PROPERTY TAX REFORM IN DEVELOPING AND TRANSITION COUNTRIES

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Executive Summary

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.

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.

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 in different countries, 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 roadmap for property tax reform. Those who might be in a position to design a reform package based on the international experience might consider the following.

First, do a thorough diagnostic of the existing system of property taxation, examining specifically what is working and what is not. This is a good way help government focus 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.

Second, government reform packages would do well to 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.

Third is the difficult question of which tax base is best: rental value, capital value of land and improvements, land value, or physical area. 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 (such as in 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).

Fourth is the need to restrict exemptions to those properties that meet certain criteria, such as properties that are protected from domestic taxation by international treaty, properties with merit uses (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 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, to reflect or approximate their use of local services.

Fifth is the question of how poor families should be treated under the property tax. There is some rough justice and probably little revenue loss in exempting low-valued properties. But, the case for providing preferential treatment for pensioners or for larger family sizes would seem less easily justified.

Sixth, 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.

Seventh, a key step in administrative reform is to bring all properties on to the tax roll. Partial coverage 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.

Eighth, 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.

Ninth, remove or reduce the incentive to under declare the value of property transactions which results from the imposition of a property transfer tax. One way to do this is to reduce the transfer tax rate to a low level and put in place a workable system to challenge and overturn under-declarations of sales values. Another is to abolish the transfer tax in favor of a capital gains tax on land transfers.

Tenth, adopt any reasonable measures to raise collection rates, especially 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 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.

Finally, 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 sub-categories.
- Prepare an annual delinquent list, classified by status (collectible or bad debt).

Table ES-1. Five Steps to Take in Preparing a Reform of the Property Tax

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 underdeclare the value of property sales.
Step 5: Establish a Monitoring Activity with quantitative indicators of success with property tax reform.

Finally, 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 the taxpayers to get used to the new system, is the best route to success.

Property Tax Reform in Developing and Transition Countries

Roy Bahl*

1. Introduction

Practitioners and scholars have scrutinized the impacts of the property tax and have argued its merits and demerits for years. The literature is voluminous.[1] Moreover, both external donors and national governments continue to invest significant resources in strengthening the property tax and its administration. Despite all of this attention, and the good work that has been done in designing more efficient property tax structures and administrations, in developing countries around the world, property tax revenues still account on average for less than one percent of GDP and less than 4 percent of all tax revenues. The record is only slightly better in the transition countries of Central and Eastern Europe and the former Soviet republics.

Despite this weak revenue performance, property tax reform remains high on the agenda in many developing and transition countries. The interest in its revenue potential continues and both analysts and government officials keep searching for the breakthrough reform that will make it more revenue productive. And rightfully so. It is in many ways an ideal tax for local governments in low-income countries. It can act as a benefit levy, is progressive in its distribution of burden, and has significant revenue potential. Moreover, it is generally available to local governments and the laws for its implementation are usually in place. Success with the property tax in developing and transition countries lies in structuring it to fit country circumstances, and then having a plan to let it develop into a proper levy on property values. Defining such a structure is no easy task, but it might be helped by understanding why the property tax has not yet reached the takeoff point in many low-income countries.

In this paper, we review the practice of property taxation in developing and transition countries, and use this history to suggest a roadmap for reform. We begin with a discussion of the conventional wisdom about the advantages of using the property tax, and of the reasons why this conventional wisdom does not necessarily travel well to the developing country setting. This discussion is important to understanding the constraints to successful reform. Next we explore the variation in the revenue performance and look for patterns that might explain why some countries do better than others. Then we turn to the practice: the rate and base structures, and the administrative practice. We conclude with a discussion of "best practices" and how these might move the property tax closer to realizing its revenue potential.

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[1] Four books of essays that review property tax practice in developing and transition countries are Bahl (1979), Bird and Slack (2004), Bahl, Martinez-Vazquez and Youngman (2008; forthcoming), and Youngman and Malme (1994).

2. Why the Enthusiasm for Property Taxation?

The property tax has inherent advantages that recommend it for use in financing local government services. These advantages are evidenced in the case of many industrialized countries where the tax is relied on heavily as a subnational government revenue source. Economists and administrators working in these countries cite a number of benefits in supporting the "good tax" argument for the property tax.

First, the property tax has significant revenue potential, and in fact averages more than 2 percent of GDP in industrialized countries. However, even among the OECD countries there are great variations—from Austria and the Netherlands, where the share of property tax in GDP is quite low, to Canada where it exceeds 3 percent. Yet, as mentioned above, the revenue yield of the property tax is almost always very low in the case of developing and transition countries.

Second, the property tax is often a more equitable way of generating government revenues than are many other levies. If one accepts the benefit view that the property tax is a charge for local government services, the equity case is made. People shop for a community that provides the services they want, and then pay for these services with the property tax. Alternatively, they vote for the political leaders who promise that tax-spending package. If, on the other hand, one accepts the "new view" that property taxes are not benefit charges and that the burden of the average national tax on property falls on owners of capital, then the equity test is met in terms of ability to pay: there is generally a good correlation between assessed value and property owners' capacity to pay the tax bill.[2] Either way, the case that the property tax is a regressive levy is not easily made, either in developed, developing or transition economies.

Third, it can be argued that the property tax is fair because those owning property of the same value, or paying the same property rent, are subject to the same tax. This advantage depends, however, on assessment being efficiently done, and on a minimum of exemptions and preferential treatments in the tax laws. Neither of these conditions is met in most developing and transition countries.

Fourth, the property tax is seen to be less distortive than alternative local taxes because as a tax on housing, it is levied on an immobile factor. This advantage has to be qualified, since capital invested in structures in general and nonresidential activities in particular is in fact mobile. Indeed, a higher property tax can drive capital to lower taxing jurisdictions. However, at present and foreseeable levels of the property tax in developing countries, this kind of distortion is not likely to be a concern.

Finally, the property tax has the potential to be very transparent. Voters are aware of the amount they pay, and can equate this with the benefits they receive from local services that they know to be financed by the property tax. There is much less transparency in the case of developing countries, at least in terms of current practice. While property owners are aware of the amount of tax that they pay, it is doubtful that they can equate this burden with the benefits from services financed by the property tax. However, fiscal decentralization—shifting increasing spending responsibilities and revenue autonomy to subnational levels of government—is still relatively new in most low-income and transition countries, and more transparency will emerge as these regional and local governments are strengthened.

What we can conclude is that some of this conventional wisdom on the advantages of the property tax can be made to fit the developing and transition country setting, but some of it cannot, at least for the present. The setting is in fact very different. Property markets are not well developed in most low income and transition countries, there is a paucity of reliable evidence on transaction values, and administrative

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[2] For a good discussion of the equity and efficiency dimensions of the property tax in the US, see Zodrow (2001).

capacity is much more limited. Moreover, the tax base almost always is narrowed by legal exemptions, perhaps even more so than in industrialized countries. The result is that taxes are paid on a base that often bears little resemblance to the true level of property values. These constraints to good practice need not be permanent, however, and they can be removed or eased over time. The caution we continue to return to in this paper is that analysts and policy makers need to structure the property tax to fit the circumstances of a particular country, rather than trying to emulate the practice in industrialized countries. If a proper development plan for the property tax is put in place, it can evolve over time to realize many of its potential advantages.

3. Democratic Local Governance and the Property Tax

Broadly defined, fiscal decentralization is *the empowerment of people by the empowerment of their local governments* (Bahl, 2008). The key term here is "local government." Fiscal decentralization is all about passing budgetary authority from the central government to elected subnational governments in the form of the power to make taxing and spending decisions. All over the world, local governments are demanding more autonomy to realize this empowerment.

A number of conditions must be met in order for local governments to capture the benefits of moving to a decentralized system: elected local councils with the power to hire and fire chief local officers, significant expenditure responsibility and autonomy, and independent taxing powers are three of the most important. With respect to the latter, local governments empowered by their voters should have the ability to set at least the rate on some taxes. This is important to democratic local government because it allows the local population to hold the political leadership accountable. The test to which politicians will be subjected by local voters will be a much harder one if voters pay for services than if services are financed exclusively by a transfer from the center. Moreover, local revenue raising powers are a condition for holding subnational governments to a hard budget constraint.

The property tax can play a key role in this democratic governance process. It is one of the few levies available to local governments that fit the criteria for a good local tax. Most of its burden falls within the local area, so it is a tax that presents local residents with a "price" for local services provided. It is transparent in that those liable know the amount they pay each year, and can use this information to hold their elected officials accountable for services delivered. The property tax is much more in step with local government accountability than are the intergovernmental transfers that now dominate local government financing in developing economies.

4. Revenue Performance

The best comparable data on the revenue yield of the property tax in developing and transition countries suggest an average yield equivalent to only about 0.6 percent of GDP (Table 1).[3] The corresponding per capita amounts can be very small, for example $0.4 in Vietnam, $3 in Egypt, $8 in Indonesia and $19 in Kazakhstan. De Cesare (2004) finds a similar result in her survey of the practice in Latin American countries.

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[3] The IMF does not report the annual property tax separately in its *Government Finance Statistics Manual* (GFS) or in the annual *GFS Yearbook*, but includes it with taxes on the use, ownership or transfer of wealth. Their definition includes property taxes that are levied at regular intervals, one time only, or upon a change in ownership.

Table 1. Property Tax Revenues Trends (Percent of GDP)

	1970s	1980s	1990s	2000s
OECD countries	1.24	1.31	1.44	2.12
(number of countries)	(16)	(18)	(16)	(18)
Developing countries	0.42	0.36	0.42	0.60
(number of countries)	(20)	(27)	(23)	(29)
Transition countries	0.34	0.59	0.54	0.68
(number of countries)	(1)	(4)	(20)	(18)
All countries	0.77	0.73	0.75	1.04
(number of countries)	(37)	(49)	(59)	(65)

Note: The average for the 2000s is for the years 2000 and 2001.
Source: Calculations in Bahl and Martinez-Vazquez (2008) based on data taken from International Monetary Fund (various issues).

