# AFTER LOCK DOWN

## Municipal finance and the local economy post Covid-19: revenues reassigned and rates reduced

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The effects of the Covid-19 pandemic on the economy may be long lasting, with the economics profession often citing what it calls post-crisis scarring effects. One such impact is on the finances of the local government sector, and, in particular, the effect of the lockdown and the subsequent contraction in economic activity on the own-source revenues of local authorities, specifically commercial rates and income from charges for local public services. Although this has been partly mitigated by the central government's compensation to local authorities for rates income forgone vis-à-vis the Rates Waiver Scheme, there is the long-term issue of the sustainability of rates from commercial properties given the megatrends of online retail, remote working/WFH, and city centre businesses and their workforce seeking relocation in their search for lower costs and more space.[1]

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[1] In the UK, a review of business rates was announced in Budget 2020 with the full report due by end 2021. An interim report was published in March 2021, and is available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/971681/Fundamental_Review_Interim_Report.pdf

Given this background, recent patterns in local government funding and likely future trends, our proposal has two objectives. Its purpose is to provide a new and sensible source of revenue income for local authorities based on sound principles of fiscal federalism and local public finance, while at the same time, grow the tax base of local authorities by providing for a reduction in commercial rates for existing ratepayers, but also on new business formation with rateable properties.

We begin with our conceptual framework. Any discussion on intergovernmental arrangements and fiscal decentralisation can be framed using the so-called four pillars or building blocks of intergovernmental finance (see Figure 1).[2]

The four pillars are expenditure assignment, revenue assignment, intergovernmental transfers, and borrowing and debt. In this brief article, we are interested in the revenue assignment pillar, namely the revenues that are assigned to the different tiers of government. Although the theory of expenditure assignment is relatively straightforward - central government is responsible for functions relating to income redistribution and macroeconomic stabilisation, with subnational governments largely responsible for resource allocation - the principles underlying revenue assignment are less clear. From the intergovernmental finance literature, we show in Figure 2 some basic guidelines or criteria for assigning revenues, with some specific examples of taxes assigned to different tiers of government.

