Chapter Three

The Structure of Tax Regimes

3.1 Own-source, shared, and transferred revenues

Federal revenue regimes are characterized by their use of three major elements: own-source revenues for each order of government, shared revenues, and federal transfers. Approaches across federations differ greatly.

The allocation and management of taxing and other revenue powers within federations are intimately linked to the system for sharing taxes and effecting fiscal transfers from the federal government to the constituent units. Some federations rely heavily on shared taxes and transfers to fund constituent units, while others emphasize own-source revenues.

Own-source revenues are those that are raised by each order of government using its constitutional power to impose tax and charge fees within its boundaries. Such revenues can be obtained from either an **exclusive** or **concurrent** constitutional authority. Concurrent authority gives both orders of government the power to impose a tax or charge on a particular source, though the power of constituent units to determine their tax or charge may be constrained.

Many federations have **shared** taxes. These are taxes that are typically federally legislated and collected, and distributed by formula among federal and various constituent-unit governments. When the formula is binding, the revenue is sometimes considered "own-source" because each government has a right to its share of the tax; but we shall restrict "own-source" to taxes and charges under the control of a government.

It appears inappropriate to designate shared taxes as own-source for constituent units. Their governments usually have little or no say in determining the tax or the sharing formula, and their share of the revenues may exceed—even greatly exceed, as in the majority of Nigerian states—what was collected within their borders. The constituent units' portion of shared taxes may or may not appear in the consolidated revenues of the federal budget. Both shared taxes and fiscal transfers can be by formula and without conditions, but even formulaic and unconditional fiscal **transfers** are rarely viewed as own-source. The absence of consistency among experts on these terms means there is a lack of standardized data that makes numerical comparisons across federations difficult.

This chapter focuses on the structure of tax regimes, including various principles that may shape them. Chapter Four looks at the allocation of specific revenue sources, while Chapter Five examines tax sharing and transfers.

3.2 Devolved versus centralized revenue raising

Federal fiscal regimes differ greatly in the extent of constituent-unit autonomy to determine own-source revenues. Autonomous revenue powers can promote political accountability and responsiveness to local preferences, but a significant decentralization of the tax system brings risks for economic efficiency, administrative simplicity, and equity. Transfers from the federal government and the sharing of federally levied taxes are alternatives to decentralized revenue regimes.

In federations, the federal government almost always raises more revenues (including borrowing) than it uses directly. This imbalance reflects the stronger logic for devolving expenditure responsibilities rather than revenue-raising responsibilities. However, practice varies from federations where the constituent units raise most—even almost all—of their own revenues to those where constituent units raise only very small amounts.

Revenue Raising in Various Federations

Federal governments raise the lion's share of revenues in most federations. In **Nigeria**, the federal government raises over 90 percent of all revenues, which reflects its control over oil revenues. Federal revenues are around 90 percent of the total in **Mexico**, **Russia**, and **Malaysia**; between 70 and 85 percent in **Argentina**, **South Africa**, **Australia**, **Belgium**, and **Brazil**; 60 to 65 percent in **Germany**, **Austria**, **Spain**, and **India**; and about 55 percent in the **United States**. Federal revenues are less than half of total government revenues only in **Canada** (47 percent) and **Switzerland** (40 percent).

Perhaps the strongest argument in favour of constituent units' having extensive autonomy to finance their own needs is that it clearly links their spending to the raising of funds. This should make these governments more responsive to their respective populations' desired mix of taxes and spending (bigger versus smaller government). Certainly, there are markedly different mixes of taxes and spending between constituent units in some decentralized federations. For example, in Canada, a standardized measure of "fiscal effort" shows Quebec to have significantly higher taxes and spending per capita than neighbouring Ontario. Some believe that such autonomy also makes constituent units more likely to manage their debt responsibly because they are exposed to its cost and less likely to seek or get federal bailouts. Constituent units may also value some autonomy in tax design, no matter the overall level of taxes. Such design is not policy neutral and constituent-unit governments may have objectives that they wish to pursue through tax policy; e.g., in redistribution or in disfavouring certain types of consumption or activity (such as alcohol or local environmental damage).

Against this, devolved tax regimes carry risks for the healthy functioning of an economy because constituent units can adopt taxation policies that distort locational decisions regarding the use of resources, erode governments' collective ability to tax a particular source, and add significant administrative and compliance costs.

