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### Making the Property Tax Work

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## **Making the Property Tax Work**

**Roy Kelly**



**ANDREW YOUNG SCHOOL**  
OF POLICY STUDIES



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Working Paper 13-11**

**Making the Property Tax Work**

**Roy Kelly**

**April 2013**

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# ***Making the Property Tax Work***

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## **Introduction**

Property taxation has tremendous potential for mobilizing improved revenue and equity, especially in transitional and developing countries. Currently the property tax generates 0.3-0.6% of GDP for developing and transitional countries and up to 2-3% of GDP for OECD countries (Bahl and Martinez Vasquez, 2008; Bird and Slack, 2004). This international benchmarking suggests a high potential for significant increases in property tax revenues, along with improvements in equity and efficiency, especially in transitional and developing countries.

To realize these potential property tax revenue improvements, countries must undertake strategic reform, combining policy and administrative interactions to improve tax base coverage, property valuations, collection, enforcement and taxpayer services. The tax policy reforms must adjust tax base definitions and tax rate structures along with making appropriate policy decisions linked to valuation standards, appeals, collection and enforcement. The tax administrative reforms must focus on improving tax base coverage, valuation, and collection, along with taxpayer services.

A major constraint to improving the property tax in transitional and developing countries is weak administration, often a result of political, institutional and capacity constraints. Property tax reforms must be designed cognizant of these constraints, the existing reform environment, legal and institutional structures, government administration capacities, and political will, as all tax reforms must be country specific, adapting international best practice to each unique reform environment. Major administrative reforms, undertaken within a proper property tax policy framework, are crucial to ensure sustainable implementation of a more equitable and efficient property tax system.

Realizing improvements in property tax revenue, equity and efficiency objectives requires a multi-year, systematic and comprehensive property tax reform. Although property tax policy can be adjusted overnight, international experience confirms that the translation of those policy and administrative changes into enhanced revenues, efficiency and equity will take time. Although certain reforms may yield immediate improvements in property tax revenues, generally speaking, property tax reform must be implemented so as to allow sufficient time for longer term, systemic and institutional reform.

Ideally property tax reform should be structured as an integral part of broader public sector management reforms, such as fiscal decentralization and governance, public financial management, local government and urban development reform. This will help create demand support for the reform, making it easier to mobilize a broader set of the key stakeholders and resources, balance the impacts and incentives of other reform initiatives, minimize political, administrative and taxpayer opposition and generate the synergy needed to design, implement and sustain a successful property tax reform. Successful property tax system can then help support these other reforms seeking to enhance responsive, efficient and accountable government and improved public service delivery.

As with any reform, making the property tax work requires visionary leadership, an appropriate policy framework, strong administrative capacity, and appropriate incentives to mobilize the political, administrative and popular support needed to enhance property tax revenues,

equity and efficiency. This paper focuses on these requirements for successful property tax reform, identifying the key policy and administrative components and possible strategies needed to make the property tax work.

Part 1 outlines the broader public sector reform environment needed to facilitate and support sustainable property tax reform. Part 2 identifies the policy and administration determinants affecting the realization of property tax revenue, equity and efficiency outcomes. Part 3 focuses on the ingredients needed to design a successful reform implementation strategy, while Part 4 summarizes the key recommendations for making the property tax work, especially in transitional and developing countries.

## **1. The Broader Reform Environment**

Countries everywhere are in the midst of development reforms to promote growth and improve living standards. These reforms are focusing on enhancing private sector led economic growth, adopting effective public sector regulations and improving efficient and accountable public service delivery. While the private sector focuses its entrepreneurial energies to maximize market efficiency, governments are focusing their fiscal attention on issues of macroeconomic stabilization, distribution and allocation.

Although stabilization and distribution functions are largely central government responsibilities, the allocation functions are joint responsibilities of both central and local governments, depending largely on the geographic scope of the public good (Musgrave, 1989; Oates, 1999, 2005). Based on the subsidiarity principle, public goods and services are to be provided by the lowest level of government that can do so efficiently. This implies that most public expenditure functions should be assigned to local governments, with the exception of those functions with economies of scale and/or inter-jurisdictional spillovers such as national defense, monetary policy, water basin management, among others.

Virtually all governments have adopted variants of decentralization reforms to improve public service efficiency, encourage more accountable and responsive governance, and promote more equitable distribution of services throughout the country. The goal is to bring public sector decisions closer to the people so as to empower local communities to actively participate in prioritizing, implementing and monitoring government resources to enhance efficiency with public and social accountability (Boex and Kelly, forthcoming). To be successful, these decentralization reforms necessarily involve a combination of political, administrative and fiscal aspects (Boex and Yilmaz, 2010), which must be strategically implemented in a country-specific approach (Bahl and Martinez-Vazquez, 2006).

‘Finance should follow Function’ is a fiscal decentralization rule stressing the need to provide appropriate funding for the expenditure functions allocated to local governments (Bahl, 1999). This requires a system of shared taxes, intergovernmental transfers and local own-source revenues, the mix depending on the nature of the allocated functions. Although intergovernmental



transfers and shared taxes typically dominate the financing framework, local own revenues, although perhaps small, are critically important to enhance local autonomy, governance accountability, ownership and responsibility, while providing an important source of additional funding (at the margin) for local budgets.

Although largely dependent on central-local transfers, local governments everywhere tend to rely on fees and charges, business licenses, and the property tax for their own source revenues, with some local governments given access to broader taxes on motor vehicle, sales and income. The property tax currently finances about 40-80% of local government expenditures in OECD countries and between 20-80% in developing / transitional countries (Bahl and Martinez-Vasquez, 2008). It has been suggested that the property tax should be able to yield between 1-2% of GDP and serve as the core local tax source for local governments throughout the world (UN-HABITAT, 2011).

Theory and international best practice identify the property tax as the ideal local tax to support ongoing fiscal decentralization strategies. The property tax has strong potential for revenue mobilization, especially in rapidly urbanizing areas. The tax base is immobile which minimizes economic efficiency implications and makes it easy to be identified and be captured and allows the properties to be the natural collateral in cases of nonpayment. Due to its immobility, the property tax base also captures the value of location-specific capital investments and benefits from government programs and services not captured otherwise through various fees, user charges and taxes. The property tax also, in many countries, tends to fall on those with the ability to pay, as immovable property can be the primary repository of wealth. And finally, as a highly visible and politically sensitive revenue instrument, the property tax can serve as a perfect tax to encourage more responsive, efficient and accountable local governments.

Despite being an ideal tax for local governments, with tremendous revenue potential, property taxes in most transitional and developing countries face a number of challenges emanating from central and local level political, institutional and administrative problems. At the central government level, reform measures must ensure that local governments are empowered with the responsibility, capacity and resources to effectively implement the property tax. At the local level, local governments must be given the adequate and necessary discretion, along with accountability constraints, to influence property tax policy and its administration (at the margin) and effectively link property tax revenue mobilization with improved levels of responsive, efficient and accountable service delivery.

Reforms should be structured to reduce excessive central government indirect and direct interference. For example, central governments should design their intergovernmental transfers and shared taxes so as to minimize disincentives for mobilizing local revenues; while the central government must be also constrained from intervening with ad hoc policy changes (eg, granting special exemptions and curtailing local tax rates) and/or administrative regulations which can dramatically discourage local incentives to mobilize revenue.

Reforms at the local level should create an enabling environment to empower local governments to effectively enhance governance and improve public service delivery. Strengthened political legitimacy and credibility will better enable local governments to be more responsive and work with their residents to mobilize additional tax revenues needed for identified local expenditure priorities. Enabling local governments to deliver high quality services and to effectively link property taxes with high quality services will encourage greater voluntary compliance and grant local governments the legitimacy and credibility to undertake enforcement against non-compliance.

To be successful, property tax reforms should be linked in a “demand-driven” fashion to the broader public sector reforms such as decentralization, in order to build on the momentum, the stakeholder interest, the political will and the available institutional, financial and human resources. Isolated ‘supply driven’ reforms rarely gain sufficient traction to generate sustainable momentum. Thus, a key design strategy for successful property tax reform could be to anchor the property tax as an integral and pivotal component of the broader decentralization reforms in a country. In this way, the property tax reform could become a demand-driven activity needed to support the broader public sector reform objective. And the purpose of the property tax reform then moves beyond just strengthening the property tax itself, to becoming a means of supporting the broader vision to improve the efficiency and accountability of governance and service delivery.

To ensure that the property tax can deliver the revenues, equity and efficiency needed to support the broader decentralization reforms, reformers must focus attention on identifying the required policy and administration components and then designing and implementing an appropriate reform implementation strategy to make the property tax work.

