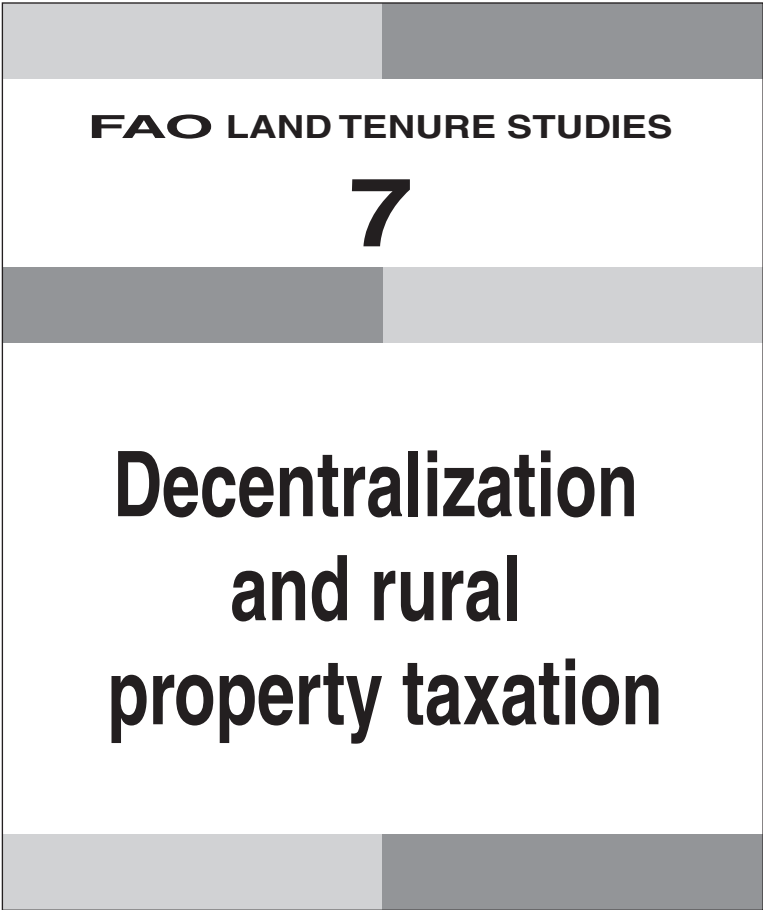




FAO LAND TENURE STUDIES

7

**Decentralization
and rural
property taxation**

FOOD AND AGRICULTURE ORGANIZATION OF THE UNITED NATIONS

Rome, 2004

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FAO Land Tenure Studies

FAO's Land Tenure Studies are concise presentations on the often complicated and controversial subject of land tenure, especially as it relates to food security, poverty alleviation and rural development. These studies do not seek to be exhaustive but instead reflect what FAO and its many international collaborators have discovered are 'good practices' for a particular aspect of land tenure and its administration. The studies cover various aspects of improving access to land and other natural resources and increasing tenure security. They address the role of land tenure in rural development, gender and access to land, improved access to land through leasing arrangements, rural property taxation systems, and land consolidation.

More information on the Land Tenure Studies, and on FAO's work in land tenure, is available at:

http://www.fao.org/sd/LTdirect/ltstudies_en.htm

http://www.fao.org/sd/IN1_en.htm

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Foreword

The present volume is part of a series of Land Tenure Studies produced by FAO's Land Tenure Service of the Rural Development Division. Land tenure arrangements are a key to food security and sustainable rural development. Equitable and secure access to land, especially for the rural poor, is a crucial factor for reducing poverty and hunger, for increasing agricultural productivity and growth, and for improving rural conditions. Effective land tenure institutions are needed to administer who has rights to what natural resources for which purposes, for how long, and under what conditions.

Increasingly, land tenure institutions are being called upon to support the decentralization of services to local governments. The main objectives of decentralization are to improve the delivery of services by the public sector and to enhance the quality of life of citizens. One expectation of transferring certain powers and responsibilities from the central government to lower levels of government is that the delivery of services should improve if the diverse demands and needs of people are served by local officials who have better information on what they want.

While the scope of services being allocated to local governments has expanded, many rural towns and villages lack the revenues needed for them to fulfil their new responsibilities. The limited revenues available to rural local governments have helped to reinforce the growing inequality between rural and urban areas in many countries. Revenues available to local governments can be improved by introducing a rural property tax. A property tax is an effective local tax because the local nature of property makes it relatively simple for local governments to identify tax-payers

and to collect the taxes. A property tax can make a substantial contribution to the tax base of a local government even if property taxes in general make a modest contribution to the national tax base.

This volume is intended to support land administrators who are involved with the design and implementation of rural property tax systems. It is based on FAO's Land Tenure Studies Number 5, which focused on rural property tax in Central and Eastern Europe. The response to that guide showed a need for information on rural property tax systems to be more easily available in other regions. In addition, this volume places a rural property tax more explicitly in the context of decentralization.

This book, like others in the series, does not seek to be exhaustive but rather reflects what FAO and its many collaborators have discovered are 'good practices'. FAO's Rural Development Division looks forward to continuing collaboration with its larger audience.

Maximiliano Cox
Director
Rural Development Division

1. Introduction

- 1.1 The transfer of responsibility for providing services from central government to local levels of government has created new needs for sustainable, local sources of revenue. Providing an adequate level of services can be difficult for rural local governments which typically have limited tax bases compared with urban centres. Property taxes have often been viewed primarily as urban taxes but their importance for rural communities cannot be over-estimated. The taxation of rural land and industries can offer to local governments an important source of ‘own tax’ revenues.
- 1.2 The main reasons for decentralization of the public sector include increasing overall efficiency and effectiveness by allowing local governments to improve responsiveness, accountability and performance of the production and delivery of services. The process of decentralization is an essential part of ensuring that local governments have an active and important role in respect of local governance.
- 1.3 The decentralization of powers must be accompanied by sufficient revenue to ensure that the new responsibilities of local government are adequately financed. Decisions are required as to which revenue sources should be available for the exclusive use of local governments and which should be subject to inter-governmental sharing. Revenues through grants and other inter-governmental transfers play a large role in the finances of local governments in most countries. However, to ensure that fiscal autonomy of a local government is real, it is essential that a significant percentage of the total revenue of the local government is regarded as its ‘own revenue’, i.e. under its control. Local taxes are an important source of locally-derived revenues.
- 1.4 Tax on property is an effective local tax as property has a fixed location within the jurisdiction of a specific local government. Few other taxes have its advantages in terms of predictability and stability of yield. Property

tax is difficult to avoid and the property provides an asset against which enforcement action can be taken to secure payment of the tax. Moreover, rural communities normally have limited access to other significant tax bases. The taxing of the land and related property of agricultural enterprises and other rural industry can thus provide an important source of revenue to local governments.

- 1.5 To enhance fiscal autonomy, local government should have some discretion in deciding the extent of the tax base and in setting the tax rates. Few developing countries currently give their local governments much freedom in this respect. However, it is important that local government have tax-setting powers, although this is likely to be within constraints set by the central government. If a local government does not possess the authority to decide the amount of any tax, then local tax policy and accountability to local tax-payers will be weak. In many developing economies, property tax revenues tend to be relatively low in part because of the way in which the tax is administered. A central government is less likely to treat a tax as important if it merely administers the tax and then passes the revenue to local governments. It is therefore important for local governments to have a leading role in property tax systems if they are to be the beneficiaries.
- 1.6 Taxation is never popular, and changes to the taxation system through the introduction or modification of a rural property tax are likely to be a politically sensitive issue. There is a need for strategies to address opposition to the tax, e.g. through the provision of good information to the public, through transparent decision-making processes, and through the phasing or gradual introduction of changes.
- 1.7 In some cases, the implementation of a decentralization policy may require the introduction of a completely new property tax. In other cases, the emphasis may be on the extension of an existing urban tax system to include rural properties. If an existing property tax system is dysfunctional, there will be a need to transform it into a more efficient and equitable system.

- 1.8 This guide is intended to assist countries that wish to introduce new property tax systems or to expand or reform existing systems. The guide is aimed primarily at supporting land administrators who have been assigned the responsibility for the technical design and implementation of rural property taxation systems. Its contents regarding policy aspects of property taxation in support of decentralization may be relevant to national decision-makers and those in central government responsible for preparing legislation and development programmes. Those in the donor community and others who work in broader rural development programmes may also find the information useful.
- 1.9 The guide starts by describing the potential benefits of decentralization for making the delivery of services more efficient and effective, and it identifies problems which can result in failure to reach that potential. The guide describes the importance of local governments becoming fiscally autonomous, and shows how rural property taxes can be a vital source of revenue for rural communities. It identifies issues that should be considered in the design and implementation of rural property taxes. The overall message is that property tax in rural areas is technically feasible and will benefit the rural economy and rural governance.