Devolved regimes may also pose equity problems if constituent units' capacity to raise revenues varies because of their relative wealth, though this may be counterbalanced by various transfer and equalization arrangements run by the federal government. One of the most devolved federal revenue regimes is in Switzerland; their experience shows that a highly devolved regime can function even in a small country, though it poses numerous challenges.

3.3 Assigning individual revenue sources

The case for assigning individual revenue sources to federal versus constituent-unit governments differs greatly by source. Economic principles such as efficiency, equity, and administrative simplicity are important. Other factors such as constitutional provisions, history, regional politics, and the priority given self-financing can also shape arrangements. One principle can conflict with another, so there is no best assignment of revenue sources.

If constituent units control certain tax sources, there is a risk that some will compete through lower rates to attract investments, labour, economic activity, or residents to their jurisdictions. Locational decisions based on tax considerations instead of economic fundamentals result in a misallocation of resources and undermine the efficiency of an economy. This problem is most acute with tax bases that are relatively mobile, as when some taxpayers can choose where to locate their activity or residence. While it is a matter of degree, typically, real property and natural resources are effectively immobile; some manufacturing (including the processing of resources) or service businesses, the choice of where to work and live, and the location of some retail business are more mobile, especially over longer periods. In practice, the degree of mobility in a federation will depend on distance, language, and culture, as well as on the location of large historic investments in plants, facilities, and infrastructure. Large corporations, with activity across a federation, can sometimes move certain activities quite easily.

Competition for mobile tax bases (at its limit, a "tax war") can undermine a tax base itself. Certain constituent units may keep lowering their rates to attract capital, labour, residents, or activity. Other jurisdictions may lower their rates to remain competitive, thus **hollowing out** the tax base—as happened in Canada and Australia where the constituent units bid the inheritance tax down to zero; a similar "race-to-the-bottom" on this tax seems to be underway in Spain.

Equity considerations arise with different revenue sources because of their distribution across the federation. We shall see this most dramatically where natural resources are important, but some federations have very unequal distributions of large corporations, rich people, or retail activity. Such inequality may be dealt with through various redistributive arrangements such as equalizing transfers or sharing federal taxes.

Some revenue sources can be devolved to constituent units with few or no extra **administrative costs** for governments, businesses, and individuals, while others prove very complicated or expensive to levy or collect on a devolved basis.

While no federation has constituent units that are entirely self-financing, one criterion to be considered in the allocation of tax sources is their size or **adequacy**, given the needs of constituent units. Many of the tax bases most clearly appropriate for constituent-unit governments are relatively small, so the criterion of adequacy can be an important consideration favouring constituent units' access to certain tax bases, even if this may pose efficiency, equity, or cost issues that may require compensation.

Few federal constitutions were written with much attention to the economic criteria for allocating revenue responsibilities. Many important taxes—income and corporate taxes, payroll taxes, value-added taxes—were scarcely dreamed of when the first federal constitutions were written, so the assignment of revenue powers in many constitutions can seem very general, obscure, or outdated. For example, in many federations, sales taxes have been a principal revenue source for constituent units; this type of taxation has been increasingly criticized as inefficient, but its replacement by value-added taxes has proven difficult in some federal contexts. In other federations, the federal role in income tax is secondary or constrained, and this, too, can pose problems. And in many federations, constituent units' access to own-source revenues is severely limited. Such assignments may have evolved through court interpretations and political compromise. Even so, considerations of efficiency, equity, administrative cost, and adequacy are constants as federations examine, debate, and adjust their fiscal arrangements.

3.4 Concurrent tax bases and tax room

In many federal systems, certain individual tax bases are available to both orders of government rather than being assigned to one or the other. This can have a number of advantages, but also raises issues of tax harmonization and the sharing of "tax room."

Several federal constitutions provide concurrent authority for both orders of government to levy taxes, such as income, excise, or sales taxes, on the same source. This is different from sharing federally levied taxes, since constituent units have autonomous powers to set rates and sometimes to define the tax base itself. Concurrent tax jurisdiction has both advantages and problems.