## **2. Property Tax Policy and Administration**

Within the broader political economy environment, reformers must clearly understand the key economic, policy and administration determinants of property taxation in order to design and implement appropriate, effective and sustainable interventions. As the property tax revenue identity equation shown below indicates, policy and administration factors closely interact to affect the equity and efficiency of property tax revenue mobilization (Linn, 1980; Kelly, 2000, forthcoming; UN-HABITAT, 2011).

The **policy factors** focus primarily on the structure of the tax base and tax rates which determine the legal tax capacity; while the **administration factors** directly affect the realization of that tax capacity through the tax base coverage (CVR), the valuation (VR) and the collection (CLR) ratios. In short, property tax revenues are equal to the tax base multiplied by the tax rate, adjusted for the administrative ability to capture the properties on the tax rolls, estimate accurate property valuations, and assess and collect the tax liability, all affected by the quality of taxpayer service.

$$\text{Tax Revenue} = \frac{[\text{Tax Base} * \text{TR}]}{[\text{Policy Variables}]} * \frac{[\text{CVR} * \text{VR} * \text{CLR}]}{[\text{Administrative Variables}]}$$

### The Policy Variables:

- a. The **Tax Base** is defined by government policy in terms of what is and is not included in the tax base, and on the basis on which the tax will be levied (ie, area or value).
- b. The **Tax Rate (TR)** is defined by government policy to be the tax amount per value of a property under an ad valorem property tax system, or by the amount per unit of property under a pure area-based rating system.

### The Administrative Variables

3. The **Coverage Ratio (CVR)** is defined as the amount of taxable property captured in the tax registry, divided by the total taxable property in a jurisdiction. This ratio measures the completeness of the tax roll information and is determined by the administrative efficiency of identifying and capturing property data using field surveys, secondary property information, and/or taxpayer-provided information, and ensuring the correct application of legally approved exemptions, reductions and tax relief policies.
4. The **Valuation Ratio (VR)** is defined as the value on the valuation rolls divided by the real market value of properties on the valuation roll. This ratio measures the accuracy of the property valuation level (ie, what percent of market value is being captured through the valuation process). The valuation ratio level is determined primarily by the frequency and accuracy of the property valuation process.
5. The **Collection Ratio (CLR)** is defined as the annual tax revenue collected over total tax liability billed. This ratio measures collection efficiency on both current liability and tax arrears, determined largely by political will, taxpayer service and the effective use of incentives, sanctions and penalties.

The administration variables can be grouped into those related to tax base administration (ie, coverage and valuation) and those related to the treasury functions of billing, collection, and enforcement (ie, captured under the collection ratio). These two separate but complementary groupings are important when structuring tax administration options so as to take advantage of distinct skill capacities, economies of scale, and avoidance of conflicts of interest and possible collusion.

To make the property tax work, reformers need to identify a strategy to combine and sequence an appropriate set of policy and administrative interventions which can be accepted, adopted, implemented and sustained in an efficient and equitable manner. Any set of policies chosen must be implementable, linked to political, institutional and administrative realities. Policy

choices may identify the potential property tax benefits, but it is the quality of administration that will enable governments to realize those property tax revenue and equity objectives.

Policy choices appropriate for one reform environment may not necessarily be appropriate for another reform environment. While the same theories may apply to every situation, the exact mix of policy and administrative reform interventions will necessarily vary, cognizant of the unique reform environment inherent in each situation. Herein lies the art of property tax reform. For the reform artist to be successful, the artist must understand the theory, the unique reform environment, and the array of policy and administrative alternatives and then creatively adapt and craft these various components into an appropriate, successful property tax reform strategy.

Let us now explore these components, focusing first on policy choices and administration options, followed by implementation strategy considerations. We will then summarize key recommendations for making the property tax work.

## **2.1. Exploring the Property Tax Base**

Property tax policy must define the composition of the tax base and the structure of the tax rates, along with the definition of the taxpayer (owner, occupier and/or beneficiary), valuation standards (valuation—capital or annual rental value—or area basis) and the related assessment, billing, collection, enforcement and dispute resolution issues. There are strong similarities, yet with interesting diversity, in the policy choices adopted by different countries across income levels, geographic and population size, legal and institutional systems, political and administration structures, historical legacies and the degree of decentralization, among others [Almy (2001), Bahl (2009), Bahl, Martinez-Vasquez and Youngman (2008, 2010), Bird and Slack (2004), De Cesare, 2012, Franzsen and McCluskey (2005), Kelly (2000, 2001, 2004, forthcoming), McCluskey (1999), Rosengard (1998), UN-HABITAT (2011), Youngman and Malme (1994, 2002)].

To quickly summarize, countries typically define the immovable property tax base to include both land and improvements (eg, buildings), although there are some countries that only tax land (eg, Jamaica, Kenya, New Zealand and Australia) or only improvements (eg, Ghana, Tanzania). Many taxing jurisdictions also include machinery and equipment in their tax base (eg., US and Canada). There are advantages and disadvantages with each tax base definition, and there are strong advocates arguing for each alternative. However, regardless of the actual tax base chosen, countries typically define that tax base coverage as broadly as possible to ensure the capture of adequate revenue in an efficient and equitable manner.

The tax base definition as to whether the property tax will be levied on land and/or building and/or equipment is not the major policy challenge. The real challenge is defining what will not be included in the tax base, that is, the exemptions and related tax expenditures. Although there are commonalities, tax base exemptions vary across taxing jurisdictions, based on such factors as

nationality, ownership, property use, property characteristics and/or characteristics of the property owners / occupier.

Although many exemptions may be well intentioned, reformers must recognize that all exemptions are implicit subsidies or tax expenditures affecting both revenue and economic behavior, which can in turn impact efficiency and equity. International best practice would be to minimize the number of exemptions and tax relief schemes, while more effectively targeting the remainder, so as to best achieve intended government objectives at least economic, administrative and compliance cost.

However, reforming these exemptions can be challenging. Aside from the political difficulties of dealing with constituencies affected by these exemptions, reformers are confronted by the difficulty of even identifying the magnitude of existing exemptions, as exemptions are often spread throughout multiple laws including the Valuation for Rating Act, the Property Tax Act, and a myriad of other miscellaneous laws on foreign and domestic investment, economic development, mining, sector specific laws linked to hotels and tourism, commercial development, cinematography, among others. This fragmentation of exemptions, spread throughout different legislations and granted by different agencies, makes the reform process a technical, institutional and political challenge, especially in developing countries.

The common property tax exemption across all countries is diplomatic property based on the Vienna Convention on Diplomatic Relations. Countries also typically exempt government-owned properties used for government purposes, although some countries provide for a Contribution in Lieu of Rates (Kenya), Payment in Lieu of Tax (PILT) (Canada and US) or Grants in Lieu of Taxes (Provincial Level in Canada).<sup>1</sup> And there are also some countries that explicitly tax government property either at the full rate (South Africa) or at reduced differential rates (Malawi with a 50% reduction and Namibia with a 20% reduction) (Kelly et al, 2001, Franzen, 2012).

Exemptions are also usually given to properties owned by religious institutions but limited to places of worship or other limited religious purposes. Education and health properties are often given a full exemption; although some countries provide only a partial exemption by taxing privately-owned facilities at a reduced tax rate (South Africa), while other countries provide an option for voluntary Payments in Lieu of Taxes (USA) (Kenyon and Langley, 2010). Although there may be a constitutional or legal rationale for granting exemptions for religious, educational and medical facilities, it is also economically rational to allow some level of exemption / tax relief in light of possible positive social externalities generated from these properties.

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<sup>1</sup> See Corn (2012) on the PILT (USA), Government of Canada (2012) on the PILT for the Government of Canada, Muniscope (2010) on Provincial level 'Grants in Lieu of Taxes' to municipalities, and Kelly (2000) on Contribution in Lieu of Rates (Kenya).

Countries also commonly provide an exemption threshold to eliminate low value properties from paying the property tax, although some countries require every property to pay at least a minimum tax amount for services (Jamaica, Latvia, State of Hawaii, Perth, Australia) (UN-HABITAT, 2011; Perth, 2012). In Latin America it is common to provide exemptions/tax relief for social purposes aimed at low income families, widows, retired and elderly people, pensioners and orphans (De Cesare, 2012).

There are also exemptions, especially in developing countries, which are given to a large portion of the potential property tax base, such as residential properties and agricultural properties. Although the rationale given is a mixture of concerns for equity, administrative efficiency and political expedience, these exemptions can have major implications on equity, efficiency and revenue, depending on how they are structured.

