Property Tax Reform in Developing Countries

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Introduction

- Property taxes are popping up on the policy agenda in countries around the world

- Potential role of property taxes in developing countries as a source of local revenues

- Appropriate role of property taxes, design, and implementation differ in different countries and change over time in any one country --- “no one size fits all”

Outline

- The (residential) property tax is a good tax for local government … in theory
- Yet, property taxes are not big revenue producers in developing countries
- What are the problems with the property tax … in practice?
- What is the rationale for reform?
- How can the property tax be reformed?

The residential property tax is a good tax in theory

- Benefits received: connection between local services and property values
- Incidence: Burden rests with middle and upper income households
- Property is immovable: difficult to evade tax
- Important part of fiscal decentralization
- Visibility and accountability: visibility makes governments accountable
- Revenue potential: though costly to get going

The non-residential property tax is not as good a local tax

- Benefits received: taxes generally exceed the benefits from local services

- Capital mobility: businesses more mobile than residents

- Accountability: tax exporting reduces accountability

- Tax competition to attract business (diverts tax base from poorer areas)

Comparison of residential and non-residential property taxes

	Residential Property Tax	Non-residential property tax
Tax base	Relatively easy to assess	More difficult to assess
Tax rates	Generally lower	Generally higher
Revenue potential	Good	Very good
Economics principles	Good local tax	Not a good local tax

Disadvantages of the property tax

- Administration: can be costly to run a property tax system
- Visibility: means it is difficult to raise or reform the tax
- Elasticity: not as buoyant as income or sales taxes

Property taxes not big revenue producers in developing countries but important source of local revenue

	Developing Countries	OECD Countries
Property taxes as % of GDP	0.6%	2.1%
Property taxes as % of subnational expenditures	18.4%	12.4%
Source: Bahl and Martinez-Vazquez (2008)		

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Property tax as percent of revenue, selected Asian cities

	% of City Revenue, 2009-2010
Hong Kong (city-state)	3.8
Kuala Lumpur	44.9
Makati City (Metro Manila)	34.0
Manila (Metro Manila)	28.0
Quezon City (Metro Manila)	21.0
Singapore (city-state)	5.8
Ulaanbaatar	5.0
McCluskey and Franzsen (2013) and Slack (2013)	

Issues with the property tax in developing countries

- Benefits sometimes harder to see
- Property markets not well developed
- Limited evidence on transaction values
- Extensive use of exemptions
- Low tax rates
- Limited administrative capacity – valuation, billing, collection, enforcement

Rationale for reform

- Improve fiscal performance – collection-led strategy to increase revenues **
- Equity – similar treatment of similar properties
- Efficiency – minimize the impact on households and businesses
- Improve administration– improve valuation, billing, collection etc.

How can property tax be reformed to increase revenue?

- Tax policy:
  - Tax base
  - Tax rates

- Tax administration:
  - Identification, Valuation
  - Billing
  - Collection
  - Enforcement

Tax base – what is included… and what is not

- Exemptions are granted by central government, local government, or both

- Common exemptions – churches, cemeteries, schools, hospitals, libraries, government properties, foreign embassies, properties owned by international organizations

- Other exemptions: agricultural land, principal residences, business properties

Tax base -- impact of exemptions

- Different treatment of similar properties
- Affect location decisions, choices about what activities to undertake
- Disproportionate tax burdens across municipalities, especially with a large number of exempt government properties (e.g. in capital cities) and SOEs
- Narrows the tax base

Don’t give away the tax base

- Minimize exemptions
- Payments in lieu on government properties
- Assessed values for exempt properties

Assessment methods

- Area-based assessment:
  - Unit
  - Unit value

- Value-based assessment:
  - Market value
  - Annual (rental) value

- Any of these could work
- Value-based in countries with long tradition of land markets; area-based where there is no formal land market

Area-based assessment

- Per unit assessment: rate is levied per m^2 of land area, building or a combination of the two
- Unit value assessment: assessment rate per m^2 is adjusted to reflect location or other factors
- Most common in countries in Central and Eastern Europe where there is an absence of developed property markets; also in parts of Germany, Chile, Kenya, Tunisia, India
- Bangalore: unit value system introduced in 2008; values regularly adjusted

Market value assessment

- Defined as price between a willing buyer and a willing seller in an arm's length transaction

