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Local Taxes, Regulations, and the Business Environment

Finding the right balance

Regional and municipal governments play a key role in establishing a local business environment that is attractive to foreign and domestic investors. However, in many countries, entrepreneurs face a complex web of local taxes, regulatory fees, and other charges. This situation increases the costs and risks of doing business, thus limiting the potential for business growth, investment, and job creation. This note explores the roots of this problem and introduces options for addressing it.

Local governments and the business environment

The local business environment[1] is determined by government policies and regulations that affect enterprises. Subnational governments' decisions directly impact the way businesses operate through local taxes and user charges; business licenses and permits; land, environment, health, and safety regulations; and enforcement mechanisms and procedures. Moreover, to the extent that they provide access to infrastructure, utilities, and other benefits, local governments are essential in creating and maintaining environments that attract foreign and domestic investors.

Even in relatively centralized countries, local governments have the responsibility, and often legal obligation, to deliver services to citizens and businesses. To finance this mandate, they typically rely on a combination of "own-source" revenues[2] (tax and non-tax), intergovernmental transfers, debt, and profits from public undertakings or shares in companies. The financing mix varies widely depending on the degree of decentralization, and the level (regional vs. municipal), type (urban vs. rural), legal status (degree of autonomy), and welfare (rich vs. poor) of the local government[3] (*see Box 1*).

For businesses, the combination of local taxes and fees may represent a heavy burden in terms of financial and administrative costs. This is particularly the case when local governments use payments related to licensing and other regulatory instruments to generate revenue.

As many countries become more decentralized,[4] subnational governments face increasing pressure to find sustainable sources of revenue. Intergovernmental transfers are not always sufficient or forthcoming, revenue bases from standard taxes are limited, and local governments

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This note and others in the series of IN PRACTICE notes on business taxation reform were developed as part of a joint program between DFID (the United Kingdom's Department for International Development) and CIC. The program focuses on operational issues in tax reform, particularly those related to micro-enterprises and small businesses. Within CIC, the business operations and business taxation product lines jointly developed this note.

in poor regions may not be able to borrow money. Moreover, local governments often have limited authority to impose taxes, but are often granted discretionary power to establish or enforce aspects of business regulation. All of these factors provide incentives for local governments to find new revenue sources, which can lead to the burgeoning of local fees.[5]

How does the proliferation of fees affect businesses?

The proliferation of local taxes and fees creates a complex web of procedures and payments that can impose a significant burden on businesses. Most significant are the heavy compliance costs driven by numerous instruments and requirements and the overall complexity of the administrative system. The package of taxes and fees may also amount to high financial costs.[6] When local administrations have the ability to introduce new fees at their discretion, arbitrary and unpredictable conduct on the part of administrators may result. The system's opacity leads firms to consider all payments as "taxes" in a confusing scenario featuring visits from multiple "tax" collectors. The potential for corrupt practices increases, through inspections and more interaction between businesses and local authorities.

Ultimately, nuisance factors and heavy compliance costs weaken business productivity and may act as barriers to entry, thus limiting economic growth.[7] Surveys of informal businesses indicate that this sort of environment encourages firms to operate with some degree of informality, which can limit the government's revenue base and companies' growth potential.[8]

Local governments also bear costs.[9] Administering regulation is expensive and not the most efficient way to raise revenue. It absorbs scarce qualified human resources that could be put to more productive use. The complex architecture also decreases transparency and accountability because collecting, allocating, earmarking, and using locally generated revenue is not straightforward.

Regulatory decision-making may also be distorted. For instance, decisions may be based on maximizing revenues rather than on protecting the public interest or addressing market failures. Excessive and unnecessary regulation may be introduced; for example, each of multiple agencies may require a firm to hold a separate license to operate in its jurisdiction.

What is a local "tax"?

Defining what constitutes a local "tax" depends on point of view. Businesses generally consider any payment made to a public agency as a tax, regardless of the jurisdiction. Politicians may play with definitions to serve their objectives (*see Box 2*).

Box 1: The Multiplicity of Local Taxes and Fees in the Republic of Yemen

In the Republic of Yemen, 55 types of fees are used to finance local authorities. Some, such as the annual district (municipal) operating fee, are subdivided into more than 500 categories of business size and activities. According to the law, a similar charge—the professional permit fee—must also be paid at the governorate (provincial) level and is subdivided into 68 different categories. Companies are also required to pay an annual registration fee to the Ministry of Trade and Industry, a membership fee to the Chamber of Commerce, various monthly local council support fees (surcharges on utility bills), city improvement fees (surcharges on specific common transactions), and a range of sector-specific regulatory fees. Companies are also subject to the zakat, originally a religious tax (2.5 percent on capital) that is used as a business operation levy assigned to local authorities.

