

PROPERTY TAXATION AND LOCAL AUTHORITY FINANCE

Moore McDowell*

Introduction

Since 1978 residential property in the Republic of Ireland has been exempt from any local property tax, although attempts have been made to introduce property-related levies in the form of water charges. The Coalition government of 1982-1987 introduced a residential property tax confined to those in high incomes and owning high value residences. This tax, which up to the present has raised little revenue, is payable to central government. For 98% of households, apart from desultory efforts by local authorities to collect water levies, the abolition of domestic rates in 1978 has meant that they pay no tax on the houses they occupy, and pay no tax to the elected local authorities in whose jurisdictions they live. This means that, simultaneously, the tax base of the Republic was drastically narrowed and in a wide area of democratic public choice the link between determining an appropriate level and pattern of spending and providing the finance was broken. The criticisms of economists at the time have now been very widely accepted as well founded. It seems to be virtually universally accepted that the removal of property taxation on residential property was a serious mistake. The fact that politicians, apparently irresponsibly, persuaded the electorate to vote for this change, and continue to show great reluctance to reverse it might suggest that the electorate demonstrated substantial collective irrationality.

One of the purposes of this article is to demonstrate that the political support for the abolition of rates was not based on irrational voter attitudes. Instead, it will be shown that the old rates system collapsed because it was no longer politically viable. This in turn reflected a quite rational discontent with the uses to which the revenues raised by rates were put, and the structure and incidence of grants in lieu of rates from the Exchequer to the country's Local Authorities, in short the overall incidence of the rates tax burden.

The second purpose is to draw conclusions about the viability of a new local property tax as a part of a package of tax reform. It will be suggested

*The author is Lecturer in Economics in the Department of Political Economy, University College Dublin.

not provide the incentive for the formation of an interest group coalition sufficiently strong in numbers and motivation to secure its repeal.

The Case for a Local Property Tax

The question of whether there should be a residential property tax has two elements to it: should residential property be part of the overall tax base? and should a residential property tax be a tax decided by and payable to the local subordinate tier of government, or should it be a uniform tax across the country payable to central government? Broadly speaking, these reflect two quite different considerations. The first is related to the overall level and composition of taxation. The second is related to political and economic concern about the role and efficiency of responsible local government.

The locus classicus for arguments concerning the first of these is the Reports of the Commission on Taxation issued between 1982 and 1986. In its first report in 1982 it called for a widening of the tax base so as to permit a lowering of tax rates. In its fourth report in 1985 it called for the inclusion of a variable local property tax both as part of the exercise of tax base widening and also as a contribution to a rational reorganisation of local government finance. The perceived need to reform the tax system in the late 1980s strongly suggests a role for tax base widening, if present levels of public spending relative to GDP are to be reconciled with reductions in the very high rates of marginal income tax on what are by international standards relatively low levels of personal income. In the context of 1992, with the imminent requirement to lower the average level of indirect tax significantly, and the political problems of replacing tax revenue from abandoned high excise and VAT rates by extension of VAT at significant rates to a series of sensitive and at present zero-rated items, the possibility of using a new or extended property tax has attractions from the Government's point of view.

It should however, be noted that there is an alternative view of the desirability of tax base widening. A narrow tax base has the effect of limiting a government's revenue raising powers. On such a base high tax rates encourage legal avoidance of tax liability by means of decisions to reallocate consumption spending and/or by altering the composition of wealth portfolios and/or by changing the level of labour supply. In contrast, a low rate, wide base system makes it easier for governments to raise their share of GDP through a policy of uniform incremental increases in tax rates (Brennan and Buchanan, 1977; McDowell, 1982). This aspect of a possible reintroduction of a comprehensive tax on residential property was not addressed in any of the four major studies which dealt directly or

addition to the first and fourth reports of the Commission on Taxation (1982, 1985), a report published by the E.S.R.I. (Copeland and Walsh, 1975) and a study by the N.E.S.C. (1985). To the extent to which one is disquieted by the propensity of Leviathan to use new tax instruments to increase this share of the national income one might regret this tacit acceptance of the conventional assumptions on the properties of a desirable structure for a tax system.