Bahl and Martinez-Vazquez (2008) point out that developing countries may not use the property tax more intensively than do OECD countries, but they often rely more heavily on the property tax to finance local government expenditures. For example, Thailand's house and buildings tax accounts for about 80 percent of local government revenue (Varanyuwatana, 1999), and the property tax is 25 percent of local government revenues in Kenya (Olima, 1999), 36 percent in Chile, and 40 percent in Poland. In the 36 largest cities in India, the property tax accounts for 28 percent of own source revenue (Mathur, et. al. 2009). De Cesare (2004) reports a survey of 52 municipalities in Latin America that shows the property tax to account for an average of 27 percent of local government tax revenue. The same is true in transition countries. For example, property taxes accounted for 8 percent of local own source revenue in Central and Eastern European countries (Sulija and Sulija, 2005). This gives a different perspective on the issue, i.e., that the property tax in developing and transition countries is an important part of the strategy for fiscal decentralization even if it is not an important part of the strategy for overall government revenue mobilization.

A number of hypotheses have been offered about why property tax revenues are so low in these countries. Arguably the most important reason is that the property tax works best as a local government tax, and fiscal decentralization has not been as warmly embraced in developing and transition as it has in industrialized countries (Bahl and Martinez-Vazquez, 2008). Developing and transition countries are generally less decentralized and therefore use the property tax less. 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 one plans the long-term strategy for property tax development.

One of the most common explanations for the consistently poor performance of the property tax in lower income countries is that the administration of the tax is inefficient. The barriers to efficient administration include the absence of a full and up-to-date survey of all land (urban and rural), records of title that would enable the determination tax liability, and reliable data on the sales price of properties. Putting the human resource infrastructure and the information base in place to efficiently administer the property tax is an expensive proposition. At current yields of the property tax, it would be difficult to justify such outlays, by either the central or the subnational levels of government (Bahl and Wallace, forthcoming). The result is that most developing countries improve their administrations with marginal upgrades, rather than with comprehensive reforms. Revenue increases, it follows, are also marginal.

Another contributing factor in this weak revenue performance in developing countries is the social engineering of the property tax that sometimes leads to a dramatic narrowing of the base. One of the most popular (and costly) of the preferential treatments is that for owner-occupiers. A recent study of Punjab province in Pakistan estimates that bringing owner-occupied property fully into the tax base would triple the level of provincial property tax revenues (Bahl, Wallace and Cyan, 2008).

Sometimes local government property tax revenues are low because policy is in the hands of central governments that are more or less disinterested. Local government property taxation is a relatively new tradition in transition economies. Under the socialist system, all policy decisions were centralized and the local authorities were considered as implementing agents. However, democratization and decentralization of government decision making has made the property tax an increasingly important instrument of local government financing, from the Baltics to the countries of Central, Eastern and Southeastern Europe (see Box 1).

Box 1. Recent Property Tax Developments in the Transition Economies

Democratization and decentralization of government across the transition economies of Central and Eastern Europe have led to the adoption of strategies to increase the dependence of local authorities on own source financing and heighten the accountability of local officials to voters. In Estonia and Poland, for instance, local governments have been delegated the authority to establish tax rates within defined limits. In Hungary, the local governments now can decide whether or not to tax real estate. In other countries, such as Lithuania, the municipalities are not empowered to determine property tax rates (Sulija and Sulija, 2005). More recently, the Baltic states have given more policy discretion to local authorities.

Similar trends have been seen in the former Yugoslav republics. Since 2003, Montenegro has allowed municipalities to levy and collect property taxes at rates within a defined range (Vusurovic, 2006). A similar arrangement has held in Macedonia since 2006 (Janevska, 2006). Croatia and Serbia have decentralized property tax administration. From 2006 onward, Serbia has allowed local governments to set tax rates (Begović, 2006), while Croatia allows them to choose a rate from a given range (Pavić, 2006). Meanwhile, Slovenia's 2006 property tax law leaves local governments some discretion to determine the rates, although the National Tax Authority has taken over collection responsibility from local governments (Žibik and Mitrović, 2006). In most countries in the region, the reforms have ensured that property tax revenues are used to finance local government expenditures, and in most cases the revenues are allocated through local government budgets.

The politics of imposing and enforcing the property tax presents additional challenges. In many countries, local councils are charged with approving new valuation rolls, but they often do this with great delay out of fear of voter reprisals. The Nairobi revaluation in the early 1980s is a good example of what can happen when a valuation roll gets too far out of date. Rapid urbanization had driven up property values dramatically, but general rate increases rather than revaluation had been used to generate property tax revenue. Kelly (2000, p. 47) reports that residential values had increased by 600 percent, commercial values by 250 percent and industrial land values had fallen by 225 percent. The introduction of the new roll, and the shifts in relative tax burdens that it brought, were met with great public outcry. The intervention of two central ministries and two cabinet papers were required before the roll was finally adopted.

Politicians may also try to minimize their exposure to such situations by capping the growth in the property tax. This is widespread practice in the United States and is now also found in developing countries where some governments have turned to the use of legal property tax limits, such as in Buenos Aires and in Bogota**.**

There are other areas of property tax policy and administration where political pressures compromise good practice. Since wealthy individuals and businesses usually represent a large component of the potential tax base, elected local politicians may often find it politically difficult to bring aggressive enforcement measures against delinquents. Local governments may also be pressured to provide exemptions to the politically powerful.

The other side of the enforcement question is whether local politicians have adequate incentives to raise higher levels of revenue from the property tax. Few politicians want to advocate an increase in any tax. At the same time, it is often the case that revenues from intergovernmental transfers are large enough to cover basic budget needs.

What to make of all of this? Politicians are loath to raise taxes, but are pressed for alternatives to finance improved local public services. When intergovernmental transfers do not satisfy the budgetary needs of local governments, they will often turn to property tax reform. The challenge then will be to fix the legal structure of the tax and to begin improving the information base necessary for its effective administration.

5. The Annual Property Tax in Practice: Policy Choices

The legal structure and implementation of property taxation in developing and transition countries varies so widely that one really cannot refer to “the” practice. The tax may be levied by local governments (Brazil), state-provincial governments (India), or in many cases it is under central government law (Chile, Lithuania, and Indonesia, to name a few). Depending on the country, the base of the tax can be: (a) annual rental value, (b) capital value of land and improvements, (c) capital or rental value of the land, or (d) land/improvement area. McCluskey, Bell and Lim (forthcoming) surveyed the practice in 122 countries and report that 52 countries have some form of capital value tax base, 37 use annual rental value as the tax base, and 16 have some form of unimproved value base (site value or land value). Within these general categories, there are all sorts of variations, including four countries that tax only improvements, 44 that use an area basis for assessing taxable value, and several that allow local governments to choose their base. The path to successful reform is likely to differ greatly from country to country. The sections that follow describe the four basic approaches to determining property value, highlighting the merits and demerits of each.

5.1 Rental Value Systems

Many countries, particularly former British colonies, tax the annual rental value of properties. Those using the rental value system include such diverse economies as India, Nigeria, Malaysia and Trinidad.

The tax base is the rent that can be reasonably expected in a fair market transaction. In practice, the actual tax base probably bears little relationship to market rent in any developing country using this system. The paucity of data on rents actually paid takes away the ability to use direct evidence to make the assessment. To complicate matters, there is the need to take account of physical differences on a premise-by-premise basis. Who would argue that, all else being equal, a two-bedroom flat and a four-bedroom flat in the same neighborhood would fetch the same rent?

The rental value approach poses a particularly difficult valuation problem in the case of properties that are not traditionally in the rental market, such as owner-occupied and industrial property. Another vexing problem with rental value systems is finding a resolution to the issue of the tax treatment of vacant land

and properties covered under a rent control act.

In spite of these challenges, countries have pushed ahead with building a tax roll based on annual rental value. The actual assessment approach relies more on expert judgment than on hard empirical evidence. In practice, three approaches are taken to determining rental value. First, estimated market rental values might be imputed to all properties in a neighborhood. The "guidance" values that are used to make this imputation may be based on available rent data from surveys, on expert judgment, or a combination of the two. This method is used for flats, some houses, and non-residential properties where there is some rental evidence available, and typically an adjustment is made for the area of the house. The best result that one can hope for under such a system is that variations in average rents paid in different areas are roughly reflected in the assessment roll.

The second approach to determining rental value is to estimate a capital value either from comparative sales data or by estimating the cost of acquiring the land and erecting the building(s) on it. This method is most often used for factories, larger commercial establishments, and for owner-occupied housing where good rental value comparatives are not available. Countries use very different capitalization rates to convert these capital value amounts to a rental equivalent. For instance, Malaysia's capitalization rate is 10 percent, while in Senegal it ranges from 3-8 percent.

Third is a profits approach where an annual rate of return is estimated for the property. Net profits are determined from the accounts of the firm, and the estimated amount of the landlord's share of these profits is then taken to be the annual rental value. While profitability may be objectively measured, the landlord's share is subjectively determined.

