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# EL SALVADOR PROPERTY TAX STUDY

Submitted to:

USAID  
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by:

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*December 1992*

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**List of Terms****Lista de Términos**

Salvadoran Mayors' Association

Corporación de Municipalidades de la República de El Salvador (COMURES)

Central Audit Agency

Corte de Cuentas

Double taxation

Doble tributación o doble impsición

Wealth Tax

Impuesto Patrimonial

National Georagraphic Institute

Instituto Geográfico Nacional (IGN)

Salvadoran Municipal Development Institute

Instituto Salvadoreño de Desarrollo Municipal (ISDEM)

Municipal Tax Law (Oct 16, 1991)

Ley de Arbitrios o Ley General Tributaria Municipal (el 16 de octubre de 1991)

Wealth Tax Law

Ley Patrimonial

Municipalities in Action

Municipalidades en Acción (MEA)

Property Tax Roll or Valuation Roll

Registro Catastral

## EXECUTIVE SUMMARY

This report on property taxation in El Salvador was prepared for the *Corporación de Municipalidades de la República de El Salvador* (COMURES), the *Instituto Salvadoreño de Desarrollo Municipal* (ISDEM), and the United States Agency for International Development (USAID) by the Research Triangle Institute (RTI). The scope of work for the El Salvador Property Tax Study directed a study of El Salvador's existing central tax on property, the real property component of the Wealth Tax, and a review of the current trends, institutional arrangements, and legal precedents related to local government revenue. The principal aim of the study was to design and recommend a practical property tax system to suit El Salvador's own legal, socio-economic, and political environment.

The study team spent 10 person-weeks, from 25 September through 6 November, 1992, gathering information and interviewing central and local government appointed and elected officials, legislators, and technical advisors in El Salvador. On 3 November the team sponsored a roundtable with legislators to obtain their feedback on the political feasibility of tentative recommendations. As the result of these activities, the team produced a series of recommendations that, if adopted, would form the base for a property tax in El Salvador.

The study team's recommendations from the study cover seven areas:

- (1) Policy direction for property taxation:  
**Recommendation:** As a matter of national tax policy, property taxes should be a major tax revenue source for municipalities.
- (2) Fixing and maintaining real property tax rates:  
**Recommendation:** The municipalities should be given authority to set property tax rates.
- (3) Valuing real property:  
**Recommendation:** Mass appraisal techniques should be adopted that are easy and low-cost to administer.
- (4) Cadastral record keeping and computerization:  
**Recommendation:** There should be a major upgrading of local government property tax records so that all properties, whether taxable or nontaxable, are properly accounted for. Although not mandatory, cadastral record keeping is best computerized—smaller municipalities should consider acquiring computer services from other public or private sources. The resulting municipal valuation rolls should be made available for public enquiry.
- (5) Administrative structure of the property tax:  
**Recommendation:** The municipalities should be encouraged and helped to use their authority to freely choose how to implement a local property tax system—rate structure, assessment practices, and collections—according to local conditions and local choice.

- (6) Constitutional and legal bases of a property tax:  
**Recommendation: The National Assembly should enact enabling legislation giving municipalities the power to implement a local tax on real property within their respective jurisdictions.**
  
- (7) Training and technical assistance requirements for implementing the property tax:  
**Recommendation: Technical assistance and training for property tax implementation must be available for municipalities. This should be done within a systematic local financial management program.**

El Salvador is on the point of making key decisions to create a property tax. If the country opts for giving municipalities control of the main policy and administrative tools this report recommends, technical assistance and training would be productive. Municipalities with the political will to administer a property tax could count on a significant and reliable source of own-source revenue.

## CHAPTER 1: PURPOSE AND BACKGROUND FOR THE STUDY

This chapter introduces readers to the reasons that the El Salvador property tax study was commissioned as a first step in property tax implementation. It covers the purposes and rationale of the study.

### 1.1 *Scope of Work and Conduct of Study*

The objective of this effort is to provide COMURES, ISDEM, and USAID with a study of property tax as a component of municipal fiscal reform. RTI was asked to analyze requirements and impacts of taxation on property on both local and central governments, as well as on the municipal support institutions represented principally by COMURES and ISDEM. The Scope of Work requests a strategy for implementing a local property tax, with an analysis of general operational preconditions that considers the special difficulties of the smaller municipalities. Phasing in of a property tax, roles for COMURES and ISDEM, the management needs of Salvadoran municipalities, and the effects of revenue autonomy on fiscal federalism all fall within the scope of this study.

The study team spent 10 person-weeks over the period 25 September through 6 November, 1992, gathering information and interviewing central and local government appointed and elected officials, legislators, and technical advisors in El Salvador. On 3 November the team sponsored a roundtable with the legislative committee of the National Assembly responsible for local government affairs to obtain their feedback on the political feasibility of tentative recommendations. As the result of these activities, the team produced a series of recommendations that, if adopted, could form the base for property tax implementation in El Salvador.

The formal terms of reference for the study are set out in the Scope of Work in Annex 1.

### 1.2 *Need for Reform*

It is a stated objective of the present government to decentralize authority to the local government level. Several concrete steps toward devolution of power to the local level have taken place: the strengthening of ISDEM, the revitalization of COMURES, the passage of the *Ley Tributaria*, and the support for the *Municipalidades en Acción* (MEA) program. ISDEM, COMURES, and cooperating municipalities are active in financial and fiscal reform at the local government level. Various actions taken by and in behalf of municipalities include: analysis of problems in municipal budgeting and accounting, training in 132 municipalities in financial

management, implementation of user charges, and preparation in several jurisdictions of municipal property rolls.

Local property taxes can finance services and infrastructure, build local fiscal autonomy, and decrease the burden of central government transfers. In the context of worldwide decentralization, local property taxation is often looked to as a major revenue source for providing basic local community services and for maintaining and upgrading local infrastructure, necessary bases of economic development. Paying for upgraded roads and public parks, for example, with revenues raised locally engenders civic pride and local autonomy. An important impetus for the creation of a local property tax is the desire of the central government to reduce transfer funds to local governments. Decentralization implies increased local government responsibility in raising greater amounts of local revenue.

Chapter 2 analyzes the Wealth Tax and discusses property taxes within the context of local government finance.

## CHAPTER 2: THE WEALTH TAX AND PROPERTY TAXES

The first section of this chapter sets the background of tax reform in El Salvador. The following sections make the case for the abolition of the Wealth Tax and for the creation of a local property tax.

### 2.1. *Introduction and Background*

The Cristiani government has undertaken a thorough revision of tax policy and tax administration at the national level. The thrust of the revision has been to liberalize and make the economy more open and competitive. The tax system has been simplified, perverse economic signals from taxes have been lessened to an appreciable extent, and steps have been taken to improve the administration and collection of taxes. The revision of the tax system is producing in El Salvador one of the best tax systems anywhere, especially among countries in the developing world.

Key measures in this tax reform include future reliance primarily on the value-added tax, the income tax, and on import duties — but with duties reduced to levels that encourage competitiveness and structural change in the economy. A corollary of this reform is that a number of taxes that give producers the wrong signals should be abolished as soon as practicable. Prominent among these are the coffee export tax and the Wealth Tax. Both are bad taxes.

In this context, the idea arose that the elimination of the Wealth Tax could be coupled politically with the imposition of property taxes at the local level.<sup>1</sup> Conceivably, this change could have at least three desirable effects. It could:

- increase municipal revenues,
- increase municipal autonomy over finances, and
- decrease the need for and the amounts of central government transfers and foreign donations to municipalities.

Indeed, such considerations induced the ARENA party to include the elimination of the Wealth Tax in its campaign platform prior to the 1989 presidential elections. The implementation of

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The term "property tax" is used here in a broad generic sense without, at the moment, specifying valuation basis or approach to administration. These issues are addressed in Chapter 3.

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this plank, however, may have to be postponed for a while until further improvements are made in reducing fiscal deficits and raising tax yields.<sup>2</sup>

Although the demise of the Wealth Tax does not now appear to be imminent, and in fact may not happen for at least another year, it nevertheless is worthwhile to analyze both the Wealth Tax and a system of municipal property taxes. The analysis will show that:

- the Wealth Tax is severely flawed both conceptually and in practice;
- a local property tax system would be vastly superior both economically and philosophically; and
- except for possible legal and political reasons, the decision to institute local property taxes should be divorced from the fate of the Wealth Tax.

## 2.2. *The Wealth Tax*<sup>3</sup>

The Wealth Tax in El Salvador is a tax on the net wealth of individuals and corporations. Net wealth is defined as the balance-sheet difference between assets and liabilities. Assets include fixed assets (such as land, structures, and equipment) and nonfixed assets (such as cash and bank accounts). Liabilities consist of accounts payable and other debts.

The Wealth Tax is flawed conceptually. It discourages investment and the accumulation of capital and it discriminates against capital-intensive undertakings. This is inappropriate for El Salvador's present stage of economic development. As the economy becomes more open to international competition, this tax will prejudice productivity, wages, and employment. The Wealth Tax could possibly be justified to some extent as a counterweight to inequities in the distribution of wealth, power, and incomes. The equity argument pales, however, in comparison with more efficient ways of achieving the same ends through income taxation and spending on social programs to redress inequities. This observation gains importance when one considers the probable widespread evasion of the Wealth Tax in El Salvador.

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<sup>2</sup> A major factor here is that the value-added tax, which became effective on 1 September 1992, was set at 10% rather than the 12-15% which the administration had hoped for.