One advantage is that both orders of government can have access to large revenue sources, which helps address the criterion of adequacy. At the same time, when the two orders of government co-occupy a tax source, the federal government can often play a central role in promoting a harmonized approach. In some such cases, the authority of the constituent-unit governments may be limited; for example, in Spain, autonomous communities may determine income-tax rates only within the centrally defined base categories and for the one-third of the income tax that is allocated to them. (Scotland in the United Kingdom and the regions in Italy also have limited powers to make marginal adjustments to certain centrally determined taxes.)

Where both orders of government have full concurrency and are completely free to determine their own taxes on a source, say personal income tax, they face the issue of their respective shares of taxes from that source. The room to extract taxes from any particular base is limited—e.g., if all profits were taxed away, companies would go bankrupt or evade taxes—and so the space occupied by one order of government can constrain the ability of the other to raise taxes from the same source. This issue of **tax room** typically evolves over time.

During World War II, federal governments in Australia, Canada, Switzerland, and the United States increased their share of tax collections dramatically. Canada did this through formal "tax rental" agreements and, after the war, entered new agreements whereby "tax points" were vacated by the federal government and then reoccupied by the provinces. The Australian and Swiss federal governments have never vacated the tax room they occupied (though the Swiss government must get regular renewals), while the United States federal government's share has effectively ceded some tax room over the half century, but with significant fluctations in particular periods. Of course, the amount of tax room available is not fixed, but is a policy judgment.

Finally, there is often more than one way to tax the same item, so that, even when the assignment of revenue-raising responsibility provides different taxing authorities to the two orders of government, both may use these distinct authorities to extract revenues from what is essentially the same source. For example, in federations where the constituent units control natural resource royalties, federal governments have used export taxes, corporate taxes, and excise taxes to get a share of resource rents.

3.5 Tax competition

Devolved tax regimes open the possibility of tax competition, which can have both advantages and costs. Controlling destructive tax competition can be done in various ways.

At one level the idea of different governments in a federal system being able to decide their own taxes is very attractive—it promotes accountability, responsiveness, experimentation and self-reliance. At another level, it conjures up concerns of a tax jungle, heavy administrative and compliance costs, and destructive competition.

Some experts argue that tax competition makes constituent units more responsible because if they overtax mobile tax bases they will see them move away and more accountable because their citizens can compare their taxes with those in other jurisdictions. However, competition can promote beggar-thy-neighbour policies that erode a mobile tax base. It can also lead to locational decisions being made on the basis of taxes, not underlying economic factors, and so impose hidden costs on an economy.

Switzerland illustrates strong tax competition in a small federation: for example, an upper-middle-class taxpayer might pay three times more income tax in one canton than in another, so some have chosen to commute to low-tax cantons rather than reside where they work. Brazil has had a tax war with states competing for foreign investment through breaks on the value-added tax. Tax competition has also been a consistent feature of American federalism.

There are two main ways to address destructive tax competition:

- centralizing revenue decision-making in the federal government, which has been the option of many federations;

- harmonizing key taxes of the different jurisdictions, which is a challenge of decentralized regimes.

As well, equalization arrangements may make poorer constituent units feel less need to compete for mobile taxpayers.

3.6 Tax harmonization

Tax harmonization between jurisdictions can limit destructive tax competition and avoid a tax jungle. Harmonization is easier if the federal government plays a major role in a tax field, or has other levers to influence constituent units.

Tax harmonization is pursued in most federations where different governments share a field of taxation. It can be **vertical** between the federal and constituent-unit governments or **horizontal** between constituent units. Both can be important. It is usually system-wide, but sometimes a federal government reaches asymmetric harmonization agreements with only some constituent units.

Governments can harmonize a tax **base** as well as a tax **rate**. A tax base (say for income tax) is defined in terms of different categories (level of income), with definitions (what constitutes income), permitted deductions (such as costs of earning income, or of children), and so on. The tax rate is the amount of tax applied to the different categories in the base (say zero percent below $15,000; 10 percent for the next $15,000; and so on). The advantages of harmonizing a tax base across jurisdictions lie in simplifying the tax system, reducing administrative and compliance costs, and enabling collection by a single tax authority. It also permits different jurisdictions some flexibility regarding their rates, though the ease of doing this varies by the field of taxation. If there is a risk of destructive competition, both the base and the rates can be harmonized, but this obviously constrains the freedom of constituent units (and perhaps of the federal government, depending on the arrangement).