For example, poor small subsistence farmers, especially in developing countries, should perhaps be exempt from property taxation to improve equity. In fact, taxing small rural farmers can cost more in administration and compliance costs than the amount of revenue collected, plus governments often provide very minimal public services to these rural properties. The same logic, however, does not apply to large commercial farmers. Countries which currently do not tax agricultural properties (eg, Tanzania, Guinea and Tunisia) should perhaps explore options to tax at least large commercial agricultural properties through introducing a minimum area rate on large commercial farmers.

Another popular exemption is the granting of tax relief to residential properties. In some countries, the push is to exempt all residential properties while in others it is to grant a single exemption to the owner-occupied residential unit (Egypt, Indonesia). While providing a blanket exemption for all residential properties may be politically expedient to garner popular support, it can generate a large loss in foregone revenue and dramatically impact equity, without effectively targeting those most in need of tax relief.

Developing countries overall face a major administrative constraint in trying to target exemptions. For example, granting a single owner-occupied exemption requires tax departments to be able to link the property (ie, the tax object) uniquely to the taxpayer (ie, the tax subject) and to be able to verify that the person living in the house is the owner and is only receiving one exemption across all jurisdictions. This proves virtually impossible to implement and enforce in countries with limited coverage of legal and fiscal cadastres and a lack of information sharing across taxing jurisdictions. Thus, although well intentioned and designed to promote greater equity, such policies are often thwarted in practice during implementation in developing countries.

Another set of exemptions often given are those linked to promoting economic development, which are quite common in OECD countries. The expectation is that these exemptions will attract and stimulate economic investment and growth to a specific region and/or to

specific areas within a city. Although quite popular among politicians and the business community, studies tend to conclude there is little evidence that these tax exemptions are effective (Kenyon, Langley and Paquin, 2012). In general, the lesson is that the property tax should be seen primarily as a revenue instrument, not as a tool to fine tune economic development and/or affect land use development patterns.

Theory and international experience confirms that poorly designed and poorly implemented tax exemptions can dramatically reduce the effectiveness of the property tax, creating a drain on revenues, increasing inequity among taxpayers and introducing major inefficient behavior and distortions. These exemptions play havoc with the tax base making it imperative for reformers to carefully review, evaluate, redesign and monitor the exemption structure to ensure that any expected social and economic objectives are being obtained at the least economic, administrative and compliance cost. This requires a political and technical process, with reformers recognizing that the political aspects often dominate the policy discussion.

## **2.2 Exploring the Tax Rates**

The second important policy choice is the determination of the tax rate structure. Once again, there is diversity throughout the world, with some jurisdictions levying a uniform single tax rate (either on a percentage basis or as a unit rate) while others apply differential rates across types or uses of property (eg, a classified tax rate structure). Still other jurisdictions levy the tax on a progressive rate, taxing higher value properties at a higher marginal percentage rate. Other countries require a uniform tax rate to be used, but do allow for valuation assessment ratios to vary by type of property, effectively allowing for a classified effective tax rate structure (Philippines) (Guevara, 2003). Given the often complex structure of the tax liability assessment process, reformers need to fully understand the explicit statutory tax rate structure and the underlying effective tax rate structure.

Applying a uniform legal tax rate on all properties allows the property tax liability to vary only by the differences in the property valuation. A high value residential property would therefore pay the same amount as an equal value commercial or agricultural property. The tax would be truly an “ad valorem” tax, with the amount of the tax based solely on the property value, not a function of differential land use and/or ownership tenure. The property value itself would capture any differentiations caused by characteristics such as location, size, property use and ownership rights.

In terms of administrative feasibility, a uniform rate simplifies administration and reduces discretion during the tax liability assessment process. In many developing countries with weak zoning and land use regulations, tax officials must use discretionary judgment to classify and determine the appropriate tax rate for each property use when properties have multiple uses—such as a residential property also serving as a medical clinic. Discretion, without clear accountability oversight mechanisms, can lead to the misapplication of the expected tax rate policy, leading to loss

in revenues, equity and efficiency. It is therefore recommended, whenever possible, that a uniform tax rate be applied in developing countries.

However, many countries adopt a classified system, allowing the property tax rate to vary by property use and tenure. Although there may be legitimate policy reasons for doing so, it appears that the introduction of differential tax rates may be largely for political reasons. For example, lower tax rates on agricultural land provides a subsidy to agriculture, taking pressure off those agricultural properties located at the urban fringe to be converted from agriculture to urban land use.

Higher tax rates on commercial and industrial properties are often justified as ‘fair’ based on the business’s “ability to pay” as a cash generating operation and with the argument that the business properties are not fully paying for the benefits they received from the government. However, the incidence of a business tax is quite complex, as property taxes levied on businesses may not be fully borne by the business owners but rather shifted backwards to the factors of production and forward to consumers in various ways, affecting both equity and efficiency. In terms of capturing the benefits enjoyed by businesses, studies in Canada and the US show that the business sector is often overtaxed in terms of the net benefits received, thus there are economic arguments to lower the property tax rate on business properties (Kitchen, 2005). Taxing business properties above the threshold of benefits received allows local governments to ‘export’ the tax to non-residents, breaking the efficiency linkage between local expenditures and local revenues.

In developing countries, however, where commercial properties may not be fully paying for the local services received through user fees and local level income and consumption taxes, there may be a greater justification for applying a higher property tax rate on commercial properties as a ‘benefit tax’ for locally-provided public services.

Some countries have chosen to apply progressive tax rates based on the individual property value (eg, Colombia, Bolivia, Chile, Guatemala, Peru and Brazil, Egypt India) (De Cesare, 2012, Kelly, 2011, NIUA, 2010).<sup>2</sup> The use of progressive rates is rationalized as a way of shifting the property tax burden to those properties with a higher “ability to pay.” The validity of this argument is questionable, however, since there is little correlation between a property and taxpayer income. That is, there are many low value properties owned by wealthy taxpayers while there are higher value properties owned by “asset rich-cash poor” taxpayers.

Most countries do not use progressive tax rate structures for their property taxes, but reserve the use of progressive rate structures for their income taxes. The only country that has successfully applied the property tax progressively on the comprehensive value of all land and residential properties is the Republic of Korea under their national-level Comprehensive Real Estate Holding

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<sup>2</sup> NIUA (2010) reports wide variation in a country as diverse as India. Ahmedabad, Chennai, Indore, Kulkata, and Pune apply progressive rates; while Bangalore, Ludhiana, and Patna use a classified tax system applying a flat rate differentiated by residential and non-residential.



Tax, which is applied on top of the regular property tax (Government of Korea, Ministry of Strategy and Finance, 2012). The Korean government is able to link the property ownership records with family registration records to aggregate total property holdings for progressive taxation. In most countries, however, comprehensively linking properties to individual owners is virtually impossible and thus it is administratively impossible to tax immovable property progressively in a comprehensive manner. And, in fact, the Government of Korea announced in 2008 that the Comprehensive Real Estate Tax will be replaced overtime with a tax on the wealthy, with short term changes introduced on its administration from 2012 (Chosun, 2008).

Rather than taxing properties under a progressive rate structure, most countries tend to adopt simpler property tax rate structures to ensure transparent and accountable revenues. Even countries which previously applied complex progressive rates are shifting to simpler tax rate regimes. For example, in 2005, Jamaica shifted from its complex, progressive rate structure for its annual property tax to a simple flat rate structure to remove the tax rate complexity and improve tax payment compliance.<sup>3</sup> Shifting away from a progressive rate structure can have a number of advantages: **First**, it can reduce the incentive to sub-divide property for purely tax purposes. **Second**, it can lower the tax burden on high value properties, which may encourage greater levels of tax compliance. **Third**, it can eliminate the problem with bracket creep, where properties can naturally fall into the higher tax brackets as property values naturally increase, unless the brackets are indexed to the general property value increases. **Fourth**, it can make it easier to adjust the rate over time (Sjoquist, 2004).

Although a uniform tax rate may be the ideal option for developing and transitional countries, it often proves to be politically difficult, forcing countries to introduce multiple rates to cater to specific groups of properties. In countries that do adopt a classified tax rate structure, the number of different tax rates should, to the extent possible, be kept to a minimum, with perhaps a maximum of three tax rates being differentiated for agriculture, residential and non-residential properties.

Reformers should recognize that, unless the property tax is being administered effectively, the differential rates prescribed under the law may not necessarily be the same differential rates applied in practice. Therefore some tax systems require higher level government to provide oversight and approval to ensure a minimum quality of tax administration before being granted permission to adopt a classified tax rate structure (eg, Department of Revenue in MA, US).