<sup>3</sup> A recent unpublished study, "El Salvador's Wealth Tax," by Mark Gallagher (a USAID/El Salvador economist) treats several aspects of the Wealth Tax.

Table 2.1 shows that the Wealth Tax has produced about 4% of total central government tax revenue in recent years. In real terms, the value of Wealth Tax revenues fell by more than a third (34.4%) between 1987 and 1990.

**Table 2.1**  
**Central Government Tax Revenues**

(millions of current colones)

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	(Preliminary) <u>1991</u>
A. Tax Revenue	2579	2588	2532	2457	3330	4106
B. Wealth Tax	57	109	120	119	125	172
C. A/B (%)	2.2	4.2	4.7	4.8	3.7	4.2

Source: Central Reserve Bank of El Salvador. Ministry of Finance.

Although the Wealth Tax is not a major source of central government revenues, the amount of revenue that it does produce is quite large compared to the present income of municipalities. Total municipal budgets during calendar years 1986-1989 amounted to 2.3-2.5% of the central government budget.<sup>4</sup> They totaled less than the revenue from the Wealth Tax in each year.

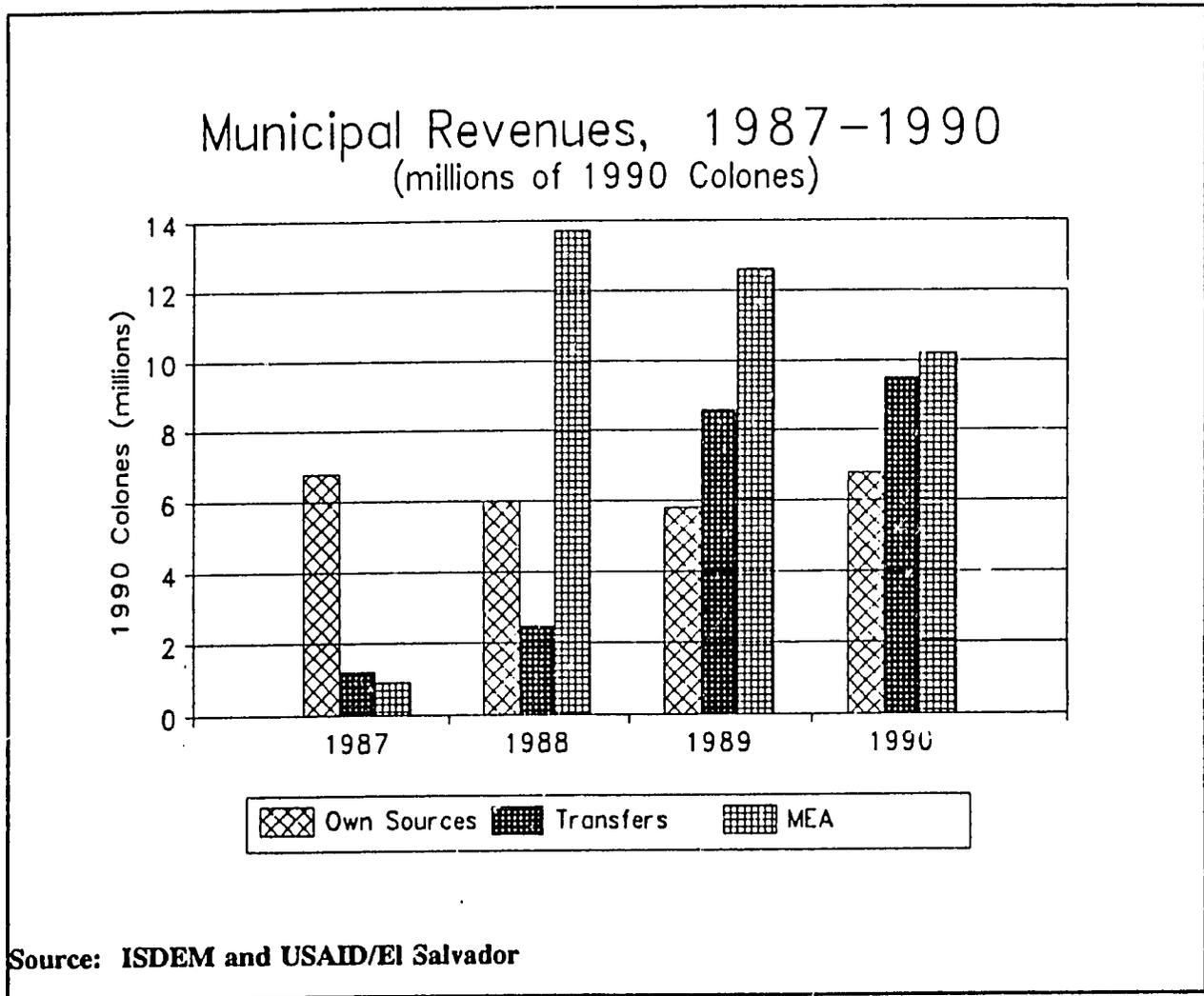
The municipal budget figures can and do differ from actual income and expenditures. The actual income and expenditure figures are recorded by the municipalities and submitted monthly to the Corte de Cuentas. The Corte de Cuentas maintains a register of these data (in the *Libros de Ingresos Corrientes* and *Libros de Egresos Corrientes*) but does not tabulate them. ISDEM has begun to tabulate them as part of its effort to develop a Municipal Data Bank. A careful analysis of these data could initiate a better understanding of municipal finances and the sorts of measures that can improve municipal finances.

A preliminary analysis that ISDEM has prepared of a sample of 34 municipalities, however, is quite revealing. It shows starkly the increased dependence of municipalities on central government transfers and other donations in recent years: from about 16% of total income in 1987 to nearly 60% in 1989-1990. These are solely direct transfers and gifts. They do not include the indirect central

<sup>4</sup> These figures from the Ministry of Finance and from the Corte de Cuentas include both the general and special budgets. They do not include funds from USAID transferred to the municipalities through the MEA program.

government expenditures for local municipal services by ministries and autonomous agencies. This sort of financial picture, no matter how necessary until now, cannot support municipal autonomy and local control over local affairs. This bleak reflection of municipal financial dependence on the central government and on funds channeled through ISDEM and the MEA program enhances the attraction of substituting local property taxes in part for a national Wealth Tax (see Chart 2.1).

Chart 2.1



There are three classes of Wealth Tax returns: for wage earners, for individuals with income from diverse sources, and for corporations. It would be interesting to use the listing of assets from the returns to determine the potential tax base that a municipal property tax could expect. Unfortunately, this information is on the last page of each return. Thus far only the first page —

listing net assets, liabilities, and tax liability — has been entered in the computers, and only for 1990. The data available for 1990 are summarized in Table 2.2.

Table 2.2

Wealth Tax Returns, 1990  
(millions of colones)

<u>Type of Return</u>	<u>No. of Returns</u>	<u>Taxable Wealth</u>	<u>Tax Liability</u>
Wage earners	91,200	2,053	1.6
Diverse incomes	54,200	11,133	47.6
Corporations	<u>10,200</u>	<u>13,994</u>	<u>104.6</u>
<b>Totals</b>	155,600	27,180	153.8

Source: Ministry of Finance

Table 2.2 shows that 7% of those filing returns, the corporations, pay two-thirds of the tax. The nearly 60% of total returns from wage earners constitutes 1% of the total tax liability. This is a very thin basis for a broad-based property tax.<sup>5</sup>

Not only do the individual Wealth Tax taxpayers provide a thin base for a property tax, but also it appears that a significant number of people evade and avoid the tax. A crude estimate with no pretense to rigor suggests that more than 80% of those who should pay some Wealth Tax may not do so. The declared wealth in 1990 could account for no more than 17% of actual gross domestic product (GDP).<sup>6</sup> Although it would be possible to extract from the Wealth Tax returns the portion of assets that might underpin a property tax, it seems clear that little would be gained by doing so. Those who pay a Wealth Tax and those who would form the base for a property tax are two distinct populations that only partially overlap.

Based on the foregoing evidence, one is tempted to conclude that the Wealth Tax is even more grievously flawed in practice than it is conceptually. From an economic point of view, the

<sup>5</sup> The reader will note that the 1990 tax liability listed in Table 2.2 (colones 153.8 million) differs from the tax collection for 1990 listed in Table 2.1 (colones 125.0 million).

<sup>6</sup> This observation is based on unsubstantiated assumptions of an average capital-output ratio of 4.0 for the economy and of full employment. Even if the assumptions are wildly inaccurate, however, the argument about extensive evasion and avoidance of the Wealth Tax is convincing.

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merits of a local property tax should be evaluated independently of whatever happens to the present Wealth Tax. Whether or not this procedure is politically or legally feasible is important and is discussed below; but political and legal considerations do not affect the conclusions regarding the relative economic worth of the two types of taxes.

### 2.3. *Municipal Finance and the Property Tax*

The preceding sections concentrated on demonstrating that the Wealth Tax is bad. It now is necessary to bridge the logical gap to demonstrate that a property tax would be good. It is clear that an increase of municipal control over local affairs must be accompanied by increased revenues if the local governments are to finance the expansion of services and responsibilities involved. It would be somewhat presumptuous to advocate strongly a local property tax without first knowing the alternatives. In El Salvador, however, the potential alternatives are severely limited.

Nevertheless, it is useful to spell out some of the alternatives and principles of property taxes. The economic case for property taxes rests heavily on results. A property tax can:

- produce large revenues,
- finance the delivery of some services more efficiently than centralized entities can, and
- decrease the need to rely on central government transfers and other gifts.