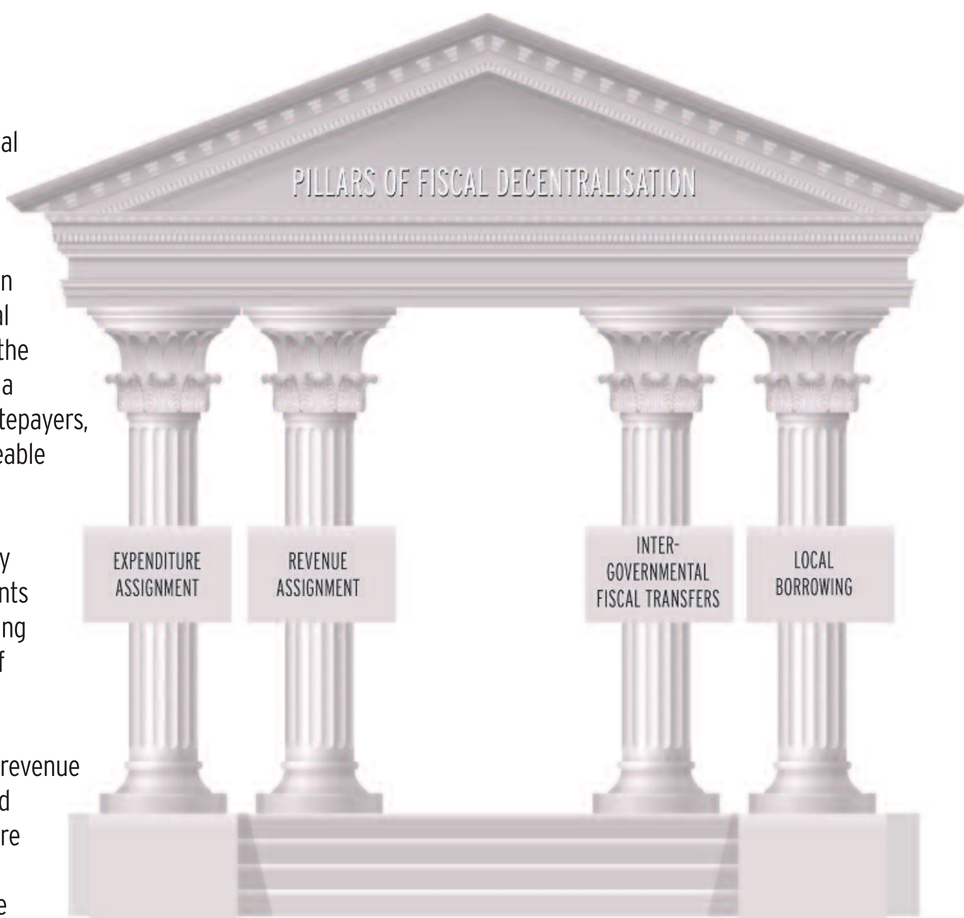
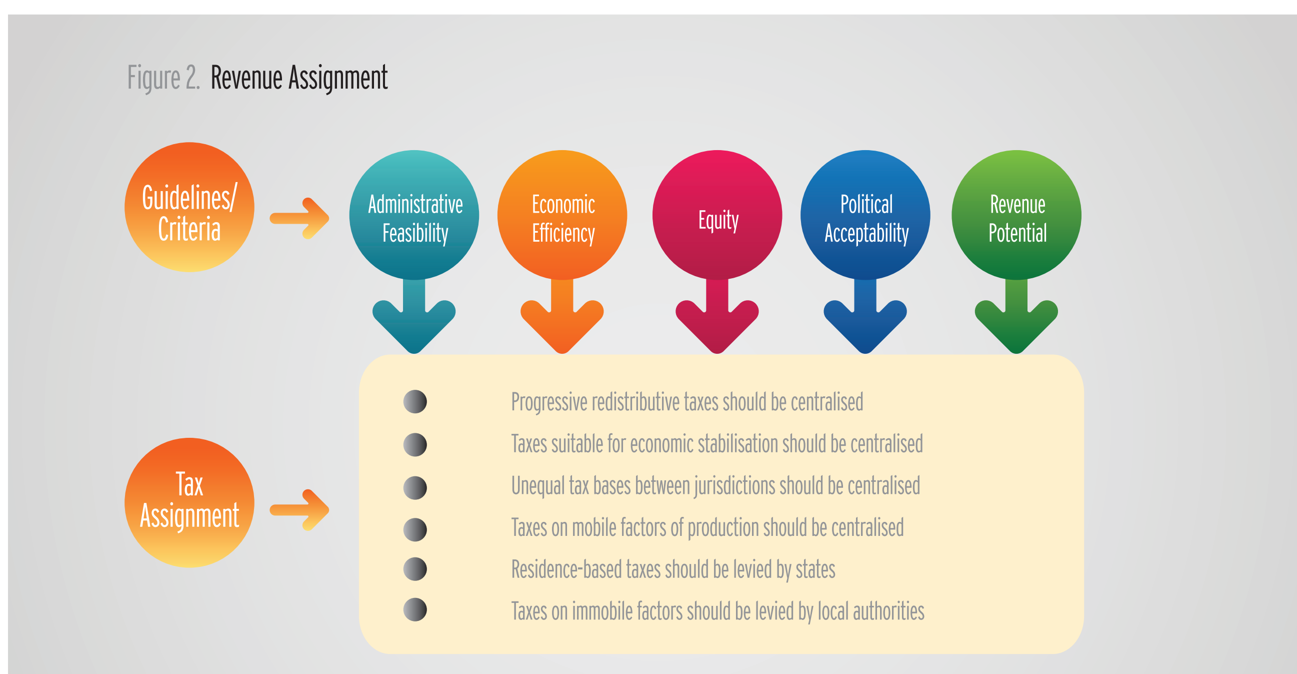



Figure 1. The Pillars of Fiscal Decentralisation
Source: Adapted from Bird (2000)

[2] This is sometimes referred to as having five pillars, where the additional pillar is the territorial and institutional arrangements that govern the intergovernmental fiscal relations of a country. We omit it here as we are focused on the assignment of expenditures and revenues.




Source: Adapted from Musgrave (1983); UNDP (2007)

Table 1. Tax Assignment

| Type of tax | Determination of base | rate | Collection and administration | Comments |
|---|---|---|---|---|
| Customs | F | F | F | International trade taxes |
| Corporate income | F | F | F | Mobile factor, stabilisation tool |
| Resource taxes | | | | |
| Resource rent (profits, income) tax | F | F | F | Highly unequally distributed tax bases |
| Royalties, fees, charges | S, L | S, L | S, L | Benefit-taxes/charges for state-local services |
| Personal income | F | F,S,L | F | Redistributive, mobile factor, stabilisation tool |
| Wealth taxes | F | F,S | F | Redistributive |
| Payroll | F,S | F,S | F,S | Benefit charge, e.g. social security coverage |
| Multi-stage sales tax (VAT) | F | F | F | Harmful inter-state tax competition |
| Single-stage sales taxes | F | S | F | Harmonised |
| Excise | | | | |
| Alcohol and tobacco | F,S | F,S | F,S | Healthcare a shared responsibility |
| Motor fuels and carbon taxes | F,S,L | F,S,L | F,S,L | To combat pollution |
| Motor vehicles | S | S | S | State responsibility |
| Business taxes | S | S | S | Benefit tax |
| Property and land | S | L | L | Immobile factor, benefit tax |

Note: F is federal; S is state, region or province; L is local or municipal. Source: Adapted from Shah (1994)

A more detailed account of tax assignment and specifically subnational (regional/state and local/municipal) taxes is outlined in Table 1.