2. Decentralization

- 2.1 The development of democracy and decentralization has increasingly captured global interest. Since the late 1980s many countries have embarked upon the road to deliver aspects of decentralization. There is no standard model of decentralization. Instead, the processes and procedures vary depending upon the original aims and objectives, and also upon the institutional and implementation arrangements.
- 2.2 Decentralization can come in a variety of forms such as political, administrative or fiscal decentralization, and through deconcentration and devolution. The different forms are distinguishable by their different characteristics, policy implications, and conditions for success. For example:
- In the case of deconcentration, the central government disperses a number of its functions, such as planning and finance, from the centre to regional branch offices while still retaining overall control. Deconcentration is primarily an administrative arrangement with the decision-making authority still residing with central government ministries.
 - Under devolution, the central government transfers certain powers and responsibilities to lower levels of government. The main purpose is to bring the government closer to the people and to increase transparency and accountability. In this environment, a local government acts within the overall policy parameters set by the central government, but it operates autonomously in relation to how it carries out its functions.
- 2.3 This guide primarily addresses decentralization through devolution. However, the design and implementation of a rural property taxation system as outlined in this guide is also relevant for countries introducing decentralization through deconcentration.
- 2.4 Decentralization to local governments is extremely complex. It involves issues of finance, administration, control, regulation, reporting and

accountability, all of which are elements of the inter-relationship between different levels of government. Also, unfortunately, the implementation of decentralization has not been particularly smooth. Despite the combined political and economic forces that are driving the demand for decentralization, there is often a gap between reality and the goal that may be defined in policy and legislation.

REASONS FOR DECENTRALIZATION

- 2.5 The main objectives of decentralization are to improve the delivery of services by the public sector and to enhance the quality of life of citizens. Decentralization has been seen as an integral component of tackling challenges such as the increasing demands that are being placed on public services, and growing public expectations regarding the quality of services. From a policy perspective, decentralization should improve the planning and delivery of public services by incorporating local needs and conditions while at the same time meeting regional and national objectives.
- 2.6 In many countries, decentralization has been proposed for economic reasons. There may be diseconomies of scale in delivering some services at the national or even regional level, which means that the local delivery of services can be less expensive.

BOX 1

BENEFITS OF DECENTRALIZATION

Reasons why governments decide to embark on decentralization include:

- **Efficiency:** The improvement of administrative and economic efficiency in the allocation of scarce resources as there is a better understanding of local needs.
- **Transparency:** There is a clear link between payments made by local tax-payers and the level of services provided at the local level.
- **Subsidiarity:** There are efficiencies gained by ensuring that democratically elected officials are accountable to the electorate.
- **Mobilization:** Greater community participation of local citizens within local institutions should enhance decision-making and the democratic process.

- 2.7 Decentralization is also proposed to strengthen democracy by moving the level of decision-making closer to those most affected by government actions. One expectation is that the delivery of services should improve if the diverse demands and needs of the population are served by local officials who have better information on what people want. Decentralization should be characterized by public accountability if local governments are to be subject to democratic control. In such a form, citizens should influence the decisions made by the elected councils of local governments.
- 2.8 Decentralization thus forms an important component of the development of democracy, for example, as reflected in the European Charter of Local Self-Government adopted by the Council of Europe in 1985. This Charter identifies several components as the basis for decentralizing public tasks and financing, including the following:
- Local self-government denotes the rights and the abilities of local governments, within the limits of law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interest of the local population (art. 3.1).
 - Public responsibilities shall generally be exercised, in preference, by the governments which are closest to the citizens. (art. 4.3).
 - Local governments shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers (art. 9.1).
 - At least a part of the resources should be derived from local taxes and charges of which, within the limits of the statute, the local governments shall have the power to determine the rate (art. 9.3).
- 2.9 The scope of services allocated to local governments has been gradually widening. While countries have developed their own mix of the share of responsibilities between the various levels of government, typical responsibilities of local government are shown in Box 2.

BOX 2**FUNCTIONS OF LOCAL GOVERNMENT**

- local development
- land use planning
- protection of the natural and built environment
- housing
- water supply
- sewage
- drainage of rainwater
- public cemeteries
- local public roads and public areas
- local public transport
- fire protection
- local public security
- primary education including kindergarten
- health care
- social services
- cultural and sport activities
- libraries and cultural centres

PROBLEMS IN IMPLEMENTING DECENTRALIZATION

- 2.10 Decentralization is not a panacea as there are limits to what can be achieved given the mosaic of cultural, historic, economic, legal and financial constraints facing countries. Restoring or establishing a balance of power and responsibility among different levels of government has usually presented significant political and administrative challenges. Devolution of powers to local governments requires substantial shifts in political, financial, and administrative authority. Importantly, in some countries it represents a major step forward in the dismantling of central command structures.
- 2.11 A problem facing many developing countries is that the central government does not already provide an adequate level of services uniformly

throughout the country. Instead, many government services are relatively easily available only to those living in the major cities, and there is a lack of presence of central government agencies in outlying regions. In such cases, effective decentralization requires access to new resources in order to provide a more uniform level of service in all parts of the country. Efforts to provide for the delivery of services by local governments cannot involve merely the transfer of resources from the centre where these resources do not exist in the first place. In such a context, the goals of decentralization will require substantial overall increases in financial and human resources.

- 2.12 The pattern of local government development has seen the creation of hundreds, or even thousands, of small local governments in some countries. There is a real challenge of assuring competent administration of such small administrative units given their available resources.
- 2.13 The list of services in Box 2, while not exhaustive, demonstrates the magnitude of the problem that has been created by the decentralization of responsibilities to local government. Many rural towns and villages currently do not generate sufficient local tax revenue to meet the cost of providing services. This has inevitably led to rural local governments being highly dependent upon grants from the central government. In addition, the inability of small rural communities to provide the necessary services has resulted in larger cities playing a strong role in providing services not only in their own jurisdictions, but also to surrounding rural communities. Thus, many small rural towns and villages tend to be merely political units, rather than true service providers.
- 2.14 Unlike the towns in the countryside, capital cities have tended to be more successful in raising necessary taxes and funds to support social and economic development programmes. Because of the crucial financial and political significance of the capital cities, they have been a focus of sustained investment and the development of infrastructure and services. This emphasis has usually been to the disadvantage of the smaller rural communities.

- 2.15 Many countries have tended to move away from pursuing a programme of full decentralization by adopting a mixture of deconcentration and devolution of powers and responsibilities. A pragmatic approach often taken is to consider a balance between centralization and decentralization. The challenge is to identify what should be considered as 'local' responsibilities and what should remain as 'central' ones. The financing of local responsibilities is discussed in more detail in the following chapter.

3. Financing decentralization

- 3.1 The fiscal functions of central and local governments are traditionally analysed in terms of their respective roles and responsibilities for income redistribution, expenditure provision, tax assignments and tax transfers. Questions about the extent of centralization and decentralization are critical when addressing the issue of inter-governmental finance. Which level of government will be responsible for providing specific services? How will those services be financed? This chapter discusses these questions.

INTER-GOVERNMENTAL FINANCE

- 3.2 Distributional and macroeconomic considerations generally argue against extremes that, on the one hand, assign all or most taxing powers to local governments or, on the other hand, assign such taxing powers to the central government. The option that is most frequently observed in countries around the world is one that assigns revenue sources such as taxes to each level of government, in combination with various types of inter-governmental transfers to bridge any gap between expenditures and locally-raised revenues.
- 3.3 There is no universally accepted solution as to how decentralization and local government investment should be financed. Lessons learned from numerous countries suggest that the first step is for the transfers of revenues and of expenditures on service to be matched as closely as possible from the start of the decentralization process. This implies that decentralization should be a fiscally neutral devolution of responsibilities. In order to accomplish fiscal neutrality, estimates should be prepared for the full costs of the services that are to be devolved to the local governments. This estimate should form the basis for an agreement on the mix of services and revenues that will ultimately be transferred.
- 3.4 The most direct way to finance infrastructure and to support decentralization is to turn over to local governments both the responsibility for providing services and the capacity for raising revenues. Many of the central and local

governments in developing countries have tended, however, to resist this approach. On the one hand, central governments are reluctant to relinquish control over the principal national taxes as it suggests losing control of the revenue side of the national budget. On the other hand, most local governments are not eager to take on the major responsibilities of a taxing authority, and they do not want to establish locally generated taxes simply because they do not have the capacity to administer such taxes. However, much can be done to increase local capability and capacity to the point where local governments can administer the assessment and collection of local taxes under the regulatory supervision of the central government.