The local property tax can produce large revenues. It is the principal source of municipal revenues in Costa Rica, the United States, and many other countries. How much revenue would a similar local property tax produce in El Salvador? The answer is affected by many factors; amounts would vary greatly among municipalities. Chart 2.2 depicts a plausible situation in which property taxes account for 30% of present municipal revenues. Together with the present national property transfer tax, the need for transfers, MEA, and other gifts could be reduced to about 5%.<sup>7</sup> The question, therefore, should be inverted: Could a local property tax contribute significantly toward meeting expanded requirements for municipal revenue? The answer to this question is an unmistakable

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<sup>7</sup> Municipal revenues for 1989 were approximately 65 million colones (own-source), 93 million colones (transfers from central government), and 78 million colones (MEA). A property tax would add in this scenario 71 million colones to own-source revenues (0.3 % x 236 total), which results in 7 million less than MEA transfers. If the land transfer tax revenues, which in 1990 were estimated at 87 million colones, were added to local revenues, this would effectively eliminate the need for both MEA and central government transfers.

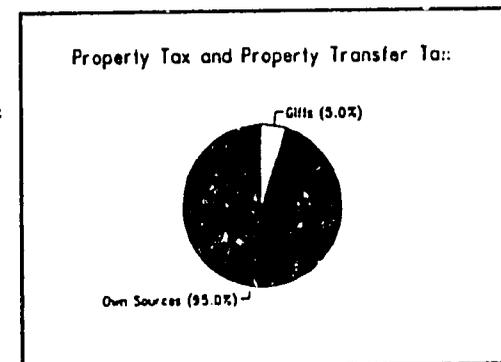
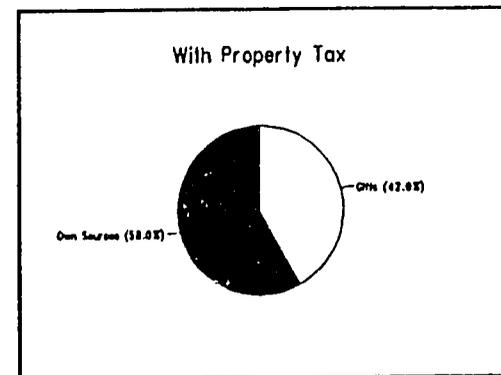
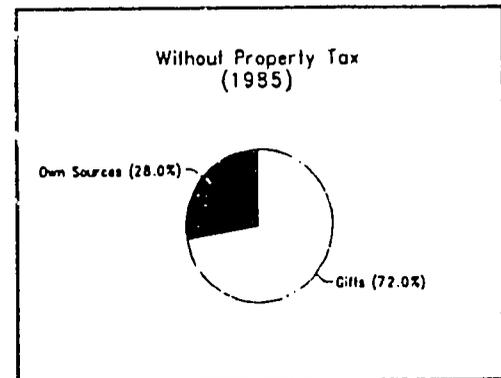
yes. The crude estimates of Wealth Tax evasion and avoidance imply that the tax base could be increased by four- to fivefold. If the tax were transparent and considered fair, it should be possible to raise the tax rate assessed to those who complete salaried Wealth Tax returns (about 60% of total returns) from the 1990 effective rate of 0.08% to something substantially higher, while also greatly expanding the number of taxpayers. Increasing the tax rate to a mil (0.1%) and quadrupling the tax base would raise revenues fivefold over present Wealth Tax revenues. Despite the lack of firm estimates, one can conclude that El Salvador clearly has the same kind of potential to increase municipal revenues that other countries have realized.

Municipalities can deliver some local goods and services more efficiently than can centralized suppliers. A sterling example in El Salvador is classroom construction for elementary schools: 45,000 colones per classroom compared with 125,000 colones for the Ministry of Education. Secondary road maintenance is another example: 25,000 colones per kilometer compared with 90,000 colones for the Ministry of Public Works. Experience in many other countries consistently reveals that citizens are willing and able to pay more for better and more efficient services. Better services generate higher revenues.

A property tax associated with the more efficient delivery of better services can reduce the need for central government expenditures through ministry budgets and subsidies to public entities, as well as reducing direct transfers to municipalities. It is largely for this reason that the centralized model is being abandoned worldwide in the interest of economic efficiency.

The introduction of a local property tax would require rethinking many issues, but the difficulties should not be exaggerated. It is possible to make the tax simple, understandable, and

**Chart 2.2 Present and Potential Municipal Revenue Sources**



Sources: ISDEM, INCAE, and Ministry of Finance

acceptable. Indeed, there are fewer technical difficulties in El Salvador than there are political and philosophical difficulties.

The technical problems are not daunting. It will be necessary to:

- assess the property tax base,
- determine the tax rate,
- bill and collect the tax, and
- enforce penalties for nonpayment.

These functions can be exercised by the same entity or by different entities. The entities used in other countries include:

- central government ministries or other central government agencies,
- autonomous national or local agencies,
- municipal governments, and
- private firms.

No one choice or combination of choices is likely to be appropriate for all of the 262 municipalities in El Salvador. The municipalities cover too broad a range of physical, economic, and administrative characteristics to be fit into a single mold. This variation is the rationale behind the recommendation that property tax legislation be enabling rather than prescriptive; that is, that it allow municipalities to judge what property tax best suits local conditions rather than mandating a single procrustean model for all communities.

The technical difficulties surrounding property valuation and assessment need not await the development of elaborate cadastres for land titling purposes (legal cadastres). Indeed, some valuable pilot projects are under way at this time in El Salvador to generate fiscal cadastres that will be adequate for property tax purposes. Property can be assessed using relatively unsophisticated techniques.

The more crucial input that will be needed is a spectrum of technical assistance and training that (a) is tailored to the needs of municipalities, and (b) will enable them to decide how to control the property tax initially and, over time, to assume an increasing measure of autonomy over their revenue systems.

Political difficulties loom larger than technical problems in El Salvador at this time. There are two main political constraints. The thorough national tax reform that is under way is an effort to

return to the level of real tax revenues that the central government received before armed conflict disrupted collections. This means that the central government expects to increase revenues in real terms by at least 50% over the next 5 years. It will require political will and skill at the local level to convince citizens to accept a property tax as being in their own interest under these circumstances. It can and should be done; it will not be easy to do.

The second foreseeable political problem is to convince central government agencies and national political representatives to surrender power to municipalities. It is not easy to persuade a person that it is in his own interest to surrender either power or budget revenues to others. The case for relinquishing authority rests on the rationale that a decentralization policy is appropriate for El Salvador at this time. The case can be made; but again, it will require skillful and dedicated political efforts.

This line of reasoning leads to the most basic difficulty of introducing a property tax. A local property tax, locally controlled, would reverse a paternalistic tradition of central government control and local dependence existing for more than a century in El Salvador. There are easier ways to raise those revenues that might be less costly and more efficient in the short run. These methods, however, would rely on continuing the tradition of centralized control and direction of local affairs. A locally controlled property tax, on the other hand, could strongly support local autonomy and long-term municipal development.

Chapter 3 presents recommended steps in the phased introduction of a local property tax.

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## CHAPTER 3: RECOMMENDED STEPS IN THE PHASED INTRODUCTION OF A LOCAL PROPERTY TAX

This chapter contains specific recommendations for a new system of local property taxation appropriate to El Salvador.

The study team asked the following questions: "Why are property tax reform programs of pressing necessity almost everywhere in Asia, Africa, and Latin America? How can El Salvador establish a property tax system that avoids, to the greatest

extent possible, making the same mistakes in policy and administration that persist in much of the developing world?" These questions look 5, 10, or 20 years into the future; if they are answered adequately, El Salvador will not have to later struggle to reform inadequate or adverse legal and institutional structures.

The answer to the first question is that property taxes in developing countries are plagued by poor rate setting and valuation policies and by poor administration of the processes of discovery, valuation, assessment, billing, and collection. In the majority of these countries, central institutions limit local government decision makers' power to effect policy and administration. Rarely are local governments given sufficient authority to apply local discretion in solving policy problems that are the result of rates and valuations lagging behind inflationary costs of local services. Rarely are local governments free to set rates, value and assess, and bill and collect the property tax according to local needs and without external controls and interference.

In confronting the second question, the team believes it appropriate to point out approaches that would maximize the potential of this tax for municipalities that wish to aggressively pursue a new fiscal decentralization. The probability of significant donor aid to strengthen local government management makes a solidly decentralized approach tenable. Unlike nations with property tax laws and institutions that are many decades old, El Salvador has an opportunity to make bold changes. The rest of Chapter 3 represents the team's best judgment among options most likely to take advantage of the opportunity for change in El Salvador.

*El Salvador has an opportunity to make bold changes in instituting a local property tax.*

### 3.1 Policy Direction for Property Taxation in El Salvador

#### Recommendation 1: Tax Policy

##### SUPPORTING COMMENTS

Local governments in El Salvador will require more sources of local revenue to carry out responsibilities mandated under a policy of decentralization. Salvadoran municipalities are now denied the property tax as a source of revenue. Still, practical efforts at creating a fiscal cadastral as a first step are being taken by a few municipalities already, a sign of political will among leading local decision makers. The central government does not administer nor is it planning to administer a property tax. These conditions imply the need for El Salvador to state a policy direction for local property taxation in the near future. The options are: decide to take no action, determine that property taxes are not reserved exclusively to municipalities, or dedicate property taxes exclusively to municipalities. Only the last option is consistent with the government's policy of decentralization.