Tax harmonization is most likely to succeed where the federal government plays a major role in setting and collecting taxes from a tax base. It can then leverage its lead role to create a harmonized system, usually with some consultation and mutual adjustment with the constituent units. As well, federal governments may offer or arrange to collect harmonized taxes, which can save constituent units (and taxpayers) money.

Some federal governments have legal powers that permit them to establish rules for constituent unit taxes. For example, the US Congress, drawing principally on the interstate commerce power, can declare its intent to make the federal government the primary source of law in a field and expressly pre-empt the states from passing laws in the area (even if they do not contradict a specific federal law) or pre-empt state tax laws having certain characteristics. This power has been used to constrain state powers in relation to sales taxes and personal and corporate income taxes.

Tax harmonization between constituent units but without federal government involvement has had few successes. Federal leadership usually depends on the federal government's having a major role in regard to a revenue source. The European Union has no independent taxing power at the centre, but has considerable institutional resources to promote a single market. However, with the EU's virtual absence of central taxes, harmonization has proven very difficult and some member states use their tax systems to encourage the migration of certain taxpayers and activities and even to facilitate tax evasion.

3.7 Tax administration

Tax administration systems should apply tax laws uniformly to achieve an optimum balance of high collection yield and low collection cost. The collection cost should be acceptable to both governments and taxpayers, and the system should promote voluntary compliance. While tax administration systems may be centralized or decentralized, a single centralized system is typically more efficient where a tax base is shared with the federal government.

Tax administration is a complex technical responsibility that requires clear and consistent interpretation of a tax law by those who collect the tax. A healthy tax administration system relies heavily on the quasi-voluntary compliance of taxpayers in filing tax forms, and this is more likely to work well in a country with high literacy, good records, and professional standards of public administration. Such systems should be well-staffed, properly accountable to the governments imposing the taxes, and appropriately transparent.

In federations, tax administration can be centralized or decentralized, even when the decision-making on taxes is not. There are three basic models, which can be combined in different ways:

- Each government collects its own taxes. In almost all federations, at least some taxes are collected by each order of government.

- The federal government collects taxes for the constituent units. Whether by constitutional provision or by delegation, the federal government's administration acts as an agent for the constituent units. This model works especially well in cases of harmonized joint tax fields and may produce both significant administrative savings and higher tax yield.

- The constituent units collect taxes for the federal government. This is unusual, but is the basic model in Germany and Switzerland. It appears this model may be significantly more expensive for both taxpayers and administrations, and poses challenges for consistent application of tax rules.

Tax Administration in Various Federations

In **Australia**, the federal government collects all federal taxes, including the value-added tax whose revenues are reserved for the states. States collect their own taxes. In the **United States** and **India**, both orders of government collect their own taxes. **Canada's** federal tax agency has provincial representatives on its board: by agreement, it collects virtually all federal taxes and the personal, corporate, and value-added taxes for some provinces; Quebec collects all its own taxes as well as the federal value-added tax in Quebec. In **Spain**, each order of government normally administers and collects its own taxes, and the central government collects shared taxes; the exception is in the Basque country and Navarre where, by historic arrangement, these two autonomous communities collect all taxes, from which they pay a levy for their share of the expenses of the central government. In **Malaysia** and **Russia**, the federal government administers and collects taxes for the constituent units. The least common arrangement for tax administration is for constituent units to collect for the federal government. **Germany** is the main example: the Länder participate in decisions on federal taxes through the Bundesrat. In **Switzerland**, the cantonal and local governments collect all taxes.

Whatever the institutional structures for tax administration, there are many technical issues that require resolution, such as double taxation and tax avoidance. There must be rules determining in which constituent unit an individual or corporation is considered to be resident, as well as where profits, losses, or certain transactions are deemed to have happened. Such rules can be part of a harmonized regime, or akin to international arrangements on double taxation. Within federations, one government may not be able to tax another, which can be especially important for lands and corporations owned by governments. This situation can be addressed through special arrangements that are equivalent to taxes; for example, in Canada, the federal government makes payments in lieu of taxes on federal properties (but the provinces make no payments of corporate income tax to the federal government from their publicly owned utilities).