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<sup>3</sup> Jamaica simplified its tax rate structure by removing bands and caps, introducing a flat rate of J\$600 for values up to a threshold of \$300,000, and a flat rate of 0.5% on the amount in excess of \$300,000. In 2010, the tax rates were adjusted upwards to a flat J\$1,000 for values up to \$300,000, with a flat rate of 0.75% for amounts in excess of J\$300,000. See <http://www.jamaica-gleaner.com/gleaner/20100425/business/business4.html>.

In order to effectively link property tax reform to fiscal decentralization efficiency and accountability objectives, reformers need to allow a degree of tax rate setting powers to the local government level. A degree of local tax rate discretion is critically important for the decentralization process as it can improve economic efficiency, allowing local governments to establish their spending priorities and set the tax rate to realize revenue needed in accordance with local demand. In addition, rate setting power can strengthen the assembly's accountability with its citizens, encouraging residents to monitor both the revenue collection and local expenditures more carefully (Bird and Bahl, 2008; UN-HABITAT, 2011).

Despite the importance of granting tax rate discretion to the local level, in reality, there are many countries in which the tax rate is determined by the central government, with no discretion given to local governments. For example, most countries in Latin America have property tax rates set by the central government, with the exception of municipalities in Colombia, Ecuador and Honduras, which have the power to set rates within a range defined in national legislation (De Cesare, 2012). In transitional countries, the national government usually sets the tax rate, with two notable exceptions, namely Estonia and Poland, where municipalities are allowed to set their own rates within limits imposed by a senior level of government (Youngman and Malme, 2002). In North America, Europe and Asia, however, local governments are largely given the power to set their tax rates, at least within limits established by the central government legislation. Indonesia's recent property tax devolution reform in 2010 provides a good example of local governments being granted tax rate discretion specifically to support decentralization reforms (Kelly, 2012).

To conclude, as regards tax rate policy choices, theory and international best practice suggest the need to allocate the property tax rate setting (at the margin) to the local government for efficiency and accountability reasons. A combination of central level and citizen oversight of rate setting is important to ensure achievement of the revenue, equity and efficiency objectives. To the extent possible, reformers should push for a uniform tax rate to simplify administration, allowing a greater focus on improving property tax administration linked to coverage, valuation and collection ratios. In the event that a classified system is inevitable, the number of tax rates should be kept to a minimum to avoid unintended major distortions in revenue, equity and efficiency.

However, all government policies on the tax base and tax rates are only effective if these are implemented in a consistent, accountable and transparent manner. The implementation success is dependent upon the quality of tax administration as discussed in the following section.

### **2.3 Exploring Tax Administration Coverage, Valuation and Collection**

"Tax Administration is Tax Policy" is now a well-recognized statement emphasizing the importance of tax administration in realizing any tax policy objectives (Casanegera de Jantscher,

1990). Although tax policy choices are obviously important, the larger challenge is always in implementing those policies, especially in developing countries with weak administration capacity.

Property taxation is a very administrative-intensive tax which requires proactive, intentional tax base identification, tax base valuation, tax liability assessment, tax billing and collection, tax enforcement, and taxpayer service and dispute resolution (Mikesell, 2007). These various administrative functions must operate in an integrated manner, interactively supporting the achievement of the revenue, equity and efficiency objectives. While all of the administrative functions contribute to defining the potential tax revenue, it is the collection function that is vital to transforming these potential to reality. Reformers need to recognize this crucial role of the collection function when designing the administrative priorities and sequencing the property tax reform implementation strategy (Kelly, 2000, forthcoming).

To improve the administration efficiency, property tax departments everywhere are structuring themselves along functional responsibilities, separating the fiscal cadastre functions (ie, tax base identification and valuation) from treasury functions (ie, tax liability assessment, tax billing collection, and tax enforcement) to allow for specialization and to minimize possible conflict of interest and collusion opportunities. Throughout the world, dispute resolution and taxpayer service functions are managed separately to ensure independent objectivity and service to taxpayers on issues related to the fiscal cadastre and treasury functions.

### **2.3.1 Exploring the Property Tax Coverage Ratio**

The first step in property tax administration is to assemble and maintain property tax base information, which involves the collection, recording and management of property information on both land and improvements, in accordance with the legal tax base definition. The tax base must be identified before one can tax that base.

Case studies in developing countries suggest that the coverage ratio for the property tax may range from 40-80% (Bird and Slack, 2004, Kelly, 2000, De Cesare, 2012, UN-HABITAT, 2011). The challenge is to ensure that this basic information is complete, up-to-date and accurate—that is, to maintain the coverage ratio as close to 100 percent as possible so as to capture the total potential tax base.

To do this in a timely and cost-effective manner, governments are increasingly following a partnership approach, where the government works together with taxpayers and 3<sup>rd</sup> party government and private sector agencies and individuals handling property tax-related information to collect information on taxpayers and the properties. This partnership approach to fiscal cadastre maintenance essentially outsources the information collection and updating process to reduce direct tax administration costs, while improving information availability. The limited government tax administration resources can then be focused selectively on auditing the submitted information and undertaking active field work where appropriate to ensure an accurate coverage ratio.

Property tax legislation and regulations typically require taxpayers to self-declare taxpayer and property characteristics (including physical and valuation-related information). The taxpayer self-declaration process is common in all property tax jurisdictions, but is often confused with self-valuation and self-assessment. Although each approach involves a taxpayer declaration of information which affects the quality of the coverage ratio, the self-valuation procedure also involved the taxpayer in the valuation, assessment and payment components of the collection ratio, while the self-assessment procedure involves the taxpayer in the coverage ratio, relies on the government for the valuation ratio and then relies on the taxpayer for the assessment and payment components of the collection ratio. While various countries may try either one or several of these approaches, reformers must understand the implications of each approach when designing a strategy to improve overall property tax administration.

In addition to taxpayers reporting on their individual property information, countries also often require 3<sup>rd</sup> party public and private sector agencies and individuals to submit their property-related information to the tax department in a timely manner. These 3<sup>rd</sup> party agencies and individuals would include the Ministry of Public Works, Ministry of Public Housing, Ministry of Lands, Surveyor General, Titles Registry as well as all private sector agencies, such as utility companies, real estate agents, rental agencies, notaries, lawyers, banks, and others. Failure to submit this information should result in appropriate penalties.

One key to this partnership approach is to determine the minimum needed property-related information, design the data capture mechanism (either manual or digital) and implement a systematic capture, processing and analysis of the taxpayer and third party information, accompanied by an appropriate awareness, education and support campaign. The property declaration / reporting form should be simple, user friendly and strictly limited to information needed to build and maintain the fiscal cadastre. Information collected but not used to improve the coverage, valuation and collection ratios is very costly.

One challenge to this partnership arrangement in developing countries is that many 3<sup>rd</sup> party agencies are also in a process of institutional development and reform, focusing on trying to improve the quality of their own information management and service related activities. Thus, any property tax reform effort towards improving the fiscal cadastre is also dependent on the quality and timing of these other agency reforms. And, as international experience confirms, information sharing across agencies is not solely a technical exercise but faces many institutional and procedural constraints to inhibit the free flow of accurate and timely information to support property tax reform administration.

As part of the partnership approach to fiscal cadastre information maintenance, tax departments must occasionally take proactive action to undertake field work, in order to audit the taxpayer declarations and 3<sup>rd</sup> party information as well as to conduct systematic property tax

coverage activities to identify properties, collect and manage relevant information and maintain and use that information to ensure the fiscal cadastre is complete and up to date.

This proactive approach is also required to initially build a tax registry, update a tax registry after a period of no maintenance or when conducting a major property valuation reassessment. Increasingly, simple, field based procedures, accompanied by appropriate technology are being used, as illustrated in the Philippines (Dillinger, 1991), Indonesia (Kelly, 1996), and most recently as reported in Somaliland, among others (UN-HABITAT, 2011).

To take advantage of economies of scale, ensure equitable treatment in application and overcome capacity constraints, there are strong arguments to involve central government in fiscal cadastre maintenance activities, including property valuation (Mikesell, 2007). Many countries depend heavily on central government to directly support the property tax cadastre and valuation (Colombia, Jamaica, Bahamas, Kenya, Uganda) or on state / provincial governments (Maryland/Hawaii in US, British Columbia/Ontario in Canada, Mexico, India). Meanwhile other countries depend on central / state governments to set and monitor the fiscal cadastre and valuation standards (US, Mexico, NZ, Malaysia) (UN-HABITAT, 2011; De Cesare, 2012). Based on the subsidiarity principle, each country should “unbundle” its tax administration activities, assigning relevant functions to the appropriate government level.

There is very diverse experience in the functional division of property tax administrative responsibilities across levels of government. The fiscal cadastre/valuation functions are often under central government responsibility, unless local governments can demonstrate capacity (Colombia). In other countries local governments are given the responsibility, unless they transfer the responsibility to the higher level of government (Mexico). In some countries local governments are fully responsible for the fiscal cadastre, regardless of their institutional capacity (Brazil, Venezuela and Ecuador) (De Cesare, 2012).