***Recommendation: as a matter of national tax policy, property taxes should be a major tax revenue source for municipalities.***

In undertaking this policy, El Salvador would move in harmony with much of the rest of the world. In many developing countries the property tax is a key local revenue source<sup>8</sup>. Virtually all market-economy developing countries have dedicated property taxes to local governments<sup>9</sup>, providing them with a tax base that is immovable and with a revenue level that is predictable and reliable. The principal local revenue alternatives to the property tax in developing countries consist of intergovernmental transfers and local indirect taxes, fees, and licenses.

#### ***The Tax Base Is Immovable Property***

The base of the property tax is immovable property; i.e., property that cannot leave the locality. So, as the property is security for the tax, the tax cannot be evaded, making it an ideal tax for local governments to administer. Other potential local tax bases may not have the same advantage. This point has been confirmed by many other countries' public inquiries into taxation sources for local government. These jurisdictions, in general, have rejected as unsuitable poll taxes,

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- <sup>8</sup> Vito Tanzi, "Quantitative Characteristics of the Tax Systems of Developing Countries," in The Theory of Taxation for Developing Countries, ed. David Newbery and Nicholas Stern (New York: Oxford University Press, 1937), pp. 206-17.
  - <sup>9</sup> William R. Dillinger, Urban Property Tax Reform: Guidelines and Recommendations, (Urban Management Program (UMP) UNDP/World Bank/UNCHS, April 1991), p. i. This joint UNDP/World Bank/UNCHS report summarizes findings in a range of developing countries: Brazil, Colombia, Indonesia, Jordan, Kenya, Nigeria, Pakistan, and Philippines, and others.

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local income taxes, and sales taxes and have confirmed that property taxes should remain the primary source of tax revenue for local governments<sup>10</sup>.

***The Revenue Level from the Tax Is Predictable and Stable***

A further advantage of property taxes at the local level is that the taxable value of the property is typically recorded and used as the base to which the tax rate is applied. Therefore, the revenue from the tax is predictable and stable. This will be so as long as assessments and tax rates remain the same, except for changes due to new construction, fires, demolition, etc. Still, this stability also may be regarded as a drawback since there is no built-in mechanism for property tax revenues to respond automatically to changes in prices and income. The revenue potential of the property tax in times of inflation thus depends upon a government's ability to modify the base and the rate of the tax to maintain its yield in real terms. Where revaluations are infrequent, the rate of tax must be increased in line with price rises if the real yield is to be maintained. If local governments have discretion over the frequency of revaluations and tax rate changes, the extent to which they use these powers will depend upon their revenue needs and the costs of revaluations as well as upon their ability to persuade the local electorate to accept higher taxes.

**3.2. *Methods to Fix and Maintain Real Property Tax Rates***

**Recommendation 2: Property Tax Rates**

**SUPPORTING COMMENTS**

The practice in El Salvador now is for municipalities to propose rates for taxes for approval by the National Assembly. There is a strong bias among legislators against granting much discretion in this matter (see discussion under Recommendation 6).

A range of upper and lower limits to tax rates appears to be a compromise, common in many countries, that would satisfy both legislators and municipalities.

***Reduce Central Control over Rates***

Central governments have a bias against higher rates. However, rate restrictions by central governments are suspect because the government has no financial interest in obtaining higher yields

***Recommendation: the municipalities should be given authority to set tax rates.***

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<sup>10</sup> A treatment of alternatives to property taxes can be found in a volume by the Organization for Economic Development and Cooperation (OECD) published as Final Draft on Immovable Property in 1982. This report examined property taxation practices in the 15 developed member countries (Australia, Canada, Denmark, France, Germany, Ireland, Japan, Netherlands, New Zealand, Spain, Sweden, Switzerland, Turkey, UK, and USA) that made up the organization at that time.

from this local revenue source. In many countries it is common for central authorities to set a range of tax rates allowable to local governmental units. In spite of this flexibility, though, too often rates or ranges set in national law stay on the books for decades, long after inflation has rendered them obsolete<sup>11</sup>. Local governments need to set rates that are appropriate to the services delivered. The local municipal budget process, as the tool to put into law a service plan for local constituents, requires much strengthening. Setting rates is the key to effective budgeting on the revenue side of the equation. A corresponding power to set the property tax rate to raise necessary revenues is basic to local fiscal autonomy.

### 3.3 *Methods for Real Property Valuation*

#### **Recommendation 3: Real Property Valuation**

##### SUPPORTING COMMENTS

In El Salvador now, valuation for property tax administration is not practiced. There is, therefore, no valuation law or statute that sets out a valuation approach and methodology. No institutions exist, commercial or public, that can be called upon immediately to support local governments in this component of property tax administration. While this state of affairs shows a lack of capacity, it also points to opportunity.

***Recommendation:  
mass appraisal  
valuation techniques  
should be adopted that  
are easy and low-cost to  
administer.***

ISDEM's pilot project with the German Technical Assistance Agency (GTZ) in Sonsonate, Juayúa, and San Miguel has seized on this opportunity. The *Instituto Libertad y Progreso* also has had success in computerizing cadastral information from the land titling projects it manages. The study team supports the approach and conduct of these pilot efforts and suggests that they be continued. Both successes and failures can yield useful information as the team's recommendations are implemented.

#### ***Approach to Valuing Real Property***

Two basic approaches to valuation exist: the direct market approach and the mass appraisal approach. The former is based on information on sales or rentals gathered directly from the market. The mass appraisal approach is based on formulas derived from a sample of properties. Mass

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<sup>11</sup> Glaring examples of property tax rate slippage are found in the cases of Philippines and Indonesia where effective tax rates have been reduced to approximately 0.1%. See Dillinger (1991), p. 5.

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appraisal is the easier and less costly of the two--making it the obvious choice for the Salvadoran context. Once unit values for land and improvements have been established and put into a table, mass appraisal valuations are derived from simple cadastral data such as size, use, and location of land and the kind of construction materials (stone, wood, earth, for example) of buildings.

The approach being piloted by GTZ/ISDEM is directly in line with a mass appraisal approach to valuing property. The cadastral information to be collected is listed on a form titled *Catastro Tributario Municipal: Ficha de Información de Inmuebles*. Key data that factor into a mass appraisal equation are listed on this form: parcel area, frontage, type of street, use, zone, area constructed, number of floors, and type of municipal services--lighting, solid waste collection, water, sidewalks, and streets.

Assigning a cadastral value based on these characteristics of land and improvements is a manageable task, but one where technical assistance of the type that GTZ/ISDEM is starting to provide will pay substantial benefits. Technical assistance programs must coordinate and learn from early experiments in the formula or table creation stage. The next steps of the mass appraisal task are: (1) obtain sample data on sales, rents, and construction to identify how the characteristics of the property determine value; (2) quantify those characteristics in a formula or table; and (3) apply the formula to the characteristics of each property to determine a valuation. The team's experience indicates that introducing additional factors (age, neighborhood, upkeep, and so forth) that require assessor judgment in the data collection process complicate the matter unproductively and introduce an element of discretion that can jeopardize the fairness and honesty of the process<sup>12</sup>. Training assessors to make this judgment with competence, likewise, is a costly exercise that would strain personnel resources not available to most local governments in El Salvador.

Valuation for tax purposes is supposed to distribute the tax burden equitably, not to establish an exact market value. This point was made to the team by the mayor of Apopa. To emphasize the difference, the team proposes the use of the term "cadastral value" to describe a valuation produced by mass appraisal methods. This term would emphasize that the valuation was derived from basic fiscal cadastral data and that, for properties with little or no market value and with no local public services, assigning a minimum cadastral value should be allowed and practiced.

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<sup>12</sup> See discussion by Dillinger (1991), pp. 18-19. "Most jurisdictions tend to elaborate on the methodology by adding variables: data on type of flooring, plumbing and electrical facilities, subjective estimates of the quality of repair, the state of technological obsolescence. These elaborations do not, however, improve the accuracy of valuations."

### ***Classifying Properties by Land Use***

Local authorities in many countries employ property use as a factor in calculating tax liability of properties for recurrent property taxation. This arrangement involves levying a different tax liability for different classes of property. To implement such a system, it is necessary to categorize each property in the jurisdiction according to some categorization of property uses. For example, the GTZ/ISDEM pilot project codes properties according to eight different uses: commercial, industrial, service, financial, agricultural, public agencies, residential, and vacant. Varyingly sophisticated land-use classification systems are used worldwide, but in selecting a system, assessors need to carefully consider the cost of keeping the records associated with land use up-to-date. Obviously, the finer the classification, the more work required to maintain the records.

The team determined from discussions with those interviewed during the study that a simple distinction between agricultural or rural land and urban land would be legitimate in El Salvador for tax purposes. In practice, larger towns will likely find use for a finer classification, while smaller ones will only distinguish between rural and urban properties. A straightforward reason for such a distinction is the absence of municipal services to rural parcels. The team believes that whether the municipality will use more than these two categories should be left to local decision makers.

### ***Unique Types of Property***

Unique properties are those suited to the needs of one particular user and worth their full cost of construction to that user, but worth perhaps little or nothing in an open sale on the market because there are no other similar users. Examples may be an electrical power station or a private airfield. From a property taxation viewpoint, it is normally necessary to provide that in such circumstances the property can be valued on the basis of what it is worth to the present owner.

