for fixed annual payments. Such an arrangement was in line with the recommendations that the Royal Commission of Dominion-Provincial Relations (commonly called the Rowell-Sirois Commission) made in 1940. In order to avoid issues that arose from the Great Depression, it recommended that taxing powers and debt be centralized. Following WWII, tax fields were progressively re-decentralized with Quebec reintroducing a PIT in 1954- Bird and Vaillancourt (2006) summarize this evolution. -To this day, nine provinces (Québec being the exception) use the federal PIT income as their tax base and thus have the federal government collect it for them free of charge. What we focus on here is the change that occurred in 2000, when these nine provinces acquired more freedom in setting their tax rates- they previously used a surcharge on the federal PIT with some limited credits and surtaxes. Currently, they are

required to set their own tax brackets and tax rates, thus moving from a tax on tax (provincial PIT tax as a per cent of the federal PIT) to a tax on income. Table 3 presents the key features of provincial PITs for 2008. From this table and from Guimond and Vaillancourt (2012), one finds that:

1. In 2008, eight of the nine ROC provinces used from three to five brackets for their PIT. Alberta had only one;
2. The minimum income for the first step up (second bracket) varied from $29,591 to $39,136. No province used the federal step up income for that bracket; all except Saskatchewan, use a lower one below it;
3. The coefficient of variation (CV) for the first step up is smaller than the other two CVs. The province with the step up values closest to those of the federal government is, surprisingly, Quebec
4. The rate for the lowest bracket varies from 6.05 to 11 per cent, the last rate being for Saskatchewan, which is very close to that of its neighbouring province, Alberta, which uses a flat rate of 10 per cent;
5. Progressivity varies from province to province: Saskatchewan has the lowest progressivity of non-flat tax provinces and British Columbia the highest.
6. The variation in the tax burden goes down as income goes up, indicating perhaps greater concern for tax competition and tax-induced mobility as income goes up;
7. Effective progressivity measured by the ratio 200 000 tax burden/25 000 tax burden does not vary much, being highest

in the two distinct (non tax) societies of Quebec (language) and British Columbia (climate);[4]

8. For high-income individuals, the highest tax burden is found in Quebec and the lowest in Alberta, while for low income individuals, Manitoba has the highest and Alberta the lowest tax burden.

In 2008, we find variations in the number of brackets used (from one for Alberta to five for British Columbia), the step-up amount to the second bracket (from twenty-nine to thirty-nine thousand dollars), the rates per bracket, and in provincial progressivity. The results of this variation in the statutory dimensions of provincial taxation are, respectively, that the variation in the actual tax burden goes down as income goes up, that effective progressivity does not vary much between provinces, being highest in the two distinct societies of Quebec (language) and British Columbia (climate), and that, for high-income individuals, the highest tax burden is found in Quebec and the lowest is found in Alberta. Comparing 2008 to 2000, one also finds that the variation between provinces increases with the passage of time.

The last finding of change over time may be influenced by the relatively short time span.

[4] Tax-wise, Alberta, with no provincial goods and services tax and a flat provincial PIT, is the most distinct province.

Table 3 Rates per bracket and income threshold, 2nd and last bracket, provincial PITs Canada, 2008

2008-Marginal tax rate (%) rate per bracket	First bracket	Fourth	Progressivity: highest/lowest rate	Income threshold for top bracket	PIT for 25000$ income	PIT for 200000$ income/ PIT for 25000$ income
Newfoundland	8.2	n.a.	1.95	60430	3242	23.0
Prince Edward Island	9.8	n.a.	1.70	63970	3483	22.3
Nova Scotia	8.79	17.5	1.99	93001	3322	23.5
New Brunswick	10.12	17.95	1.77	113274	3464	22.3
Ontario	6.05	n.a.	1.84	72042	3132	23.7
Manitoba	10.9	n.a.	1.60	66001	3622	21.2
Saskatchewan	11	n.a.	1.36	111815	3097	23.2
Alberta	10	10	1.00	flat	2670	24.2
British Columbia*	5.06	12.29	2.9*	97637	2659	25.9