A more convincing and less controversial case can be made for a new, comprehensive property tax based on the issue of the appropriateness or otherwise of having a tier of government with spending responsibilities which is relieved of the burden of deciding on the imposition of the taxes necessary to finance that spending. The assignment of spending control to subordinate (local) organs of government can be rationalised in terms of a comparative advantage of the lower tier in ensuring expenditure efficiency in the case of some types of public spending programmes. This arises from lower information and monitoring costs in certain areas of public spending programmes when locally-specific information is of paramount importance. If, however, effective decision making on the level and allocation of spending is left to local bodies, but they are not required to raise the necessary taxes, a classical free-rider situation emerges, and the system is predicted to produce a level of public spending which is greater than optimal.

Considerations of efficiency and equity suggest that the assignment of spending responsibilities to local authorities should not be linked to requirement that they should balance their budgets by raising the tax revenues necessary to finance the expenditure for which they have responsibility. The smaller is the economic and geographical size of a local jurisdiction, the weaker is the case for assigning to it an independent tax structure in the sense of allowing or requiring it to use different bases or rates of tax from neighbouring areas. The smaller the tax district relative to the country as a whole, the greater will be the excess burden costs of variable taxes (the costs in terms of resource allocation responses to tax differences).

Optimising fiscal relations between central and local government will, therefore, be subject to a trade-off between the costs of decentralising taxation powers and the free-rider costs arising from local spending autonomy divorced from the responsibility to raise the necessary taxes. The outcome will inevitably involve some measure of grant finance to local authorities from the Central Exchequer. The precise form of this grant is of some importance. So, too, is the relation between the type of taxation autonomy given to local authorities and the expenditure responsibilities assigned to them.

of linking taxation autonomy to spending responsibility that produced the "rates revolt" of the late 1960s and the 1970s. If this is accepted, then the popular demand for the abolition of the residential property tax no longer appears to be an irrational demand for a fiscal free lunch. Instead, it can be treated as a rational and predictable response to a deficient matching of tax and spending responsibilities, as well as to the impact of a pattern of central government grants which gave rise to inter area transfers and to the marginal financing of intra area transfers by inappropriate taxes, specifically, rates.

Rates and Grants in Local Authority Finance

During the 1960s local authorities in Ireland were financed partially from rates and other "own" resources (mainly rents and user charges) and partially by transfers. The latter were mostly from central government, but there was a smaller element of "upwards" transfers from Urban Districts to County Councils and "lateral" transfers from Boroughs to County Councils. Central Government grants were of three main types:

- (i) *Rates Relief Grants*: designed to reimburse local authorities for loss of rates revenue arising from centrally legislated revisions of rates liability, mostly from the derating of small farm holdings;
- (ii) *Other Nonspecific Grants*: of little importance and may be ignored for the purposes of this study;
- (iii) *Specific Grants*: payments made to help defray the costs of specific local authority programmes; originally in many cases on a percentage basis, but by the end of the 1960s the proportionality factor had broken down.

Many of the important aspects of this system of joint finance of local spending have already been examined in two major published studies (Copeland and Walsh, 1975; N.E.S.C., 1980). The present article draws on recently published work by the author based on similar data to those used in these studies, although differently aggregated (McDowell, 1989). This work examines the system of grants from Central to Local Government to establish the underlying motivation for the transfers. This revolves around whether the division of taxation and spending between tiers of government is consistent with subordinate bodies being the agents of central government or whether the underlying reason for the transfer system is to redistribute income between local areas and/or to alter resource allocation within areas by altering the behaviour of Local Authorities. In general, the evidence support an allocation/distribution mechanism. In this article the distributional aspect of the grants system are examined, and their implications for the possible role for a new property tax are described.

the sources and uses of funds spent by Local Authorities in the Republic. Estimates for incomes by county for four years, 1960, 1965, 1969, and 1973, were published between 1969 and 1975 (Ross, 1969, 1973, 1975). These were used to estimate the degree to which the grant system sought to redistribute income as between counties, and to assess the implications for a property tax. For each of four years 1960, 1965, 1969 and 1972 cross section estimates were made of the relationship between grants per head by Local Authority area from Central Government and income per head, local spending per head (current) and the composition of local spending as between broadly defined allocative and distributive programme areas. Income data for 1973 were used with the other observations for 1972 (the last year before rates began to be removed from urban areas) in the absence of any published estimates of county incomes for that year. A political variable, the Fianna Fail local election vote share in 1965, was included to allow for the possibility that the party in power during the period 1957-1973, Fianna Fail had tried consistently to use the grant system to transfer resources to its own supporters. There was no evidence, as it turned out, to support this possibility.