The result of this process—almost everywhere in the developing world—is dramatic underassessment. Even here we can only guess at the degree of underassessment because few low-income countries carry out sales-assessment ratios to gauge the quality of their assessment. Mathur (1996) gives a flavor of the degree of underassessment in his review of Indian local government finance. He cites assessment ratios of 50 percent or lower in Calcutta, and 25 to 35 percent in Delhi and Madras.[4]

5.2 Capital Value Systems

The capital value of land and improvements is the principal form of property tax base used in OECD countries and in most Latin American countries. The base in a capital value system is the market value of the property, i.e., the amount that the land and improvements would sell for in an open market. Sometimes the legal, taxable base is the full market value of the property, and sometimes it is discounted by a fixed ratio of assessed to full value.[5]

Capital value systems get around some of the practical issues that plague rental value systems. Since the legal base is the true market value, conceptual problems with defining the base in cases of vacant land, rent controlled properties, and determining the taxable value for land used for non-residential purposes are mostly eliminated. While the sales of properties are reported, they usually are not accurately reported.

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[4] The "assessment ratio" is the value of the property that is subject to tax expressed as a percent of the true market value of that property. For example, if a property has a true market rent of $10,000 but is assessed for purposes of property taxation at $4000, the assessment ratio would be 40 percent.
[5] In many Latin American countries, vacant land is taxed at a differentially higher rate, but in Peru, for example, it is not taxed at all (De Cesare, 2004).

McCluskey, Bell and Lim (forthcoming) report a worldwide trend of a shift toward the capital value approach. Certainly the concept of taxing property values is more easily understood than the concept of taxing rental value. It also seems in step with common sense notions of fairness because of the intuitive connection between the value of one's house and his wealth. Moreover, since the capital value base is much larger, the nominal tax rates will be lower, giving taxpayers the impression of a lower tax burden.

This is not to say that the capital value approach is easily implemented. The assessment of capital values for purposes of taxation is constrained by the absence of good comparative data on the sales value of properties. The problem is that transfer values or sales prices are often under declared, and usually not monitored in an effective way. In part, the under-declaration is attributable to property transfer taxes that often are levied at high rates (e.g., 6 percent in parts of Bosnia and Herzegovina, and 13 percent in Jamaica). There is likely great variation across as well as within countries in the quality of the data on the sales value of properties and oftentimes these data are supplemented by the "expert judgment" of assessors and real estate professionals.

In most developing countries, the actual valuation is made using a separate approach for land and buildings. The "cost approach" to valuation in Porto Alegre, Brazil establishes market value as the sum of land value and building costs (De Cesare and Ruddock, 1999). Land values (per unit of local area) are established by reference to recent sales of vacant land in each of a number of relatively homogeneous zones in the city. This land value is adjusted for each site, based on the physical characteristics of the site and the availability of infrastructure services. Building costs are estimated from an average cost per area unit (e.g., m^2) of construction of various types of buildings, discounted by a depreciation rate.

Many developing countries use the same approach as that taken in Brazil. Botswana, for example, values land and improvements separately but has greater reservations about using the land value data from declared sales prices of land (Monagen, 1999). The result is that expert judgment is relied on more heavily. There might be some rough justice in this approach. The right experts, taking a systematic approach, probably can do a reasonable job of estimating land value gradients in an urban area.

Other countries base their assessment on the total (land and improvement) value of the property. In Cyprus, there is no separate valuation of land and improvements; instead, the assessed value is based on reported open market sales. "…with the provision that they are reliable and genuine and not understated" (Panayiotou, 1999, p178).[6] In South Africa, sales data are used directly in the valuation of residential properties (Bowman, 2002, pp. 51-52).

An interesting possibility in a capital value system is to use a computer model that can take account of the characteristics of individual properties to identify the determinants of property values. The problem with such models is that they require accurate data on sales values of properties, a requirement that few developing and transition countries meet.

Another concern is that properties assessed using a capital value system would be just as prone to under-assessment as they would be with a rental value system. De Cesare (2004) reports a wide variation in the assessment ratio in Latin America, e.g., 30 to 35 percent in Buenos Aires, in Chile and in the state of Sonora (Mexico), 10 percent in Guayaquil (Ecuador), but nearly 90 percent in Bogota.

The administrative cost of capital value systems can also be high, although it depends to a large extent on

[6] Even where comparative sales values are available, the process of establishing values for individual residential properties is not an easy one. Adjustments of these estimates of average sales prices must be made according to factors such as the quality and size of the improvement, lot size, and accessibility to certain public services.

how well the assessment is done. If based on comparative sales, the cost can be very high. A reasonable estimate for revaluation in the United States, where comparative sales information is very good, is about $20 per parcel (Dornfest, forthcoming, based on data covering the 2000-2007 period). While costs in developing countries likely will be much lower, they will be high relative to per capita collections.

5.3 Land Value Systems

The tax base for site value systems is the market value of land, inclusive of improvements made to the land, such as clearing, grading, and installation of utilities.[7] Site value systems are used in such diverse places as Australia, South Africa, New Zealand, Denmark, Estonia, Jamaica and Kenya.

The land value base is distinctive. The main idea is to raise revenue, of course, but the impact on land use is an important secondary reason for choosing this tax base. The best known advantage of the land value tax is that it encourages the most efficient use of land. The argument is straightforward. If the tax is levied only on the land, the owner will have an incentive to invest in improvements that will maximize her return. Under a capital value system, by contrast, investment in higher valued improvements or in a more intensive use of land draws an increase in taxes.[8] Under the land tax approach, there is no distinction between the tax treatment of vacant land and any other land.

A second advantage is that a land value approach has lower administrative costs than a capital value approach because structures are not included in the tax base. Many developing countries already value land and improvements separately (and by different methods). In these cases, a land value system guarantees a lower administrative cost. The maintenance of the tax roll will also be easier since the physical characteristics of the land may change little over time, while structures are continually being improved and depreciated.

The assessment of land values is plagued by the absence of adequate, reliable data on transaction values for land transfers. Declared transaction values supplied by the stamp duty office usually are supplemented with expert judgment and other evidence of land values (e.g., bank mortgage information and real estate listings). The expectation is considerable underassessment, just as it is the case with assessing property values under a capital value system. Sjoquist (2005) estimated the median ratio of assessed to market value in Jamaica in 2003 to be about 11 percent. Kelly (2000) reports the assessment ratio to vary between 20 and 80 percent for Kenyan municipalities.

Even if the issue of under-declaration of sales values can be resolved, there remains the question of whether there are enough sales of vacant lands in various neighborhoods to impute land values to all properties in the taxing jurisdiction. As urbanization continues, this will be an increasingly important issue. Franzsen (2009) says that this challenge to appraisers already has led them to rely on sales from adjacent neighborhoods to estimate land values, which may compromise the integrity of the traditional method of imputing land values. If there are not enough vacant land sales in the jurisdiction, it may still be possible to “back out” a land value by using one of a number of accepted appraisal techniques (Bell, Bowman and German, forthcoming).

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[7] For a good discussion of the taxation problems arising from differentiating between improvements to the natural land (e.g., drainage and grading) and physical structures, see Oldman and Teachout (1979).
[8] For a comprehensive review of the merits and demerits of land value taxation, see Dye and England (2009).

A problem with the site value approach is that the aggregate value of the tax base for a jurisdiction is smaller in nominal terms because improvements are not included. As a result, the statutory tax rate must be higher to yield any given amount of revenue. This can cause taxpayer resistance, because higher nominal tax rates appear to imply higher tax liability. Another common argument against the land value approach is that it places a lighter burden on those properties with visible, high valued structures. Whether this is a valid argument or not, it can nevertheless cause considerable taxpayer discontent.

Finally, limiting the tax base to land may result in some arbitrary rules in assigning tax liability within multi-unit structures in cases where there is not a private or single owner of land. For example, a newly proposed property tax law in Vietnam would prorate a higher share of land tax to first floor apartments than to those on higher floors, presumably to reflect better access to public services (Gallagher, 2009). Such prorating is bound to be arbitrary.

5.4 Area-Based Systems

The area-based approach to property taxation in developing countries has caught on, and is now used in at least 44 countries (McCluskey, Bell and Lim, forthcoming). The idea is a simple one. Each parcel is taxed at a specific rate, per area unit of land and per area unit of structures.[9] The area approach is widely used in Central and Eastern Europe, as well as in Vietnam, where property markets are not well developed (Bird and Smart, 2004, Table 2.2). As is discussed below, this relatively simple approach brings both advantages and disadvantages.

The advantage of the area-based system is that it does not require parcel-by-parcel valuation, or it may not require valuation at all. It is, therefore, easily understood and more easily administered than *ad valorem* (value-based) systems. It offers the possibility of imposing a property tax in countries where there is only a fledgling property market or no property market at all. Countries that have taken advantage of this possibility include China, Hungary, Kosovo, Slovakia, Slovenia and the Czech Republic.

Area-based systems range from a "pure" form where the tax is actually imposed on physical area irrespective of value, to a hybrid where physical area is used as a key input in mass appraisals of value.[10] The pure area version is easily understood and passes the transparency test. The appeal of the area-based approach is that it solves the valuation problem by simply not valuing, and it would appear to be acceptable to many voters so long as the tax rate is kept low. The only relevant test of the coverage of the base is whether all the taxable area has been accurately reported and properly classified (e.g., residential, commercial, etc). Indeed, the pure version of the area-based property tax is very much like a specific rate excise tax, charging a uniform, flat rate on each unit of a "good".

But the advantages of a pure, area-based property tax come at a cost. It hardly seems fair, for instance, to tax a property based on its size (area) without considering the quality of any improvements or the access to amenities. A rented flat that is sewered and fronting a paved road with streetlights will be assessed the same tax as one with equal area but reliant on a septic tank and no access to good transportation services.

The other problem is that the area-based system can only generate increased revenue through growth in the number of buildings, or by periodic, unpopular tax rate increases. There is no automatic growth in the

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[9] By contrast, under a capital value approach, each parcel is *valued* at a specific rate, per area unit of land and per area unit of structures. A separate tax rate is then applied to the total value.