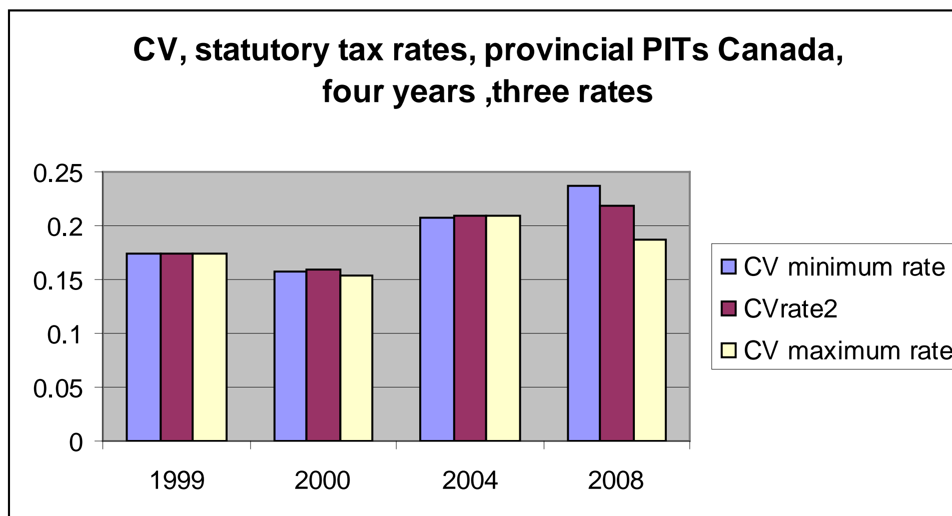
Mean	8.88	14.44	1.63	95561		
Standard deviation	2.10	3.92		16582		
CV	0.237	0.271		0.174		
Québec	16	n.a.	1.50	75 001		
Federal	15	29	1.96	123185		

Table 2,Vaillancourt (2012) CV Coefficient of variation =standard deviation/mean

Note* the rate for the fifth bracket in British Columbia is 14.7% n.a not applicable as no bracket and thus no such rate

Charts 1 and 2 present the evolution of the statutory tax rates and effective tax burdens for Canadians over four years (1999 being the last year before the reform, 2000 being the first year of the reform, 2004 being a mid-point and 2008, being the last year covered by Guimond and Vaillancourt,2012). Both figures show higher CVs in 2008 than in 1999. Thus it appears that tax rate setting freedom allowed provinces to express their differing preferences for various degrees of progressivity more clearly as practices in place before the 2000 reform receded in time.

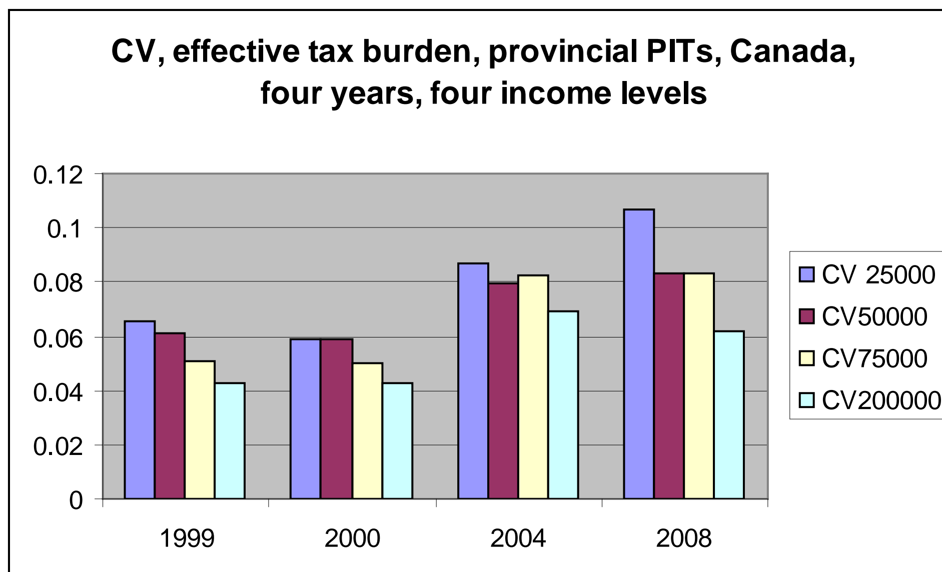
Chart 1



Source: chart 2 Guimond and Vaillancourt.

The CVs are for the minimum, the second, and the highest statutory rate.

Chart 2



Source: chart 3 Guimond and Vaillancourt.

The CV are for incomes of $25 000, 50 000, 75 000, and 200 000.

The acquisition by Canadian provinces of more powers over personal income tax has thus increased the diversity of personal income taxation at the provincial levels. This diversity, for 2008, is less than that observed in the United States for the same year. One explanation for this may be the difference in number of jurisdictions. Another may be the difference in the nature of federalism in each country. Canadian fiscal federalism, at least in the case of the nine English-speaking provinces, may foster more co-operative federal-subnational government relations than its equivalent in the United States. One indication of this greater co-operation is the existing tax collection arrangements which both result from and create intergovernmental co-operation. These arrangements may yield more harmonized outcomes in Canada.