All of these payments are in addition to the standard taxes (corporate income tax, goods and services tax, property and property transfer taxes, fuel tax, and a tax on insurance contracts), as well as earmarked contributions to social, transport, and development funds. In sum, a medium-sized fishing company registered in Aden, for instance, would typically have to pay up to 15 fees plus standard taxes. The same is true for a hotel or construction company located in the capital city of Sana'a.

Source: FIAS (unpublished 2009 desk review of Yemeni legislation).

For the purpose of analysis, local "own-source" revenues are classified into four categories:

Standard taxes are compulsory payments that feed into public finances and are not tied to specific goods or services government delivers for the taxpayer's direct benefit. Standard taxes impacting businesses include those on land and property, income, sales, and excise taxes on products such as alcoholic beverages, cigarettes, and automobiles. The assignment of taxes at the local level varies by country, depending on how fiscal decentralization is structured.

User charges are payments that are directly tied to the purchase of goods and services delivered by the public sector. User charges, like prices in a market, usually vary with consumption. They typically include payments linked to garbage collection, water or electricity (when provided by the public sector). To be viable, user charges should be set at full cost recovery plus return on investment.

Regulatory fees are payments linked to a wide variety of instruments such as licenses, permits, and certifications. In principle, these fees are meant to cover (all or part of) the cost of administering the regulation.

Other non-tax payments from businesses to local governments, in the form of interests, royalties, and rents (mainly on natural resources and government properties) as well as fines and penalties, constitute another important set of revenue sources. (*Table 1 provides a summary of local revenue instruments.*)

How are regulatory fees used?

Licensing is a common type of regulation that affects specified businesses and occupations by regulating entry into markets and conduct within markets. Licensing typically imposes a range of obligations and rights on firms. Breach of licensing conditions often results in sanction by the relevant regulatory authority, such as a fine or revoked permission to perform an industrial activity.

Licensing and other business regulations may involve agencies charging a fee to deliver the license or administer the regulation. From the firms'

Box 2: Is It a Tax or a Fee?

"The Democrats have devised a plan to get around [California's budget crisis], albeit a desperate and legally questionable one. They want to relabel taxes as "fees" and increase them. Although it takes two-thirds of legislators to pass a tax increase, fees could be increased by a simple majority vote. Republicans, who have more than a third but less than half of the seats in both chambers of the legislature, would be overridden [...]".

Source: Economist (2009).

Table 1: Typology of Local Own-Source Revenue Instruments

Instrument	Revenue Source	Examples
Standard taxes	Compulsory payment; base varies by instrument	(a) Profit or corporate income tax
		(b) Property (land and building) taxes
User charges	Revenue from sales of goods and services provided directly by the government	(a) Utility fees (water, gas, electricity)
		(b) Garbage collection fees
Regulatory fees	Revenue from licenses and permits for regulated activities, and delivery of administrative services	(a) General business/trade license fees
		(b) Construction permits
		(c) Examination and inspection fees
- Interests - Royalties and concession fees - Rents and fees for usage rights	Revenue from public assets, property resources under government custody, and natural resources to which property rights are not assigned	(a) Admission fees (national parks, historical sites)
		(b) Road and bridge tolls
		(c) Public works (rents on buildings, hire charges)
Fines and penalties	Punishment for non-compliance with the law or regulation	(a) Traffic/parking fines
		(b) Penalty for late payment/notification

Source: Adapted from Das-Gupta (2004).

perspective, fees are payments to the government like taxes. Distinctions between the types of payments become blurred when fees have no clear link to the government performing its regulatory function. The key distinction is between revenue-generating and regulatory instruments. Inefficiencies and excessive burden arise when governments use regulatory instruments to raise revenue, which is accomplished more efficiently through taxation.

Three forms of misuses with regulatory fees and other such payments are among the most common. First, the introduction of regulatory instruments (such as licenses, permits, and other forms of authorizations) may occur without a justified regulatory rationale; the purpose is purely revenue collection. Second, the fee collected is greater than the cost of administering the regulation. Finally, when licensing generates significant social gains to the community, excessive fees can act as a tax on these public benefits (*see Box 3*).

Box 3: Principles for Imposing Licensing Fees

While this note emphasizes the costly consequences of regulatory fee misuse, imposing such fees need not be negative. Government agencies can appropriately impose regulatory fees in a transparent manner:

- On a cost-recovery basis, when licensing generates direct benefits for the firm receiving the license;[a]
- When the business generates negative effects on the broader community, such as pollution.