This division of responsibility and the role of the central and local governments in tax administration is a critical challenge currently facing the devolution of the property tax in Indonesia. According to Law 28 (2009), all administration responsibilities, including fiscal cadastre and valuation, are to be shifted to the local governments. A recent ADB study suggests that, while all local governments have the capacity to assume the treasury functions related to collection, only about 30% of the local governments could realistically assume the fiscal cadastre / valuation responsibilities in the short term with the remaining 300+ local governments (70 percent) needing some form of central administration and/or joint administration support for the medium to long term, as local capacity is increased over time (Kelly, 2011).

Capacity building and effective human resource management at the local government level are crucial to implementation success. To make best use of scarce capacity, reformers should clearly separate data collection functions from valuation functions. Property field information enumerators need to be experts in filling out the required property information forms and do not need to be

experts in valuation. Scarce valuation experts should focus on determining land value maps, building cost tables and other valuation-related models, which can be applied to the collected information in the fiscal cadastre. In many countries this will require a change in the law and/or regulations, which currently stipulate that the valuation roll (including the collection of property information) is the responsibility of a qualified valuer (Uganda, Tanzania, South Africa) (McCluskey, et al, 2003; Kelly, 2000).

Although government policy measures can facilitate the systematic maintenance of property-related information, the coverage ratio can only be substantially improved through adopting appropriate administrative procedures, relying on a partnership approach working with taxpayers, and 3<sup>rd</sup> party agencies, taking advantage of the relative strengths of the central and local governments, providing capacity and incentives, and ensuring systematic and periodic cadastral information maintenance. Given the dynamic nature of urbanization, this is a continuous and information intensive activity.

Let us now turn our focus to the important valuation ratio.

### **2.3.2 Exploring the Property Tax Valuation Ratio**

The importance of the valuation ratio, as defined, applies only to property tax systems that levy taxes based on property value. Area-based systems only need accurate cadastre information on property characteristics. Valuation-based systems depend both on the quality of the cadastre information under the coverage ratio as well as the accuracy of property valuation estimates under the valuation ratio.

Case studies, especially in developing countries, suggest that the valuation ratio for properties may be no more than 30-40%, with large variations in the accuracy of the relative valuations (Bird and Slack, 2004, Kelly, 2000, De Cesare, 2012, UN-HABITAT, 2011). Although valuations may be relatively more accurate when first produced, this accuracy erodes over time due to shifts in relative and absolute market values. These low valuation ratios and the variation among the property values create efficiency and equity distortions, which impact the compliance level and the revenue yield from the property tax.

The purpose for property tax valuation is to determine the property tax amounts that each taxpayer will be expected to pay based on the relative property value vis a vis other taxpayers. Property valuation should be primarily undertaken to promote equity in the tax system so that properties of equal value should pay equal amounts; and not to determine the total level of tax liabilities. The absolute amount of the property tax revenue to be collected should be decided through a policy choice linked to property tax rates. If the government needs additional tax revenue in a particular year, the government should increase the tax rates, rather than solely adjusting the absolute or relative property valuations.

The accuracy of the absolute and relative valuation ratios requires constant attention to ensure consistent and periodic updating of valuation rolls, so as to capture the changes in property market values. Within an appropriate legal and regulatory framework, countries need to adapt appropriate valuation standards tailored to institutional, system and human capacities and the availability of market-based information and appropriate valuation methodologies.

Although the absolute valuation level could be supported through indexing the tax base to an annual inflation rate, indexation itself does not adjust for the relative changes in value across properties. For those relative value changes, international best practice suggests that tax departments should update property values at least once every 3-5 years, perhaps annually in case of dramatic increases in property values. Frequent revaluations are important to maintain equity and revenues as well as to reduce taxpayer resistance to periodic large increases in property values.

Tax departments must be proactive in updating the valuations included in the tax rolls. This should be done through relying on valuation-related information from taxpayer declarations and 3<sup>rd</sup> party agency reports as well as a separate, integrated set of activities related to the collection and analysis of property market trends and linking property characteristics to changes in property value over time. This market trend analysis can then be used to update the property tax roll on a periodic basis.

There is a continuum of valuation methodologies available—ranging from simple market based land value maps and building costs tables used throughout Latin America and SE Asia to the more complex statistical estimation models used largely in North America. A uniquely different market value approach is the ‘banding’ system in England, which classifies all residential properties, based on their estimated capital value, into 8 interval ‘bands’ of value (Plimmer, et al, 2002).

To implement the range of simple to more complex valuation systems, all countries need to access, collect, manage, analyze and monitor market information on property prices in order to update the valuation roll. This information will largely come from third party sources such as conveyance documents, other government departments, banks and mortgage institutions, newspaper and other sources. Tax departments need to develop administrative procedures to systematically collect and analyze market value information from a variety of third party sources. This market value information can be used to develop land value zones and building cost tables under the simple market value based system or as inputs into various statistical models in those economies with easy access to quality market value information. The accuracy and equity on the valuations depends primarily on the quality of the available market information, not on the sophistication of the modeling.

To ensure consistency, transparency, accountability and equity in the property valuation and assessment process, all property tax systems must include an appeals and dispute resolution component. Taxpayers should be able to lodge an objection to the property assessment valuation

and/or the tax liability calculations based on that valuation. Such appeals systems are essential to help ensure that property valuations are fair and close to market value, which produces a more accurate and high valuation ratio. International best practice provides for both administrative and judicial appeals, with multiple levels to ensure fair, cost efficient and quick resolution. To avoid frivolous appeals, countries typically require a taxpayer to pay either all or a part of the property tax liability before being allowed to file a judicial proceeding.

Several countries are constrained in the valuation of rent controlled properties (Egypt, India). These laws and regulations control the setting of the rents, which in turn affects the property values determined for those properties. Rent control constrains the equity of the property tax system. For example, although residents living in rental control units use the same government services as residents in non-rental control units, those in rent control units are being subsidized by being charged less property tax. Property tax revenues needed by government to pay for local level services are therefore underfunded or governments are forced to shift a larger tax burden to those occupants living in non-rent control units. To circumvent this rent control constraint, many Indian states have successfully shifted towards a simplified area-based valuation approach, basing the property tax valuations on a unit area values based system rather than on the annual rents themselves (Mathur, et al, 2009, NIUA, 2011).

The valuation ratio is closely linked to the coverage ratio, as the combination of coverage and valuation determine the quality of the fiscal cadastre. The administrative procedures for capturing the taxpayer and tax property information, combined with the technical capacity and property valuation information needed to estimate valuations, are essential for ensuring that the valuation roll effectively captures the total potential property tax base. It is this potential tax base which is used by the tax department to levy the property liability for collection.

Let us now turn our focus to the important collection ratio.

### 3.3 Exploring the Property Tax Collection Ratio

Property taxation is primarily an instrument designed to mobilize government revenue in an efficient and equitable manner, at the least economic, administrative and compliance cost. Identifying and valuing the tax base produces the valuation roll, which represents the potential legal tax base. Applying the tax rate to the valuation roll produces the tax roll, which represents the potential tax revenue. This potential tax revenue is then transformed into reality through the tax collection process. Without the ultimate tax collection, the property tax system will not be able to achieve the revenue, equity or efficiency goals.

Property tax collection levels vary considerably across countries. Collection rates in most OECD countries are close to 100%; while in most non-OECD countries collection ratios only range from an estimated 30-60 percent (Bird and Slack, 2004; Kelly 2000, 2012; NIUA, 2010; Youngman and Malme, 1994, 2002). These low collection ratios can be attributed to a



combination of political, cultural, administrative and personal reasons, requiring governments to implement policy and administrative changes to encourage voluntary compliance and to take decisive action to enforce against cases of non-compliance.

To improve the collection ratio, countries should focus first priority on enhancing voluntary compliance, providing incentives to taxpayers to pay their taxes in a timely manner. Possible incentives can vary, from linking the property tax payment to improved public services, enhancing taxpayer service, reducing compliance costs, and providing discounts and incentives for timely and complete payment.

Linking property tax revenue collection to a general improvement in public services is very important. The property tax, unlike user charges for direct services such as utilities, cannot be easily linked to a specific government service. Thus it is important that taxpayers understand the role of property tax as a general benefit tax linked to location-specific infrastructure and services, such as improved roads, drainage, and parks. To encourage this understanding, governments need to undertake taxpayer awareness and education, explaining the role and benefits of property taxation and, even, more importantly; governments must effectively use property tax revenues to deliver those improved public services in an efficient and accountable manner.