- Approaches to estimating market value
  - Comparable sales (residential)
  - Income (non-residential)
  - Depreciated cost (non-residential)

Market value assessment

Approach	Tax Base	Property Types
Comparable sales	Estimate market value by comparing to recent sales of similar properties	Residential; need transactions to get objective sales values
Income	Convert future returns from ownership of property into present value equivalent	Income-producing properties e.g. non-residential and commercial
Replacement cost	Estimate value based on land value, building cost, depreciation	Unique properties with no comparable sales and which do not generate income

Market value assessment

- Used in many OECD countries (e.g. Canada, US, Japan); used in Indonesia and Philippines
- Variation of market value used for residential property tax (council tax) in UK
- Indonesia: no valuation of individual properties; assessed according to prescribed land zone rate per m^2 and building class rate per m^2

Annual (rental) value assessment

- Used in several countries: Australia, UK (for non-residential property), India, Thailand, Malaysia, Singapore, Hong Kong
- In theory, tax on rental value should be equivalent to a tax on market value
- In practice, rents reflect current use and not highest and best use
- Difficult to estimate rental value when there are rent controls (e.g. India); issues around vacant land

Area-based versus value-based assessment

- Market value is preferred because it:
  - Reflects benefits from local services
  - Captures neighbourhood amenities
  - Less regressive than area-based
  - Less inequitable over time
  - Revenues more buoyant than area-based
- Can move from area to value-based

Property tax base in selected Asian cities

City	Tax Base
Hong Kong	Annual value
Ahmedabad	Adjusted area value
Bangalore	Unit area value
Mumbai	Annual value
Jakarta	Capital value
Kuala Lumpur	Annual value
Manila	Capital value
Bangkok	Annual value
Singapore	Annual value

Property tax rates

- Who sets them?
  - Local setting of tax rates places accountability at the local level (yet, often not local)
- Are they differentiated and, if so, how
  - Justified if based on benefits received or on mobility of capital (rarely, if ever, differentiated on this basis)
- How high are the rates?
  - Not very high in most countries (0.5% to 1.0%)

Tax rates: how are they differentiated?

- Many countries differentiate rates by property class
- Often favourable treatment for single-family properties (politics not economics)
- Farm properties often favoured (lower assessments, different assessment system, exemptions, lower tax rates, farm tax rebates, or a different tax)

Tax administration

- Tax administration has impact on revenue yield and efficiency and equity of the tax
- Elements of tax administration:
  - Property identification
  - Preparation of a tax roll (description of the property and the amount of assessment)
  - Issuing tax bills, collecting taxes, and dealing with arrears

Tax administration: property identification

- In many developing economies, information is incomplete, out of date
- Information fragmented between central and local governments and within local governments
- Bangalore – GIS system used for unique property identification numbers linked to property tax data (location, size, use, ownership, tax liability, taxes paid)

Tax administration: assessment

- Assessments are local in some countries; central in others
- Even where assessment is local, detailed methodology is set out by central government; should also train and monitor
- Frequency of assessment:
  - varies across countries ranging from annual to infrequent; the average is 3 to 10 years
  - some use indexing between valuation periods

Tax administration: tax collection and enforcement

- Tax collection usually a local government task

- Tax arrears low in most developed countries (3 to 4 percent of taxes); high in some developing economies (e.g. 50% in the Philippines)

- Lower compliance costs increase collection rates (e.g. pay at municipal offices, banks, retail stores, online, etc.)

Steps to property tax reform (1)

- Policy reforms:

  - Choose the tax base (market value, annual value, area)

  - Determine which exemptions will be made

  - Set the tax rate structure

Steps to property tax reform (2)

- Administrative reforms:

  - Bring all properties on the tax roll
  - Keep unified records
  - Upgrade valuation methods (through training)
  - Adopt measures to raise collection rates (reduced compliance costs; tougher enforcement)
  - Establish monitoring systems with quantitative indicators

- Phase in property tax reform

Preconditions for reform

- Adequate technical expertise
- Existence of cadastre, land registration system, local government capacity, solid administrative structure (expensive to set up and run)
- Phase-in mechanisms
- Political will
- Taxpayer support

Final observations

- Property tax has potential for mobilizing revenues in developing countries
- Need policy and administrative reforms to get the details right
- To be successful, need to take note of existing reform environment, legal and institutional structures, administrative capacity, and political will