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LAND VALUATION AND TAXATION POLICY FOR TIMOR-LESTE

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ACRONYMS AND ABBREVIATIONS

GPA	General Public Access Area
NGO	Nongovernmental Organization
PBB	Single building and land tax
USAID	United States Agency for International Development

1.0 BACKGROUND

Timor-Leste is the newest nation, which achieved independent state status only during 2002. When the country obtained its second independence following the Indonesian occupation, the laws and regulations which were applied during the Indonesian regime were no longer functional. Among other issues, the land valuation and taxation procedures remain rudimentary. No formal market mechanism and guidelines exist for land valuation. Similarly, Timor-Leste has no clear basis for land and property taxation because it lacks effective taxation laws and policies. Based on review of different country cases and circumstances in Timor-Leste, this report suggests policy options for land taxation and valuation in Timor-Leste.

2.0 LAND VALUATION APPROACHES: A REVIEW

Land valuation involves first determining the valuation of the site in its highest and best use, then estimating its value using current appraisal theory, and finally reconciling these amounts to produce a final estimate of value. The first step in the valuation of land is determining the highest and best use of the site. The four criteria that highest and best use must meet are: physically possible, legally permissible, financially feasible, and maximally productive. Two types of analysis are undertaken in determining the highest and best use. The first is the highest and best use of the site, if vacant; the second is the highest and best use of the site as improved, or if undeveloped, as proposed to be improved.

There are three standard approaches to estimating market value that form the foundation for current appraisal theory: the sales comparison approach, the income approach and the cost approach.

The sales comparison approach utilizes prices paid in actual market transactions of similar properties to estimate the value of the site. This appraisal technique is dependent upon utilizing truly comparable market or sales data which have occurred near enough in time to reflect market conditions relative to the time period of the appraisal. This method could also be used to estimate the rental value.

The **income capitalization approach** is widely applied in appraising income-producing properties. Anticipated present and future net operating incomes, as well as any future reversions, are discounted to a present value figure through the capitalization process. This approach also relies upon market data to establish current market values and expense levels to arrive at an expected net operating income.

The **cost approach** is based upon the principle that the informed purchaser would pay no more than the cost to produce a substitute property with the same utility as the subject property. It is particularly applicable when the property being appraised involves relatively new improvements which represent the highest and best use of the land, or when relatively unique or specialized improvements are located on the site and for which no comparable properties exist on the market.

The resulting indications of value from the three approaches to valuation are combined to generate a final estimate of value for the site. It is not always possible or practicable to use all three approaches to value. The nature of the property being appraised and the amount, quality, and type of data available dictate which of the three approaches can and should be used in a given valuation proceeding.

3.0 SPECIFIC METHODS USED IN APPRAISING LAND VALUE

In the valuation process the land value estimate is a separate step accomplished by applying either sales comparison or income capitalization techniques. The most reliable way to estimate land value is by sales comparison. When few sales are available or when the value indications produced through sales comparison require substantiation, other procedures may be used to value land. In all, seven different procedures can be used to obtain land value indications.

1. *Sales Comparison*: Sales prices of similar, vacant parcels are analyzed, compared, and adjusted to provide a value indication for the land being appraised.
2. *Proportional Relationship*: Relating a site to a known standard site. The difference can be expressed as a percentage. This procedure can be used when little value evidence exists.
3. *Land Residual Technique*: It is assumed that the land is improved to its highest and best use. All operating expenses and the return attributable to other agents of production are deducted, and the net income imputed to the land is capitalized to derive an estimate of land value.
4. *Allocation*: Sales of improved properties are analyzed, and the prices paid are allocated between the land and the improvements.
5. *Extraction*: Land value is estimated by subtracting the estimated value of the depreciated improvements from the known sale price of the property.
6. *Ground Rent Capitalization*: This procedure is used when land rental and capitalization rates are readily available, as in well-developed areas. Net ground rent, the net amount paid for the right to use and occupy the land, is estimated and divided by a land capitalization rate.
7. *Subdivision Development*: The total value of undeveloped land is estimated as if the land were subdivided, developed, and sold. Development costs, incentive costs, and carrying charges are subtracted from the estimated proceeds of sale, and the net income projection is discounted over the estimated period required for market absorption (sale of all) of the developed sites.

With the appraisal process and approaches to valuation understood, it is appropriate to consider the methods and procedures used to analyze and interpret the land data. The choice is based upon what data is available, its reliability and usefulness in producing a value estimate.

The Arizona Department of Revenue, Property Tax Division (2001) has applied different valuation methods to value individual land parcels. The Division typically employs the sales comparison approach and the income approach. The commonly used methods under sales comparison approach are Comparative Unit Method, Base Lot Method, Allocation Method, Abstraction Method, and Anticipated Use or Cost of Development Method. Under the income approach, the department used Capitalization of Land Rent and Land Residual Capitalization.