Belgium

The personal income tax is federal, but since 1990, a positive, or negative, piggy-back tax can be used by the first tier of Belgian SNGs, the *Regions*. Regional autonomy margins are set such that the sum of regional tax reductions or increases does not exceed 6.75 per cent of the federal PIT revenue raised in each region. Furthermore, the regions are not authorized to reduce the tax's progressivity. The Flemish Region is the only one to have used that possibility, through a lump-sum reduction of €125, introduced in 2006 but for the tax year of 2008 (2007 income), for taxpayers with market incomes above €5,500 and below €21,000. If this income was above €21,000 and below €22,500, then this non-refundable credit was reduced by 10 cents for each additional euro, and thus tapered off at €22,250.[5]
This lump-sum amount varied over time and has been abolished for the income year of 2011[6]. Two reasons appear to have motivated this: the need to reach budgetary equilibrium, and the objection brought forth by the European Commission, in October 2010, stating that such a reduction was discriminatory against non-resident workers. There are also regional investment incentives that affect the PIT paid (Vaillancourt, 2012)

Overall, Belgian regions make little use of their limited tax rate setting powers in the PIT area. On October 11th 2011, an agreement, which has yet to be adopted by the national Parliament, was reached by the various political parties on the sixth institutional reform.[7] One chapter of the agreement is dedicated to the increase in tax autonomy for the *Regions*. The most important federal grant to the *Regions* is withdrawn while the federal income tax is reduced by an equivalent amount, leaving tax room (about 25% of the base) for the *Regions* that they will need to maintain revenues through a piggy-back tax. *Regions* may differentiate tax rates across tax brackets, but their autonomy is limited in order to prevent tax competition. The progressivity of the federal income tax may not be

[5] Moniteur Belge 26 09 2006 p 50043
[6] http://fiscus.fgov.be/interfafznl/fr/downloads/fc2010-0542-1.pdf
[7] http://www.lachambre.be/kvvcr/pdf_sections/home/FRtexte%20dirrupo.pdf

reduced by the regional piggy-back tax except if the value of the reduction in progressivity does not exceed 1000 Euros per year, per taxpayer.

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Verdonck (2012) examines why, notwithstanding Flemish demands for such powers, so few tax powers are exercised by Belgian *Regions*. She enumerates six reasons specific to the Belgian case, but which probably apply in other countries. They are:

1. The history of the country (inversion of rich/poor region ranking);
2. The geography of the country (smallish and thus having greater potential tax-induced mobility);
3. The institutional structure (asymmetry between united Flemish region/community and separate Brussels-Walloon/francophone groupings);
4. The under-financing of one region (Brussels) due to tax arrangements (PIT on residence, non taxation of Eurocrats) making for unequal starting conditions;
5. The risks of a race to the bottom in tax rates;
6. The existence of non-tax instruments (public spending grants) available to reach a similar degree of political autonomy.

These six items constitute a helpful checklist that can be applied to any other tax devolution situation. Finally, one should note that the personal income tax autonomy obtained by all the Belgian regions in 2001, but exercised only by Flanders, is the result of political trade-offs: more cash transfers for the French community and more powers for Flanders. It was not a choice based on public finance considerations. The recent (October 2011) agreement may be seen as a second round of tax autonomy most likely to be used by Flanders and granted in exchange for more revenue for the Brussels region.

Spain

The first level of SNGs in Spain is made up of the autonomous communities (ACs). From a tax perspective, there are two kinds of constituent units in Spain: the fifteen common ACs and the two foral communities which, in terms of taxation powers, are much more powerful[8] Since the 1990s, non foral or common ACs have been able to offer various tax credits as well as modify their tax rate on their share of the PIT.. However, the tax rates established by the ACs must follow the same progressivity pattern as those of the central government and they must use the same number of brackets, though establishing a surcharge can circumvent this. Moreover, they may only establish tax credits for certain items: family and personal situation of tax payers, non-entrepreneurial investments and donations or gifts (Ruiz Almendral and Vaillancourt, 2006).Table 4 present the main credits employed in 2006.

In 2011, Spain implemented a key change agreed to in late 2009 as part of a reform of the inter-governmental financial arrangements (see Zabalta and Lopez-Laborda (2011) for a description of this) that requires all non foral ACs to set tax rates and, in particular, to set their personal income tax rate. Thus, one interesting interpretation of the 2010 reform, which gives more powers to common ACs, is that it could be one more step in the convergence of tax powers of common ACs with those of the highly autonomous foral ACs. Hence, while more powers may lead to more differences in the tax outcomes among the common ACs, more powers also create a greater measure of legal similarity between the foral and common of ACs.

In 2011, four ACs (Andalusia, Asturias, Catalonia, and Extremadura) implemented PIT rates different and higher than the central ones. In Catalonia, for example, the community tax rate increased to 23.5% for gross incomes between €120,000 and €175,000 and to 25.5% for gross incomes of over €175,000. Andalucía, on the other hand, raised its

[8] The foral autonomous communities are those of the Basque country (formally its three provinces) and Navarra.

community tax rate to 22.5% for gross incomes between €80,000 and €100,000 and to 23.5% for gross incomes between €100,000 and €120,000[9].