With subnational government providing goods and services characterised by limited spillovers and limited economies of scale, on the funding side we know what constitutes a good local tax i.e. levied on relatively immobile bases and imposed mainly on local residents, easily administered locally, with a base that is relatively evenly distributed, and with yields that are relatively stable over the economic cycle.

Returning to Table 1, from a theoretical perspective our interest here is on taxes assigned to subnational governments and, in particular, the case of motor taxes assigned to local government, where revenue from the tax levied on motor vehicle ownership accrues to the local authority where the owner of the vehicle resides. A central feature of any good system of local government is the matching or benefit principle i.e. linking the taxes paid with the benefits received and in line with the costs of the service provided. As with benefit-related taxes, the motor tax accrues to local government, and, in turn, is used for the delivery of local services including the maintenance of local roads, traffic management, road safety, street cleaning, etc.

For this reason, motor taxes are generally considered to be good candidates for assignment to subnational (or in the Irish case, local) government. We already know that a property tax is a good local tax. Although not on a par with property taxes due to the mobile nature of motor vehicles, what is less well known is that motor tax meets many of the criteria of a good local tax. Quoting the late Richard Bird (2000: 2), 'The only major revenue source usually seen as passing these stringent tests is the property tax, with perhaps a secondary role for taxes on vehicles,...'.

For some tax sources listed above, tax base and revenue sharing mechanisms are popular, where, in the case of the latter, revenue is shared between two or more tiers of government. Given the theoretical argument outlined above to assign motor tax to local government, combined on the other hand with the political necessity for central government to retain its current tax sources, a compromise is a revenue-sharing arrangement with respect to motor tax where the motor tax revenue is shared between Irish central and local government. In theory, if earmarked, central government could use motor tax to help finance the national roads network while local governments could use such a tax to fund regional and local roads. The actual fixed share is a political decision based on political economy considerations and other constraints, and would normally be subject to periodic review and adjustments.

Before the local government reforms and the introduction of the Local Property Tax (LPT) in the mid 2010s, motor tax

was assigned to local rather than central government. More specifically, it was paid into the Local Government Fund (LGF), which, in turn, allocated monies to local authorities in the form of central government grants, both general-purpose payments and specific-purpose grants for non-national roads.[3] Motor tax income was about €1bn per annum. With the establishment of Irish Water, the introduction of the LPT and other changes to local government funding, motor tax is now paid to the Exchequer for central government spending. As for the separate issue of collection, it is still collected by the motor tax offices of the local authorities.

Rather than assign this revenue source to only one level of government, our proposal is to share the yield between central

Table 2. Local Authorities and Commercial Rates*

| **20% or less reduction in the ARV** | **ARV 2019**** | |
|---|---|---|
| Clare County Council | 72.99 | |
| Cork City Council / Cork County Council | 74.98 / 74.75 | |
| DCC / DLR County Council / Fingal County Council / SDCC*** | | 0.2610 / 0.1673 / 0.1500 / 0.2760 |
| Kerry County Council | 79.25 | |
| Kildare County Council | | 0.2246 |
| Limerick City & County Council | | 0.2677 |
| Louth County Council | 60.00 | |
| Waterford City & County Council | | 0.2583 |
| **21% - 25% reduction in the ARV** | | |
| Carlow County Council | | 0.2571 |
| Donegal County Council | 71.81 | |
| Galway City Council / Galway County Council | 67.4 / 66.59 | |
| Mayo County Council | 75.40 | |
| Monaghan County Council | 59.04 | |
| Offaly County Council | | 0.2198 |
| Sligo County Council | | 0.2300 |
| Wexford County Council | 73.67 | |
| **More than a 25% reduction in the ARV** | | |
| Cavan County Council | 60.87 | |
| Kilkenny County Council | | 0.2000 |
| Laois County Council | | 0.2217 |
| Leitrim County Council | | 0.2103 |
| Longford County Council | | 0.2401 |
| Meath County Council | 69.62 | |
| Roscommon County Council | | 0.2250 |
| Tipperary County Council | 56.77 | |
| Westmeath County Council | | 0.1830 |
| Wicklow County Council | 72.04 | |