- 3.5 A strategy adopted by many countries is to attempt to strengthen local governments by giving them greater responsibilities in terms of the services they have to provide. While this may appear to create more independent local governments, the reality is that local governments will not be able to apply their new powers unless they are properly financed. The assignment of more responsibilities for expenditure to local governments than they can finance from their revenue sources results in the mismatching of functions and finances. This mismatch is referred to as ‘vertical imbalance’ and it results in local governments being highly dependent upon transfers from the central government. Therefore, it is essential that those responsible for the design of local government responsibilities should be aware of the revenue sources that will be needed to fund them.
- 3.6 An additional problem that is at the heart of inter-governmental finance in many countries is the existence of ‘horizontal balance’. This occurs when local governments are not equal in terms of population, geographic area, level of urbanization and per capita income. Designing fiscal decentralization and equalization programmes to cater for this complex reality is a major challenge.

NEED FOR FISCAL AUTONOMY OF LOCAL GOVERNMENTS

- 3.7 Decentralization is more likely to be effective when a local government can raise a relatively large share of its revenues locally. If the transfer of

responsibilities from the central government is not matched by the ability to finance the carrying out of these responsibilities, there is a risk of creating a largely fictional decentralization. In such a case, local governments will tend to remain overly dependent on the goodwill of the central government to finance them. Since the central government sets the rules and generally takes the highest yielding taxes for its own use, local governments tend not to have access to tax revenue and sources that would effectively free them from dependence on transfers. Inter-governmental transfers are vital for local governments but they should not be used to prevent local governments from attaining an appropriately independent status. Without an adequate revenue source under the control of local government, a suitable degree of fiscal autonomy cannot be realized.

BOX 3

BENEFITS OF LOCAL SOURCES OF REVENUE

Reasons why the revenues of local governments should come from local sources:

- Local taxes are necessary to enable a local government to vary the quantity and quality of its services in respect of local preferences.
- If a local government relies on grants there is a danger that local politicians can spend the money inefficiently.
- There tends to be greater accountability for money raised locally than with fiscal transfers from the centre.
- Grants from the central government often come with pre-conditions attached and constrain the way the grant is spent.

- 3.8 Local governments should be able to raise revenue to finance the costs of proposed services from the beneficiaries of those services. The connection between beneficiaries and tax-payers is relevant from the perspective of public finance: public services should be decided by the beneficiary group who should also pay for their costs. That is, the ideal tax pattern is based on 'benefit taxation' as far as the allocation function is concerned. Locally raised revenues that are spent locally for the benefit of local tax-payers

illustrate the direct link of the tax to the benefits received by the community as a whole. This means that the local citizens should pay higher taxes if they want better services or if the local government is inefficient. This gives the right incentives for the local citizens at election time. A high level of own taxation also deprives the local government of the excuse of lack of money from the central government for any failure to deliver local services.

- 3.9 In practice, there is great variation in the proportion of resources raised locally, or over which local governments have a significant decision-making authority. This proportion is difficult to measure because such measurement requires an assessment of the share and nature of government transfers as well as the actual degree of autonomy of local governments in setting the level of locally raised resources (both tax and non-tax). However, there is a broad consensus that the autonomy of local governments in developing countries is still weak compared with practices in other countries. The advantage of increasing local taxes compared with increasing tax-sharing arrangements is that control over ‘own taxation’ increases accountability. It affects the behaviour of the local population and the local governments in a positive way.

POSSIBLE REVENUE SOURCES FOR LOCAL GOVERNMENTS

- 3.10 The composition of revenues varies greatly from one country to another but the main types of local government revenues are typically the following:
- Revenue from the sale of services (non-tax revenues and user charges/fees).
 - Borrowing, e.g. for investment expenditure.
 - Different types of grants (e.g. general and specific) made available to local governments from the central government.
 - Tax revenues: local taxes (e.g. property tax) or shared national taxes.
- 3.11 **Service fees** are an important source of revenue, especially if local governments are viewed primarily as service providers. In part, this view

is in agreement with the concept of decentralizing certain responsibilities to the local level by using efficiency criteria for the allocation of resources. Such services could therefore be financed through a charging system.

- 3.12 **Grants** from the central government are a key factor. While grants are declining they still remain a significant revenue source for local government. In a number of countries, 50 percent or more of a local budget is represented by transfers from the centre. Grants will remain important given the breadth of new local government responsibilities and the generally inadequate level of local revenue sources. Grants should normally provide only part of local revenue because local governments are usually more accountable for revenues that they raise directly, and because tax-payers are better able to link the receipt of public services and the payment of the taxes if both are housed within a single government.
- 3.13 **Automatic revenue sharing** of national (or regional) taxes to local governments is seen as a solution to financing decentralization in many countries. This approach allows central governments to retain control of tax rates and tax administration, while simultaneously ensuring that local governments receive a higher flow of revenues. However, automatic revenue sharing does not always provide a stable basis for financing decentralization and local infrastructure projects. Where the central government retains the power to adjust annually the share of centrally collected taxes, local governments continue to face a fundamental uncertainty about their revenues, which in turn makes it difficult for them to do advance budgeting and planning of capital finances.
- 3.14 Income tax rates have grown during the last two centuries, particularly in times of war, until reaching historically high levels in the 1980s. Since then individual tax rates, particularly those relating to the top slices of income, have fallen. Figures of the Organisation for Economic Co-operation and Development (OECD) show that the share of personal income tax as a proportion of tax revenue has fallen on average in member countries from 30 percent in 1975 to 27 percent in 1998. There are

democratic and economic pressures that are likely to inhibit any significant change in the present situation.

- 3.15 **Corporation taxes** were once seen as an easy tax target. There were few votes to be lost if corporation taxes were increased. This has now changed as a consequence of the intense international competition to attract business to national or regional locations. Corporation tax rates are a significant factor in decisions by multilateral corporations of where to locate their businesses. This is therefore a major constraint preventing national governments from increasing corporation tax rates to previous levels.
- 3.16 **Social security contributions** have tended to rise in response to increasing social benefits and now constitute on average 25 percent share of taxation in OECD countries.
- 3.17 **Consumption taxes** as a source of revenue have remained on average constant in proportion to other taxes in OECD countries, but the emphasis is now on value added taxes. There are economic, competitive and democratic constraints that governments have to take into account when considering increasing consumption taxation rates.
- 3.18 **Property taxes** show a large variation in the ratio of property tax to total tax revenue. If wealth taxes and certain other taxes are included in the definition, property taxes account for more than ten percent of the total in the United Kingdom, United States of America, Canada and Japan. In previous centuries taxes on property formed the most important source of tax revenue for both national and local taxes. Property taxes have, however, seen a long-term decline in relative importance and now represent about five percent of tax revenues in OECD countries. However, the importance of the property tax is not in relation to the national tax base, but instead to the tax base of local governments.

LOCAL TAXATION

- 3.19 The choice of a good tax for local governments is limited compared with

the choices for central and even regional governments. This is because the higher levels of government are larger, cover jurisdictions having larger populations and have a greater capacity for tax administration. A number of conditions should be met for a tax to be a good ‘own local tax’:

- The revenue of a good local tax should increase over time in order to match the natural growth in costs and to fulfil the growing need for local public services.
- Local taxes should not be too sensitive to cyclical fluctuations.
- A good local tax should be distributed relatively equally among local governments. Equalization of the revenue between local governments may be required to balance differences in access to tax bases.
- The size of the potential revenue is important. If the local governments are allowed only relatively small yielding taxes, vertical imbalances will result (i.e. the assignment of more responsibilities to local governments than they can finance from their local revenue sources).
- There should be a close relationship between the citizens who pay and the citizens who benefit.
- The tax administration should be inexpensive to administer, i.e. the tax yield should be much higher than the administrative costs. A realistic target is that the cost of administering a property tax should be significantly less than five percent of the revenue generated.

3.20 According to the classification of the OECD, the extent of local government autonomy over revenues should be judged against two criteria: freedom to determine the tax base, and the setting of the tax rate. (The tax base is the collective value of the property assets subject to taxation, and the tax rate is the percentage of the value of a property asset that is paid as tax.) The following classification of own and shared revenues was developed by OECD, in accordance with the degree of local revenue autonomy:

- Local government in control of both the tax rate and the tax base;

- Local government sets the tax rate;
- Local government sets the tax base;
- Tax sharing arrangements;
- Local government determines the revenue split.

As local taxes normally represent the greatest source of autonomous income for local governments, the ability to influence the tax base, the tax rate or the collected revenues is a very important condition. With such an ability, a local government is able to adapt the service level to its financial circumstances.

- 3.21 It is good practice that conflict of interests should be avoided. The actions of setting the tax base and the tax rate should be treated separately and independently. Setting the tax base is done by valuers and should be accountable through an appeal process. Setting the tax rate is usually the prerogative of elected politicians. Such a division of responsibilities should exist even if both the actions of setting the tax base and setting the tax rate are carried out at the same level of government. Conflict of interest can also be avoided by having actions carried out by different levels of government. For example, where local sources of revenue are scarce, local governments might be tempted to inflate the tax base in an attempt to increase their revenue, or locally influential people may exert pressure to have their tax liabilities reduced. In such cases, valuers of the central government might provide a more objective assessment of the tax base.
- 3.22 There is extensive literature on the criteria for good local taxes, and it is possible to evaluate each alternative tax against these criteria to see how well they perform. While an exercise like this may be useful, it is limited to some extent as there is no perfect local tax. There is, however, general international consensus about which local taxes are most satisfactory. The most common local taxes are property, income and sales taxes. Few countries have implemented large revenue-raising local taxes other than these.
- 3.23 Property tax is an effective local tax because the nature of property makes it relatively simple for local governments to identify tax-payers and to collect

the taxes. Property tax is generally less attractive for central government because its revenues are usually much less than income tax, sales taxes and corporate taxes. Moreover, property tax is typically not considered as an instrument for broader social and economic policies which tend to be the domain of central government.