El Salvador, like every country, has its share of unique properties. Unless this issue is addressed in some way administratively or legislatively, there could be substantial disagreement between the owners and the public assessing authority about how these properties should be valued. The team brings this point to the reader's attention so that provision can be made to provide technical assistance with unique property valuation as the property tax comes into wider use. In practice, the pilot municipalities can provide the experience about how to resolve this matter in the Salvadoran context.

### ***Notification of Value Assessments to Owners***

One of the most important aspects of preparing valuations on property for taxation purposes is sharing the information with property owners. In the Salvadoran towns that the team visited, bills for

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municipal user fees were delivered with electricity notices. This practice (along with the penalties for late user fee payments) demonstrates a seriousness about collection of local fees that is often not present in other nations.

Taking the extra step of notifying landholders of their property tax liability should be feasible, but again will require technical assistance and training in areas where this is a new idea. Local governments will also require assistance in setting up a review process whereby taxpayers may contest valuations. Further, a mass valuation approach that is simple and understandable will reduce the likelihood that protests will be made.

#### ***Market Evidence of Sales and Rents***

Data on the sale and rent of properties are difficult to obtain in most developing countries; El Salvador is no exception. The mass valuation approach will need to rely on private and public valuation specialists, especially real estate professionals, to perform the periodic studies necessary to ensure that gross inequities do not result from rapidly inflating property values. This activity will be of chief concern to the largest towns, i.e., those with the greatest financial and personnel resources to address this issue. Town officials the team interviewed volunteered that in smaller jurisdictions the knowledgeable public were keenly aware of relative property values. The team, therefore, believes that lack of ample market data is not critical to the success of the property tax system proposed in the study report.

### ***3.4 Cadastral Record Keeping and Computerization***

#### **Recommendation 4: Record Keeping and Computerization**

##### **SUPPORTING COMMENTS**

The team reviewed the state of tax registers for user fees in the municipalities visited. Bound ledgers were used that had to be recopied for each year. Organized according to taxpayer name, there was no identification of taxpayers' addresses in the cases of Nueva Concepcion and Chalatenango. While existing records are far from what is needed for effective tax administration, mayors interviewed were very aware of the limitations and in Chalatenango and Apopa were in the process of upgrading tax records.

### ***Computerization of Tax Rolls***

In formulating its position on computerization, the team visited the microregion project operated by GTZ/ISDEM. Under this technical assistance effort, the Municipalities of Sonsonate, Juayúa, and San Miguel are just now getting microcomputers for building up a fiscal cadastre database. Application software for cadastral purposes is in the early training and testing phase. For the municipalities mentioned, the National Geographic Institute is providing parcel maps and cadastral data in printed form. In a subsequent phase the municipalities, with help from GTZ/ISDEM, will try to get cadastral data in electronic form so that transferring data will not require time-consuming data reentry. The lack of computer hardware and software necessary for the National Geographic Institute and the Ministry of Finance to perform this transfer to media usable on standard microcomputers will temporarily impede, but not stop, progress on this project.

Parcel maps and fiscal cadastral data are available to municipalities through the National Geographic Institute but are not up-to-date. The GTZ/ISDEM pilot will provide very useful information on how much work will be required to update cadastral information to a basic level for property valuation purposes. The National Geographic Institute informed the tax study team that, especially in areas of former conflict, such as along the border with Honduras, where aerial photography has been impossible, municipalities will have an extensive task to identify owners and parcels just to acquire basic cadastral data. All municipalities will have to make field visits to identify and measure parcels and to gather basic taxpayer information. The GTZ/ISDEM pilot has provided concerned municipalities with guidelines for such cadastral field surveys.

The local valuation rolls should be organized in an order that allows each parcel to be given a unique identifier. In El Salvador the National Geographic Institute and the Ministry of Finance already use a unique geocode to identify each parcel on maps and cadastral rolls maintained at the central level. In addition to this manner of identifying properties, local authorities should maintain multiple indexes that allow for easy access to cadastral information. Indexes common in various

***Recommendation:***  
*there should be a major upgrading of local government property tax records so that all properties, whether taxable or nontaxable, are properly accounted for. Although not mandatory, cadastral record keeping is best computerized--smaller municipalities should consider acquiring computer services from other public or private sources. The resulting municipal valuation rolls should be made available for public enquiry.*

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countries are by street and house number, owner's name, taxpayer identification number, survey lot, and certificate of title.

***Public Record Systems--Open Access***

Most successful property tax systems have as a basic tenet the need for the entire system to be open to public scrutiny. Openness means all taxpayers can be assured they are not paying more than a fair share of their community's property tax burden. This approach, of course, is at variance with the principle that personal taxation is a private matter between the state and the individual. The team has interviewed local officials in El Salvador who interpret privacy provisions in the law as prohibiting open access to cadastral records. The team's experience is that closed land titling, cadastral, and valuation processes can cause significant compliance problems in a property tax system.

Although the team cannot address further (during this study) the likely legal objections raised about open access, the legal and administrative aspects must be addressed in the future.

***Fiscal Cadastre and Valuation Rolls***

A listing of all properties should be prepared and regularly maintained. This schedule of properties within a local government's jurisdiction that is open to inspection by any member of the public is called variously a fiscal cadastre, valuation roll, or property tax roll. The valuation roll is important because it contains minimum information necessary to identify the owner (i.e., the taxpayer) and the property, and it records the assessed value of the property. Without this information on each property--information that needs to be open to public inspection--individual property owners cannot know whether they are being treated in the same way as their neighbors and the owners of other similar properties in the jurisdiction. Local valuation rolls thus lend credibility to any property tax system in which the taxing authority wants those liable for the tax to pay what they owe voluntarily.

Many countries charge a reasonable sum for information that is supplied from public valuation rolls. In El Salvador this fee could provide a source of revenue helpful in offsetting costs of maintaining these records.

### 3.5 Administrative Structure of the Property Tax

#### Recommendation 5: Administrative Structure

##### SUPPORTING COMMENTS

##### *Managing the Cadastre at the Local Level*

Municipalities in El Salvador should be able to choose their own administrative structures to carry out the responsibilities of property tax management. For many, establishing cadastral units at a municipal or multijurisdictional level will be the choice.

Contracting out of various cadastral-related tasks such as field survey tasks and computerization of record keeping systems are options that should be left to mayors and municipal councils to decide. Already in El Salvador, municipalities are choosing how to establish fiscal cadastres. In Apopa, for example, the mayor told the team that the town has a cadastral office with nine regular

employees. At the Municipality of Sonsonate the study team learned that the town has also hired professional staff competent in mapping and urban planning for the local cadastral office. Smaller municipalities in the Juayúa microregion have combined resources to establish a fiscal cadastre in a multimunicipality area. Municipalities taking the lead in cadastral matters, like San Miguel, are managing field surveys to identify and put parcels on the tax rolls.

##### *Avoidance of Central Government Interference*

Where the Salvadoran central government is responsible for administering components of the property tax system, it should do so by contract with the municipalities. Making the central government the client of the local authority reverses the traditional relationship and addresses the central government's inherent lack of interest in generating local revenues. The team's experience is that central governments in various countries are involved in all aspects of administering the property tax. For example, in an extreme case, in Costa Rica property taxes are administered by six different central government agencies: *Dirección General de Tributación Directa, Banco Central, Tesorería Nacional, Oficina Nacional de Contabilidad, Controloría General, and Auditor del Banco General*<sup>13</sup>. In cases where central cadastral offices or collection branches are not engaged contractually by the

***Recommendation: the municipalities should be encouraged and helped to use their authority to freely choose how to implement a local property tax system—rate structure, assessment practices, and collections—according to local conditions and local choice.***

<sup>13</sup> Research Triangle Institute, *Costa Rica: Diagnostico de Desarrollo Municipal y Propuesta de Politicas*, (Report prepared for USAID/Costa Rica, 1990), p. 29.

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local units, the result is poor service and, worse, a weakening of the sense at the local level that there is any likelihood for improvement. The team recommends that, in light of Salvadoran history and bureaucratic culture, these mistakes not be repeated in El Salvador.

The controlling and auditing roles of the central government should be limited to those of ensuring that the provisions of law are adhered to and that funds are accounted for according to principles of accepted practice.

#### ***Payment Enforcement***

In El Salvador, like in so many countries of Central America and throughout the developing world, the lack of enforcement of payment of property taxes is a real problem that, by its nature, escalates. In municipalities visited by the study team, mayors estimated that 40% and upward of local fees due are delinquent in any given year. In effect, if taxpayers come to realize that a taxing authority will not enforce payment of taxes due, increasing numbers of taxpayers feel no compulsion to pay because they believe it is highly likely that they can get away without paying at all.

Administrative solutions alone are unlikely to make a large impact on collection performance. Collection systems that are poorly designed and managed often reflect deliberate political choices: they encourage administrators to enforce payment only at their own discretion and obscure embarrassing delinquencies. Still, the best political and institutional incentives for property taxation cannot succeed without adequate collection mechanisms. The legal bases giving the municipalities in El Salvador adequate mechanisms and authority to collect the property tax have been incorporated into the draft law presented as Annex 3 to this report. Paragraphs 7 through 12 of this law deal with who has the authority to collect the tax, how debt is to be secured and recovered, and directs the municipalities to publish delinquencies in the newspapers or to post at the municipality.

### ***3.6 Constitutional and Legal Bases for Establishing a Property Tax***

#### **Recommendation 6: Constitutional and Legal Bases**

##### **SUPPORTING COMMENTS**

In order to recommend options leading to the implementation of a real property tax, effected by and administered by the cities and towns of El Salvador, the study team analyzed the legal structure and institutions within which the taxation must take place.