[10] Bell, et. al. (2008) have surveyed the practice of area-based property taxation and show that there is a wide variation in the actual practice.

tax base. It is precisely this lack of revenue buoyancy that often dooms the area approach. There are many examples of property tax revenue growth remaining flat even while property values were growing rapidly (e.g., in Vietnam in the 2000s).

In some developing and transition countries, the pure version of the area approach is applied (Bell, et. al., 2008). Nigeria's "spot value assessment" is area based, but only applies to tenements where rents are very low. A very similar area-based approach is used in Namibia and in Poland. In the Czech Republic, an area-based system is used, but rates vary across cities depending on the level of development.

Under a slightly more complex version of the area-based approach, the local government area is broken into zones with each zone subject to a different rate depending on the amenities available. In effect, this converts the pure area-based system into a banded property tax where tax liability depends on the basic tax rate and the location value of the property. This version of the area-based system is less simple, and in some cases not very different from the value-based systems discussed. In fact, it might be better referred to as "area-based assessment" where the location and the physical characteristics of a property are used to estimate value, in lieu of information on sales values of individual properties.

Bell, et. al. (2008) points to a few examples of such a hybrid system. The tax base in Chile, for example, is calculated by a formula that includes a value per square meter for each zone, based on municipal land value maps that take into account the use and location of a property. A similar system is used in Indonesia. In Romania, cities are classified, presumably according to the quality of services, and then a rent gradient is determined for each city, which also reflects access to services. This defines the tax rate, which is then applied to the land area. Hence, there is some concept of value built into the tax rate.

This version of the area-based system is subject to two of the same problems that are also found in the pure area-based system. First, to gain more revenues, either the nominal tax rates must be increased, or the zone to which properties are assigned must be changed. Second, the location zone to which a property is assigned is usually done on a judgmental basis, and each "zone" contains a wide mix of property types and qualities with some variations in access to amenities.

Again, the revenue buoyancy problem is the most serious. Even with a "graduated" area-based system, collections may remain nearly constant even while property values grow. The discretionary rate increases required to resolve this problem are politically painful, and the temptation to live with poor revenue performance is great. However, some localities have introduced innovative measures to overcome this problem. Bangalore City in India, for instance, has addressed it by holding the specific tax rate constant but changing the zone to which a property is assigned (See Annex B).

Area-based systems have gained acceptance because they appear to simplify the tax by not calling explicitly for valuation. Yet, as noted above, this may be false advertising. In fact, the location value version of the area-based approach has long been in play in developing countries. The most common approach to valuation is to determine a land value map for areas within the jurisdiction and apply those unit values to the land area, and then to value buildings according to construction cost and physical characteristics. Still, the unassailable advantage of the area-based approach is that it enables the imposition of a property tax when there is no property market—that is, when there is no direct evidence on the market value of properties. As such, it might be an appropriate interim, if not long term, approach for a country while it waits for its formal property market to develop. The transition countries of Eastern and Southeast Europe are a good case in point.

5.5 Which is the Best Practice?

There is no easy answer to this question for developing and transition countries, and certainly no general agreement among either analysts or policy makers. If the test for "best" is the most common practice in developing countries, then the preference would seem to be for a capital value system where both land and improvements are taxed.

In making the choice of a base, most low-income countries probably would do best if they focus on administrative considerations, i.e., adopt a system that they have a chance to effectively administer. For most developing and some transition countries, and particularly for low-income areas within developing countries, this might suggest the area-based approach. In other words, convert the property tax into a specific excise tax. Standing against this, however, is the unfairness of the area-based system and the possibility that it will not generate adequate revenue growth. One might justify living with these disadvantages by noting that a crude area-based approach is a transition measure that can be abandoned once a complete tax roll and some capacity to do basic valuation are in place. But culture and the setting do seem to matter. Bangalore has adopted an area-based approach as a transition measure and has developed a method for generating revenue growth at the time of revaluation (See Annex B).

This all leads us to the conclusion that the best system for a given country probably depends on the present state of property markets, housing tenure, and on what that country most wants to accomplish with its property tax (See Table 2). The following list is illustrative.

- If the goal is to treat taxpayers equitably, then any of the value-based systems can work well, depending on how assessment is done. The more use that is made of notional methods of assessment, and the more use that is made of mass appraisal, the less fair the system will be. Area-based systems would not score well on an equity scale.

- McCluskey, Bell and Lim (forthcoming) suggest looking for the strongest correlation between the availability of transaction data and the property tax base. In other words, if most property is held in leasehold, then the focus might be on annual rental value. If tenure is dominated by owner-occupancy, there is a stronger argument for an (improved) capital value base.

- If the country has some large cities but is still heavily agrarian, then a combination of an ad valorem system for urban places, and an area-based system for the more rural areas, may work best.

- In urban areas where land is subject to speculation, or is not being developed intensively, a social cost might be imposed. In this case, a land value tax might be considered preferable for its ability to encourage efficient land use.

- Where no real property market exists, the area-based system is the only feasible choice. In some countries, land ownership is not in the private sector, e.g., in Cuba and China. In other cases, privatization and restitution of property rights has opened the door to private ownership but, not surprisingly, well functioning land markets have been slow to follow. Land registries and cadastres are weak, another inheritance from the socialist system. Valuation is still, therefore, plagued with issues requiring attention. And, vital property records are still developing. For instance, Slovenia still does not have a concept of registry of property, causing problems in the identification of the property tax base. Similarly, local government databases in Croatia are generally incomplete and not regularly updated.

- If the goal of the system is to treat the property tax as an extension of the individual income tax, then a rental value system might be considered. Since rental income is often under-declared for income tax purposes, the property tax can be seen as a backup.

- If the property tax is seen as a wealth tax, then a capital value or a land value property tax would seem a reasonable approach.

Table 2. Property Tax Bases and Considerations in Choosing a Base

Tax Base	Considerations
Capital Value of Land and Improvements	Works best when there is some objective evidence of sales values, though notional assessment is feasible.
Rental Value of Properties	Best when rental is the main form of housing tenure, and when there are no rent controls
Capital Value of Land	Can be used to encourage more intensive development of land. This approach also avoids the need to value improvements. Works best when there is ample vacant land on which to base value estimates.
Area	Is best used when there is no formal land market, hence no 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.

Finally, if the lens is strictly revenue mobilization, then the right approach is very straightforward: establish a broad tax base (few exemptions) and then capture the level and the growth in property values with an efficient assessment process. Any of the rental value, capital value and land value bases can do this, depending on how willing the local authorities are to set the effective rate at a high enough level, how willing they are to revalue property, and how willing they are to reduce or eliminate exemptions.

5.6 Tax Rates

In practice, many different tax rate structures are used in developing and transitions countries. Some of the more common choices made in developing countries, and the rationale for their use, are described in Table 3.

In terms of the authority to set the nominal tax rate, there is a wide variation in the practice. Sometimes local governments may set the property tax rate, sometimes they are permitted only to choose a rate within a prescribed range, and sometimes the rate is set by a higher level government. The choice usually depends on the commitment of the higher level government to fiscal decentralization. Since the property tax is usually a local government revenue source, the accountability of elected local officials can be enhanced if the responsibility for rate setting is placed at the local government level.

Best practice on rate setting is to choose a simple rate structure in order to minimize complexity in administration and to encourage compliance. Good valuation can take account of differences in ability to pay, so discriminatory tax rates should not be necessary in that regard. Rate differentiation is a poor substitute for good valuation. The exception to this general rule may be vacant lands, which may be protected by the law from equivalent property taxation.

Table 3. Property Tax Rates: The Practice

Practice	**Rationale**
Flat *ad valorem* rates	Simplest way to tax property value
Flat *specific* rates	Simplest way to tax an area base
Progressive *ad valorem* rates	Build more equity into the system by taxing higher valued property at highly nominal rates
Differential rates applied to different types of property, with non-residential property tending to be taxed at the higher rates and agricultural property tending to be taxed at lower rates.	Usually to protect agricultural property from higher taxes, and to capture the greater tax paying capacity of commercial and industrial firms.
Different rates applied to land and structures. Sur rates applied as a penalty for keeping "priority lands" out of development or for underutilizing land. (e.g., Brazil, Venezuela and Senegal).	To encourage the development of vacant and underutilized land.
The tax rate is applied to the *total value* of an individual's land holdings (Peru).	To penalize concentration in the holding of property wealth.
Annual increase in tax rates to compensate for the failure to revalue (indexing).	To protect revenues when revaluation is postponed.

5.7 Exemptions and Relief

The objects of property tax relief might be divided into four classes. The first are those properties that are tax free by international convention (e.g., foreign embassies) or by virtue of a merit use of land (e.g., schools and churches). Nearly all countries include these on the list of exemptions from property taxation and there is little controversy here.[11]

Second are exemptions given to protect low-income families. The most common form here is the forgiveness of property tax for those who live in properties valued below some threshold level. Since the poor usually live in areas that are not well serviced and therefore have low assessed values, there is some rough justice here. Countries choose very different exemption levels based on the value of property. Another justification for exempting low valued properties is that the cost of collection in such areas could be as much as the revenue take, if not more.

[11] Best practice includes placing a qualifier on such exemptions—that properties not used for the main purpose of the organization are taxed. For example, the church sanctuary can be exempt but rental lands owned by the church would be subject to taxation.

Other well-meant attempts to make the property tax more progressive may be less successful. One such approach is to provide tax preferences to pensioners. However, not all retirees are poor, and without an income test, the net for this preferential treatment is likely to capture many of the non-poor. Another approach, practiced in Southeast Europe, is to increase the property tax exemption for larger family sizes. For example, in Serbia, owner-occupiers receive a 40 percent reduction in taxes, and this is increased 10 percent for every member of the household up to a limit of 70 percent (Begovic, 2004). Yet a larger family size by itself does not necessarily signal that the property tax is less affordable; and besides, monitoring such a provision is extremely difficult.