RURAL PROPERTY TAX

- 3.24 A property tax can be a good local revenue stream that is relatively predictable, stable and non-distortionary with regard to its impact on economic decisions. Of course, a property tax should not be considered on its own, but should be looked at in relation to other local and national taxes. The taxation system of a country is subservient to national social and economic aims. The detailed considerations required in the design or administration of any individual tax should not obscure a wider view, informed by a knowledge of history and international experience.
- 3.25 Property tax is an annual tax on real property. It is usually, but not always, a local tax. It is most commonly founded on the concept of market value. The tax base may be the land only, the land and buildings, or various permutations of these factors. For the purposes of this guide, property tax is restricted to annual taxes and excludes annual wealth taxes and once-off taxes on transfers and realized capital gains.
- 3.26 Rural property tax is usually applied to commercial, industrial and residential properties located in rural areas, in addition to agricultural land and buildings. The use of rural property taxes is not unique. Many countries around the world tax agricultural land and other rural properties. Rural property taxes are also not new. Property tax has been in existence for at least three millennia. The strengths and weaknesses of this type of tax are well known and possibly more widely understood than any other tax.
- 3.27 Many developing countries tend to focus on taxing urban property, at least initially, given that this is usually the most valuable property. Even when agricultural and forestry land are taxed, it is typically done at relatively

modest rates in comparison to urban land. However, the inclusion of rural property for tax purposes in developing countries should be seen as an important policy directive to make the property tax base as extensive as possible. Such a broadening of the tax base creates one of the few stable revenue sources available to rural local governments.

3.28 **Advantages** of the tax are clear and include:

- It is technically and administratively possible to introduce and maintain in almost any circumstances.
- It is cheap to administer, and it is possible to aim for a cost yield ratio of two percent or less.
- It is very difficult to avoid or evade, and collection success rates of 95 percent are readily achievable.
- It is transparent.
- The public understand the concept of market value (whether capital value or rental value) and therefore appreciate the basis of assessment.
- In general, there is a good correlation between assessed value and the ability to pay.
- If designed correctly, the tax can be marginally progressive.
- The revenue is predictable and buoyant.
- It is very well suited as a source of locally generated revenue for local governments.
- It imposes political accountability on local elected officials. If they decide to increase the property tax, they face direct criticism from voters.

3.29 **Disadvantages** of property tax are less clear than the advantages. The tax is not perfect and is often not popular; although it should be remembered that there are no perfect taxes and taxation is never popular.

- 3.30 Some of the advantages incorporate hidden disadvantages. The transparency of the tax reveals any inconsistencies which may become magnified in public perception. These inconsistencies will be both those of assessment (which are inevitable in a valuation list of property tax assessments which may consist of thousands, or hundreds of thousands, of properties) and those of ability to pay. Other taxes, such as income tax, are very much less consistent in practice but the public only know how the tax should work and not how it is actually applied in practice. Confidentiality hides the actual results. With property tax the public see the tax system working with all its imperfections. In a similar way the difficulty of avoiding or evading property tax may make it unpopular. This is particularly the case in societies where the rich and powerful are accustomed to manipulating the tax system for their own advantage. These people tend to be the most articulate and politically influential and may effectively oppose or undermine the equitable operation of the tax at the political level.
- 3.31 There is also a more subtle and less well-understood shortcoming. In some circumstances property tax can provide 'representation without taxation' for a large segment of the population. Universal suffrage means that not every voter will be a property tax-payer. If non-tax-payers greatly outnumber tax-payers, the link between democracy and taxation at the local level will be damaged. The adverse effects of this will be magnified if property tax forms the only local revenue over which the local authority has control. In this case, a modest increase in total revenues may require large increases in individual property taxes because of the small number of tax-payers.
- 3.32 There is also the problem of building 'buoyancy' into property tax. Buoyancy refers to a change in tax revenues and, in the context of property tax, is a function of two mechanisms. The first of these is the revaluation of properties at regular intervals; in situations of rising market values, such a revaluation results in an increased tax base. The second is the increase in the rate of tax to produce the needed revenue. Both are highly political. In theory either one or the other could provide buoyancy. It is technically possible to increase tax rates on an out-of-date valuation list

of property tax assessments. However, the experience from many countries is that the public do not understand and do not accept an out-of-date valuation list. There is always resistance to revaluations and the more out-of-date the valuation list, the greater the resistance. The biggest factor behind declining yields for property taxes in many countries is the failure to regularly carry out revaluations.

- 3.33 The difficulties of implementation should not be underestimated. Although the technical difficulties can be overcome, they can restrict progress, especially in the early stages of implementation. Such technical factors include:
- The system is dependent upon a pool of technical expertise to create and maintain a valuation list, and to establish and conduct the appeals process. In many jurisdictions, there is a shortage of skilled personnel, especially at the local level.
 - Parts of the process can be time-consuming and expensive. Examples are compiling a comprehensive list of taxable properties (especially where records are poor or incomplete, or where there are large numbers of legal status issues); outsourcing services to the private sector; establishing a valuation tribunal to determine appeals, and administrative and infrastructure support (such as dedicated information technology for the valuation system and the financial accounting system for the billing, collection and enforcement procedures).
 - While it is true that the public generally understands the concept of market value, confusion does arise in the relationship between ‘taxable value’ and setting the ‘tax rate’. This is particularly so where revaluations take place after a long interval, or where there has been political unwillingness to increase the tax rate. This often results in large numbers of unjustified appeals.
- 3.34 In addition to being a primary source of revenue for local governments, property tax can provide support for other functions of government.

Valuation lists compiled for local government may be used by other bodies, particularly those that can be termed 'single function authorities' such as water boards. Water charges are sometimes based on a property's assessed value in the list of property tax assessments. Such procedures are very cost-effective and may have a reasonable correlation with water usage in many circumstances (although cases do exist where commercial and industrial properties have low water consumption but have relatively high values). Drainage boards can also be funded by charges related to the valuation list, which has advantages over charges related only to the surface area of the property.

- 3.35 Almost invariably the benefits of rural property tax will be local rather than national. It will be apparent in almost every country that the extension of the property tax to rural areas will have limited impact on the total national tax revenue. The rural tax base is typically very much smaller than the tax base constituted by the urban economy. Frequently a national capital city and two or three other major cities produce a major part of the national GDP. The relative size of the regional GDP gives a good indication of the magnitude of the tax base. Thus if, for instance, an improved property tax covering the entire country has a potential to produce ten percent of total tax revenues, the proportion arising from rural areas is unlikely to be more than 20 percent of this. In such circumstances the rural property tax base may constitute only two percent of the national tax total and may be disproportionately more expensive to administer.
- 3.36 In most instances the illustrative figures above will overstate the potential yield from rural areas. However, this does not diminish the importance of a rural property tax. It is a vital part of decentralization. It is not so much its size relative to the national tax base that is important, but its magnitude in relation to revenues available to a local government and especially to those revenues that are generated locally. This is why a property tax is a vital instrument in improving conditions in rural areas.

BOX 4

REVIEWING PROPERTY TAXES

Factors listed below may lead governments to review the scope for introducing a property tax where it does not exist, and examining the administrative machinery with the purpose of making it more efficient.

Scope for increased yields: While many taxes are now reaching upper limits created by economic factors, international competition or public acceptance, in most countries property taxes could yield more. There are few examples of property tax accounting for more than about 12 percent of total tax revenue and this may represent a limit of public acceptance. Property tax in most countries is much less than this theoretical ceiling.

The relatively small size of the rural tax base: The rural tax base will always be comparatively small in comparison with the urban tax base. The importance of property tax in rural areas is of local significance. The benefits to the national economy are indirect.

Importance beyond its relative size: The importance of a property tax covering rural areas is greater in political terms than might be supposed from the absolute size of the property tax yield. As the foundation of local government autonomy, and as a means of financing some single function authorities, there is often sound justification for the introduction of the tax.

Administrative feasibility of property tax: The wide application of property tax and its long history shows that, if there is sufficient political will, there are no insuperable technical or administrative problems to the introduction of property tax.

Political will: All taxes require political determination and public acceptance. The openness and transparency of property tax mean that it is impossible to introduce the tax by stealth. Political determination is therefore essential. If there are substantial political doubts, do not waste time and money considering the introduction of property tax.

