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Best Practices in Fiscal Reform and Economic Governance

IMPLEMENTING PROPERTY TAX REFORM

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The property tax is one of those good ideas that has not yet caught on. It has great revenue potential, its burden rests with middle and upper income families, and it distorts business and consumer economic decisions less than do other taxes. It is a mainstay of the local government finance system in many countries—central governments usually do not want to bother with it—and it could be an important part of a national fiscal decentralization strategy. Yet, the property tax has failed to become a significant revenue producer, raising only an amount equivalent to about 0.6 percent of GDP, on average, in developing and transition countries.

This note draws from experience in designing and implementing property tax reforms around the world. The goal is to draw lessons and provide guidance that will help developing and transition countries overcome obstacles to successful property tax reform, and introduce a viable, modern property tax that delivers on all its promise.

Box 1. Property tax reform—Recent USAID experience

- Afghanistan: 2004–2009
- Bosnia and Herzegovinia: 2005–ongoing
- Jordan: 2009–ongoing
- Macedonia: 2003–2007
- Montenegro: 2001–2006
- Kosovo: 2001–ongoing
- Vietnam: 2009–ongoing

Why property tax has not lived up to its hype

The property tax has not been more revenue productive in low-income and transition countries for a number of reasons.

Typically, the tax base is significantly eroded by a combination of legal exemptions, undervaluation, and a failure to include all properties in the tax base. In many countries, less than one-half of property value is taxed. This is compounded by low collection rates. Voters, local governments and the central government all contribute to this weak performance. Voters resist increases in the tax, often strongly, even though effective tax rates are already quite low. Perhaps to avoid such resistance, local governments are often unwilling to implement the necessary policy and administrative changes that would remove preferential treatments and broaden the tax base. Moreover, in many cases the central government provides enough revenue in intergovernmental transfers that elected local officials are spared the political pain of increasing local taxes.

Transition economies have faced additional obstacles to effective property tax development. Under the socialist system, all policy decisions concerning property and other taxes were centralized and the local authorities were considered merely as implementing agents. To complicate matters, property markets were undeveloped, limiting options for establishing a viable tax base. However, in recent years, decentralization of government and democratization have led to adoption of strategies to increase the dependence of local authorities on own source financing and heighten the accountability of local officials to voters. Hence the growing importance of property tax reform, particularly in these countries.

Some pointers in guiding property tax reform

Property tax proponents have long advocated to redefine the property tax so that it might come closer to realizing its potential. Many have identified specific best practices, including administrative and policy reforms that have been broadly successful. But the setting, the culture and the politics are different from one country to the next, and so what "works" in Argentina may not work at all in Pakistan. Though specific practices may not be easily transferable, there are some generic rules for good property tax practice that can serve as a road map for property tax reform.

[1] This note was prepared by Steve Rozner and is based on Bahl (2009), "Property Tax Reform in Developing and Transition Countries." The views expressed in this publication do not necessarily reflect the views of USAID or the U.S. Government.

Box 2. A primer on the property tax

The property tax is an annual tax on real estate, i.e., land and permanent structures and improvements on the land. For present purposes, property taxes are distinct from one-off taxes on property transfers or on capital gains from such transfers, and from other levies with related bases, such as annual wealth taxes. The tax is usually, but not always, a local tax, and it is most commonly an ad valorem tax, founded on the concept of market value, although area-based property taxes are still seen in some transition countries of Central and Eastern Europe and Vietnam. The tax base may be the land only, land and buildings, or various permutations of these factors. If designed and applied correctly, the property tax can be a transparent, equitable, and stable source of revenues for local government. Voters are aware of the amount they pay each year, and can equate this with the benefits they receive from local services that they know to be financed by the property tax. Tax assessments are in the public domain and, therefore, the public can observe how the tax is applied to all properties and their owners. There is also generally a good correlation between assessed values and the ability of proper-ty owners to pay. Moreover, revenue from a market value property tax is generally predictable and buoyant, rising steadily with growth in the economy.

Those who might be in a position to design a reform package based on the international experience might consider the following:

Understand the existing conditions. Do a thorough diagnostic, specifically addressing what is working and what is not. This is a good way for government to get focused on what it most wants to accomplish with the property tax, whether it is revenue mobilization, fiscal decentralization, land use control, or something else. Several useful models for such a diagnostic are available, including models for countries as disparate as Pakistan, Montenegro, the Philippines and Jamaica.

Adopt a "policy first" stance. Unless the tax structure is simple enough to be efficiently administered, and fair enough to gain the confidence of the population, administrative reform by itself will not succeed. Administrative reform comes second, but of course is essential to the success of any reform.