However, when licenses generate broader benefits for the community (such as enhanced health, safety, or security outcomes) than for the business, then imposing licensing fees may be inappropriate and inflict undue costs on the community. In such cases, license fees essentially impose a "tax" on services provided by business that benefit the broader community. In this situation, the taxation system should ideally be strengthened so that inefficient and costly fees can be reduced over time and eventually replaced by more efficient revenue mechanisms (including strengthened intergovernmental transfers or an appropriate local business tax).

Such measures are sustainable only when a functioning, broadly based taxation system is in place. When this is not the case, establishing such a system should become a long-term objective. In the short-run, however, when regulations protect broader policy objectives (such as health, safety and the environment), then license fees may be applied if two conditions are met:

- Revenue collected provides tangible benefits for the community that clearly exceed the direct and indirect costs on the business and the community of collecting license fees; and,
- Licensing revenues are collected more effectively and at lower cost than broader taxation measures.

a. For a detailed report on cost recovery, refer to Productivity Commission (2001).

Source: FIAS (2009).

An integrated approach to local business environment reforms[10]

Local business environments can be improved by rationalizing the use of regulatory fees. This has not been dealt with very effectively in developing countries, in part because practitioners have failed to integrate regulatory and fiscal aspects of the problem. Because the rationalization of regulatory instruments typically affects local public finances, efficient and effective tax options need to be offered to compensate for lost revenues and deliver sustainable local reforms.

There are four key steps to integrating reforms of the local business environment (*see Figure 1*):

1. Start with a comprehensive inventory of all instruments involving a payment made by businesses to local authorities.
2. Check the legality of the instrument. If the legal basis is not robust, then the instrument should either be eliminated or legalized (if it serves a legitimate purpose).
3. Categorize inventoried instruments based on the standard definitions discussed in this note.
4. Single out regulatory fees, and assess the purpose of the instrument:
   - When it serves a legitimate regulatory purpose, the instrument may be kept and the process streamlined, where possible. Fees

should generally be set on a cost-recovery basis.

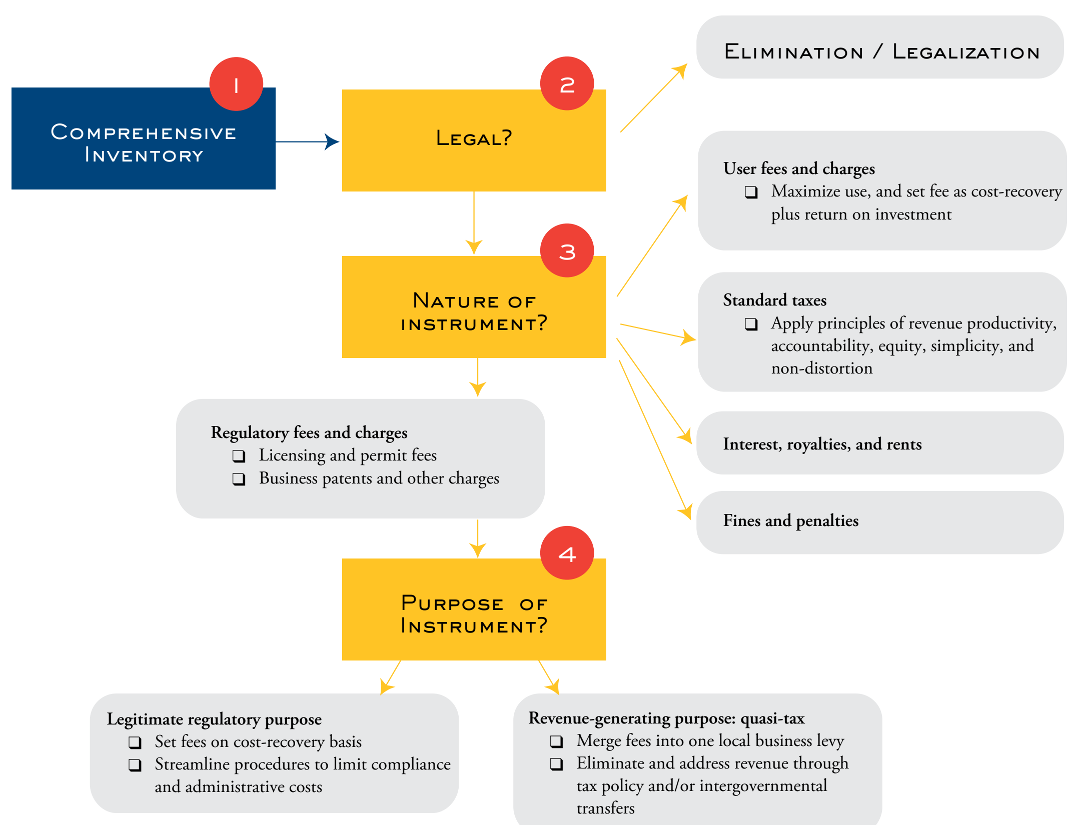
- When the purpose is primarily to generate revenue, when no regulatory function is performed, or when revenue collected is greater than the cost of regulating, the instrument may be considered a disguised tax. In this case, three options should be considered: to eliminate such quasi-taxes; to collapse them, where applicable, into a local business levy; or to rely on other fiscal instruments, including transfers, to compensate for the revenue loss.