***Constitution and Statutes***

In 1983, the Constitution of El Salvador was amended to include an Article on local government autonomy. That article reads as follows:

Article 204: The autonomous authority of the municipality extends to:

1. The creation, modification, and repeal of fees and public assessments to accomplish certain defined work projects within the limits established by law.

The fees and assessments having been approved by the municipal council shall be published in the official newspaper. Eight days after publication the fees and assessments shall become effective.

2. Adopt a budget of income and expenditures
3. Act freely in matters of its responsibility
4. Appoint and remove officers and employees from its agencies
5. Adopt local ordinances and regulations
6. Define proposed taxes, tax rates and their reforms in proposals to the National Assembly for enactment into law.

(Original version attached as Annex 4, Exhibit A)

The National Assembly has defined taxes, fees and assessments as follows:

**Municipal taxes: Title I, Article 4**

Municipal taxes are those payments required by the municipality that are not directly related to any service provided.

**Municipal fees: Title I, Article 5**

Municipal fees are those payments required by the municipality that are created to pay for administrative and judicial services provided by the municipality.

**Special assessments: Title I, Article 6**

Special municipal assessments are those payments required by the municipality based upon real or presumed direct benefits resulting from public works provided by the municipality.

**Methods by which taxes, fees and assessments may be established: Title I, Article 7**

The National Assembly may create, modify, or repeal municipal taxes based upon a proposal recommended by the municipal council, by incorporating the same in a legislative decree.

***Recommendation: the National Assembly should enact enabling legislation giving municipalities the power to implement a local tax on real property within their respective jurisdictions.***

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The municipal council may create, modify, or repeal fees and assessments by ordinance according to the process set forth in Article 204 of the constitution of the nation and pursuant to this law:

(Original version attached as Annex 4 Exhibit B)

Further expanding the definition of taxes that may be submitted to the National Assembly for passage into law are the following:

Title V, Municipal taxes  
Chapter I, Taxes, Basic Disposition  
Article 125

Municipal taxes may be implemented on commercial, industrial, financial and service businesses and any other economic activity realized within the municipal jurisdiction as well as the real property located within the municipality.

(Original version attached as Annex 4 Exhibit C)

The Ley Patrimonial is also important. It reads as follows:

Title III, Chapter I Article 7

Calculation for the purpose of this tax includes the value of personal and real property

(Original version attached as Annex 4 Exhibit D)

The Wealth Tax is important in this discussion because it includes an element of tax on real property. Because of the constitutional prohibition against double taxation, until the Wealth Tax is repealed, no law can be passed that would authorize real property taxes for municipalities.

The impact of the statutes and constitutional provisions cited above is that the municipal council may impose fees and assessments related to services and administration. Taxes, however, may only be imposed by the National Assembly upon specific recommendation of the municipal council. Taxes, by definition, include real property taxes (as authorized in articles of municipal tax laws) as well as taxes on commercial activity (as authorized under Article 25 of the same law). Neither may be implemented, however, unless the municipality submits a tax proposal to the National Assembly, and the Assembly enacts it by decree.

By law, taxes are taxes (and not fees or other type of revenue) because the National Assembly has decreed that they are taxes. The assembly could change or modify that definition. The definition is, however, built into the culture of El Salvador and it is not likely that it will change.

Given the provisions of both the Constitution of El Salvador and the statutory law, the processes by which a real property tax can be imposed are:

1. The municipal council would draft a proposal for such a tax and submit it to the National Assembly for implementation into law.
2. The National Assembly would enact the proposed tax law into statute, paving the way for implementation of the tax law in the municipality.
3. As a corollary to point 2 above, the National Assembly will not consider real property tax legislation until the Wealth Tax is repealed. It is generally accepted that unless the Wealth Tax is removed, assessing property taxes as well would create double taxation, which is prohibited by the Constitution.

***Political Will to Accomplish a Municipal Real Property Tax***

Visits with several mayors in their respective municipal centers led to the observation that these mayors visited would impose a real property tax immediately if they had the power to do so. As mayors they recognize the political risks but would take steps to implement a real property tax anyway. This view is also supported by additional mayors the team contacted within COMURES. In the recent Seventh Annual National Congress of Mayors of El Salvador (September 29-October 1, 1992), a resolution was adopted supporting a real property tax. The resolution adopted was as follows:

I. Report of the Committee on Decentralization

This Committee dedicated itself to examining the process of decentralization and makes the following principal recommendations:

"C. In the process of decentralization, municipalities should seek and improve additional sources of revenue. . . ."

"VI. The technical, economic, and social effects of a real property tax dedicated exclusively to the resolution of education and health needs of the municipality should be evaluated."

(Original version attached as Annex 4 Exhibit E)

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In 1990 ISDEM published a study entitled "Plan of Municipal Rescue" (*Plan de Rescate Municipal*). This plan lists as one of its objectives to "create the conditions that will permit progressive administrative decentralization in order to more efficiently respond to local problems and needs . . . ." (original version attached as Exhibit F)

During the week of October 26 through October 31, 1992, GTZ, in cooperation with ISDEM, created an operations manual in a 3-inch, three-ring binder format that was to be distributed to 133 different municipalities. The purpose of the manual was to help in solving problems related to administration, accounting, regulations, and other matters. A significant section of this manual was composed of a draft law or model which, modified and completed, could be adopted by the municipal council to be subsequently directed to the National Assembly for passage into law. This working model of a municipal tax law was drafted pursuant to Article 125 of the *Ley Tributario de Municipios*, which authorizes a tax on commercial enterprise. Undoubtedly, many of the 133 municipalities to which these manuals will shortly be provided will submit their drafts of a tax law to the Assembly to be implemented into law.

The City of Nuevo San Salvador did not wait for help from GTZ/ISDEM but proceeded to draft and submit its own commercial tax legislation. The measure was designated *Decreto No. 350* and was passed into law on Friday, October 30, 1992, by what appeared to be the unanimous vote of the Assembly.

These commercial tax laws are significant milestones because they indicate not only that the municipalities are willing to go as far as they can under the restraint of the double taxation provision of the Constitution, but also that the municipalities would submit a total package—including municipal land taxation—if the constitutional problem of double taxation did not exist.

Commercial statutes, like *Decreto No. 350* are half statutes because they will enhance municipal revenue but will stop short of being a municipal property tax. They do, however, provide evidence that the city councils are moving ahead. It is anticipated that the GTZ/ISDEM project will produce a number of commercial tax recommendations in the near future. The willingness of the Assembly to act on *Decreto No. 350* for the municipality of Nuevo San Salvador indicates that these proposals probably will be passed into law without major difficulty. We conclude that there is near unanimous support among the mayors and municipal councils of El Salvador for a municipal real property tax.

With respect to the political will of the National Assembly, the team made contact with a number of legislators, including the major political parties and leadership of the National Assembly.

Every legislator contacted, although concerned about local administrative capacity, indicated support for the municipal real property tax.

A roundtable presentation was made to the *Comision del Interior y Seguridad Publica* (Committee on the Interior and Public Safety), which is the legislative committee of the National Assembly that has the responsibility for tax legislation. The vocal members of the committee expressed support for the property tax and for repeal of the Wealth Tax. They expressed real concern, however, about the capacity of the mayors and city officials to administer a property tax.

It would be fair to observe that other than the party leaders, few members of the Assembly have given much thought to the subject of a property tax until our interviews. Undoubtedly, questions other than the capacity of the municipalities will arise as tax legislation becomes more in the spotlight.

The ARENA party's position of record is to repeal the Wealth Tax prior to the national elections in March of 1994. ARENA officials interviewed by the team expressed support for local property tax legislation but voiced reservations based upon competence of municipal government officials. Current revenue produced by that tax could be available for use by the current administration but could not be relied on for the subsequent government.

It can be concluded that there is a political will within the Assembly to repeal the Wealth Tax. Actual repeal of the Wealth Tax, however, may depend on economic conditions, assistance available, and political stability. At present, it appears that a repeal will come about when the timing is proper. There is also a general feeling of support for proposed tax laws that would grant taxing power to the municipalities. This support must be taken, however, as having been expressed by many who had not given in-depth thought to the subject. The support has also been colored by a general feeling that many municipalities do not have the executive and technical capacity to administer local taxes.

Corollary recommendations of this section are:

1. The effort of ISDEM and GTZ to create draft commercial tax legislation proposals should be all possible encouragement.
2. The National Assembly should be encouraged in every way possible to repeal the Wealth Tax.
3. Assuming that by the time the Wealth Tax is repealed several municipalities (such as Nuevo San Salvador) will have commercial tax legislation in place, it would be simple for such municipalities to amend their commercial tax legislation to include a

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municipal property tax. ISDEM and GTZ have the resources and sophistication to draft such prospective legislation and should be encouraged to do so.

4. As a strategy measure an amendment to the commercial tax law could be couched in two measures, one of which would allow the law to take effect on a certain date following the repeal of the Wealth Tax.
5. Given the paucity of trained personnel and lack of training media, cadastral information and automated equipment, special attention should be given to ensure that any tax law submitted should be simple to draft, easily understood and easily complied with.

### *3.7 Training and Technical Assistance Requirements for Implementing a Property Tax*

#### **Recommendation 8: Training and Technical Assistance**

##### **SUPPORTING COMMENTS**

Due to the wide range of resources available to municipalities of a widely divergent range of capabilities in El Salvador, any program of training and technical assistance must structure and target its support in a flexible manner.

