Strasbourg, 18 June 2010

CDL-UD(2010)033

Engl. only

EUROPEAN COMMISSION FOR DEMOCRACY THROUGH LAW

(VENICE COMMISSION)

in co-operation with
the Swiss Federal Department of Foreign Affairs
and
the "Executive Campus HSG of St Gallen University"

in the framework of the Swiss Chair
of the Committee of Ministers of the Council of Europe

CONFERENCE

on "Democracy and decentralisation -
Strengthening democratic institutions through participation"

St Gallen, Switzerland, 3-4 May 2010

SPEECH

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St Gallen

Professor Kirchgassner has asked me to talk chiefly about UK and east and central Europe where I have worked on public administration reform for over 20 years, and to discuss issues of tax assignments, tax autonomy and the conditionality of intergovernmental transfers.

Tax autonomy and competition are clearly keen in Switzerland. I am reminded of this every month when the Soros network pays my fees and expenses from an account with Kantonal Bank Zug. I also remember renting a car at Zurich Airport; my Swiss hosts pointed out that the registration plates were from Canton Appenzell. I am fascinated to find myself close to Appenzell; no doubt closer than the car ever got.

But neither in UK nor central and eastern Europe is there much tax competition about. British local government levies only one tax which is on residential property, paid by the occupant rather than the owner. Tax competition for commercial investment stopped when Mrs Thatcher's Government imposed a uniform national rate of taxation of commercial property although the yields are distributed to local authorities on a per capita basis. British local authorities have to attract investors with golf courses and symphony halls. But that's enough about UK whose local government system is not a model of anything.

In the former socialist states of central and eastern Europe there is little tax competition because there is little tax autonomy. When intergovernmental financial relations were reformed after the Berlin Wall came down, ministries of finance were pretty stingy in giving away taxing power. But neither did local government associations demand it.

In a few states municipalities are freemto set property tax rates within limits. Interestingly it is in those states like Poland and Romania that property taxes contribute most to local revenue budgets; municipalities have got accustomed to making small increases every year, just ahead of the rate of inflation. Even so the overall contribution to local budgets is modest – under 1% of GDP, compared to local budget expenditures of between 6 and 13% of GDP. It is the usual story with property taxes. The lack of connection between liability for the tax and the resources from which it has to be paid means that public opinion tolerates only low rates of incidence. 2% of GDP seems to be the threshold of taxpayer revolt

By far the most important revenue source assigned to local government in the new member states of central and eastern Europe is the personal income tax. The whole of the tax goes to local budgets in countries like Ukraine and Slovakia, and at least 50% in most other new member states..This is basically excellent because it is the most suitable tax base for local government. Forget all the Musgraves said about local government not being the right level for redistribution; even they changed their minds in their last edition. PIT is most clearly aligned with ability to pay, individual payers can be clearly located and enjoy the benefits of the local services like schooling and social care which fall on local budgets, while rates can be varied between localities without too much hassle. And, most importantly and unlike property taxation , PIT really does pay the bills. In several Ukrainian cities it meets the full costs of education, health and social care.

Only Croatia, however, allows local governments to vary PIT rates. Elsewhere, PIT assignments do not provide any tax autonomy. But it is perceived nevertheless as promoting some accountability to taxpayers, and to the consternation of the Council of Europe governments usually classify PIT shares as "own revenue". It certainly helps autonomy in another way by protecting local governments from arbitrary annual budget decisions over their resource levels.

Local taxes on consumption, business turnover or profits, have contributed substantially to some local budgets but only a few, like the Hungarian business tax have provided scope for local discretion and tax competition. Such taxes are very idiosyncratic and all come under fire for duplicating VAT and potential conflict with the Treaty of Rome. Like their Austrian neighbours, Czech and Slovak municipalities have had to surrender their lucrative levies on beer drinking. The local sales taxes which were the bedrock of local revenues in the former Yugoslavia, have all disappeared, largely replaced by formula shares in national VAT receipts, while Hungary's business tax hangs on by a thread.

The difficulty with all taxation of commerce is its vulnerability to recession. Property taxes have remained pretty stable over the last two years, since the efforts of World Bank, USAID and other international agencies to introduce market based systems of assessment mercifully failed. But revenues from shares of corporate profit tax, business tax, VAT etc have nosedived. Czech municipal shares of Corporate Profit Tax fell by 27% last year. It is a moot point whether local government with its preponderance of payroll dominated expenditures should be funded by such volatile revenues.

So the reforms of intergovernmental finance which followed the democratic transition in central and eastern Europe did not promote much in the way of tax autonomy. This was not simply due to national government resistance. Local authority associations did not campaign for it. It was only outsiders from the Council of Europe, USAID etc who fussed about fiscal decentralisation in its fullest form. Mayors did not, by and large, seek the blame for tax rates. In fairness their newly acquired powers to set utility charges were challenge enough when prices were liberalised.

I have referred to the apathy of local government associations about tax autonomy. What they were far more insistent on was the neutrality, stability and transparency of intergovernmental transfers. Autonomy has been more generally enhanced in the management of expenditure. The use of intergovernmental transfers has been widely liberalised. Block grants prevail, with the possible exceptions of education finance and, of course, capital investment. On the other hand the categorisation of large services like education, social care and culture as delegated rather than devolved competences has given ministries opportunity to dictate expenditure through the backdoor of service standards, often at high cost to efficiency.

The second guarantee of autonomy which is prevalent in most central and eastern European states (but absent in UK) is the legislative framework for intergovernmental transfers. With the significant exception of Hungary, the quantum of transfers (as percentages of individual or total national revenues) and the criteria for their distribution are a enshrined in permanent legislation rather than annual state budgets. Parliaments can, of course, amend these laws but it is politically far more difficult to do. Local government associations opted for certainty over their share of national taxes rather than freedom to set their own levies; having lived through totalitarian days, they knew on which side their bread was buttered.

Of course local accountability may suffer. But having been both an administrator and an academic in my career, I find much fiscal federalism theory both naïve and simplistic. The idea that local voters and representatives know best is not always self evident. In the case of most government functions there is a hierarchy of choice from how much to spend on education to whether to buy test tubes or board markers. Who knows best at each level of choice ranges from Parliament to the individual teacher.

Nor do I find payers much more eager to pay taxes because the local council has imposed them. It may only sharpen their scepticism. Moreover local tax increases are often driven largely by external factors such as rates of inflation or interest, national wage settlements or health and safety regulations from Brussels.

What I am saying may be heresy in Switzerland . But after 40 years of regular visits to this wonderful country, I have two contrasting but abiding memories. One is of discussion on this topic at the University of Fribourg, in which the Canton President said "Cantonal autonomy? Forget it; everything's fixed at Berne". But we were staying with our Swiss friends when they voted in a 21 issue referendum; they decided whether nuclear power generation should be extended. That decision rested with national politicians in Britain, but they avoided it for years for fear of offending the public; it has never occurred to them to ask the public.