Taxpayer education programs are also critical to provide information on the property tax structure, payment procedures, appeals and dispute mechanisms, and enforcement provisions. This information, combined with simplified and easily accessible payment systems, can lower compliance costs and encourage voluntary compliance. In order to reduce administrative and compliance costs, countries are increasingly providing multiple convenient payment options through banks, post offices, ATM machines, or via internet, electronic checks and credit cards, and allowing for direct bank deductions and/or payments through cell phones credit transfers. Some countries try to link the property tax to the electricity or water bills to facilitate collection (Greece, El Salvador, South Africa).

Effectively using social pressure to encourage property tax payment compliance has been effective in many countries. Publishing names of top compliant taxpayers publicly recognizes outstanding compliant taxpayers as positive role models, thereby helping to encourage voluntary compliance (Philippines, Indonesia). Other countries publish the names of the delinquent taxpayers, who are given advance notice to pay the tax to avoid the negative publicity (Kenya, Malawi, Tanzania). Some countries provide a direct monetary incentive to encourage compliance by giving a discount for those paying in a timely and complete manner (Philippines, Barbados, Ecuador, and Kenya) (Kelly, forthcoming).

In addition to lowering compliance costs and providing incentives to encourage tax payments, countries also encourage voluntary compliance through applying stricter enforcement measures in the form of sanctions and penalties (eg, the imposition of late payment penalties,

possible interest payments, various sanctions such as the use of tax clearance certificates, tax liens, and penalties). Credible strict enforcement against non-compliance can encourage a culture of voluntary compliance to avoid being sanctioned or penalized.

In cases of non-compliance, countries apply sanctions and penalties. Sanctions can be applied to the withholding of location-specific public services (eg, building permits, business licenses, land/title registration, withholding and/or suspension of utilities) typically enforced through “tax clearance certificates.” Tax clearance certificates could also be required for private sector services (eg, financial institutions issuing mortgages or home equity loans) and other public sector departments and private sector agencies to promote collection compliance.

In addition to requiring tax clearance certificates, countries should be able to impose a tax lien (or encumbrance) on the title of a property to ensure tax payment when the property is sold or transferred. A tax lien on a property also affects the collateral value of a property for borrowing purposes. This tax lien approach should be encouraged for those properties in non-compliance with legal title. A combination of tax clearance certifications and tax liens can be quite effective to deter non-compliance.

To complement incentives and sanctions, countries should apply a system of progressively strict penalties to encourage compliance. These typically include the imposition of a lump sum payment penalty and/or a monthly interest payment for late payment to encourage compliance by increasing the cost for non-payment (Bahamas, Indonesia). Government policy should make interest payments for late property tax payment consistent with other major taxes, such as VAT and income taxes, and these should be set higher than the prime interest rate to encourage early tax payment.

Ultimately these late payment and interest penalties must be enforced through tax debt recovery. Countries use various alternatives to secure legal debt recovery, including civil proceedings, the ability to garner wages and rents, seizure and sale of movable properties and/or the seizure and sale of immovable property (Philippines, Indonesia, US, Canada, Chile). Other options for enforcing property tax collections include linking the property tax to location specific services. For example, South Africa allows cutting electricity in cases of non-payment,<sup>4</sup> while the court in Greece in 2012 has ruled that cutting electricity for non-payment would be unconstitutional.<sup>5</sup>

In North America, tax departments ultimately rely on property seizure and auction to enforce compliance for tax nonpayment leading to collection rates close to 100 percent. In contrast, enforcement using seizure and auction in developing countries is very rare, with three

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<sup>4</sup> <http://www.news24.com/SouthAfrica/News/Power-to-Shabangus-property-cut-off-20120621>

<sup>5</sup> In 2012, the Greek High Court ruled that it would be unconstitutional to cut electricity for nonpayment of the property tax. [http://articles.businessinsider.com/2012-03-02/europe/31115881\\_1\\_property-tax-ruling-electricity#ixzz24Ph9gdUy](http://articles.businessinsider.com/2012-03-02/europe/31115881_1_property-tax-ruling-electricity#ixzz24Ph9gdUy)

documented exceptions: Philippines, Indonesia and Chile (Kelly, forthcoming). Each case illustrates the importance of strong political will and technical capacity to implement enforcement measures.

Improving the collection ratio on land owned under lease rights present special challenges. While the government can take enforcement measures against freehold rights, through placing a lien against the property and ultimately selling the property to recover property tax debt, the government's only option for properties under leasehold is to take action against the individuals or businesses owing the tax, such as attaching taxpayer wages and bank accounts, seizing taxpayer movable assets, or canceling property leases. In cases where the property ownership is not clearly defined, not registered and/or communally owned, tax departments can rely on moral persuasion, communal social pressure, and/or seizure of movable properties.

Some countries have used the private sector to assist in the tax collection process (Uganda, Pakistan) (UN-HABITAT, 2011). These private sector approaches, often used for collecting market fees or parking / bus park fees, have been used for property taxation as well. Contracts are typically structured as a lump sum payment through a bidding process, with the winning contractor able to keep any amounts collected over the contracted amounts. A best practice would be to allow the government to be responsible for collecting all current liabilities and delinquent accounts for up to a year, after which the outstanding accounts could be contracted to collection agencies and/or lawyers to take legal action for recovery.

Other countries engage neighborhood organizations (Paraguay), urban neighborhood governments (Philippines), and village and/or traditional leaders (Indonesia, Sudan, Ghana) to encourage tax compliance<sup>6</sup>. To mobilize their active support, governments typically provide a collection incentive or institute a system of shared revenue from the property tax to ensure a portion of the collected property tax revenue is retained at the lower government levels (Guevara, 2003).

In short, improving the tax collection ratio requires a comprehensive collection and enforcement approach to promote voluntary compliance through a combination of payment and collection incentives, sanctions and penalties, combined with the necessary political will to ensure follow up action be taken against noncompliance to the full measure of the law. Ultimately the property tax is primarily a fiscal instrument to provide government revenues, and thus, governments must establish an efficient and equitable tax collection system to ensure that the fiscal cadastre information can be transformed into government revenue (Kelly, forthcoming).

All administration reforms require strong political and technical support, legal authority, institutional capacity and financial and human resources to implement and sustain improvements in the collection, coverage and valuation ratios. Combining these key ingredients into a successful reform strategy is important to maximizing the chance of success and assessing risks

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<sup>6</sup> See USAID (undated) for Paraguay, Kelly (1993) for Indonesia and Radio Miraya (2012) for Sudan.

of wrong sequencing, as well as synchronizing the reform effort to link effectively with the electoral, economic planning and financial budgeting cycles.

Let us now explore issues of reform implementation strategy design.

### **Reform Implementation Strategy**

Reform implementation is always a major challenge. Changes always disturb the status quo, affecting existing stakeholders both inside and outside of government, creating losers and winners, as the system moves towards a more sustainable, efficient and equitable system of mobilizing revenues. Managing this change is a difficult process of political, technical, and social reengineering, simultaneously mobilizing sufficient support to overcome the natural resistance to change, while convincing the broader society of the inherent benefits to the proposed changes. This requires a mix of quick wins to overcome opposition and gain broader support, while allowing time to implement more systemic and institutional changes needed for sustainability. Designing and implementing the appropriate reform strategy is the true challenge facing reformers everywhere. It is the creative blend of the science and art within the entire reform process.

As Machievelli observed in the 16<sup>th</sup> century,

*“... there is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new order, this luke warmness arising partly from fear of their adversaries, who have the laws in their favour; and partly from the incredulity of mankind, who do not truly believe in anything new until they have had the actual experience of it.” (Machievelli)*

Designing an appropriate implementation strategy must recognize these natural areas of resistance and the importance of garnering broad political, technical and social support to ensure ownership of the reform objectives. This ownership of the reform, and the resulting commitment and support, is critical during the design and adoption phase, but perhaps even more important during the implementation phase, to ensure sustainability in the property tax system. Often the real impacts of a reform are not clear until the reform is being implemented. It is then that the various stakeholders see the reality of the policy and administrative choices made. It is then also that strong, sustained reform leadership is needed to sustain implementation and to effectively deal with stakeholders throughout the reform cycle to enable the reform objectives to be fully realized.

Mobilizing the levels of reform support needed requires stakeholders to appreciate the costs and benefits of the reform, to engage in the debate and to develop a consensus on the need

for the reform, thereby gradually ensuring that the property reform becomes demand-driven by the broader community. Focusing solely on the property tax reforms in isolation limits the ability to mobilize the broad support needed for success. Thus it is important to broaden the agenda to include property tax reform as a requisite to broader decentralization reforms aimed at improving efficient and accountable public service delivery. Linking property revenue mobilization to improved public service expenditures will allow the government to mobilize a wider level of social support needed to implement and sustain property tax reform efforts.