Table 1: *Determinants of Grants Per Head by County, 1960-1972.*

	A_0	A	A_2	A_3	A_4
1960	11.456 (3.223)	-.051 (-6.227)	.481 (5.652)	-9.483 (-2.257)	.060 (1.492)
	$\bar{R}^2 = .806$	SEE = .791	F = 29.537		
1965	6.352 (1.069)	-.962 (-8.698)	.659 (8.197)	7.025 (1.818)	.441 (.709)
	$\bar{R}^2 = .903$	SEE = 1.365	F = 65.153		
1969	10.414 (1.449)	-.081 (-10.057)	.873 (7.473)	7.910 (.820)	$.2 \times 10^{-4}$ (.912)
	$\bar{R}^2 = .896$	SEE = 2.477	F = 60.117		
1972	24.192 (2.663)	-.060 (-7.117)	.703 (10.567)	.970 (.138)	.081 (.565)
	$\bar{R}^2 = .535$	SEE = 4.776	F = 8.916		

Test

Equation: $G/N = a_0 + a_1 Y/N + a_2 CX/N + a_3 D/Cx + a_4 P$

Y/N = income per head, nett of transfers.

CX/N = current L.A. spending per head.

D/CX = proportion of L.A. spending allocated to primarily redistributive programmes.

P = political variable: Fianna Fail's share of the TVP in the 1965 local elections.

t-statistics in brackets.

coefficients on the income per head variable are strongly negative, indicating that grants per head per county were inversely related to income per head. The coefficient on local spending per head was strongly positive, which was to be expected, given the importance of specific grants in the overall grant structure. The composition of spending variable, however, performed very poorly. The failure of this variable to show a consistent and significant influence on grant per head is of importance to the argument of this section of the article. If the specific grants from the exchequer had been structured to redistribute income, then a local authority which spent more on redistributive purposes for any given income per head and overall level of local spending per head should have received more in grants per head. Not only did this not happen, but at the beginning of the period under study grants per head appeared to be weakly negatively correlated to the composition variable.

This implies that at the margin the local authorities which spent more on redistributive programmes had to rely on other sources of revenue. For all practical purposes this meant rates. Authorities would be obliged either to raise rates to finance redistribution or to reduce non-redistributive spending per pound of rates revenue raised, which meant raising the tax price per unit of allocative output. This might be expected to incite discontent with the rates system for two reasons. In the first place, it meant that property taxes were being used at the margin to redistribute incomes within counties even though the "rich" in one county might be relatively "poor" in another. This clearly offends against any rational criterion of horizontal equity. Secondly, since rates were paid by a declining and largely better off section of the local population, while the entire population were entitled to vote for local spending programmes, a bias towards the growth of locally redistributive spending would be expected. Models of collective choice predict the emergence under such conditions of an interest group coalition to secure an alleviation of the burden of the property tax.

The rates revolt of the 1960s was predominantly an urban affair. The high point was the refusal in 1969 of the Dublin Corporation to strike a rate, which led to its being suspended by the Government. Further analysis of the data reveals why this urban revolt should have been expected. Cross section analysis of the country as a whole for the four years provides a predicted value for Central Government grants to any Local Authority based on income per head, local spending per head and the composition of spending. Table 2 contains the predicted and actual values for the four counties containing the largest urban areas.

	1960		1965		1969		1972	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Dublin	5.03	5.13	3.89	17.40	5.25	5.65	9.24	12.44
Cork	9.18	9.52	9.50	24.51	11.26	12.43	15.16	19.08
Limerick	8.90	8.90	9.07	28.53	12.07	13.86	17.71	18.04
Waterford	10.07	9.74	9.76	26.33	11.92	14.40	17.62	17.68

(1) actual grants per head

(2) predicted grants per head

Although the magnitude of the bias varies by area and by year, the overall message is clear: with the exception of two counties in one year (Waterford and Limerick in 1960) the level of central grant per head was below and frequently substantially below the level that would be predicted by considerations of horizontal equity.

It is obvious that during this time Central Government was using the system of Exchequer grants to Local Authorities out of general tax revenues to finance nett transfers from urban to rural areas of the country. The mechanism responsible for this was the basing of non-specific grants on rates relief for small farm holdings which are conspicuously absent from urban areas.