Determine which tax base is best. These include several ad valorem, or value-based, approaches, including rental value, capital value of land and improvements, and land value, as well as the physical area approach (see Table 1). Though the international trend seems to be toward capital value of land and improvements, the fact is that any of the four can work effectively. The right choice needs to be determined by the specifics of the country. For instance, area-based systems are popular and relevant in countries where there is no formal land market, and little comparative sales data on which to base value estimates (such as in some of the transition countries of Eastern and Southeastern Europe). By contrast, the capital value approach is favored in countries where there is a longer tradition of land markets (such as in Latin America). Still a different approach might be taken where most property is held in leasehold (favoring rental value), or where the country has some large cities but is still heavily agrarian (favoring an ad valorem system for urban zones, and an area-based system for rural areas).

Restrict exemptions to those properties that meet certain criteria. These might include properties that are protected from domestic taxation by international treaty, properties used for "merit" purposes (e.g., schools and churches), and perhaps properties of low value. Other exemptions tend to be politically driven, erode the tax base substantially, and introduce unfairness to the system. Arguably the most problematic of the preferential treatments is that given to owner-occupiers, and to government properties. These issues are too sensitive to warrant a blanket recommendation to discontinue them, but best practice might dictate the following actions:

- Place a "sunset clause" on all exemptions. Make renewal dependent upon a successful evaluation. At a minimum, institute a periodic review of property tax exemption policy

TABLE 1. CHOOSING THE RIGHT BASE

Approach	Tax Base	Considerations
Capital Value of Land and Improvements	Market value of the property, i.e., the amount that the land and improvements would sell for in an open market	Works best when there is some objective evidence of sales values, though notional assessment is feasible
Rental Value	Annual value of the rent that can be reasona-bly expected in a fair market transaction	Best when rental is the main form of housing tenure, and when there are no rent controls
Land Value	Market value of land, inclusive of improve-ments made to the land, such as clearing, grading, and installation of utilities	Works best when there is ample vacant land on which to base value estimates. Can be used to encourage more intensive development of land, and avoids the need to value improvements.
Physical Area	Each parcel taxed at a specific rate, per area unit of land and structures, irrespective of value	Best when there is no formal land market and little comparative sales data on which to base value estimates. Has the advantage of simplicity, and is a good first step toward a transition to a value-based system.

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with the goal of determining whether exemptions continue to serve their intended purpose.

- Adopt the practice of valuing all property, whether taxable or exempt, and publish an annual tax expenditure note for the property tax quantifying the revenues foregone from exemptions and other reliefs.
- Charge a "payment in lieu" for government properties and for relevant non-profit uses of property. Payments can be set to approximate the costs of delivering local services to these properties and thereby compensate the government, at least in part, for providing such services. Many countries, including India, Kenya and Canada, apply some form of payment in lieu.

Decide on treatment of poor households. There is some rough justice and probably little revenue loss in exempting low-valued properties. On the other hand, the case for providing preferential treatment for pensioners or for larger family sizes would seem less easily justified.

Build the requisite property tax administration capacity. Best practice shows that all four steps in property tax administration (identification of properties, valuation, recordkeeping, and collections) must be part of any administrative reform program. To leave out even one of the basic pillars of administration may jeopardize the success of a property tax reform, whether in terms of revenue mobilization or any other objectives the reform was designed to achieve.

TRAINING AGENTS TO ASSESS PROPERTY VALUES

Source: USAID/Macedonia Decentralization Project

Box 3. Property tax reform in Montenegro

From 2001 to 2006, USAID assistance played an important role in property tax reform in the former Yugoslav Republic of Montenegro, in tandem with broader efforts to forge a new system of intergovernmental fiscal relations for the country. USAID advisors helped diagnose problems with the property tax system, presented reform options, helped prepare new legislation (enacted in 2001), and provided technical assistance, training, and equipment in the implementation of the reform. The new legislation, which came into full effect in January 2003, replaced a "schedular," area-based property tax riddled with exemptions, reliefs, and unclear language with a value-based tax collected directly by municipalities. It also granted municipalities the power to set tax rates within a prescribed range, from 0.08 to 0.80 percent of market value. During the first full year of execution, property tax revenues, which are now administered by local government finance offices, rose dramatically. The capital of the country, Podgorica, with about 15 percent of the national population, collected more than double the amount of revenues collected nationwide two years prior by the Republic-level Department of Public Revenues. Many other cities or municipalities have seen their revenue take rise in large multiples, some as much as nine-fold. Overall, property tax revenues in the Republic grew between 2003 and 2006 from 0.2 to 1.3 percent of GDP, putting Montenegro above the worldwide average. Analysts partly attribute the rise in revenues to the doubling in the value of real estate in Montenegro over this period. Without the new property tax, it is unlikely that local governments would have been able to benefit from this real estate boom.