4.0 LAND TAXATION ISSUES IN DIFFERENT ASIAN COUNTRIES

4.1 INDIA

- Municipal corporations in India raise about 20% of their revenues from the property tax on buildings and land with structures on it.
- The share of the tax varies across cities because tax rates and assessment ratios are set by each council.
- Vacant land is generally exempted from taxation except in a few cities.
- The tax base is the property's annual rental value.
- The statutory rate structure is usually flat or proportional.

4.2 INDONESIA

- In Indonesia, the central government collects the property tax.
- Indonesia levies a single building and land tax (PBB) on the capital value of the property.
- PBB is levied at a uniform rate of 0.5% of the assessed capital value which is equal to 20% of the market value of the property.
- Collected revenue is distributed among central government (10%), provincial government (16%), local government (65%), and collection costs (9%).

4.3 JAPAN

- The Local Tax Law provides the legal framework for taxation of property by local governments.
- The main local property tax is a fixed asset tax on land, buildings, and tangible assets levied by municipalities.
- The tax base is the market value of the property and assessment ratio averaged 36%.
- Land and buildings are valued separately.
- The tax is levied annually on holdings of vacant land that exceed a specified minimum surface area at the rate of 1.4%. Land used for housing is exempted from the tax.

4.4 KOREA

- A unique feature of the Korean system is that a local tax on land is levied on the aggregate value of all plots that each individual owns throughout the country.
- Administration of land-related taxes is the responsibility of local government within the legal framework laid out in the Local Tax Code.
- This comprehensive landholding tax applies a progressive rate structure ranging from 0.3% to 5.0%.
- Assessment ratios are around 20% of full market value, so the effective rate is between about 0.06% and 1.0%.
- A separate building tax is levied on structures, also at a graduated rate running from 0.3% to 7.0%. Valuation is based on reproduction cost.

4.5 THE PHILIPPINES

- Real property tax is the most important local revenue source, accounting for about 30% of local revenue in the municipalities in the national capital region.
- Valuation is the responsibility of local authorities in compliance with Ministry of Finance rules and regulations.
- The tax is levied on land, buildings, and machines.
- The tax base is the current and fair market value of the property, and the assessment ratios are 20% on land and 10% to 60% on buildings.
- Dwelling units whose fair market value does not exceed P 175,000 (US $l = P 25) are exempted.

4.6 THAILAND

- Thai municipalities levy a house and rent tax (or building and land tax) on land with structures and a local development tax on undeveloped land.
- The house tax is levied on the declared annual rental value of the property at a rate of 12.5%. Owner-occupied houses are exempted.
- The national government collects this tax, allocating two-thirds of the revenue to local government and keeping one-third for itself.
- The local development tax is assessed on the unimproved land value.
- The tax rate is progressive, ranging from 0.25% to 0.54%.

4.7 A PRELIMINARY TRAINING SURVEY RESULT FROM TIMOR-LESTE (JULY 1-8, 2005)

In Timor-Leste, although land markets are not well developed, property rights are not properly assigned and no effective land taxation mechanism exists, the trainees of the "Land Valuation and Taxation" workshop during early July 2005 conducted a market survey in and around the Dili area to assess land values and tax potential based on key informants' expressed willingness to pay. For the market survey, participants were divided into four groups representing the business district, the general public access (GPA) area, the residential area, and peri-urban areas. They considered aspects of land valuation and taxation in and around Dili. Each group interviewed three to four key informants using a pre-structured checklist, and their cumulative responses were analyzed.

The analysis shows the results of responses as presented in Table 1. Further, the willingness to pay the land tax for different categories of land was as follows: $10/house plot of 30x40 feet located in a peri-urban area, $15/house plot located in the urban GPA, and $5/house plot located in agricultural rural area. The responses of the selected individuals signify the presence of informal market development in various zones and existence of an informal rental (including investment and purchasing) network.

TABLE 1. ANNUAL LAND RENT, TAX AND TOTAL PROPERTY VALUE (PER PLOT) IN DILI AREA AND VICINITY **

Zones	Annual rental value (US $)	Annual land tax value (US $)	Property value (US $)***	
			20% capitalization[1]	6% capitalization[2]
Peri-urban area-residence				
Teacher category	90	0	5400	16000
Government officer	100	0	6000	18000
NGO staff	150	0	7500	28000
Peri-urban area- (1/4 ha farm plot)	60	0	300	1000
Business district	379.2	86.4	1463	4881
GPA area	6000	120	29400	98000
Residential area plot	300	120	900	3000

***Based on the market survey during training program, July 1-7, 2005.*

**** Based on the land valuation formula*

$$\textbf{Land Market Value} = \frac{\text{Land Rental Value - Land Taxes}}{\text{Capitalization Rate}}$$

[1] The 20% capitalization rates reflect the lack of developed market and tenure insecurity factor.