Linking the property tax reform to these other reforms needs to be a critical part of any reform implementation strategy. In addition to linking the property tax reform as an input to public sector management and decentralization reforms, it is equally crucial to ensure that other reforms which affect the property tax are effectively linked to the property tax reform strategy. For example, property tax reformers should be cognizant of ongoing reforms, such as those on land titling and registration, surveying and mapping, urban and rural development, land and property transfer taxes, housing and rent control, housing development and finance, infrastructure finance, water and sanitation management, and transportation, all of which can impact the design and implementation of a property tax reform.

Designing and implementing successful reform requires strong leadership. Garnering the necessary political, technical, operational and social support needed for successful property tax reform requires strong leadership, not only at the top, but on many levels throughout the entire property tax system. Political leadership is required to ensure a sound policy and legal property tax framework. Technical leadership is required to lead the analytical process to understand and monitor the policy and administrative challenges, identify the needed changes and develop the systems and procedures for implementing the changes. Operational leadership is required to apply those policies and administration systems in the field, while social leadership is needed to mobilize the public, encourage voluntary compliance and ensure social accountability. Any reform implementation strategy should identify and empower leaders throughout the system with the authority, capacity and resources needed to support the reform effort.

Strong institutions are also essential to support the design and implementation of successful property tax reforms. Although the primary focus may be on the tax administration departments, successful reform depends on an array of supporting public and private institutions dealing with policy and administration aspects linked to land and mapping, property title registration, property valuation, public works, housing and infrastructure, business and economic development, banking and revenue management, media and communication networks, legal adjudication and enforcement and governance and social accountability, among others. In countries with relatively weak institutions, property tax reformers must recognize these constraints and the dynamic nature of institutional reform in order to develop appropriate strategies that can be implemented immediately, but which are flexible enough to adapt and grow with the improvements within the broader institutional environment. An important example is

the adoption of appropriate valuation methodologies, which can gradually improve as the supporting institutions are able to provide better quality property value information.

In light of these various political, technical and institutional constraints, many countries have effectively adopted a pilot project approach to strategically design and implement changes in the property tax system. These pilot projects allow for field experimentation to develop systems and procedures, create opportunities for training and capacity building and provide a demonstration effect, all of which can help facilitate the successful reform roll out throughout the country, while limiting the political and financial risks of introducing new reform policies and procedures (Indonesia, Philippines and others) (Bird and Slack, 2004, Kelly, 2012; UN-HABITAT, 2011).

In addition to these broad issues, a successful property tax reform requires an understanding of the integrated connections within the property tax system. Policy decisions affect administration feasibility, while administration decisions affect the policy results. Reformers should choose an appropriate combination of complementary and supportive policy and administrative options, in order to successfully realize the property tax reform objectives. Similarly reformers must appreciate the integrated nature of a property tax administration system. Each administrative function of data collection, valuation, assessment, collection, enforcement and taxpayer service and dispute resolution is necessary to generate property tax revenue, equity and efficiency. Thus, in designing an implementation strategy, reformers need to think globally, but act strategically. It is important to remember that prioritization and sequencing are not the same thing, but understanding the contributing importance of each administration function to achieving the property tax goals can assist in correctly sequencing the reform activities.

The key to property tax administration reform lies in finding how best to improve the coverage, valuation and/or collection ratios. While improvement in all three ratios is needed to achieve the potential revenue, equity and efficiency goals, it is the collection ratio that ultimately determines the realization of these goals. That is, without tax collection taking place, the potential revenue and equity impacts of the coverage and valuation will only remain hypothetical and not become a reality. Thus the collection ratio must function well, in order to enable governments to take advantage of improvements in coverage and valuation ratios.

Understanding the relative priorities of each function, combined with a situational analysis of the current property tax system performance, the reformer should be able to identify an appropriate sequencing of reform activities. Where to start? Does one start by focusing on expanding the coverage ratio? Or does one start by increasing the level and accuracy of the valuation ratio? Or should one start by focusing on the collection and enforcement? Trying to improve all functions simultaneously ignores the importance of prioritization and sequencing, especially in reform environments with limited political, institutional, financial and human capacity.

In a stylized fashion, there are two basic sequencing strategies to undertaking a property tax reform process. Countries either tend to start with strengthening property tax collections (ie, the collection ratio) through a “collection led” strategy or they tend to start with strengthening the fiscal cadastre (ie, the coverage and valuation ratios) through a “valuation-pushed” strategy (Kelly, 1993,2000, forthcoming). Let us identify the underlying rationale and appropriateness of each stylized implementation strategy, with some country examples.

The collection-led strategy places priority on improving collection and enforcement, with taxpayer service. Secondary attention is placed on improving the quality of property information and the accuracy of property valuation. This sequencing strategy recognizes that the “collection” function is what “realizes” the revenue, equity, efficiency and accountability objectives of the property tax. Improved tax mapping, fiscal cadastre information and property valuations linked to the coverage and valuation ratios are seen as secondary, but complementary to the collection process.

The collection-led strategy recognizes that a credible collection and enforcement process becomes a catalyst to drive further reforms to improve the coverage and valuation ratios. That is, it is only when property tax is actually collected and enforcement is a reality that taxpayers have a very keen interest to ensure that the property tax physical information and property values are accurate. Taxpayers then worry about appealing the property values to ensure they are not forced to pay taxes based on an inaccurate valuation. Without tax enforcement, taxpayers have the option just to ignore inaccurate property information and valuations by ignoring the property tax payment itself. Focusing on property tax collections sets in place the incentives for higher voluntary compliance and more active taxpayer participation, exerting pressure on tax administration to ensure accuracy in the property and valuation information.

This collection-led strategy approach was introduced in Indonesia following the enactment of the Land and Building Tax in 1986. The Indonesia strategy placed priority on the introduction of an effective payment collection monitoring system, which led to a credible delinquency list, thereby enabling government to undertake a historic seizure to enforce payment compliance in 1991 (Kelly, 1993). To build on the collection-led success, the reform introduced major improvements in improved property tax administration linked to the fiscal cadastre, including property valuation (Kelly, 1996). This focus on collections lasted from 1988 to 1994, after which tax administration has been focusing more on routine fiscal cadastre and property valuation maintenance, to the neglect of systematic property tax enforcement. This said, it is important to note that the current, ongoing reform in Indonesia is transforming the shared property tax system to become a devolved own-source tax revenue system, now opening up 400+ opportunities for Indonesian local governments to possibly adopt and implement an effective local-government level collection-led strategy (Kelly, 2012).

A second, perhaps more successful, collection-led strategy experience is the case of Quezon City (Philippines). Through a combination of strong local political and technical support, Quezon

has been able to sustain the collection-led strategy for over a decade. Quezon has actively pursued a collection led strategy, which blends voluntary compliance and strict enforcement, and is complemented by high quality taxpayer service and improvements in the fiscal cadastre and property valuation maintenance (Ignacio, 2005).

Both the Indonesia and Quezon cases show us the necessary ingredients for successful reform: strong political leadership, excellent technical support and the successful delivery of quality taxpayer education and awareness, lowering compliance costs, and ensuring equitable implementation of the property tax system. Although both cases followed a collection-led strategy, Quezon City appears more successful in sustaining the strategy. Quezon directly linked their property tax reform to local government management reforms, connecting the enhanced revenues with expenditures on improved local services. With its property tax as a local tax, Quezon City was able to successfully mobilize broad stakeholder support, by linking the improved property tax mobilization with improved service delivery. This case clearly demonstrates how linking property tax reform to decentralization and local government service delivery reforms is crucial to ensure a sustainable property tax reform implementation.

In contrast to the collection-led strategy, most countries follow a valuation-pushed implementation strategy. This approach places top priority on updating the property tax roll, through expanding the fiscal cadastre and improving the accuracy of property valuations. This approach assumes that major improvements in property tax yield will come from improving property valuations. The assumption is that the non-valuation administrative functions are fully functional, with the major constraint being low and inaccurate values.

Although this may be true in many OECD countries, this is typically not true in developing countries. Focusing on the fiscal cadastre and related improvements in property valuation is not necessarily as useful, when there is a primary problem of inadequate political will, collections and enforcement. At the same time, relying on a one-time valuation roll creation exercise, even by the private sector, may be expedient but not necessarily useful unless institutional capacity is simultaneously developed to ensure that the coverage and valuation ratios can be maintained over time and used to generate improved revenues.