##### ***Strengthening Local Policy Makers' Understanding of Financial Management Principles***

A program of training and technical assistance must acknowledge the critical role of mayors and municipal councils as the key local decision makers, and sensitize them to financial management principles. Decision makers must learn (a) how to interpret revenue and expenditure trends, and, (b) how their decisions on tax and spending matters can make a difference in local service delivery and development.

##### ***Strengthening Central Government Support Institutions***

Current institutional players that are involved in supporting local governments must be systematically strengthened. The value of experimentation and learning from experience must be emphasized. Where central government institutions have been used to a controlling role, they must be encouraged and shown examples whereby staff learn the new skills of training and advising. Where nongovernmental institutions can be mobilized to offer competing services on a contract basis, competition should have the effect of making bureaucrats more client-oriented.

<p><b><i>Recommendation: training and technical assistance for property tax implementation must be available for municipalities within a systematic local financial management program.</i></b></p>
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**COMURES:** The role of this body vis-à-vis the National Assembly must be strengthened. The potential political strength of this organization that represents the 262 locally elected political leaders has yet to be tapped in full. Study tours to various countries where associations of mayors are an effective force for local government can be useful. Visits with mayors in various countries to learn about policy making and administration of property tax is called for.

**ISDEM:** The important technical assistance role that ISDEM and GTZ have provided to municipalities on cadastral matters is treated in earlier recommendations. Donor aid to support pilot efforts of this type can be very effective.

**National Geographic Institute:** This agency is providing parcel maps and cadastral data to municipalities of the GTZ/ISDEM cadastral pilot project. Much needs to be done to strengthen this agency's institutional and technical capacity so that it can play a major helping role in developing local property tax systems.

#### ***The Property Tax in the Context of Overall Revenue Mobilization***

A property tax can, and (one could strongly argue on many grounds) should take its place as the major own-source revenue for municipalities in El Salvador. Still, the management of other sources of revenue—user fees, betterment fees, business licenses, and so forth—must be strengthened. Better management of one revenue source builds skills and learning that are readily transferable and reinforce the management practices of other revenues.

#### ***Measuring Local Service Delivery Effectiveness and Efficiency***

Measuring the performance of local service delivery allows local decision makers to choose rationally what levels of service to provide among competing priorities. Without firm measures, for example, of the unit cost per ton of solid waste collected and disposed of, the link between revenues expended and service output remains an imponderable. Such measures also provide the basis for more efficient service delivery when service unit directors are made responsible for targeted objectives.

#### ***Transforming Local Budgeting and Accounting Systems***

The weak link between taxation level and service delivery level must be reinforced through transforming local budgeting and accounting systems. Moving toward performance-based budgeting and accounting and away from traditional line-item systems created solely for control of revenues and expenditures will require much time and effort. Nevertheless, it should be part of an integrated financial management strengthening program for local governments in El Salvador. Also, developing

multiyear capital improvement plans for municipalities is critical to infrastructure planning and financing. Increased fiscal resources must be channeled for local investment to be effective.

***COMURES and ISDEM***

It is important to distinguish between the respective roles of COMURES and ISDEM. COMURES should play the leading role in developing and articulating the case for increased resources and responsibilities at the local level. It should also play a significant role in establishing priorities for the training and technical assistance activities that will be implemented by ISDEM. ISDEM, following the policy lead of COMURES, should be responsible for developing and implementing programs of technical assistance and training in support of the objectives articulated by COMURES. It is absolutely critical that ISDEM develop a nonpartisan image that will enhance its ability and acceptance among municipalities of all political persuasions. Over time ISDEM should develop a capability to respond to requests for training and technical assistance from the municipalities themselves. In order for ISDEM and COMURES to successfully play their respective roles, a high level of cooperation and communication must be established. El Salvador cannot afford to have municipal support agencies with competing visions of municipal development.

# ANNEX 1

## ANNEX 1: SCOPE OF WORK

The Team Leader shall organize a work plan outlining the schedule of activities of the team. This preliminary work plan shall be submitted to the IRD/RUD Office Director for approval prior to the arrival of the rest of the Contractor's team. Upon the teams arrival, the Contractor shall refine the work plan for submission to IRD/RUD for final approval.

The Contractor, in addition to assisting in preparing a draft law for the National Assembly, is expected to advise COMURES on all the necessary elements required for the transfer from central to local government of the indicated component of the Wealth Tax as well as for a continued, efficient collection and use of the new tax outputs: a) Definition of a system for local assessment and collection of property taxes; and b) a draft law to allow the occurrence of a). Specific points the Consultant shall address are the following:

1. A brief analysis of the conditions and efficiency of the existing central government Wealth Tax;
2. A financial analysis of the impacts on both central and local governments of the transfer of the real property component of the Wealth Tax. This analysis will make up part of the justification for the related proposed law;
3. Methods for equitably and efficiently fixing and maintaining real property tax rates within the specific economic context of El Salvador; these rates should reflect the economic needs of the smaller and poorer municipalities as well as the more prosperous ones;
4. The most efficient methods for property valuations in different categories of municipalities, as decided upon with COMURES, given the cadastral information available. In the absence of cadastral information, the Contractor will suggest other, interim methods of assessing real property. The Contractor will also present methods for obtaining property valuations given normal cadastre conditions;
5. The question of staging the transfer of the Wealth Tax to the extent that may be called for by administrative and political recommendation for staging for different categories of municipalities, as determined with COMURES. The Property Tax should be developed to complement overall fiscal reforms being developed (IVY and MOST project);
6. A general analysis of cadastral requirements and recommendations for further study of less expensive methods of acquiring basic information needed to make operational a real property tax within the context of Salvadoran municipalities; this analysis will be made in accordance with the determined categories of municipalities;
7. The administrative structure that will be required to collect this tax efficiently by determined categories of municipalities;
8. Specific training requirements for implementing the property tax;

9. A general estimate of the revenue that can be generated by the real property tax at the present time and under differing, assumptions; and

10. Together with the support of legal advisors from COMURES and/or ISDEM, the Contractor will assist in the preparation of a draft law (bill), with its respective justification, to be presented by the competent authorities to the National Assembly for passage. The responsibility of the contractor will be restricted to those elements of the Law that treat the property tax and its justification.

## ANNEX 2

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## **ANNEX 2: BASIC PRINCIPLES OF PROPERTY TAXATION**

### ***Voluntary Compliance***

Voluntary compliance refers to a general principle that should apply to all taxes. It means that taxpayers voluntarily meet their liability without a heavy enforcement presence. This is important because taxes can become nearly impossible to collect if taxpayers are determined to resist. (Such resistance is happening with central and local taxation in El Salvador now.) A tax that people voluntarily comply with must appear to be fair. It must be easily understood and the extent of the liability clearly known. Taxpayers also must realize that if they do not pay their tax, the taxing authority will enforce payment. Still, there are commonly some concessions in most tax systems for hardship.

### ***Equity and Fairness***

Traditionally it has been claimed that ad valorem property taxes are regressive and therefore not in accord with the principle of ability to pay. Recent analysis questions this view, however, and suggests that property taxes may be progressive. Most argue that local taxes should not be progressive because taxes levied at higher levels of government represent funds to be redistributed.

It is often held that the criterion of fairness--getting the benefit of what you pay for--is a better guide to local tax policy than considerations of relative ability to pay. In practice, property taxes in most countries combine elements related to both ability-to-pay and benefit principles, although one or the other may be more heavily stressed and other principles, such as ease and cost of administration, are also relevant.

A heavily discussed issue in the literature on property tax is who actually pays the property tax. It has usually been argued that these taxes are regressive because higher-income households pay relatively less tax than lower-income households. This view is increasingly being challenged and some commentators have argued that, in the long term, these taxes may be progressive because they fall on owners of capital, and not (as was previously thought) on the users of property. In countries where land is highly concentrated in the hands of the rich, there is a strong element of progressivity in a real property tax because of wealthy citizens' consumption of luxury housing.

The team noted a trend in El Salvador toward relating the amount of taxes assessed to the costs of providing a range of local government services to individual properties. This concept is known internationally as "user fees." This approach makes tax payments more regressive because lower-income people who live in cheaper housing pay more of their income in local property taxes than higher-income people living in better housing.

### ***Political Acceptability***

Anything to do with taxes is highly political. Bureaucrats above all must recognize this fact. By extension, taxes, particularly unpopular ones, can be politically damaging to a government. This study, directed as it has been at property taxes, deals with a very visible tax. In making recommendations, the team has considered this aspect. However, it is worth noting that

internationally, the trend is away from highly visible taxes such as income tax, toward consumption taxes, which are more acceptable to the electorate because they are less visible and nearly impossible to evade.

Certain taxes have been popular in many developing societies, partly because they are easy to administer and collect. An example is a border tax where a government may levy, say, a 20% tax on the value of goods coming into a country through a port. These taxes have been widely applied; because they are easy to collect and hard to avoid (nonpayment would mean seizure of the goods) payments are usually assured.

In the 1990s, because of international pressure to dismantle border taxes, governments are finding that they are being forced to abandon this source of tax revenue and to replace it with other forms of tax, such as consumption taxes. This influence may partly explain why value-added taxes have been adopted by so many countries over the past 20 years, with additional countries, including El Salvador, joining the ranks each year.