[2] The 6% capitalization rates reflect the presence of developed markets and tenure security factor.

5.0 SOME POLICY LESSONS REGARDING LAND TAXATION

Review of relevant comparative cases reveals the following policy lessons regarding land taxation:

- Property tax reform should be integrated with overall decentralization of local government finance.
- A reform should have a clear objective and simple policy and operational procedures.
- A reform in property tax administration is likely to succeed when it addresses the following factors and focuses strategically on the last aspect:
  - Identification of property site, ownership, and record keeping,
  - Valuation, assessment, billing, and collection and enforcement.
- Administrative reforms should aim at achieving permanent procedural changes, especially with regard to maintenance.
- Political will to enforce appropriate measures is critical in sustaining reform.
- Computerization can improve the entire process of property tax administration.

6.0 SUGGESTIONS FOR LAND TAXATION ISSUES IN TIMOR-LESTE

No established land tax structure and enforcement mechanism exists in Timor-Leste. For this reason, central as well as local governments mobilize very few resources. The following issues are most important for improving the effectiveness of the country's rudimentary tax structure.

- It is unclear whether the country's central or local governments bear responsibility for administering taxes. A detailed participatory discussion among the stakeholders should define a clear-cut mechanism in this regard.
- Likewise, it is unclear whether central and/or local governments have authority over land and property tax, which should be resolved by involving representation of all concerned stakeholders. Only then can a clear guideline be drafted to fix tax rates, tax bases, and the systems for land and real property valuation, and a responsible authority designated to oversee that process.
- Taxation-related policy and legislation should be formulated/or strengthened. Different administrative and procedural obstacles like the systems of recording and valuing the property should be improved.
- A strong institutional mechanism should be established to assign tax liabilities, valuation, collection, and enforcement of tax obligations.
- Awareness and reliable government performance are needed to convince citizens to make contributions through the land property tax for local and national development.

7.0 POLICY RECOMMENDATIONS FOR LAND TAXATION AND LAND VALUATION IN TIMOR-LESTE

The land taxation policy should reflect several criteria but be realistically based on the present context of Timor-Leste. The following model might serve as the initial approach, which could be fine-tuned as the processes of land and property rights systems are established.

1. The fundamental issue for effective taxation systems concern local participation, accountability and decentralization. To mobilize local people's participation, it is important that they not only pay land and other related taxes to governments, but that they also control decisions to invest their taxes in their own communities for their own development. Therefore, it might be useful to involve the local government body not only in collecting taxes but in retaining a significant portion of the revenue collected to finance community development work at the local level. A small portion of the resources mobilized locally could be transferred to the regional and central treasury beginning with say only 1-2% of the total amount.
2. For marketed cereal and cash crops, taxation should be based on the actual volume marketed rather than the amount produced. This can be integrated into the market system and revenue generated to finance public sector developments. Again, the mechanism for collection of these taxes should be entrusted to the local entrepreneurs with the same principal of retaining major revenue for local infrastructure development and sending only a small portion of the amount collected to the central treasury.
3. These proposed models do not make any extra demands on human resources. In addition, they would contribute to local-level development and also generate a small but sustainable revenue source for the central government.
4. Concerning most major land valuation systems, valuations should be developed based on private use and ownership and should reflect "market values." But in situations such as East Timor's in general and Dili's in particular, where the market system is not developed and where there is a lack of policy direction, it will be helpful to classify the land for valuation by combining zonation and strategic location of the land as defined by the existing legislative structure in several developing countries.
5. The system of land valuation for private property could for example be based on such factors as: dimension and type of terrain, location, existing services (including size and condition of the building

in city area or the proximity of markets for agricultural produce marketed) and the actual use of the land resource.

6. With such dimensions incorporated in zonation, the valuation method for agricultural lands then could be based on current uses. The main uses for rural/urban lands with established property rights, for example, then could be agricultural (irrigated, non-irrigated, upland-lowland, cash vs. cereals, permanent vs. seasonal vegetables, private forestry plantations vs. agro-forestry), residential, and commercial (including retail and industrial).

7. For public land property used by the community at large and state-owned resources, when issues of right transfers arise, it should be noted that customary uses of resources must be respected and property rights assigned as a first priority. Only after this process can the remaining land and related property be transferred to the needy individuals based on the criteria established by the State.

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