4. Implementing a rural property tax

- 4.1 In jurisdictions where a property tax system does not exist, the devolution of certain responsibilities to local governments may require the introduction of a completely new property tax system. In jurisdictions where an existing property tax system is limited to urban properties, and especially only to those properties in larger cities, the extension of an urban tax system to include rural properties may require almost all the steps needed for the implementation of a completely new property tax system. Other jurisdictions which already tax rural properties may find their tax systems to be ineffective or otherwise dysfunctional. The emphasis in such cases is likely to be on the transition to a more efficient and equitable tax system.
- 4.2 Whether a completely new rural property tax system is to be introduced, an existing urban tax system is to be extended to include rural property, or an existing rural tax is to be substantially improved, important political decisions must be made. While the scope of the implementation will vary depending on whether a tax system is being introduced for the first time, expanded or improved, in all cases there will be a change to the tax structure and to the assignment of the burden for paying the taxes. Because the design and implementation of a rural property tax are politically sensitive, there is a need for strategies to mitigate some of the effects of the changes that will be introduced. An impact assessment should identify how different target groups will be affected by the proposed changes to the tax system. Appropriate phasing of the tax should be considered, for example by gradually increasing the tax burden, to make the tax more acceptable to those who will pay it. Dissemination of information on the tax, and how the revenues will be used, is necessary to win public support.
- 4.3 The details of administration of the tax should be designed in accordance with the underlying philosophy of the tax. For what purpose is a property tax required? How does it fit into the present or proposed government structure? How does it fit into the decentralization strategy? How will it fit

with other existing taxes? What will be the social and economic effects of introducing a property tax or modifying an existing one? The detailed design of the tax depends on the answers to these questions.

- 4.4 While property taxes are well suited for local governments, it is essential that the central government creates and maintains the enabling conditions that allow local governments to take on more responsibilities. Central ministries have crucial roles in promoting and sustaining decentralization by developing appropriate and effective national policies and regulations for strengthening local institutional capacity to assume responsibility for new functions.
- 4.5 In relation to property tax a split of functions will have to be arranged between the central and local governments, for example:
 1. Local access to information in land registry offices can assist in maintaining the tax base and identifying tax-payers, and will improve access to services by buyers and sellers of property. Local land registries may be operated as decentralized offices of the central land registration agency, or through devolution to local government agencies where local governments have the capacity to provide registration services. It should be noted, however, that while a comprehensive land registry can be valuable, it is not a pre-requisite for the establishment of a tax system. Examples exist of independent tax lists which use land registry data as only one of a number of sources in their compilation.
 2. Property identification is ideally suited as a local function given the local knowledge of local government officials. The identification of property for tax purposes should be based, where possible, on the records of the land registry.
 3. Maintenance of the tax base should be regarded primarily as a local function. However, checks should be established if there are incentives that prevent local government officials from carrying out this function objectively.
 4. Responsibility for the provision of valuation assessments requires the allocation of sufficient resources to provide for a robust and uniform

valuation system. Ideally the central government should have the capability to provide this service for smaller jurisdictions. However, larger local governments could have the necessary resources to provide this function. In such cases, checks should be established to ensure that valuation assessments are carried out objectively.

5. The appeals system should be independent from the responsibility for valuations. Appeals against valuations should be heard first by a locally based system of tribunals or courts. The appeals system may provide for a right to appeal on questions of law to a higher level, which is likely to be provided centrally.
6. A regional or central billing system can create economies of scale in terms of human resources and required technology.
7. Collection is an important local function particularly where all revenues collected are allocated to the local budget. There is therefore a financial incentive for effective collection at the local level which would be absent at the central level. Where local governments lack the capacity to collect taxes, a central government agency can provide a tax collection service to local governments.
8. As with collection, enforcement is suitable as a local government function.

4.6 **Policy decisions** will have to be made before the detailed design can be undertaken. These policy decisions will depend on the choice of decentralization and whether the jurisdiction is introducing a completely new property tax system, or modifying an existing system by expanding its scope or by reforming it. An important aspect of policy planning is to assess the impact of the proposed changes on various target groups of taxpayers, and to evaluate options to mitigate some of the effects.

4.7 **Public debates** are needed if taxation is to be introduced or changed. However, if that debate is not to become bogged down by ill informed prejudice, the ground needs to be carefully prepared with a well researched discussion paper setting out the pros and cons of the different options available in the local circumstances. There is a need for a positive

communications campaign linking the proposed property tax to the anticipated benefits, i.e. improved local services.

- 4.8 **Legislation** for the implementation of a rural property tax will be required. The following section lists the separate but interrelated issues for which rules should be provided in the legal code. This could be done either directly in the law or through powers devolved to ministers under the law. The section provides a checklist but is not exhaustive.

PRACTICAL DETAILS OF RULES: A CHECKLIST

- 4.9 **Jurisdiction of tax.** The law must specify the jurisdiction and extent of the tax. What bodies can impose the tax? What areas does it cover? What type of property will become liable to the tax? Who will be responsible for payments of the tax?
- 4.10 Administrative benefits and responsibility. Administration of property tax falls into various stages:
1. The legal initiation of the tax, commonly the responsibility of the central government minister.
 2. The valuation, and the choice of where the responsibility for this task should be assigned in the law.
 3. The responsibility of setting the tax rate. This can be specified in the law or be assigned to the local government body, possibly within limits set by central government.
 4. The law must specify the duty of collection.
 5. The law must specify which body receives the benefit of the revenue.
 6. The law must specify which body will enforce the collection of taxes and adjudicate disputes.

It is possible for every one of these functions to be assigned to the local government body but generally this situation is unusual and rarely is central government willing to give local governments an entirely free hand. Providing for statutory independence of the valuation base can be important for public credibility of the property tax system. Legislation should give legal backing and support for those people who carry out the valuation task.

- 4.11 **The basis of valuation assessment.** The basis of valuation assessment forms the core of the taxation process. Unfortunately, public and political discussion of the options is often misled by those with an over enthusiastic attitude to one basis or another, and frequently fuelled by unrealistic expectations of the economic benefit that their preferred option will bring with it. In practice, however, there are not great differences between options and in most cases there are at least three options that would work almost equally well. No solution will have the monopoly of benefits and there are always disadvantages. Table 1 illustrates the choices available.

TABLE 1
Comparison of bases of valuation assessment

	A - Valuation assumption: Value restricted to existing use only.	B - Valuation assumption: Valuations taking into account the ' highest and best use ' of the property.
1. Capital value. The price that the property would sell for in the open market.	1A: Common and well-tried basis of assessment, based on the value of the property in its present state. Probably the most used globally. Easy to understand. Potential value from redevelopment is ignored unlike 1B.	1B: Well known and well tried. Thought to have economic advantages in encouraging best use of the property. It requires a clear physical planning legal code so that the highest and best use is apparent. Not as easy to collect as bases 1A & 2A.
2. Rental value. The price at which the property could be leased from year to year.	2A: Well-tried basis of assessment. Works in almost any circumstances. Many fiscal advantages. The easiest tax option to collect. Less well understood than 1A in situations where there is a limited or statutorily controlled market.	2B: Not an easy option to apply in practice and rarely worth considering. Not realistic to take into account potential value from redevelopment in relation to an annual value.
3. Site value. The value of the land only. The price that the property would sell for without buildings and other improvements.	3A: Well-tried basis of assessment that often works well. It can have administrative advantages and be a cheap system to run. Less easy to understand than 1A or 1B which may affect ease of collection. Correlates less well with ability to pay than 1A or 1B.	3B: Realistic option in some circumstances. The different potential uses that may be considered are only those permitted by physical planning or zoning classes.

- 4.12 The selection of an appropriate tax base must be in line with the general philosophy underlying the tax and fit with other administrative provisions.

For instance, is it intended as a tax on ownership or on occupation? The underlying philosophy probably determines the best option for the basis of valuation assessment. It is also fundamental to the legal provisions relating to many of the items listed in this section. The selection of an appropriate tax base for an ad valorem tax system (i.e. a tax system based on value) should also take into account the preponderance of available evidence of value. If most properties are rented, a rental basis of valuation would be sensible and most easily understood. If most properties are bought and sold on the basis of their market capital value, this will provide a more credible basis.

- 4.13 There are advantages of adopting one of the ad valorem tax bases identified in Table 1. Generally, they are well understood by the tax-paying public, particularly where the basis is natural rather than artificial, and where it reflects the prevalence of market evidence that will be known and available to the public. They encourage the better use of property and have some correlation with ability to pay. Usually the potential yield from ad valorem taxes is higher than from other options. However, they are not the only choice. Several countries use what might be termed ‘flat rate property taxes’ which are less dependant on valuation skills and are often a quick and easy option. An attractive low-cost option, particularly where valuation skills are in limited supply, is to adopt a system of ‘banding’ of values to provide a reasonable degree of equity in liability for tax payment without being too demanding in terms of data and professional skills. In a system of banding, each property is assigned to one of several ‘bands’ or categories, and all properties assigned to a band pay the same property tax. This means that there is no need to provide a discrete, detailed valuation of each property.
- 4.14 **Definition of the separately assessed property.** What should constitute a single valuation assessment? It is by no means self evident in all circumstances. For instance, in the context of areas where farms are held in many scattered non-contiguous fields, the question is whether each field is a separate assessment or the farmer’s entire holding is a single assessment.