Third, there are the "social engineering" exemptions, and those given for political reasons. Chief among these is the owner-occupier exemption, which is used in nearly all countries. It may be politically popular, but it is regressive in its impact and imposes a significant tax expenditure on local budgets. Moreover, the owner-occupier exemption increases administrative costs because it requires classification of every parcel in terms of tenure, and it usually requires the application of differential nominal tax rates or differential assessment rates. Whether the owner-occupancy exemption achieves the social purpose of encouraging homeownership is debatable at best. Whether it achieves the political goal of gaining favor with owner-occupiers is less debatable. Some countries go even further. Residential property is not taxed at all in Central and Eastern European countries like Latvia and Lithuania, an exclusion that narrows the tax base considerably.

A fourth class is the exemption from property taxation of government-owned properties, and properties occupied by nonprofit enterprises. This exemption deprives local governments of the right to charge for some of the land use within their boundaries and it imposes a revenue cost. The considerable services provided to those properties are, therefore, not compensated by the users (Bahl and Linn, 1992, p. 100). Mathur, et. al. (2009) estimate that the revenue cost of exempting government property is equivalent to about 12 percent of collections in India's 36 largest cities.

How do developing and transition countries define a "best practice" with respect to exemption policy? Three steps might be taken.

First, institute a periodic review of property tax exemption policy with the goal of determining whether exemptions continue to serve their intended purpose. Place a moratorium on any new preferential treatments, and introduce a "sunset clause" for all existing preferential treatments, or at least a time period for their review.

Second, adopt the practice of valuing all property, including that which is exempt, on an annual basis. Use this information to prepare an annual tax expenditure budget for the property tax, identifying all property tax revenues foregone by exemptions and reliefs.

Third, and based on this valuation determined by the tax expenditure budget, charge a payment in lieu of property tax for government properties and for most not for profit uses of property. Such a practice is followed in many countries, including, for example, India and Kenya. In Mumbai, the payment in lieu is set at 80 percent of the tax that would have been paid if the property were privately owned (Tata Institute and University of Mumbai, 2001).[12]

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[12] In Canada, it is the federal government, and not the taxing authority, which determines the values and rates to be used in the payment in lieu calculation with respect to federal property.

6. Administrative Practices

Analysts usually point to poor administration of the property tax usually as the main reason why revenues are so low in developing and transition countries, and why the tax is thought to be so unfair. Most reform efforts have focused on administration as the top priority for attention, and there has been a remarkable uniformity in the recommendations made.

6.1 Constraints to Administrative Reform

Voters and elected local government officials are often reluctant to make improvements in property tax administration. This is because administrative reform almost certainly would go hand in hand with unpopular structural reforms, challenging practices such as the undervaluation of property, exemptions for owner-occupiers, and lax enforcement efforts.

Moreover, the cost of the needed administrative reforms is usually seen as very high relative to the amount of property tax revenue collected at present rates. The same amount of investment to improve Value Added Tax (VAT) or income tax administration would almost certainly yield a greater revenue return. The high cost of property tax reform probably cannot be avoided, but its burden could be lessened if it were accompanied by a significant revenue increase.

6.2 The Conventional Recommendations

There are four key components in property tax administration: (i) identification of all properties, (ii) keeping the records so that the tax roll can be continuously updated, (iii) valuation and revaluation, and (iv) collections, enforcement and appeals.

To raise revenues that match the potential of the property tax in any country, all four steps must be accomplished. If a reform program does not recognize this, it is not likely to be successful. For example, Dillinger (1988) reports how the Philippines' "Property Tax Administration Project" was successful in producing tax maps and updated property assessments, but this effort never yielded a substantial increase in revenue because the poor collection practices were never addressed. Even though valuations increased by 37.5 percent and collectibles by 13.6 percent, actual tax revenues increased by only 1.1 percent. In contrast, as Kelly (1993) reports, the Indonesian reform was more successful. By focusing on improved collection efficiency <u>and</u> improved valuation and assessment, property tax collection rose from 65 to 79 percent of the amount demanded, and the share of property tax revenue in total own source revenue almost doubled between 1990 and 1991.

The discussion below looks at each of the four key components in property tax administration and provides guidance and recommendations on how to address each separately.

6.2.1 Have a Complete Tax Roll

The place to begin in building a viable property tax administration is with ensuring that all land and all improvements are on the tax roll, and that a method is in place to keep this roll up to date.

The usual case in developing countries is that some land and many structures are not on the tax roll. For example, it was reported that one of every four properties in Peru is not reported in the real estate cadastre and less than 40 percent of the excluded properties are in slums. In Chile, half of recent new construction is not included. In Kenyan municipalities, the coverage ranges from 30-70 percent (Kelly, 2000). And in Gabon, another interesting example, there are 45,000 properties identified, but only 15,000 titles (Monkam, 2008).

How does a government go about putting its cadastre in place? This is a tall order for most developing countries. The completion of a full cadastre can be an expensive project, though these costs have become more manageable because of the use of GIS systems and tax mapping.[13] The titling exercise is no less daunting in most low-income countries. Both exercises require a combination of local knowledge and outside technical assistance. The question is whether government will, or should, spend that much money for so little revenue return.

A further question revolves around whether the development and maintenance of a cadastre can be done better in developing and transition countries by a central authority or by a local government. In fact, both approaches and many variations of each are used. In some transition countries in Eastern Europe, the organizational responsibility for the records and for valuation lies with a central authority, such as the State Land Cadastre in Lithuania (Aleksiene and Bagdonavicius, 2008). A central valuation authority arguably is able to gather more professional expertise in a single place, and develop better analytic systems. Lithuania's fully computerized property registration system links data bases on land and buildings and includes all parcels in the country.

Some would be more cautious about relying on a central authority. Kelly (2000) argues that when local governments receive the revenues, efficiency demands that they must play the major role in preparation of the tax roll and in assessment. In several Latin American countries (e.g., Guatemala and Mexico), there has been a gradual shift of administrative responsibilities to local governments, following their capacity to absorb these new responsibilities (De Cesare, 2004). In Brazil, responsibility for property tax administration rests fully with the local governments. In Uruguay, the central government is responsible for the cadastre and valuation, except in Montevideo, which has developed its own cadastre and valuation.

There are no straightforward rules that tell us whether central or local administration is "better". Moreover, a division of property tax administration tasks is feasible. If the central government is responsible for registering property ownership, then it is probably reasonable for it to maintain the cadastre. Central governments have other reasons (than property tax) for needing access to records of land ownership. Moreover, valuation manuals, training, and technical assistance in matters such as computerization can be a central government responsibility. But where the property tax is a local revenue source, the higher level government may not have enough of a vested interest to value and do aggressive collection, and the case becomes very strong for local government responsibility. Oversight, as in the calculation of sales-assessment ratios and collections rates, is best carried out by a higher level government.

6.2.2 Record Keeping

It is important to maintain and constantly upgrade record keeping methods and systems. The master file should include full information for each parcel, including a physical description of the property, assessment and tax payment history, and tenure and ownership information. In many countries, only

[13] We use the term "cadastre" in the general sense to refer to all land records, ownership records, and property tax information (also see Almy, 2004).

partial information is available in the records and the system is not fully automated.

Not only is a complete property information system necessary, but it must be kept current. This involves tracking all new improvements to properties, as well as changes in ownership and any sub-division of properties. Best practice would feature a timely and accurate flow of data through the system, involving adequate staff, inter-departmental coordination, proper automation, and a significant investment by the government.

A relevant point here is that the more complicated the property tax law, the more difficult becomes the updating task. For example, owner-occupied properties are given preferential treatment in many countries, hence tenure status must be tracked. Another common practice is use value assessment and higher statutory tax rates for non-residential properties. Thus land use status must also be tracked, and changes in the intensity of mixed use properties (residential – commercial) will need to be kept up to date.

Sometimes politics, and even the law, get in the way of maintaining records that can support property taxation. Good practice requires that all systems for identifying land values and tracking tax payments should be linked. The adoption of a unique parcel identification number would make it possible to have information readily available on land and improvement description, tax payment and assessment history, transfer values, and ownership changes. De Cesare (2004, p. 16) reports that in the city of Guayaquil, Ecuador, an online integration between the public registry of properties and the cadastre made it possible to increase the number of properties recorded from 165,000 in 1993 to 418,474 in 2001.

Yet, the land registration department and the valuation authority sometimes do not cooperate. In Jamaica, for example, the stamp duty office, which records values at transfer, and the land valuation department do not even use the same parcel identification number (Sjoquist, 2005). In some cases, ministries that collect relevant information do not provide information to local governments (Pavić, 2006). The Ministry of Justice in Croatia, for example, maintains the official registry for property rights, but does not share the information with local governments, which are often unaware when properties are extended or change hands. As a result, new information is not recorded in the municipal registers and bills are sent to the wrong address.

6.2.3 Valuation

The goals for valuation are clear: to assess properties at levels required by law, to revalue as required by law, and to maintain some standard of equity in assessments. Unfortunately, the current practice in few developing countries measures up to these standards.

The first step in improving valuation practices is for government to be clear about whether it will tax rental value, capital value or area, and how it will treat improvements. In addition, it should be clear if the legal base is to be full market value or some fractional assessment. Oftentimes, governments simply wink at the market value target laid down in the property tax law and move ahead with gross undervaluation. In fact, a good place to start the reform process is with a comprehensive review of the structure and practice of property taxation in the country.[14] Too often, new features get inserted on a piecemeal basis and they outlive whatever purpose they might have served. Such a review could clarify what is being attempted with the property tax, and could make it less complicated and, ultimately, easier

[14] For a good example of proposed reforms of the property tax in developing countries, see the Urban Unit (2006) for Pakistan, and Bahl, Wallace, and Cyan (2008).

for the taxing authority to administer.