Table 4 Main tax credits, Spanish autonomous communities, 2005

AC	Child related	Age related	Disability	Housing purchase	Entrepreneurial start-up	University attendance
Andalusia	√ BB	√	√	√	√	
Aragon	√BB					
Asturias		√		√	√	
Balearic	√CC	√	√			√
Canarias						√
Cantabria	√					
Castilla la Mancha						
Castilla leon	√ AR+BB +CC		√ 65+			
Catalonia	√ BB			√		√

9 https://outlook.umontreal.ca/exchweb/bin/redir.asp?URL=http://www.fitchratings.es/adjuntos/382_fitch_-_spanish_autonomous_communities_-_2011_draft__budgets.pdf
https://outlook.umontreal.ca/exchweb/bin/redir.asp?URL=http://www.euroweeklynews.com/money/ask-the-expert/tax-hikes-for-wealthy-in-spains-2011-budget.html

Extramad ura				√		
Galicia	√ AR+ BB					
Madrid	√ BB	√	√			
Murcia	√ CC			√		
La Rioja	√ BB			√		
Valencia	√ AR+B B		√ 65+	√		

Notes: AR: Annual reduction; BB: baby bonus; CC: Child care expenses

Source Table 3 Vaillancourt 2012

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. **United Kingdom / Scotland**

Jeffery (2012) begins by reminding us that while the United Kingdom is as the name states, united, it is not a *unitary* state, and that there are, de facto, four sets of fiscal arrangements covering England, Northern Ireland, Scotland, and Wales. The Scottish one is of particular interest since both a recent commission report (The Caldman Report 2009) and a Scottish office policy paper (November 2009) have proposed more tax-setting powers for Scotland. Jeffery shows that all parties, be they pro independence (SCOTTISH NATIONAL PARTY) or anti Scottish independence, favour more tax autonomy for Scotland. The SNP favours this outcome on the grounds that it is a normal step, as well as stepping stone, towards independence. The Unionist parties (Conservative, Labour,

and Social Democrat), on the other hand, favour greater tax autonomy because it will enhance the accountability of the Scottish Parliament to its electorate. Such autonomy also appeals to the English electorate, who know well that Scotland receives more public funding (per capita) than does England. Finally, Jeffery examines the factors that came into play after the British election of May 2010, and raises the interesting possibility of a trade-off between more autonomy in Edinburgh and less power in London.[10]

What broad lesson should we draw from the Madrid conference paper? In the words of the editors of the volume:

First, geography, both physical and ethno-linguistic, matters. Because mobility is costlier, constituent units in large countries can more easily implement different PITs than those in smaller countries. Constituent units that are different ethno-linguistically can more easily differ in terms of taxation than those that are not. Larger constituent units are less likely to cut rates since the gains from newly arrived taxpayers may not compensate the losses from existing ones.

Second, history matters. Countries that have a tradition of tax freedom at the constituent unit level are unlikely to give it up, while countries that are without this tradition find it difficult to accept.

Third, institutional (constitutional, legal, consensual) arrangements matter. If constituent units have a powerful voice at the centre, they may feel less need for tax autonomy. If budget constraints on constituent units are weak, with frequent/generous central government bailouts, then again tax autonomy may seem less desirable.

Fourth, economics matter. The greater the difference in tax potential or in natural endowments between constituent units, the stronger will be the demand for autonomy by the better-off and the rejection of it by the less well-off. This can be mitigated by equalization arrangements.

Under the constraints listed above, the two logics of political autonomy and fiscal accountability can combine to produce change in the direction of more tax powers at the

10 Thus providing a partial answer to the vexing West Lothian question.

constituent unit level. Indeed, taking a long-term perspective, this seems to be the natural outcome one would expect to emerge in countries with well-functioning constituent units.

A question that remains is: what tax powers should be increased for constituent units? In our opinion, these should be PIT powers and not value added tax (VAT) or corporate income taxation (CIT) powers. CIT powers are inappropriate for constituent units given the mobility of capital and the difficulties of establishing the tax base even at the national level (transfer pricing, thin capitalization, royalties, etc). VAT powers are difficult to implement at the subnational level, although the Canadian experience shows that it is feasible. And while the American experience shows that retail sales taxes can be used successfully at that level, it is a unique North American system that is becoming a strictly American one not easily implemented elsewhere and with many failings. In Canada the retail sales taxes, at the provincial level, are being replaced by a VAT (six of ten provinces as of 1 July 2010).[11]

PIT powers are thus more appropriate since constituent units are usually responsible for providing people-oriented services (education, health, social services). These services are natural complements for a PIT since they often have redistributive effects in kind, while the PIT may be redistributive in cash.

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