The definition of the holding must accord with other aspects of tax. For instance if it is a tax on ownership, a single apartment block that is occupied by tenants might have one assessment. This is not possible if the tax is one on occupation, in which case each apartment must be separately assessed.

- 4.15 **The tax-payer: who pays?** The choice is broadly between the owner and the occupier. There are fiscal advantages to the occupier being the tax-payer especially where land registers are incomplete. The occupier is much easier to find and identify and there may also be a greater correlation with ability to pay. The occupier is also more likely to be the consumer of the services provided by local government. However, it is politically easier to persuade the public of the merits of a property tax with the owner as a tax-payer. To the uninformed it sounds fairer for the owner, who may be a landlord of rented property, to be the one liable for property tax. In reality in many instances it will matter little and either may be feasible. In any case the ultimate burden will lie with the land owner (although of course, the land owner may try to pass the tax on to the consumer of produce or goods generated from the land). A tenant can only afford a certain amount in rent and property tax. If tenants, as occupiers, are liable for a new property tax this will reduce the rent that they can afford to bid on a new lease. This point emphasises the importance of transitional arrangements to ease the introduction of a new tax.
- 4.16 There is an important caveat if the owner is to be specified as the tax-payer. The definition should not be too closely tied to registration of ownership because failures in the land registration system may cause properties to go unassessed. Moreover, where registration triggers annual property tax liability, this creates serious disincentives to registration and undermines the effectiveness of investment in registration systems. In systems of property taxation in which the primary liability is on the owner, there are known legal formulae which allow the assessment of the occupier in cases of doubt, with legal protection for the occupier to pass on this liability to the land owner where this can be done. In countries where public lands are leased to private individuals or companies, and where the owner has

primary liability to pay, it is common to put the tax burden on the person leasing the land from the public sector.

4.17 **Revaluations.** The law must stipulate how often properties must be revalued to ensure the valuation assessments are up-to-date. Commonly this will be specified under the law for a period of around every five years. There are considerable disadvantages if the interval is greater. The more often the revaluations are carried out, the better the tax base value reflects the current market and the better it is understood by the tax-paying public. Information technology (IT) allows the possibility of annual revaluations. There are good reasons to introduce the concept of annual revaluations into any revisions of property tax where there is sufficient IT capacity to do so reasonably inexpensively. Revaluations can be politically difficult to handle if they result in large changes in values and tax liabilities. As more frequent revaluations are likely to result in smaller changes in value than less frequent valuations, the need for sensitive political decisions can be reduced by introducing annual revaluations.

4.18 **Setting the tax rate.** There are several possible approaches:

1. The tax rate is fixed annually by local government taking into account the budgeted needs of the authority. The setting of the tax rate is a political act, which will give rise to local debate. This approach provides greatest autonomy to decentralized local governments, giving the flexibility to set tax rates in accordance with the need for revenues. Transparency and accountability in local government are essential.
2. The central government fixes the tax rate annually taking into account the needs of local government and reflecting the extent of inter-governmental transfers from central to local government.
3. The law fixes the tax rate in primary legislation and the tax revenues will vary according to changes in market values and regular revaluations. This results in limited tax buoyancy, and revenues depend on the timing of the revaluation exercise in relation to highs and lows of the market values. The approach does not give any discretion to decentralized local governments.

4. The law fixes a maximum tax rate in primary legislation, leaving local governments with the opportunity to set actual tax rates within the established limit.
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- 4.19 It is also possible to have differential rates depending on the value of property or the type of property concerned. Thus it is possible to introduce a policy where a higher tax rate is applied to properties with larger assessed values. In theory it makes the tax more progressive and it sounds attractive at first sight. There are, however, many technical reasons to avoid this and to adopt a single tax rate. Multiple tax rates usually lead to the artificial splitting of properties to avoid the higher rates. The approach makes the total yield of the tax less predictable and therefore complicates local government budgets. It makes the tax less transparent. The greater complexity decreases the level of accountability achievable from the administrative staff and can lead to corruption.
 - 4.20 **Exemptions.** In general, the fewer the exemptions, the easier and cheaper it is to administer a property tax. The larger the number properties assessed, the lower the tax burden carried by any individual property. Exemptions seldom bring with them any lasting political popularity, may distort the property market, and rarely have the expected beneficial economic and social consequences.
 - 4.21 There are few, if any, good reasons for exempting *agricultural property* from being taxed. Most reasons commonly proposed do not bring about the desired result. There is a belief that exempting agriculture from tax will reduce food prices but there is little evidence that it has ever done so. Economic theory suggests that the exemption tends to increase the price of land relative to other assets that are subject to tax and there is evidence that this is the case. Another belief is that access to land is facilitated if agricultural land is exempted from tax but, in practice as already noted, tax relief causes the price of agricultural land to rise and makes it more difficult for newcomers to gain access to farms. Furthermore, by exempting agriculture, damage is done to perceptions of the role of the tax as a fair

way of apportioning local expenditure. It also renders it of little use for raising revenue for single function authorities that deal principally with agricultural land (such as drainage boards, irrigation authorities, etc.)

- 4.22 There are few sound reasons for exempting *small properties*. At first glance, such exemptions may appear sensible. Much of the total assessed value may derive from a small percentage of valuable properties, and much of the population live in less valuable properties that may account for a small percentage of the total assessed value. (In developed economies, perhaps 40 percent or more of the total assessed value typically derives from less than ten percent of the properties, while about half the population live in properties that account for less than ten percent of the total value). Because of the higher cost/yield of assessing these less valuable properties, and the greater difficulties of collection, it could be argued that exempting small properties from tax would be possible with little loss of revenue. Despite these apparent advantages, exempting small properties is rarely done. First, it diminishes the tax as a channel of local accountability because a smaller proportion of the population are tax-payers. Second, it can lead to artificial division of properties to avoid the tax. Third, it creates dissatisfaction and aggrieves those property owners at the margin who just meet the requirement to pay the tax.
- 4.23 There is also little reason for exempting *government property*. In a number of countries government property is exempt. Such exemptions may appear sensible at first. Taxation of property owned and occupied by the public sector would seem to be an unnecessary bureaucratic exercise. On closer analysis it may be seen that there are very good reasons for public sector properties to be subject to property tax. First, such taxation is a method of apportioning liability between the different levels of government. A central government agency uses local facilities and there is no reason why the central government should not contribute to the cost of locally provided services through property tax. Taxation of central government property may be very important for those local governments in which a relatively large number of central government properties are located. Second, it is

generally the case that the public sector is not a careful user of property. Payment of property tax is one step towards better management, because then holding property is no longer cost free. As the public sector is almost always a very large owner and occupier of property the issue is important.

4.24 Properties which may be considered for exemption include:

1. Properties used for religious purposes, e.g. churches, mosques, temples, etc., together with associated burial grounds.
2. Roads, public parks and similar properties that are 'occupied' by the public. The same consideration may apply to similar public amenities in rural locations such as common grazing areas. Even if such amenities are not included in valuation lists, the benefit is not lost to the tax base. Their value is often reflected in the increased value of the properties that benefit from such amenities.
3. Land used for commercial forestry. In general, the value of forestry land is very low if the value of standing timber is excluded. Moreover the ability to pay is restricted by the periodic cash flow pattern of forestry yields that does not sit comfortably with an annual tax.

4.25 **Rules for payment.** The law must specify how and when payment must be demanded and made.

4.26 **Enforcement.** The law must provide powers of enforcement in cases of non-payment. Typical remedies include the removal of goods for sale to make the payment, seizure of rents and profits, fines and interest on late payment exceeding the commercial rate, forfeiture of the property and imprisonment.

4.27 **Settlement of disputes.** Experience throughout the world shows the advantage of having a system of tribunals or local courts that are local, accessible without professional representation, speedy and cheap. It is important to ensure that tribunals used to settle property tax appeals are seen to be independent from both the body responsible for the property tax assessments and the body responsibility for collecting the property tax.

- 4.28 Many of the disputes relating to property tax will be judged on matters of fact and valuation. The typical composition of such tribunals (at least three persons, often but not always chaired by a lawyer) will reflect this. The non-legal members are typically informed and respected local persons or professionals such as valuers and accountants. The dispute resolution system is very important to the smooth administration of the tax and is also an important safety valve. The law must of course specify how and when appeals can be made.
- 4.29 **Relation to other taxes.** A decision must be made as to whether property tax is an expense allowable against income tax for an individual, and corporation tax on company profits and, if so, in what circumstances. It is common for property tax to be an expense that can be deducted against income tax paid by individuals, and against corporation tax paid by businesses.