### *Ease of Administration*

Complex taxes such as an income tax require national- or state-level administration to impose and collect the tax. Income tax also requires well-trained staff for its administration. And some administrative body must ensure that rulings on complex tax issues are consistent. On the other hand, property taxes are much simpler and therefore are very suitable for passing to local governments to administer and collect. A second reason for delegating the authority to levy these taxes to local governments is that many of their services are property-related. Therefore, there is a close linkage between raising money using this form of tax and spending it for the benefit of individual properties. In a sense, it can be classed as a tied tax: a tax that raises money to be used for a specific purpose.

In the majority of Organization for Economic Cooperation and Development (OECD) countries, the "owners" rather than the "occupiers" of property are those legally obliged to pay property taxes. In the Philippines, the U.S.A., and some other countries, land and improvements are taxed, regardless of occupation or ownership. The approach of taxing the real property itself emphasizes that real property is tangible, is easily observed, and does not change jurisdiction. These features rank property tax high on administrative ease.

A related characteristic of any tax is its visibility to the taxpayer. Some taxes, such as sales and value-added taxes, are incorporated into the price of goods, are hidden, and are unlikely to meet taxpayer resistance as a result. Direct taxes such as the property tax, on the other hand, are very visible. Unless they are seen to be fair, there is likely to be reluctance to pay.

### *Cost of Collection*

All taxation involves some cost of collection, which clearly should be kept low. In designing any tax system it is important to keep it simple so that the cost of administration is kept to a minimum. The team could find no reliable data that directly addressed this question of cost of administration of property taxes in developing countries, but reports do exist that state costs per parcel for surveying, mapping, and valuing the long-term cadastral projects in Brazil and the Philippines. Both countries kept costs low by standardizing cadastral procedures, but neither the

Brazilian or the Philippines projects focused on how to keep rates up relative to inflation or on how to design and manage the collection and enforcement process. Obviously, if the amount raised is low, then the cost of assessment and collection will rise.

## ANNEX 3

## **ANNEX 3: DRAFT PROPERTY TAX LEGISLATION**

The Property Tax Study team has reviewed real property tax laws of various other countries in Central and South America, as well as tax laws of Spain. There are as many different approaches to the problem of real property taxes as there are countries which have treated the subject. The law should be simple and enabling rather than detailed and prescriptive.

The following is a recommended draft of a tax law the team believes appropriate to the subject.

### **WHEREAS,**

I. It is necessary to strengthen the municipal autonomy as honored in the constitution of the Republic by granting to municipalities those instrumentalities which will secure for them the greatest administrative and financial independence in addition to providing the self-financing of services and works of a social and economic benefit for the population of the same;

II. that municipal autonomy in its economic aspect is in large part based on the generation of resources from the power assigned to the municipalities to establish taxes and for this reason the tax systems and their administration should receive permanent attention in order to adequately create social and economic conditions imperative in national life;

III. that it is also convenient to define general principles and norms for application and administration of municipal taxes;

### **NOW THEREFORE:**

In furtherance of the objectives set forth above, it is appropriate and seemly that the following amendments to the "Ley General Tributaria" be amended by the adoption of the following Property Tax Legislation:

#### **Title I, Chapter IV, Municipal Tax on Real Property**

1. The Municipal Tax on Real Property shall be calculated using a percentage of between \_\_\_ and \_\_\_ applied to urban properties and a percentage of between \_\_\_ and \_\_\_ applied to rural properties. The rate shall be determined by the Municipal Council and shall not be increased by more than \_\_\_ from the current rate in any one year.
2. The rate shall be applied to the cadastral value of the property or, in the absence of cadastral value, a value assigned by the Municipality.
3. The assessed value of all property shall be adjusted in every year which ends with zero (0) or five (5) if not adjusted previously, such that each property value shall be adjusted not less frequently than every five (5) years.

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4. The assessed or assigned value shall be calculated taking into consideration among others the following criteria:
    - (a) Use of land
    - (b) Market Value
    - (c) Location
    - (d) Size of land parcel
    - (e) Improvements.
  
  5. The assessed value shall be established as of January 1 of each year and the tax thereon shall be due and payable during each month of the year on an amortized basis. In case of default, a late fee charge of \_\_\_ per month shall be imposed on all unpaid tax amounts pursuant to Article 47 of this law.
  
  6. The following properties are exempt from the payment of the taxes created in this chapter:
    - (a) Properties occupied as living accommodations to up to \_\_\_\_\_ colones in assessed or assigned valuation.
    - (b) Property belonging to the Republic of El Salvador or its political subdivisions, departments and municipalities.
    - (c) Privately-owned school land and improvements where the educational services are performed without charge or are provided by a non-profit organization.
  
  7. The collection of the real property tax shall be the responsibility of the Municipal Treasurer, pursuant to Article 83 of this law.
  
  8. Real property taxes shall not be barred by any statute of limitations.
  
  9. Any tax obligation arising out of the real property tax, or on industry, services or payment for improvements shall have priority in favor of the municipality in all judicial proceedings. The right to subject the property to the judicial determination of the tax claim shall be by certificate of debt issued by the Mayor of the Municipality.
  
  10. The default in payment of the tax established by this law may give rise to legal action by the Municipality. Two written notices shall be given, one month apart. A certificate of debt shall be issued by the Mayor consistent with Article 119 of this law.
  
  11. The real property subject to the tax shall be security for payment of the tax without regard to the change of title, even when the property has been subject to judicial sale. New owners are obligated to pay the tax before the change of title can be recorded.
  
  12. When taxes are in default, notice shall be published in a local newspaper in the month of January of each year, such notice to include the description of
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the property and the name of the owner. If there is no local newspaper, the list of delinquencies shall be placed on the board of notices at the Municipality.

13. The data upon which real property taxes are assessed or assigned shall be exempt from the requirements of Section II, Article 86 of this law.

## ANNEX 4

## **ANNEX 4: CITATIONS OF SALVADORAN LAW**

### *Exhibit A*

**Art. 204.** La Autonomía de Municipio comprende:

1. Crear, modificar y suprimir tasas y contribuciones públicas para la realización de obras determinadas dentro de los límites que una ley general establezca.

Aprobadas las tasas o contribuciones por el Concejo Municipal se mandará publicar el acuerdo respectivo en el Diario Oficial, y transcurridos que sean ocho días después de su publicación, será obligatorio su cumplimiento;

2. Decretar su Presupuesto de Ingresos y Egresos;
3. Gestionar libremente en las materias de su competencia;
4. Nombrar y remover a los funcionarios y empleados de sus dependencias;
5. Decretar las ordenanzas y reglamentos locales;
6. Elaborar sus tarifas de impuestos y las reformas a las mismas, para proponerlas como ley a la Asamblea Legislativa.

*Exhibit B***IMPUESTOS MUNICIPALES**

Art. 4. -- Son Impuestos Municipales, los tributos exigidos por los Municipios, sin contraprestación alguna individualizada.

**TASAS MUNICIPALES**

Art. 5. -- Son Tasas Municipales, los Tributos que se generan en ocasión de los servicios públicos de naturaleza administrativa o jurídica prestados por los Municipios.

**CONTRIBUCIÓN ESPECIAL MUNICIPAL**

Art. 6. -- Contribución Especial Municipal es el tributo que se caracteriza porque el contribuyente recibe real o presuntamente, un beneficio especial, derivado de la ejecución de obras públicas o de actividades determinadas, realizadas por los Municipios.

**ORGANISMOS COMPETENTES PARA  
ESTABLECER IMPUESTOS, TASAS, Y  
CONTRIBUCIONES ESPECIALES MUNICIPALES**

Art. 7. -- Compete a la Asamblea Legislativa, crear, modificar, o derogar Impuestos Municipales, a propuesta de los Concejos Municipales, mediante la emisión del decreto legislativo correspondiente.

Es competencia de los Concejos Municipales crear, modificar o suprimir tasas y contribuciones especiales, mediante la emisión de la ordenanza, todo en virtud de la facultad consagrada en la Constitución de la República, Artículo 204 numeral primero y de conformidad a esta Ley.

*Exhibit C*

IMPUESTOS  
DISPOSICIONES BASICAS

Art. 125. -- Podrán ser afectadas por impuestos municipales, las empresas comerciales, industriales, financieras y de servicios, sea cual fuere su giro o especialidad;

cualquier otra actividad de naturaleza económica que se realice en la comprensión del Municipio, así como la propiedad inmobiliaria radicada en el mismo.

*Exhibit D*

LEYES TRIBUTARIOS DE LA NACIÓN  
TITULO III DEL PATRIMONIO  
CAPITULO I DEL ACTIVO

Art. 7. -- El activo comprende el valor real o comercial de todos los bienes muebles o inmuebles . . . .

*Exhibit E*

REPORTE DEL COMITE DE CENTRALIZACION  
EN EL SEPTIMO CONGRESO NACIONAL DE ALCALDES

(el 29 de septiembre hasta el primero de octubre de 1992)

1. Esta mesa de trabajo que se dedica al examen del proceso de centralización planteo en sus principales recomendaciones: . . . .
- C. El proceso de descentralización debe buscar y recuperar fuentes de nuevo ingresos . . . .
- VI. Que por analice la conveniencia técnica, económica y social de crear un impuesto predial que pueda dedicarse especialmente a resolver los problemas educativos y de salud de los municipios.

*Exhibit F*

**BASES PARA EL RESCATE MUNICIPAL  
EL ESTADO AL SERVICIO DEL HOMBRE**

Crear las condiciones que permiten la progresiva descentralización administrativa para atender los problemas locales, y satisfacer las necesidades que demanden los vecinos de los municipios para alcanzar el progreso de los pueblos y el bienestar de los habitantes en todos los ámbitos del país.