Options for reforming local taxes and regulations[11]

Reformers must closely monitor the revenue impact of proposed changes to regulatory fees, because eliminating or rationalizing them will likely weaken the revenue base of the concerned government agencies. To compensate, local governments may need to rely more heavily on intergovernmental transfers, but that is not always possible. Other options include merging multiple fees into one local business levy and strengthening own-source revenue instruments such as taxes and user charges.

Merging fees into one business levy. When the authority introduces "regulatory" fees to raise revenue but does not perform a regulatory function, such fees are de facto taxes that are

Figure 1: A Four-Step Reform Process



Source: Author.

inefficient and distortionary. However, while their introduction may represent abuse by the local government, it may also be the administration's only alternative in the absence of a broad-based tax system and reliable transfers. In such a context, multiple fees may be replaced by a single business levy that merges several instruments into one. This practice allows for a revenue-neutral simplification of the system, which still benefits businesses (by reducing administrative costs to comply and improving transparency) and government (by simplifying the system and reducing costs to administer it). Two commonly cited examples include the single business permit in Kenya[12] and a low-rate gross receipts levy in Tunisia.[13] Although this approach seems appealing, it is not particularly easy to execute (*see Box 4*).

Box 4: The Challenge of Consolidating Multiple Fees in Kenya

The local licensing and revenue collection practices in Kenya are characterized by a high level of informal economic activity, insufficient budgets and poor regulatory governance, which has led to a proliferation of licenses, fees, and burdens on both formal and informal businesses.

Prior efforts to ease the burden of the local government licensing system on businesses have yielded the opposite result, although local revenue has increased. When local governments introduced a single business permit (SBP) between 1999 and 2000, the SBP became the third most important source of revenue after the Local Authority Transfer Fund (from the national government) and property-based collections. According to a 2006 study, the SBP represented nearly 16 percent of all locally generated revenues, while pre-SBP revenue from licenses amounted to 7 percent.

But with the introduction of the SBP, the burden on formal businesses increased because local officials arbitrarily applied the purportedly progressive bands of the SBP. The SBP is now cited by businesses as one of the main deterrents to business activity at the local level.

Businesses that are formal (to a greater or lesser extent) still face higher administrative and financial costs under the SBP, and they are subject to other charges and fees that should have been consolidated into the SBP. Local authorities in Kenya also rely on production, transport, and market cesses as output taxes collected at the time of sale or transit. These cesses affect informal businesses as well. Businesses also complain about coercive enforcement and rent-seeking by local officials, which foster taxpayer resistance and encourage evasion.

Recent reforms to streamline the SBP are expected to significantly reduce the administrative and direct financial costs on businesses across the country by an estimated $11 million annually.

Sources: Kenya, Ministry of Local Government (2006) and FIAS research.

User charges. Governments should charge for the goods and services they deliver whenever possible—except for licenses and other services that generate broader benefits to the community, as highlighted above. When local governments rely on user charges, they are seen to deliver services for a price within a market context. User charges also provide information about demand to public suppliers, because consumers will only pay for services they want. This dynamic should enhance economic efficiency and fairness. Although it can be difficult to design and implement good-practice user charges, they should be considered whenever feasible; in most cases, they are one of the most desirable ways for local governments to generate revenue.

Local business tax. In many countries, local business taxes include corporate income tax, capital taxes, non-residential property taxes, and various forms of commercial levies. Business taxes tend to be popular with politicians as well as citizens; they often produce substantial revenues and voters generally prefer to shift taxes from themselves to firms. The economic case for a local business tax is that it sometimes can be considered a benefit tax. Business taxes have been faulted, however, for their distortionary impact on companies' location decisions. When poorly designed, they may also constrain business with heavy financial and compliance burdens.