ADMINISTRATIVE MACHINERY

- 4.30 Essential features of property tax administration. Important features of property tax administration to be considered when planning the implementation of the tax or a revaluation include the following:
1. Chain of functions: The successful implementation of property tax requires the completion of a number of different functions, each of which is essential to the success of the whole process. They are links in the chain and the absence or failure of any one link causes complete failure.
 2. Completion of the valuation list: Property tax requires that every taxable property should be included in the valuation list. If a list is incomplete, potential revenue is not being collected. Inclusion of all properties is also important for fairness and equity as it ensures that the tax burden is placed fairly on all eligible tax-payers. Every property must be assessed within the planned time schedule.
 3. Schedule: The time taken to implement the system will depend on the scale of the task and the resources available. It will normally take at least two years to implement a new valuation list from scratch, and

often takes longer. The time can be reduced in subsequent years if the list has been well maintained and if well-designed computer systems are used. Policy-makers need to take this into account.

4. Yearly modules: It is usual for a new valuation list to come into effect at the beginning of a financial year. The timetable should take this into account. Failure to complete the valuation list and to have it properly approved in accordance with the legislation at the beginning of the financial year is likely to cause a full year's delay.

4.31 There are several factors that can give rise to failure. Furthermore, the work done for failed valuation lists may well be completely wasted. Most of the data has a comparatively short useful life. The effect of this is that property tax administration must be carefully planned and executed with considerable determination.

4.32 **People and professional skills.** In the developed market economies, the number of people working in valuation and property management in the private sector is usually three or four times that working in the public sector. In every country with established annual property taxes, the assessment process is organized in ways that minimise the number of fully qualified valuers used. Using computer assisted mass appraisal techniques, much of the work can be carried out by people with appropriate IT and statistical skills, in collaboration with valuation technicians. The requirements for professionally qualified valuers could be reduced through the use of approaches such as banding (i.e. putting properties into one of a number of valuation bands rather than providing individual valuations of all properties).

4.33 Valuation knowledge and skills are still in short supply in developing countries. Moreover, the specific skills necessary for rural valuations require appropriately trained valuers with experience and standing in the valuation districts. This shortage has been considered a factor limiting the implementation of an ad valorem tax. The requirements for property tax skills in the public sector have to compete with demands in the private

sector and in the other functions in the public sector which use valuation and property management skills. In some countries, property market valuation skills are developing more rapidly in the private sector than in the public sector. There may often therefore be private valuers but few, if any, in the public sector. In other countries, the private sector has not developed to the stage in which it can be used reliably in valuation for taxation purposes.

- 4.34 Particularly when introducing an ad valorem based property tax, countries will need to consider training and education for valuers, property advisors and property managers. The shortage of professionally qualified valuers will remain a challenge for most developing economies for some time, and the public sector will find it difficult to secure and retain these scarce skills. Strategies for combating this difficulty will include support for development of capacity in universities for training and research in this area, the in-house training of technicians, and the use of the private sector and professional institutions. Strategies must also address the fact that training and education for valuers generally includes no instruction on the organization of a property tax office or the planning and execution of a revaluation.
- 4.35 **Institutions.** The location of the different property tax functions within the government administration is not straightforward and may make the difference between success and failure. There are several different sub-functions which can be located in different ministries or at different levels of government. Table 2 illustrates possible choices.
- 4.36 There are often entrenched interests that must be taken into account when considering the assignment of responsibility for the assessment function. Property records that could be relevant to assessment may be divided and located in several ministries. The Ministry of Agriculture may hold records of soil classification and farm units. Land ownership records may be with the land registration office or cadastral department and records of buildings may be held separately.

TABLE 2
Choices for locating responsibilities

Function	Possible location
1. Overall responsibility	Ministry of Finance, Ministry of Financial Planning, Ministry of Local Government, Ministry of the Environment, Ministry of Agriculture, and/or whichever ministry controls the surveying and cadastral functions
2. Assessment	Ministry of Finance, Ministry of Local Government, Ministry of Agriculture, Ministry of the Environment, and/or whichever ministry controls the surveying and cadastral functions (if not one of the above), Local government Sub-contracting to the private sector by any of the above
3. Collection	Local government Central government on behalf of local government Sub-contracting to the private sector by any of the above

4.37 The shortage of professional valuation skills in many countries suggests that in most cases it is may not be an option to devolve the assessment function to the local governments. Where local governments lack the professional capability in-house, it may be more effective to concentrate skilled resources in a central valuation unit. In other cases, there may be the option of contracting with the private sector to carry out the work. Even when valuation is contracted to the private sector, the government agency should have sufficient expertise to assess the quality of the valuations.

4.38 There are good reasons for separating the collection function from that of valuation, and in many cases local government carries out the collection function while central government retains control of valuations.

4.39 **Technical considerations.** Valuation lists of high quality have been compiled for several millennia without the benefit of modern information technology (IT). It is worth bearing this in mind when deciding on the level of technical sophistication to be used:

- IT does not automatically improve on the quality of the final product;

- IT does not remove the requirement for valuation skills; and
- IT does not produce organizational skills.

However, the careful and well-planned use of IT may reduce costs, should increase accuracy and consistency of the data, and will certainly save time. A valuation list is a very large database and IT allows the data therein to be reproduced in several different formats. There is a wealth of experience (of both successes and failures) of computerizing property tax throughout the world from which to learn. It is important to get the strategy right.

PUTTING IT INTO PRACTICE: A CHRONOLOGICAL CHECKLIST

- 4.40 This section presents the chronological order of the actions required to introduce a local property tax, and the interrelation between them. The sequence of events illustrated in Table 3 indicates the steps that must take place from conception to collection. The table is intended to help plan the process in individual countries and to assist identifying the critical path in each individual case. The sequence is also intended to emphasise the unity of the process. All parts of the process must be in place if the system is to succeed. The malfunction of any one process will cause failure of the whole. This guide cannot do more than indicate the functions. It does not discuss the detail of how they are implemented as this will vary from case to case.
- 4.41 **Policy planning.** It is obvious that policy makers must decide the direction in which they wish to go. It is clearly impossible to start the detailed design before careful consideration of the preferred policy has taken place.
- 4.42 **Public awareness.** A very important aspect of preparation is the need to provide information to the public about the proposed tax and, in particular, the benefits that will flow from its introduction.
- 4.43 **Legislation.** The legislative process must be complete by the time the tax is to come into effect. If the government is certain that it can get the legislation through by that time, this step can proceed during the preparation of the valuation list. In the table it is suggested that the legislative process

TABLE 3
Sequence of events

Action and responsibility	Time in years relative to the tax coming into operation					
	-3	-2	-1	+1	+2	continuing
1. Policy planning (Central government)	-----					
2. Public information		-----				
3. Legislation (Central government)	-----					
4. Establishing the valuation office (Central government)	-----					
5. The assessment process (Valuation office)		-----				
6. Depositing the legal valuation list (Valuation office)				-----		
7. Setting the rate (Local government)			-----			
8. Dealing with objections and appeals (Valuation office)				-----		
9. Setting up collection office (Central government)		-----				
10. Collection (Collection office)				-----		
11. Enforcement (Collection office)					-----	
12. Maintenance of the valuation list (Valuation office)					-----	

should be complete before this. This may be advisable. There is a risk in setting up a valuation office if the changes in the legislation may fail. There is also a need for the valuers to have legal powers to enter properties for survey purposes and to obtain information necessary for their task.

- 4.44 **Establishing the valuation office.** Although the valuation assessment process is only one of the functions, it is the one that is most technically and organizationally demanding. There must be an office capable of carrying out this step completely, punctually and to the required quality standards. It requires technical valuation skills, organizational skills and computer skills. If valuation work is contracted to the private sector, the valuation office should have the skills necessary to manage the contracting exercise.
- 4.45 **Establishing the collection office.** There must be an entity to collect the tax. It requires fewer technical skills and fewer people than the assessment process but as much determination.