A second step is to be clear about the way in which assessments will be made. This is especially important in developing and transition countries where evidence on values and valuation experience are limited. Every jurisdiction should have a manual that clearly specifies the way in which assessments are to be carried out, and that lays out an approach that will be acceptable to the courts.

Still, a major constraint to good valuation in developing countries is the shortage of qualified valuers working in the government sector. In some countries, the problem is the absence of good quality valuation training and degree programs for valuers. Almost everywhere, the significant gap in compensation of valuers between the public and private sectors is a major problem. In many developing countries, this lack of qualified valuers shows itself in poor assessment equity and long overdue revaluations. At a minimum, capacity-building programs should be put in place to address this problem.

Given the paucity of qualified valuation staff and other deficiencies, there is a need for careful attention to the efficiency of the assessment process. If the law calls for valuation at market levels, or if the goal is a specified fractional assessment, then tests should be put in place to monitor the accuracy of these assessments. Specifically, a sales ratio study can be used to identify the average degree of underassessment across properties.[15] In developing countries, however, there usually are no reliable transaction values with which to compare assessments. Resort can (and should) be made to a panel of experts (realtors, mortgage bankers, real estate agents, etc.) or to valuation staff to make estimates of the average degree of underassessment.

Finally, there is the issue that underlies the valuation problem in most developing and transition countries: the absence of reliable data on the sales values of properties that are exchanged. Because many developing countries impose transfer taxes with high rates, there is significant incentive to understate values, and there is ample evidence that this understating does occur. An effective program that scrutinized or challenged declared sales values might resolve this problem, but this would be quite costly. Few stamp duty offices will take this on in more than a perfunctory way.[16] Another route would be to eliminate property transfer taxes altogether, or to replace them with capital gains taxes on real property. This would at least remove the incentive for under-declaration, and in the case of a capital gains tax would provide a self-checking mechanism for declarations.

6.2.4 Collections, Enforcement and Appeals

The revenue take from the property tax can be markedly enhanced by an effective collection/enforcement system. Various studies have measured the property tax collection ratio (collections as a percent of liability) and have shown a dismal record: Philippines – 50 percent (Guevara, 2004); Kenya – 60 percent (Kelly, 2000); Croatia – 70 percent;[17] Macedonia – 15 percent, Mumbai – 55 percent; and, Montenegro – 43 percent. But in Latin America, the collection rate is generally much higher. For instance, in Colombia the overall collection rate is about 75 percent, while in Bogota it is 90 percent (De Cesare, 2004).[18]

[15]A sales ratio study compares market sales values with assessed values for a sample of properties that sold during the period in question.
[16] For a discussion of the method used to challenge declared values in Jamaica, see Bahl (2004).
[17] Refers to the tax levied on the use of urban land.
[18] One must be careful about whether or not the collection rate is measured to include the collection and demand for arrears.

Why are collection rates so low in many developing and transition countries? The most obvious reason is that people will avoid payment of any tax if enforcement is weak enough and if the likely penalties are small. We also know that people resist paying taxes when compliance costs are high. To stand in line on a designated day represents a high compliance cost. So does the requirement to pay (or bribe) collectors who visit residences and businesses to receive payment.

The collecting government often bears much of the blame for poor collections. When responsibility for collections is at the local government level, as it often is, there is a hesitance to aggressively enforce collections on property owners who are politically powerful in the local area. When responsibility for collections is at the central government level, but revenues are shared with the local governments, there is seldom a strong incentive for strict enforcement.

There are other reasons as well. Voluntary compliance may be low because the taxpayer thinks the tax is inequitable or just because s/he does not understand how it works. Often one hears the complaint, "Why pay a local tax for services that are not adequately delivered"?[19]

Finally, large taxpayers may find the option of appeal to be an effective strategy if they are not required to pay the tax due while the issue is being settled. Oftentimes, such taxpayers count on a court system that is clogged with work and is often without sufficient expertise in property taxation to bring resolution to the matter.

Governments could be more aggressive about increasing the collection rate, but they rarely are. Draconian measures, such as foreclosure and sale at auction, are not often used. Clearance certificates are effective only at the time of selling the land on which taxes are due.[20] Even publishing the names of delinquents in the newspapers (the so-called "name and shame" approach) is not often applied.

Is there a better practice for collections and enforcement than is presently followed? There is, and the list must begin with the government being willing to enforce the tax by using the powers granted by the law. Other possibilities are to simplify the tax and make the liability to pay more transparent. Those using the more simple area approach argue that compliance has increased because taxpayers understand their liability. Some countries have found that replacing collectors and moving collection points to banks has increased the collection rate. Apparently, the ease of compliance and the feeling of a more corruption-proof collection process can increase willingness to pay property taxes (Rao, 2008: Kelly, 1995).

Collection incentives have also been proposed. In India, for example, local governments are rewarded with an increase in intergovernmental transfers for increased property tax collections. In principle, this approach should work in other countries as well, but there is not yet enough experience with it to provide good evidence on how such schemes should be structured.

Finally, there are more draconian measures. In El Salvador, for instance, electricity service is tied to the payment of property taxes. A similar approach is being used in South Africa.

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[19] An interesting survey of urban residents in Bulgaria gave the result that only about 20 percent of respondents could identify the level of government that set the tax rate (Ivanov and McCullough, 1998).

[20] In many countries, a tax clearance certificate must be obtained before property can be legally transferred. Such certificated typically verify that there are no outstanding tax debts related to the property in question.

6.3 Measuring Administrative Success

How would a country come to know that its property tax administration is efficient? The fact is that administrative costs depend on many factors, including at least the amount of revenue collected, the assessment equity that is achieved, the complexity of the tax structure itself, and the investment that government has made in building the infrastructure for a sound property tax administration. Identifying a norm for the cost of collections, and comparing countries by this standard, is no straightforward matter.

Some research has turned to cross country comparisons to try and gain an estimate of the average cost of collections. These studies have mostly focused on OECD countries and have given some comparative "norms". However, as Almy (2004) indicates, "…annual administrative costs in the range of 2 to 5 percent of revenues often are achieved in developed western countries. Ratios in excess of 10 percent are symptomatic of problems." (Almy, p. 25).

If one went through the exercise of estimating administrative costs for the property tax based on evidence from a cross section of developing and transition countries, s/he might learn little. The numerator of the cost ratio would be the amount actually spent in each of the departments charged with the various steps in property tax administration. The denominator would be the amount of revenues collected. A low ratio could indicate some efficiency in the administration, but it also could indicate a very low expenditure on tax administration. Perhaps more could be gained from a notional determination—that is, a hypothetical calculation of the cost of collecting a given amount of revenue based on targeted norms for assessment efficiency, collection rate, and other factors. This could best be done in the context of a country case study.

Even if a value-based tax is well administered, it will not come off as a relatively efficient revenue collector. This is mostly because of the inherently high cost of property identification and valuation. Unlike income tax withholding or VAT invoices, there is little objective evidence that can be called on for determining property tax liability. Notional assessment is necessary. Moreover, collection costs can be high because of low rates of voluntary compliance.

To be sure, collection costs for the property tax can be lowered—by taking measures to increase voluntary compliance, by improving registration procedures, and by providing for a regular flow of accurate data on the sales value of properties—but the costs will still be high by comparison to general consumption taxes, excise taxes or taxes on payrolls. The place of the property tax in the revenue system in a developing or transition country will need to be justified by one of its many other desirable characteristics.

7. Taxes on Property Transfers

The other widely used tax on immovable property is the transfer tax, i.e., a tax on the sales value of properties paid at the time of exchange. This may be levied as a stamp duty on the transfer document and/or as a separate property transfer tax.

Transfer taxes are a component of the tax system in most developing countries, and they are roundly criticized (Bahl, 2004; Alm, Annez, and Modi, 2004). The criticisms are especially harsh for the tax on real property transfers.[21] While there is a need to legalize documents and assure that they are properly

[21] Stamp duties on the transfer of shares are also contentious.

filed, the present role of property transfer taxes in developing countries goes well beyond documentation of a change in ownership.

There are several reasons why real estate transfer taxes have found their way into tax systems in developing and transition countries, and why their staying power is so great. First, it is an easy tax handle because most buyers and sellers desire a legal record of ownership and therefore will voluntarily comply. Second is the revenue motivation and what might appear to be a very low cost of collection. Third, if property ownership is concentrated in the higher income classes, and if turnover is greater for higher income properties, the distribution of tax burdens for a property transfer tax will be progressive.[22] Fourth, the number of people in the taxpaying population in any given year is much smaller than in the case of more general taxes, hence lessening voter opposition. Finally, a property transfer tax might reach that part of the taxable capacity (property wealth) that is not captured by most income taxes and value-added taxes.

There also are major disadvantages to the property transfer tax. For instance, it imposes a cost on property transactions, thereby reducing the volume of formal transactions and slowing the development of the real estate market. If the tax is properly assessed, administrative costs could be very high because of the need to verify the declared sales prices and revalue when necessary. Furthermore, in many countries, declared values are not checked for accuracy. The property transfer tax gives property owners an incentive to understate taxable value, and so it weakens the database that is necessary for objective assessment of the annual property tax. This problem is not so often discussed, but it is a very great drawback to levying the property transfer tax.