Several proposals have advocated for a "business value tax"[14] that would differ from a conventional value-added tax (VAT): it would be levied on business income, taxing production (not consumption), and assessed on the basis of annual accounts (not transactions). To limit the risks of harmful tax competition between jurisdictions, a floor (and possibly a ceiling) could be put in place. Although this tax is not an ideal instrument, it has been conceived as a less harmful alternative than other business levies when local revenues need to be strengthened. It is not designed for small enterprises that do not keep formal accounts, which limits its potential base. However, where the context allows, this practical measure could help compensate for the elimination of more distortionary instruments such as excessive fees.

Property taxes. Property taxes have long been hailed as the only appropriate general tax source for local governments because they target immobile factors (buildings or land), thus avoiding distortion and harmful tax competition across jurisdictions. These bases are visible and not easily hidden, so property taxes are less subject to evasion by taxpayers (although this is less true when building censuses are infrequent, particularly in fast-growing areas). A low-rate uniform tax on property or rental value can be an important tool for local governments to secure revenues. However, it should not be overplayed. In fact, property taxes have proven difficult and costly to administer, particularly due to discretionary aspects in assessing the value of real estate.

The high visibility of property taxes has both positive and negative effects. It may enhance government accountability and responsibility, but also makes taxpayers highly sensitive to property tax increases. With property taxes, taxpayers make regular, large lump-sum payments directly to governments, whereas other taxes are more invisible because they are directly collected when taxpayers earn (payroll deductions) or spend (sales and excise taxes). As a result, it is always challenging to increase revenue from this source through higher rates. It is also difficult and costly to maintain the property tax base by keeping up-to-date building censuses.

Conclusion

Local governments are particularly prone to the misuse of regulatory instruments as revenue mechanisms. By reforming regulatory and revenue systems jointly, local governments can eliminate an array of distortionary levies and secure more efficient revenue streams. Streamlined, more transparent revenue structures and business regulations reduce the financial and compliance costs imposed on firms and the risks of doing business. Local governments are able to operate more efficiently and fulfill their core functions, which are important to the private sector. Integrated reforms help create attractive environments for a range of investors from small start-ups to multinationals.

Over the long term, sustaining local business environment reforms may require that higher levels of government allocate more revenue-raising autonomy to local authorities and hold them to hard budget constraints. Until this happens, local politicians will likely continue to rely on whatever revenue-raising instruments are available to them, even when fees are excessive or distortionary. The alternatives highlighted in this note offer reformers a head start in the right direction.

While integrated business environment reforms are no silver bullet, they have the potential to sustain long-term local development. Investing in a low-compliance cost tax regime helps build a future in which businesses can operate more efficiently, the tax base widens, and the tax burden is more broadly distributed.

Endnotes

1 This includes both national and local policies and regulations, which exacerbates the complexity of the environment in which businesses operate. This note focuses on the local level exclusively, which encompasses the regional and municipal levels.

2 Own-source revenues are taxes and other levies assigned to local governments, which collect them and have some degree of control over rates.

3 A wide body of research on subnational finance and fiscal decentralization deals with these issues. This note focuses on local taxes and fees exclusively.

4 See Shah (2004), for instance.

5 See Taliercio (2005) for examples of proliferation of local taxes and fees in East Asian countries. FIAS research documents similar cases in other regions.

6 This may affect small firms more heavily as fees are often fixed amounts. It is also likely to divert more of managers' time.in small businesses who may not have dedicated staff to deal with it.

7 See Iarossi, Saliola, and Tanzillo (2006) and Dollar, Hallward-Driemeier, and Mengistae (2003) for studies of the impact of administrative burden on firm productivity; see Djankov, McLiesh, and Ramalho (2006) for a study of the impact of regulatory costs on growth.

8 For example, see USAID (2008).

9 See Lewis (2006) for a study of the administrative cost inefficiency of local taxation in Indonesia.

10 See Rozner and Gallagher (2008) for a detailed guide

IN PRACTICE

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CIC assists the governments of developing countries and transition economies in reforming their business environments, with emphasis on regulatory simplification and investment generation. CIC relies on close collaboration with its donors and World Bank Group partners—International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the World Bank—to leverage value and deliver tangible results for client governments. CIC is the operational center for IFC's Business Enabling Environment Advisory Services and FIAS, the multi-donor investment climate advisory service of the World Bank Group.

following a similar approach to reforming taxes and the business enabling environment.

11 This section does not cover the full range of tax instruments occasionally used at the local level. Refer to Bird (2006a) for an in-depth and more comprehensive coverage.

12 See Kelly and Devas (2001) for an analysis of Kenya shortly after the reform.

13 See Vaillancourt (1998).

14 See Bird (2006b) in particular.

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