- 4.46 The valuation assessment process. This is the main time-consuming function. It will certainly be on the critical path. There are many sub-functions within this step. These include:
- identification of taxable properties and the relevant characteristics;
 - carrying out of property surveys;
 - collection and assembly of data on market transactions;
 - analysis of market information;
 - devising of mass valuation benchmarks;
 - preparation of the valuation scheme;
 - carrying out of valuations; and
 - compiling the valuation list.
- 4.47 If a property tax system is being newly introduced, then compiling the basic data required for the valuation list (property identification, ownership or occupancy, billing addresses, etc.), can be extremely difficult if no comprehensive register already exists. The collection of available data will not necessarily achieve a complete valuation list. The list itself is likely to contain errors. At some stage a decision will have to be made whether to publish the valuation list despite its incomplete stage.
- 4.48 In order to assist in updating the valuation lists, the valuation body should establish links with other land administration agencies such as the land registry and cadastre (for information on characteristics of the land parcels, transfers and selling prices) and the planning authority (for information on new buildings, etc.) The mass assembly of relevant data on land parcels for property taxation purposes are major initial and ongoing tasks that require careful planning and budgeting of resources.
- 4.49 **Setting the tax rate.** In some systems the tax rate is set in the law. Otherwise this step is essentially the taking of a decision. However, it is a politically charged decision and should be preceded by political debate. A balance needs to be achieved between setting a tax rate that (a) produces the level of revenue that is required to meet the cost of services to be provided, and (b) recognises the tax-payer's ability to pay. If the tax rate is

set too high, there will be widespread dissatisfaction and resistance by tax-payers. If the tax rate is set too low, the revenue generated may not be sufficient to meet the needs of local governments, and may not even justify the cost of assessment and collection. The decision on the tax rate is probably the most important decision to be taken in connection with property tax.

4.50 Steps of setting the tax rate include:

1. Depositing the valuation list. This is the culmination of the assessment process.
2. Dealing with objections and appeals. The assessment process does not end with the deposit of the list. In any transparent and sustainable system there must be an appeal system.
3. Collection of the tax. The collection process follows an annual cycle.
4. Enforcement. Collection will not be complete without effective enforcement.
5. Maintenance of the valuation list. The tax base is always changing as new properties are built and others are altered or demolished. These changes must be tracked and recorded. The process must roll on continuously.

5. Valuation approaches and techniques

- 5.1 Although the administration of property tax is a complex process in its entirety, there is no single element that cannot be explained in simple terms and judged by commonsense standards. Policy-makers and tax-payers are entitled to understand property tax issues. The public are increasingly intolerant of land administrators hiding behind technical jargon so it is important to keep the public well informed throughout and for the terms used to be clearly explained.

VALUATION METHODS AND STANDARDS

- 5.2 'Valuation method' means the calculations and techniques used to arrive at the value. Valuers and non-valuers and policy-makers should keep in mind that there is only one simple test of a method. Does it work? If a valuation method is intended to provide an estimate of market value, does it correctly predict the selling price before the event in a market situation? Non-valuers are interested in the end result and not in the finer points of the techniques. In the case of valuations made for property tax, the test is whether the resulting figures are acceptable to most tax-payers as a fair representation of the value of the properties concerned, and whether those figures are defensible in court on appeal.
- 5.3 In fact the starting point is not the valuation method but the method of analysis of market transactions. The method of analysis, if successful, will be reflected in the method of valuation. For instance, dwelling houses are normally analysed and valued by reference to the floor area. It is known from the analysis of sales evidence that size, quality, age and location are significant factors and so values are determined using those factors. If someone devises an alternative method that works better, it will be used instead.
- 5.4 In property tax the most contentious problems of valuation arise when there is no sales or rental evidence of that class of property. For the small

number of properties where this is the case there are conventional methods by which market values can be assessed.

- 5.5 Valuations for property tax are defined by national legislation which identifies what must be taken into account in such valuations.
- 5.6 Valuation standards define the matters to be taken into account in valuation practice primarily when dealing with valuations for private sector activities such as mortgages, investment and accounting. Such standards are increasingly international in character reflecting the growing awareness of the strong links between valuation standards, financial markets and globalization.

COMPUTER ASSISTED MASS APPRAISAL (CAMA)

- 5.7 Mass appraisal is the process of valuing a large number of properties at the same time using standardized procedures. In many cases, it is the only practical way to complete a valuation list. When one person (the valuation officer) has responsibility for assessing perhaps 100,000 properties for property tax within a two-year period, the officer can accomplish this only by good organization and effective delegation. The valuation officer can personally value no more than perhaps 1000 properties in this period. The work must be done by valuers and valuation technicians working for the valuation officer but in accordance with established guidelines. Thus for instance agricultural land of category 'x' within a specified location is valued at 'y' per hectare. Perhaps houses of a certain category in a defined location are valued at 'z' per square metre of floor area. Of course the guidelines will become intricate because the resulting figure must be the market value as defined in the law. These mass appraisal methods are not new. There is evidence that the Romans used methods just as careful and complex.
- 5.8 How does 'mass appraisal' become 'computer assisted mass appraisal'? If failure is to be avoided, the answer is that it must evolve in stages. The first stage in computerization is the handling of the data in the valuation list as a database. The next major priority will probably be the computerization of

the collection process. Only when these applications are well established should attention turn to the computerization of the valuation process. It will be apparent from the description of the mass appraisal process above that many of the processes are very suitable for computer assistance. The guidelines can be computerized and the valuations automatically generated.

- 5.9 This approach works well but there are caveats. The guidelines, whether computerized or not, will not cover every case. For perhaps a maximum of 80 percent of the properties the guidelines will work without modification. The remaining properties will be atypical and require varying degrees of special attention. When handled manually the valuer or technician soon recognises when the guidelines are producing a wrong figure. It is more difficult when using computers and the design must reflect this. It must also be remembered that computers do not assist directly with the capture of information in the field which is a major part of the work. However, the use of simple inspection checklists that act as automated input forms, and palmtop and laptop computers, can be extremely helpful in the assessment process.
- 5.10 There is an essential stage in the mass appraisal process, which has not been examined in detail in this guide. Before the valuation officer can compile the valuation guidelines there must be an analysis of the market information. For instance, how many sales of agricultural land have there been? How much per hectare is agricultural land of category 'x' selling for on the open market? What are the significant valuation factors?
- 5.11 One analysis technique which can allow the valuer to make sense of market information is regression analysis which is particularly useful for handling large amounts of data. It helps to identify the significance of different factors and to identify trends. Information technology makes regression analysis simple and readily available. Regression analysis is also a key phase when the various applications above are linked to form an automated loop. Sales information is fed into the market information database and analysed directly through regression analysis. Alterations of value are

detected and fed into the valuation guidelines from which, in turn, new valuations are generated. This process can allow for very efficient annual revaluations. The complete loop is unlikely to be feasible in some countries in the medium term because it relies on the vigorous operation of a property market and the complete and accurate reporting by the parties of the true sales price.

- 5.12 Regression analysis is not new. It is a well-established and widely used technique. It does not over-ride common sense. People make judgements everyday about the value of things – whether it is a bag of potatoes, a second-hand car or the house next door – without using regression analysis. In fact in the case of an individual valuation there may be fewer than ten relevant open market transactions and regression analysis is neither necessary nor helpful. However, regression analysis is a very useful and powerful technique in the right circumstances and particularly in the context of mass valuations for property taxation purposes.

6. Final comments

- 6.1 Property taxes can play an important role in developing sustainable rural livelihoods and rural communities. The tax is transparent, cheap to administer, efficient to collect and well understood by the taxpaying public. It is administratively feasible in virtually any circumstances.
- 6.2 It is particularly suitable as a source of locally generated revenue for local government. It enables local communities to provide for locally determined needs. This is important in countries where central governments find it increasingly difficult to respond to local rural needs. Rural livelihoods will be inhibited without sound rural infrastructure. Property tax has an important part to play in providing it. Well administered, transparent property taxes have the potential to generate greater revenue and to reduce the opportunities for corruption.
- 6.3 Any review of the effect of taxes on property as an investment, or how tax affects access to land and other property, must have regard to many other wider factors: the economy, the existing pattern of taxation, and the taxation of investments other than land and other property. Taxation is, of course, primarily about raising revenue and is therefore an issue that goes well beyond the property market and land administration.
- 6.4 A tax on land and other property can have distorting effects on property markets. The design of each tax has the potential to affect the market in unintended and undesirable ways. It will be necessary to review what taxes on land and buildings exist, and to identify any distortions caused by taxation. Remedies can only be devised in the light of the larger economy, the need to raise revenue, the national capacity to implement new taxes and political realities.
- 6.5 Most tax reforms take time and property tax is no exception. The longest and most unpredictable phase is the public debate and policy planning.

Only when this stage is complete can the execution begin. Thereafter there are a number of interrelated steps which will take not less than two years. Thus time from initiation of the policy debate to the flow of tax revenue is likely to be about five years. Time is then an important element. The most complex step is the valuation assessment process which must be completed within a certain period (say, a maximum of three years) because the information captured becomes out-of-date and undermines the credibility of the tax.

- 6.6 The most important step is setting the tax rate. If the tax rate is set too high, there will be widespread resistance. If the tax rate is set too low, the system will not be cost-effective. The aim should be to set the tax rate at a level high enough to generate sufficient revenue to make it worthwhile, but not so high that it becomes impossible to collect the taxes because of an ‘inability to pay’.
- 6.7 Property tax is an ancient and well understood tax. There is plenty of experience from countries around the world and it is well known what works and what does not. There are probably no circumstances in which property tax cannot be introduced or improved if there is the political will to do so. The overall message is that property tax in rural areas is technically feasible and will benefit the rural economy and society.