Bring all properties on to the tax roll. A comprehensive land register, or cadastre, records details including the location, dimensions, tenure, ownership and value of each individual parcel of land. (The cadastre is often maintained in conjunction with other records, such as a register of titles or deeds.) Yet partial coverage of properties is a major problem in many developing and transition countries. There are two ways to move toward the goal of full coverage: (i) institute a GIS and tax mapping system for identifying properties; and (ii) adopt a unique parcel ID numbering system in order to link the various land, building and property tax records.

Concentrate administrative resources on improving the ratio of assessed to market value of property. In some cases, this will require strengthening a weak staff and revamping antiquated procedures. In other cases, it will require overcoming the lack of political will in government—for example, when the government resists or delays efforts to revalue properties as required by law. Reformers should proceed slowly until the local government shows its resolve to remove such constraints.

Eliminate or reduce the incentive to under declare the value of property transactions. This type of fraud typically results from the imposition of a property transfer tax, where such a tax exists. One way to minimize the risk of under-declaration is to reduce the transfer tax rate to a low level and put in place a workable system to challenge and over-turn under-declarations of sales values. Another is to abolish the transfer tax in favor of a capital gains tax on land transfers.

Adopt aggressive measures to raise the collection rate. This is especially important in low income and transition countries where collection rates tend to be miserably low. A more horizontally equitable tax structure can contribute to this by removing preferential treatments. This will give taxpayers a sense that the

FIVE STEPS TO PREPARING A PROPERTY TAX REFORM

Step 1: Do a Diagnostic of the present system and prepare a Policy Paper that outlines the structural and administrative reform program.
Step 2: Reform the Tax Structure. Concentrate on the Choice of a Tax Base, on Rate Structure and on Exemption Policy.
Step 3: Administrative Reforms a) Increase Coverage (GIS, mapping) b) Upgrade Valuation (Training, Procedures) c) Unified Record Keeping (Interagency cooperation and unique numbering system) d) Improve Collection Rate (Reduce preferences, reduce compliance cost, toughen enforcement)
Step 4: Reform the Property Transfer Tax to remove the incentive to under-declare the value of property sales.
Step 5: Establish a Monitoring Activity with quantitative indicators of success with property tax reform.

property tax is fair, and might even increase property owners' willingness to pay. Furthermore, reducing compliance costs—for instance, by establishing collection points at banks or neighborhood offices—can also go a long way to increasing compliance and, ultimately, collection rates. But still, the major route to increasing the collection rate is for the local government to enforce the tax according to the provisions given in the law. Again, it is a question of the will of the government to establish a strong, sustainable property tax.

Establish monitoring systems and capacity. The local (or central) government should establish a monitoring activity that will help with tracking the success of a reformed property tax. The following are some of the important components of such diagnostics:

- Carry out an annual sales ratio study of properties in order to track the disparity between the sales value of property and the actual market value.
- Do an annual analysis of the collection rate.
- Prepare an annual tax expenditure note for the property tax in order to track the cost of exemptions.
- Track the activities of the property transfer tax office in terms of declared vs. actual values of property, and the percent of unchallenged declarations.
- Do an annual breakdown of revenue collections by subcategories, e.g., by zone, use (residential, commercial, rental), etc.
- Prepare an annual delinquent list, classified by status (collectible or bad debt).

Phase property tax reform. With the above guidance in mind, analysts should recognize that developing and transition countries cannot move immediately to the level of practice in industrialized countries. A better route would be to define a long-term plan for improved property taxation, and to implement the reform program over a period of years. A planned transition, one that both allows the administration to catch up and allows taxpayers to get used to the new system, is the best route to success.

SOME FINAL THOUGHTS

Experience has shown that the property tax works best as a local government tax, as evidenced by its important role in financing local government expenditures in industrialized countries around the world. Yet fiscal decentralization, and particularly the notion of empowered, self-reliant local governments, has not yet been as warmly embraced in developing and transition countries as it has in richer ones,

An interesting implication here for fiscal planners, and for those who would provide assistance to them, is that the demand for property tax financing is likely to grow in the future as local governments play a larger role in service delivery. This could become an important consideration as donors, analysts and policy makers map out country strategies for property tax development.

Suggested readings:

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