Table 3: *Grants Per Head Regressed on Income Per Head and Local Spending Per Head*

1969	G/N = 63.45	- .1026	Y/N	R = -.74
	G/N = 8.94	+ .86	CX/N	R = .81
1960	G/N = 21.27	- .065	Y/N	R = -.68
	G/N = 3.655	+ .345	CX/N	R = .41

Further analysis of the data suggested by this result yields some more interesting results. In Table 3 are contained the expressions obtained by a simple regression of grants per head on (a) income per head and (b) local spending per head for the 22 counties not included in Table 2 for the years 1960 and 1969. Using these to obtain a predicted equitable transfer to the four "urban" counties yields the values contained in Table 4.

This shows more clearly the structure of the urban to rural transfers implicit in central to local transfers. It was not so much that urban areas did badly in terms of grants relative to income per head. The problem lay in the level of grants relative to Local Authority spending per head. This tended to be higher in urban areas, presumably reflecting greater

	Implied	Actual
$G/N = f(Y/N)$		
1969		
Dublin	6.93	5.25
Cork	19.55	11.26
Limerick	22.21	12.07
Waterford	20.63	11.92
1960		
Dublin	4.24	5.03
Cork	8.97	9.18
Limerick	8.62	8.90
Waterford	8.23	10.07
$G/N = f(CX/N)$		
1969		
Dublin	22.67	5.25
Cork	29.28	11.26
Limerick	19.55	12.07
Waterford	21.12	11.92
1960		
Dublin	11.04	5.03
Cork	10.30	9.18
Limerick	9.94	8.90
Waterford	11.44	10.07

extremes in the distribution of income in urban areas which contain large concentrations of poorer people. As a consequence, the distributive proportion of local spending was (and remains) higher in these areas. Poverty related spending programmes, such as public housing, are frequently determined by Central Government policy, while under the system as it obtained up to the early 1970s the financing of them in urban areas was left to a great degree as the responsibility of the Local Authorities charged by law with the execution of this portion of centrally determined social policy.

It is reasonable to conclude, therefore, that when property taxation was last fully operational in the Republic the system of rates and the structure of Exchequer grants resulted in the system as a whole (1) transferring resources nett from urban property taxpayers to the rural population, and (2) using rates at the margin within counties to finance redistributive

to a number of the apparent difficulty and the manner in which it is dealt with by commentators.

It was quite rational for urban property tax payers to seek (a) the removal of distributive spending financial responsibility from the Local Authorities, and (b) the replacement of property as a tax base for local finance by grants from the Exchequer. Nor was this a peculiarly Irish problem or response. It will be remembered that in the United States at that time the question of capping state property taxes was a major political issue, culminating in the passing of "Proposition 13" in California in 1978, and a similar reform in Massachusetts in the early 1980s for similar reasons.

Implications for A New Property Tax

The relationship between grants and property taxation in the financing of local expenditure and its consequences for the political viability of the property tax have major implications for the proposal to reintroduce a comprehensive tax on residential property as part of a reform of the Irish tax system. In its 4th report, the Commission on Taxation recommended the introduction of a locally variable tax on owner occupied residential property. In the light of the foregoing analysis and results, the desirability and feasibility of such a proposal will be affected by considerations of the scope of the tax (the range of property which is liable) and the variability of the tax (differences as between counties).

Notwithstanding the Leviathan type arguments against base widening, a strong case can be made for the introduction of some form of property tax. Both the Commission on Taxation and the exigencies of the completion of the internal market of the EEC after 1992 suggest that VAT should be levied on house rental. Horizontal equity and the avoidance of further distortion in the market for private accommodation would require the introduction of a tax on owner occupied housing. Further, since there is plenty of evidence that house value is closely correlated to the income of the occupant, a tax on residential housing at a constant rate would be proportionate rather than regressive, and a property tax could be easily made progressive. This would enable the government to impart a progressive slant to the tax structure without incurring the disincentive costs of a progressive tax on earned income. The tax system would be moved towards the ideal position in which the individual's liability can be made to reflect his objective capacity to earn and spend without in any way discouraging him from using that capacity as best he can or distorting the manner in which he uses it.

particular proposals put forward by the Commission on Taxation. In its report the Commission made the case for a property tax at least in part on the grounds that responsible local government required the linking of spending and taxing decisions. This is unexceptionable. The report, however, ruled out a locally variable tax as administratively too costly and potentially distortionary. This view is supported by others who have written on the subject. Local sales taxes, if genuinely variable as between counties in the Republic, would undoubtedly cause substantial and costly avoidance, and inter-jurisdiction competition would in all probability result in a uniform, country-wide local sales tax. This would, of course, defeat the purpose of the exercise, which was to introduce a locally variable tax so as to permit Local Authorities to decide on the appropriate level and mix of local spending and simultaneously on the method of financing that spending.