A classic example of a valuation-pushed strategy was the USAID Real Property Tax Administration project in the Philippines in the 1980s. This reform initiative saw property tax revenues increase by less than 1 percent following a multi-million dollar project (Dillinger, 1988). Another example was the World Bank supported property tax reform in Tanzania in the mid to late 1990s (Kelly and Musunu, 2000; McCluskey, et al, 2003). Unfortunately, almost all ongoing property tax reforms around the world are being structured as valuation-pushed reforms, placing priority on GIS-based tax maps, new valuation techniques while neglecting improvement in tax collection.



Within the context of these two stylized extremes, each country should identify the appropriate priorities and sequencing to strategically implement the reform. All administrative reforms need to be comprehensive, targeted strategically to ensure success in increasing the various ratios, leading to sustainable property revenue mobilization. Although each situation differs, it is critical that reformers think strategically in choosing the appropriate mix of policy and administrative reforms and identifying the appropriate sequencing of those reform components.

Property tax reforms which are introducing new systems for the first time start by building the fiscal cadastre, perhaps by initially introducing a pure area-based system and putting in the necessary collection and enforcement mechanisms (Hergesia) (UN-HABITAT, 2011). Over time the area-based system can switch to a valuation based system, while maintaining the progress in overall property tax administration (Croatia, 2012). The key is to target the intervention appropriate to the situation, but always keeping in mind the critical importance of property tax collection and enforcement to ensure that potential can be turned into the reality.

In OECD countries, with functioning collection and enforcement systems and related supportive institutions, a valuation-pushed strategy may also be the appropriate choice. However, in most developing countries, a more comprehensive approach is warranted following a collection-led implementation strategy. In those countries which already have an operational property tax system which is confronted by low levels of collection, coverage and valuation ratios, it is suggested that a collection-led strategy may be the more appropriate approach (eg, India).

Overall emphasis should be placed on ensuring that the property tax reform places proper attention to the collection and enforcement of the tax system, mobilizing the political will and ensuring the availability of legally enforceable enforcement procedures, accompanied by the needed improvements in ensuring the highest coverage and valuation ratios. Revenue collection is the ultimate objective of a tax system, with the mapping, fiscal cadastre and valuation activities supportive components to the collection function. Without the ultimate collection of the tax, the property tax system will not achieve revenue, equity or efficiency goals.

Although policy choices affect the potential property tax liability to be collected, it is the administration choices which directly affect the level of tax effort, that portion of tax capacity that can be realized. This being said, however, inappropriate and/or complicated tax policy can make tax administration costly and/or impossible to effectively implement. Thus, reformers should carefully evaluate the policy alternatives, so as to choose tax policy options, which are implementable within the legal and institutional environment. The general rule is to keep the policy simple and appropriately tailored to the existing reform environment, cognizant of political will, legal structure, institutional capacity across property-related agencies, level of available property and market value information, human resource capacity and financial resources.

Let us now conclude by summarizing key recommendation for making the property tax work.

#### 4. Summary Thoughts for Making the Property Tax Work

Theory and international experience identify an extensive array of best practices related to successful design and implementation of property taxation. The challenge for each country is to identify the right mix of policy and administration choices, molding and adapting them to each unique reform environment, in order to lay the foundation for strategically implementing sustainable property tax reform. This paper closes by summarizing several key recommendations for helping make the property tax work in developing and transitional countries.

- **Countries should link property tax reform to broader public sector management reforms.** Property tax reform should not be seen as an independent reform to be implemented in isolation. Rather, property tax reform must be recognized as a supportive input to broader public sector management reforms aimed at improving governance and public services. This would help link revenue mobilization and improved services, a necessary ingredient to encourage voluntary compliance.

Public finance experts widely recognize the property tax as the ideal local tax. It has substantial revenue potential, with minimal efficiency distortions. It is able to capture location-specific net benefits and is relatively easy to administer. In addition the property tax is highly visible and politically sensitive, thus making it an excellent tax to generate local government revenues while forcing a degree of public and social accountability.

By recasting the property tax reform as an essential requisite for successful decentralization, property tax reforms can take advantage of the broader reform momentum, along with political, technical and popular support, and access to human and financial resources needed for success. The property tax reform can serve as a possible cornerstone for empowering local governments with a degree of financial resources in an efficient and accountable manner.

- **Countries should adopt appropriate policy.** Ultimately property tax policy choices must be implementable to realize the revenue, efficiency and equity results. Therefore policy choices need to be adopted, cognizant of the institutional and administrative constraints, recognizing that these policy choices be structured to evolve over time in line with improvements in the broader reform environment and administrative capacity. All reforms are dynamic, thus requiring government to systematically monitor and periodically adjust the property tax policy options to ensure effective implementation and achievement of the expected revenue, equity and efficiency objectives.

Reformers must focus on the tax base and tax rate choices, always bearing in mind the need for simplicity to enable implementation. Policy reform, especially in developing countries, should rationalize exemptions so as to limit tax expenditures, reduce excessively generous tax breaks, and target tax relief more effectively to reduce revenue loss, inequities and inefficiencies. Exempted properties, and those receiving tax reliefs, should be required to submit a formal request to facilitate a periodic review process. A situation of “once exempted, always exempted” should be avoided.

Tax rate structures should be kept uniform, to the extent possible. Classified tax rate systems, if adopted, should be limited to few categories, such as residential, non-residential and agricultural properties. Progressive property tax rates should be avoided. Governments need to focus on realizing property tax equity, efficiency and revenue policy objectives through improvements in administration.

- **Countries should focus priority on improving property tax administration.** Priority must be placed on property tax administration to ensure that the coverage, valuation and collections ratios are close to 100%. The weakest link in property tax reforms, especially in developing countries, is the quality of tax administration. Cognizant of the institutional, systems and human capacity constraints, countries must adopt simplified data capture, data management and tax mapping procedures, appropriate valuation methodologies, transparent assessment procedures, accountable collection mechanisms, effective enforcement systems and targeted taxpayer service. These administrative procedures should be integrated into a computer-assisted administration system which can improve the speed and accuracy of data management, valuation, billing, collection, enforcement and taxpayer service, as needed.

Ultimately all tax departments should be rationalized, unbundling the functions, allocating those functions to the level of government and/or to the private sector based on factors such as efficiency, accountability, economies of scale, need for equity, need to avoid conflict of interest, and need to mobilize political will. Doing so will improve the cost effectiveness, equity and efficiency of tax administration. A transitional, incremental approach should be adopted to phase in the reform implementation tailored to the absorptive capacity of the tax administration and the taxpaying public.

- **Countries should implement property tax reforms in a comprehensive, yet strategic manner.** Property taxation is ultimately a revenue instrument, which should generate revenues as efficiently and equitably as possible, while minimizing economic, administrative and compliance costs. The property tax administration is neither a mapping agency nor a valuation agency; all mapping and valuation functions are intermediate prerequisites needed to enable tax departments to collect revenue. Priority must be placed on collection functions, as it is ultimately only through tax collection that the revenue, efficiency and equity objectives can be achieved.

Countries must recognize that an effective tax collection function is only possible, however, if supported by an effective supportive system of tax base coverage and valuation. Therefore countries must implement a strategic combination of policy and administration reforms to improve coverage, valuation and collection ratios. While analyzing the property tax system comprehensively, all countries must identify the specific areas of reform intervention and sequence those interventions to ensure results.

In general, however, a critical priority, at least in most developing countries, should be on improving the collection system. Tax policy which is not collected / implemented will not generate the intended revenues, efficiency and equity objectives. International experience would suggest the need to adopt a ‘collection-led’ implementation strategy, supplemented by improvements in the coverage and valuations. Revenue collection is the ultimate objective of a tax system, with the mapping, fiscal cadastre and valuation activities supportive components to the collection function. Without the ultimate collection of the tax, the property tax system will not achieve revenue, equity or efficiency goals.

- **Countries must recognize that property tax reform is a long-term process.** Property tax policy can be changed overnight through passing a law and/or changing policy regulations. However, implementing those policy changes into “realized” policy success in terms of revenues, equity and efficiency will take time. Policy changes must be translated into reality through effective administrative processes which require sustained political will, operational and technical capacity, systems and procedures, funding and time to be successfully implemented.

In sequencing the reform it is always important to phase in “quick wins”, giving time for more long-term systemic and institutional changes. Countries operating with manual systems need time to transform policy changes into results, using pilot projects to test reform procedures, for further replication. Countries operating a pure area-based system will need time to evolve toward valuation-based system, as valuation-related information and capacity is developed to improve buoyancy and equity of the property tax system. Countries must focus on a comprehensive approach to property tax reform to ensure improvements in collection, valuation and coverage ratios. International experience suggests that nationwide property tax reforms can take 5 to 15 years to realize sustainable results.

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