A moment's reflection will lead one to the conclusion that the problems with the property transfer tax are dependent on the level of the nominal tax rate chosen. At very low rates, these problems may be of little consequence. But when the tax rate is high, the implications of these problems are magnified. For example, Alm, Annez and Modi (2004) studied Indian states with different stamp duty rates and found that under-declaration of sales prices tends to rise with the stamp duty rate. Very high rates of transfer tax (e.g., 13 percent in Jamaica) are an open invitation to under-declaration and a signal that monitoring will not be vigorous.

Best practice in this area would be to remove disincentives to a functioning real estate market and to correctly reporting sales vales for property transactions. This would then suggest three options:

- Abolish the property transfer tax.

- Keep the property transfer tax, but significantly lower its rates where they are high, and aggressively monitor declared values for transactions.

- Abolish the property transfer tax in favor of a capital gains tax on real property. A capital gains tax would have a self-checking feature that could lead to an accurate statement of sales values, and so could help strengthen valuation for the annual property tax. In the early years of its implementation, assessment of capital gains would be notional, just as the present declaration of sales values under the transfer tax is also notional.

[22] To the extent the tax on land is capitalized into land values, it likely is borne by all owners of land. Since land ownership is concentrated in the higher income brackets, the distribution of the tax burden will be progressive.

8. Property Taxes in Rural Areas

Despite their low revenue potential, there is a strong case to be made for rural local government property taxes. This is virtually the only significant source of revenue open to smaller local governments. It could also be used to develop some accountability of elected local officials to taxpayers for the quality of services provided. In recent years, many developing countries have rethought the structure of their system of rural local government revenue mobilization with an eye toward making these local governments less dependent on intergovernmental transfers.

There is much variation in the practice. The property tax is virtually the only source of own revenues for India's village (*gram panchayat*) governments. In Brazil, it is levied as a separate tax from the urban property tax. Indonesia exempts most improvements in rural areas. Tanzania does not tax rural property at all. If fiscal decentralization is to extend to the rural sector, even a small own source revenue is an important part of the equation. These taxes tend to be very primitive and usually are levied on an area basis or even a per house basis, rather than on a value basis. The yield tends to be very low because the tax base is small, because the tax roll usually does not cover all properties, and because collection rates are low. Yet, this poor administration of the rural property tax suggests that relatively small improvements in identifying the tax roll and in valuation could potentially add large proportionate increases to own source revenues.

Governments in some developing and transition countries also might benefit significantly from rethinking their approach to taxing agricultural land. Certainly there is justification in many countries for bringing the tax burden on the agricultural sector up to the level found in other sectors. Agricultural income is often exempt from income tax, so non-farm households at any given income level face a higher tax burden on their labor income than do agricultural households. This can be a particularly egregious inequity when there are large numbers of (above subsistence) individuals employed in the agricultural sector.

The above notwithstanding, rural property taxation is bound to present considerable challenges, from navigating the political resistance to taxing agriculture, to determining how best to administer a tax on what Rajaraman (2004) has termed the "hardest to tax" sector. One reasonable reform option is to adopt and enforce an agricultural land tax. In fact, this is provided for in the law in some countries, with revenues usually assigned to subnational governments. An approach, discussed in Rajaraman (2004) and in Bahl, Wallace and Cyan (2008), is to introduce a presumptive tax based on land area and crop. Such a levy would capture the significant differential net returns from different crops (and arguably the differential productivity of the land). All farms above a certain acreage size could be subject to this tax. Assessment would seem manageable, if a full survey of agricultural land was in place and kept up to date.

9. The Way Forward?

The property tax has been maligned for years as a badly administered tax that has not lived up to its potential in developing and transition countries. In many ways, the prophecy has been self-fulfilled. Governments have continued to neglect the administration of the property tax and ravaged its base with exclusions, with the result that it has fallen into even more disrepair. Taxpayers have lost confidence in it as a fair tax.

Is there a way out of this state of affairs, or is the best course to concentrate on national income and consumption taxes, on which there seems to be some willingness to gradually upgrade administration and raise effective tax rates?

Fortunately, there is a way forward with property tax reform. Furthermore, this is a road worth taking, because of the significant advantages of the property tax as a source of financing decentralized local government service delivery. This study ends with a list of several "avenues" for reform that could lead to a significant ratcheting up of revenues and an improved fairness in the tax. Of course, the necessary condition for success with this advice is the political will of governments to implement—and ultimately maintain—a stronger property tax.

1. Make a decision about the role the property tax will play in national development policy, e.g., a tax on property wealth, a stimulus for the better use of land, an integral part of a fiscal decentralization strategy, etc. The government should begin the effort by doing a thorough analysis of the present property tax and of the reform directions that might be taken. If the goal is to support fiscal decentralization, then an overall strategy should be put in place to give local governments more incentive to make intensive use of the property tax. This might be done by reducing the availability of intergovernmental transfers to those with significant unrealized property tax revenue potential. Alternatively, it might be done by providing a significant reward in the transfer system for those local governments that increase property tax effort.

2. Take a holistic approach to property tax reform, with appropriate diagnostics, adequate focus on both policy and administrative reforms, and effective monitoring of ongoing and completed reforms. A schematic describing the overall approach to comprehensive property tax reform is described in Table 4.

Table 4. Five Steps to Take Preparing a Reform of the Property Tax

<u>Step 1</u>: Do a Diagnostic of the present system and prepare a Policy Paper that outlines the structural and administrative reform program.

<u>Step 2</u>: Reform the Tax Structure. Concentrate on the Choice of a Tax Base, on Rate Structure and on Exemption Policy.

<u>Step 3</u>: Administrative Reforms

- e) Increase Coverage (GIS, mapping)
- f) Upgrade Valuation (Training, Procedures)
- g) Unified Record Keeping (Interagency cooperation and unique numbering system)
- h) Improve Collection Rate (Reduce preferences, reduce compliance cost, toughen enforcement)

<u>Step 4</u>: Reform the Property Transfer Tax to remove the incentive to underdeclare the value of property sales.

<u>Step 5</u>: Establish a Monitoring Activity with quantitative indicators of success with property tax reform.

3. Take an aggressive approach to upgrading administration. Even if the cost of administrative improvement is high relative to the present level of collections, it should be pursued. An upgraded

valuation and collection system, and a staff to sustain this, are the necessary first steps to building a revenue productive property tax. The next step, of course, is for the local governments to commit to a higher effective property tax rate.

4. Developing and transition countries should get the division of property tax administration right—that is, the division of responsibilities between higher and lower levels of government. This should be based on comparative advantage, particularly with respect to who handles the maintenance and upgrading of the cadastre, property transfers and valuation. The weaker the local government capacity, the stronger is the case to centralize such responsibilities.

5. Governments should develop a system that generates and records accurate information on property transactions. Such information is essential to developing the value map that underlies a good assessment practice. Replacing the property transfer tax with a capital gains tax on real property could remove an impediment to accurate self-reporting of transaction amounts. An alternative approach is to lower the rate of transfer tax and adopt an aggressive method of checking declared sales values.

6. Exemption policy should be reviewed and revised. A broad-based property tax would better serve equity goals. Low-income housing might warrant exemption, but the practice of exempting owner-occupied property and government property, and of providing special exemptions to others should be rethought. At a minimum, all exemptions should be reviewed periodically and the tax expenditure implied should be annually calculated and reported.

7. Most low-income countries might do well to concentrate their reform and revenue mobilization efforts on the larger urban areas. Larger cities have the larger tax base, the administrative machinery, and the local public financing needs to justify this approach. Smaller governments and more rural areas are important, but the type of tax imposed is likely to be more rudimentary and these governments will in any case remain more dependent on central (or state-provincial) transfers. Large cities will be more easily weaned from their dependence on grants from above.

8. Finally, there is the more far-reaching idea of a comprehensive reform of land and property taxes. One might think of the present system of property and land taxation in developing countries as a schedular system, i.e., the annual use of urban property is subject to one rate schedule, annual agricultural use to another, gains from the sale of property to a third, and so on. A plausible idea is to begin moving this system toward one that taxes a more uniform base. Such a global system could increase the revenue yield from property taxes to a level where the significant increase in administrative expenditures could be justified.

Developing and transition countries cannot move immediately to the practice in industrialized countries. A better route will 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 that both allows the administration to catch up and allows the taxpayers to get used to the new system, is the best route to success.

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Annex A

Property Tax Reform in Montenegro: A USAID Success Story[23]

USAID assistance played an important role in property tax reform in Montenegro. Two separate USAID-funded local government development projects, implemented first by the International City/Country Management Association (ICMA) and the Urban Institute, diagnosed the problems with the property tax system, made recommendations for its reform, helped prepare the legislation, and provided technical assistance, training, and equipment in the implementation of the reform. The property tax reform was carried out along with other related USAID-supported reforms, including the development of a new system of intergovernmental fiscal relations, local government capacity development, and reform of elections and municipal authorities.

In 2001, a USAID advisor prepared a comprehensive set of recommendations for property tax reform. The underlying problems with the existing system were identified as the following:

1. The property tax, which was shared between the local and Republic-level government, produced very little revenue.

2. Local government officials had knowledge of defaulters but did not have the authority to enforce tax collection, because the property tax was a Republic-level tax.

3. The property tax had many exemptions, exonerations, special treatments, and unclear language, all of which made the tax unfair and difficult to interpret as well as difficult to administer and comply with.

4. The property tax was not based on value but rather on a number of factors related to the characteristics of the construction.

The consultant was requested to prepare a draft property tax law that would address these weaknesses as well as meet other international best practice guidelines. At the same time, the consultant prepared a new, draft law on local government finance, which included guidance on the new systems of transfers and intergovernmental fiscal relations and responsibilities. Along with these two pieces of draft legislation, the consultant prepared a simulation model that would facilitate the assessment of the likely or possible fiscal outcomes of the new property tax, and of the new system of intergovernmental fiscal relations.