In effect this leaves Local Authorities with user charges and property taxes. Given that some local spending is on "public" goods for which user charges are not feasible, and that some is on "merit" goods on which user charges to cover costs are not charged, there will have to be a local property tax. Since, it is argued, a property tax does not impose serious administration costs, and since avoidance is effectively impossible (as real property cannot move), such a tax seems a very suitable source of local revenue.

The argument, unfortunately, is flawed. In the first place it is based on an assumed Tiebout (1956) solution to the problem of the optimal provision of a local public good. Apart from the problems arising from the complex characteristics of levels of public spending, the Tiebout mechanism depends critically on the existence of an effective exclusion mechanism whereby only tax-paying residents of an area can enjoy the public goods provided from their tax payments. In the Irish context Local Authority areas are so small that effective exclusion is hard to imagine in the case of many public goods (e.g. parks, recreational facilities, street lighting, local roads ...).

Second, the idea that higher property taxes cannot be avoided because property cannot be moved is only true in the short run, as the phenomenon of tax induced urban blight in the U.S.A. testifies. In the longer run if higher taxes reduce the ratio of property prices to replacement costs in one area relative to another, the high taxed property will in effect "move" to the lower taxed area as new building is relocated to minimise tax burdens and as, at the margin, the property base is eroded as the market value of some properties is driven below the capitalisation of maintenance costs.

to question. Perhaps even more pertinent is the question of its political viability. The message of this article is that its long run acceptability will be weakened if it is used for intra-area redistributive purposes.

Drawing these together, we are left with a very limited role for a hypothetical locally variable tax as envisaged by the Commission. It would be confined to financing local spending on non-redistributive goods or services which can only with difficulty be enjoyed by those living outside the local tax jurisdiction. This narrows the scope of property tax financed local fiscal autonomy. It also calls into question the appropriateness of using the present counties or county boroughs as tax districts.

In effect the above is an argument for limiting a property tax to the financing of locally produced goods and services which are complementary in consumption to the consumption of the services of real property, and especially of residential property. Policing, refuse collection, local environmental control, road maintenance, street lighting... these are the type of public sector output which could in whole or in part be produced locally and which are plausibly treated as complementary in consumption to housing. Activities which would not qualify for the property tax as an earmarked source of finance would be low income housing, health, education. In between lie such things as public libraries, local administration costs, water supply or sewerage investment.

In other words, many of the major areas of public spending for which Local Authorities are at present responsible would be either excluded from property tax finance or treated as doubtfully includable. The limited usefulness of a locally variable property tax, however, should not be allowed to rule out the possible introduction of a property tax at a national level. As part of an overall package of tax reforms it offers the possibility of introducing lower marginal taxes on earned incomes while retaining a strongly progressive bias in the tax system as a whole.

REFERENCES

- Brennan, G., and Buchanan, J.M.: "Towards a New Tax Constitution for Leviathan"; *Journal of Public Economics*, Vol 8, 1977.
- Copeland, J., and Walsh, B.M.: *Economic Aspects of Local Authority Finance and Expenditure*: Economic and Social Research Institute, Dublin, Report No. 80, 1975.
- McDowell, M.: "Leviathan Unchained: Twenty Five Years of Public Expenditure Growth"; *Administration*, Vol 30, Nos 2 & 3, 1982.
- McDowell, M.: "Agency, Allocation and Distribution: Evidence on the Motivation of Central to Local Transfers"; *Economic and Social Review*, April 1989.

Ross, M.: *Personal Incomes by County, 1965*, Economic and Social Research Institute, Dublin, Report No. 49, 1967.

Ross, M.: *Further Data on County Incomes in the 1960s*; Economic and Social Research Institute, Dublin, Report No. 64, 1972.

Ross, M.: *Personal Income by Counties 1973*; N.E.S.C., Dublin, Report No. 30, 1977.

Tiebout, C.M.: "A Pure Theory of Local Government Expenditure"; *Journal of Political Economy*, Oct. 1956.