Notes: *In Dublin, Cork and Galway, motor tax is collected by DCC, Cork County Council, and Galway County Council motor tax offices on behalf of the other local authorities. As a breakdown of motor tax receipts for these local authorities is not available, we use the number of households as a proxy to apportion the motor tax income. Although we report above the actual ARV for each of these local authorities, we use an average rate when calculating the change in the ARV in the case of these three administrative areas. For the four Dublin councils we use two separate groups (DCC/SDCC and DLR/Fingal) to calculate averages due to the similar ARVs in each group. **The two columns of ARV reported here are due to local authority areas that have had rateable properties revalued (e.g. the four Dublin local councils, with an ARV beginning with 0.1 or 0.2) and those where a rates revaluation had not taken place by 2019 (e.g. the two Galway local councils, with an ARV beginning with 66. or 67.). *** DCC = Dublin City Council, DLR = Dún Laoghaire Rathdown, SDCC = South Dublin County Council. Source: authors' calculations

[3] The LGF is a central fund financed by motor tax (up to 2017), the LPT and Exchequer contributions, and is used to pay for certain local government services, vis-à-vis LPT payments. Since 2018, motor tax is paid to the Exchequer and LPT receipts are paid directly into the fund by Revenue.

and local government, on a pre-determined basis. As already alluded to, revenue-sharing arrangements between different tiers of government are common in other jurisdictions, and especially in federal countries and in many Central and Eastern European economies. Revenue sharing of tax receipts on ownership of motor vehicles is also not uncommon. Indeed as noted by the World Bank, in many countries motor vehicle tax is typically a shared tax with local governments receiving 50 to 100% of the yield.[4]

For illustrative purposes, we take the financial year 2019, and motor tax receipts of €964m. In our simulations, we take a modest 25/75 split, with 25% of motor tax receipts accruing to local government on a derivation basis i.e. shared in proportion to the revenue collected in each local authority.[5] With a 25% share to local government, amounting to €241m in 2019, this translates into a 16% reduction in commercial rates income needed by local authorities to balance their adopted budgets.

In terms of the Annual Rate on Valuation (ARV) which when multiplied by the rateable valuation of a property determines the annual ratepayer's liability, this amounts to a 20-25% average reduction in the ARV.[6] While urban councils, in Dublin and Cork for example, that depend relatively more on rates for their annual income could see, on average, a potential rate cut of up to 15% or so, some smaller rural councils could implement a reduction in the ARV of up to about 30%, while at the same time, continue to maintain public services and manage the local public finances. Whatever the precise cut in the ARV, it amounts to a significant and permanent reduction in the annual rates bills for businesses with rateable properties. Table 2 reports the 31 local authorities, their 2019 ARV and the range of estimated reductions in the ARV arising from the proposed revenue-sharing arrangement for motor tax. Given the wide range of reductions we report three categories, namely cuts in the ARV of 20% or less, cuts between 21 and 25%, and cuts of over 25%.

It is important to restate that these ARV reductions do not mean cuts in local public services or any softening of subnational fiscal discipline. The revenue-sharing arrangement whereby local government is assigned 25% of motor tax revenues affords local authorities the opportunity to maintain the level of public service provision and balance their annual revenue budgets but all at a lower ARV as a smaller amount of commercial rates needs to be levied.

We recognise that the annual extra income from motor tax could be used in alternative ways to, for example, improve the delivery of existing public services or increase reserves to fund capital projects in the future. Although a policy choice for local authorities, we believe that in the current circumstances priority should be given to reducing commercial rates as a way to grow the local economy, post Covid-19.[7] As for the Exchequer, the cost to the central government of sharing this revenue source and the tax income forgone is offset by a local government sector that is financially more sustainable and a local economy that is bigger in size. This proposal to reassign revenues and reduce rates can be a win-win for all.

For more details on this and other research on the economics of local government in Ireland, go to www.localauthorityfinances.com.

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[4] The same World Bank publication states that a '...great variety of local taxes exist, although most countries rely on property taxes, motor vehicle taxes, and sales and income taxes' (Freire and Garzón, 2014).

[5] Although this revenue would appear in the local authority budgets and the income and expenditure account of the annual financial statement as a tax, from a local public finance perspective it is technically a transfer and not a local tax as the local authorities do not have any autonomy or power over the tax base or the tax rate. This classification of local authority revenues does not change the rationale or substance of this proposal.

[6] With the amount of rates to be levied equal to the difference between budgeted expenditure and budgeted income from non-rates revenues (i.e. grants, charges and LPT), and used as a balancing item in the revenue account of the local authorities, the ARV/commercial rates multiplier is calculated as the ratio of rates income to the rates base, with the latter called the Net Effective Valuation as reported in the local authorities' annual budgets.

[7] A variant of the cut in commercial rates is a targeted reduction in rates for SMEs, by means of a lower ARV for businesses and ratepayers with rateable valuations below a certain threshold. This is the practice in England where a standard rate/multiplier applies in addition to a lower rate/ multiplier for small businesses.