ICMA then held a series of workshops to review the new draft legislation, discuss options, assess the impacts based on the scenario model, and generate support for the reforms. The draft legislation was turned over to the Ministry of Justice for further refinement. Additional assistance was provided via ICMA. A final draft property tax law was accepted by government (Vlada) and sent to the legislature. Further refinement was added and a final bill was passed into law.

By the end of 2001, the new legislation had been enacted. The law came into full effect in January 2003. Further legislation was introduced later to provide more guidance on assessments. USAID also provided assistance and training to a variety of agencies and to local governments to prepare them for implementation of the new legislation. As a result of these efforts, property taxation is performed in

[23] This annex was prepared by Musharraf Cyan.

accordance with the Property Tax Law, and by the Decree on "Detailed Criteria and Methodology for Determination of Market Value of a Property." The statutory tax rate ranges from 0.08 to 0.80 percent of market value, with the exact rate determined by each municipality.

During the first full year of execution, property tax revenues, which are now administered and collected by local government finance offices, rose dramatically. Indeed, the capital of the country, Podgorica, with about 15 percent of the national population, had collected more than double the amount of revenues collected nationwide two years prior, i.e., 2002, 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.

Figure 1. Montenegro: Property Tax Revenues in Selected Municipalities, 2002-2004

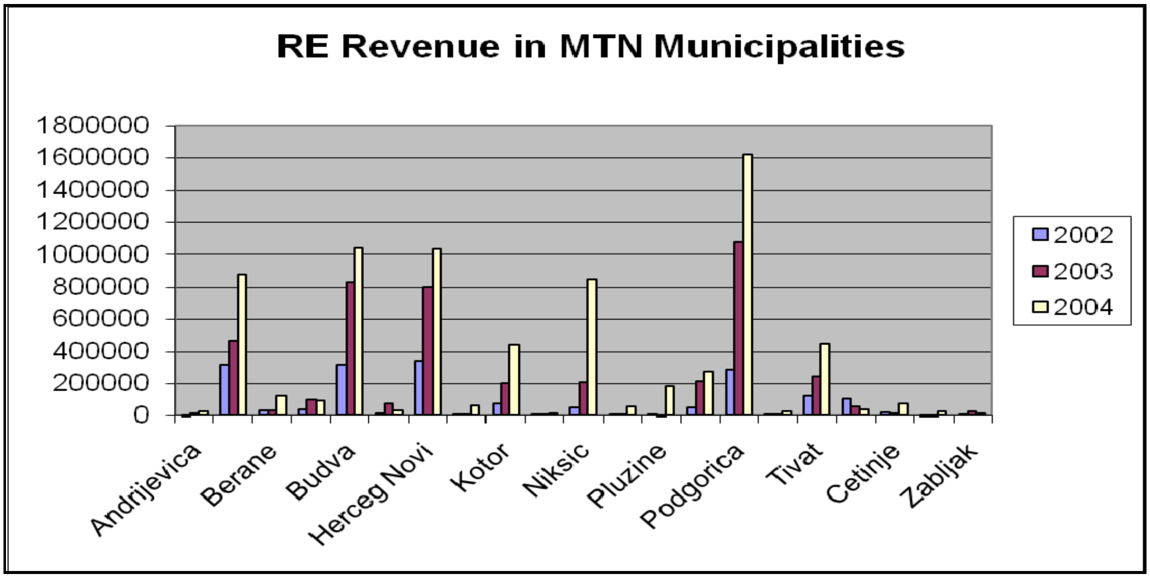

Figure 1 illustrates (in Euros) just how dramatically real estate tax revenues soared in many municipalities in Montenegro upon implementation of the new law. By 2004, total national collection of the real estate tax had nearly tripled compared to the year prior to implementation, i.e., 2002.

More recent data on property tax revenues are difficult to come by, but one report by GTZ indicates that, "(T)he six coastal communities were able to more than double their land tax revenues between 2003 (first full year of implementation of the new law) and 2005, measurably increasing the municipalities' investment capacity." GTZ began providing assistance to municipalities after USAID concluded its assistance to the sector. GTZ assistance, which has focused on helping local governments develop their databases, seems to have led to even further increases in revenues, and, to fairer assessments.

The IMF's Article IV Consultation of February 2008 shows quite positive trends in property tax collection, and is bullish in its projections of future receipts. Table 5 (below) shows overall property tax collections from 2004 to 2009 as a percentage of GDP. The last three years are estimates.

Table 5. Montenegro: Property Tax Collection as Percent of GDP

2004	2005	2006	2007p	2008p	2009p
0.2	0.3	1.3	2.0	1.9	2.1

One important reason for the rise in revenues from 2004 to 2007 is the more than doubling in the value of real estate in Montenegro. Without the new property tax, it is unlikely that local governments would have been able to benefit from this real estate boom.

Annex B

Successful Property Tax Reform in Bangalore City, India

The property tax in Bangalore, the capital of the Indian State of Karnataka, has undergone a significant transformation over the past decade. Most notably, a sweeping reform in tax structure has led to a significant increase in revenues and in the rate of compliance (Rao, 2008). The most recent evidence suggests that the progress with revenue enhancement can be sustained. In this annex, we track the property tax through the various stages of its development in Bangalore.

Phase I: 1957-2001

The state government of Karnataka has long imposed a property tax on rental value. The state switched from an annual to a capital value basis of property taxation in 2002. The new tax base is the sum of land value as estimated from reported data on property transfers, and building values as estimated using a construction cost method adjusted for depreciation. In practice, the property tax saw little revenue growth during the 1957-2001 period. A World Bank Report (2004, p. 2) described the situation as follows: "Perhaps the major explanation of the poor revenue performance is the failure to reassess properties for nearly 30 years. Another longstanding problem has been enforcement (a 55 percent collection rate). Finally, the total enumeration of properties has lagged, and particularly new properties developed on the urban fringe have not been brought on to the property tax roll."

Phase II: Area Based Assessment[24]

In 2001, Bangalore moved to a new approach to assessment—an area-based unit value system—and introduced a new valuation roll.[25] At once these reforms got around the badly outdated list of values, with quite successful results.

For assessment purposes, the metropolitan area was divided into six land value zones, with each "zone" assigned a rental value per square foot. A "zone" is not necessarily a contiguous area. Though buildings are assessed according to their capital values, these amounts are "factored" to rental value equivalents using a formula approach. The sum of the land and the building value is the taxable rental value. Preferential treatment is granted to owner-occupiers in the form of a 50 percent reduction in value for certain types of properties.

When designing the assessment rates, the city government limited the overall increase in tax liability that a residential taxpayer would face to a multiple of 2.5. While a 250 percent increase may seem very high, it should be noted that taxpayers' liabilities were very low to begin with.

The so-called "self-assessment" feature of the Bangalore reform is that each taxpayer who chooses to voluntarily self-assess her tax is charged with identifying the location of her property, and declaring the classification of the structure. Based on the schedule of values provided by the taxing authority, the taxpayer may then calculate her tax liability. The guidance values that were the basis of these assigned rates were drawn from declarations of sales values at transfer. The tax rate was set at 20 percent for

[24] In this section, we draw from World Bank, 2004.

[25] A number of large Indian cities have adopted an area-based system, including Ahmedabad, Bhopal, Patna, Luckknow, Mirzapur, Thrivananthapuram, Bangalore and Hyderabad. (Ravindra and Rao, 2002).

residential properties and 25 percent for non-residential properties. In addition, a 34 percent surtax was levied on the total property tax liability and earmarked for specific social services. If a taxpayer chooses not to self-assess," the city will assess the value of property. For those who do comply, a 5 percent tax rebate is given.

The new system also provides for a change in payment procedure. Taxpayers may pay directly at a bank, in designated payment boxes, or at the electric utility. The net result of this process is that there is no longer any need for contact with the taxing authority, and taxpayers have many more options for easy payment of their property tax bills.

The first years of experience with the new property tax system showed some encouraging results. The revenue increase was due to several factors: an increase in the collection rate from 64 to 79 percent, a 4-percent increase in the number of properties on the tax roll, and an increase of about 28 percent in the amount of tax payment per property. Bangalore city officials estimate that one-third of the revenue increases resulted from revision in property values, and that about three-fourths of all property owners paid higher property taxes.

Another success of the reform was a reduction in compliance costs. The city offered its taxpayers a lower cost of compliance in return for a higher payment. Apparently, property tax inspectors regularly harassed taxpayers. It was reported that inspectors came on the property, sometimes unannounced, and oftentimes "negotiated" the property tax liability with the owners. Apparently, taxpayers were willing to pay more under the new system to eliminate this type of informal contact with inspectors.

Phase III: Revaluation under an area-based system

The flaw in an area-based system is that it does not provide for automatic revenue growth unless there are discretionary changes in assessed value per square foot. The Bangalore model seems to have resolved this issue through a program of de facto revaluation.

The tax officials have carried out a revaluation by assigning many properties a different zonal classification, i.e., moving about one-half of all properties from a lower to a higher tax zone (Bruhat Bangalore Mahanagara Palike, 2008). The justification for doing this is that the quality of public services has improved since the original zonal classifications were assigned. In this way, an automatic revaluation and a revenue increase were built into the system, helping the government avoid an unpopular, discretionary increase in the tax rate. The results were striking. Between fiscal years 1999-00 and 2000-01, property tax revenues increased by 33 percent. Between 2007 and 2009, following rezoning of properties, property tax revenues doubled.

In addition to the above measures, the city government has been moving to complete its fiscal cadastre. Among others, a GIS system has been instituted, based on satellite photos and field-based tax mapping. This will have the effect of expanding the tax base by adding new properties.

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