

A Primer on Property Tax

Administration and Policy

Edited by

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A Primer on Property Tax

Administration and Policy

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Foreword

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The property tax is an important revenue source for local governments across the world, although the relative reliance on it varies widely. There are also substantial differences across countries in the structural and administrative components of the property tax. To operationalize the property tax requires a mix of choices regarding design issues such as: what property will be taxed – land, improvements, personal property; what is the basis of the tax – market value, rental value, area or something else; who will the tax be imposed on – owner or user; what will the tax rate structure be – a flat rate or rates that differ by value, type or location of property; and what options will be available to enforce collection, for example foreclosures. Developing administrative procedures involves addressing such tasks as: identifying the property to be taxed; determining the taxable basis of each property; identifying the taxpayer for each property; setting the tax rate or rates; invoicing the tax payer; and collecting the tax.

The chapters in this book explore in detail the choices regarding both the structure and administration of the property tax, drawing on the extensive knowledge that the authors have acquired in studying property taxes around the world. The chapters provide a wide-ranging treatment of the design choices and administrative tasks, both in terms of the breadth of design options and administrative tasks covered and the depth of the discussion. The authors describe the range of design choices, discuss the associated issues and the advantages and disadvantages for each and present the criteria to help choose among the options. Regarding administration, the chapters offer in-depth

discussion of the administrative tasks and how they can be addressed efficiently and effectively. There is consideration of such extraordinary policy and administrative issues as the taxation of public leasehold property and informal settlements, the use of GIS technology and forecasting revenue capacity. Not only do the chapters provide extensive discussion of the options, they provide insightful discussions of implementation issues. The chapters are also rich in examples of the choices that have been made in various countries for each of these design issues and administrative tasks.

In Chapter 1, Harry Kitchen provides an introduction to, and an overview of, the property tax and an initial discussion of many topics and issues inherent with the property tax. Kitchen starts with a discussion of the role that the property tax should play in local government finance. Given the characteristics of the property tax, for example its relatively immobile base, Kitchen develops the argument that the property tax is the ideal tax for local governments. But, the primary focus of the chapter is on issues associated with the assessment of property and the setting of the tax rate. Determining the assessment involves a series of critical tasks. Kitchen discusses the importance of each of these tasks, the difficulties involved in accomplishing the tasks, the implications if the tasks are not appropriately carried out, and how the procedures actually used differ across countries. Kitchen then explores the issues associated with selecting the property tax rate structure (namely a flat rate, or rates that vary with type, use or value of the property), the tax rate (for example, which government should set the rate, should there be limits on the rate, etc.), and the economic consequences of these decisions. Kitchen provides a summary of the debate over the incidence of the property tax, namely the conflicting views that the property tax is a distortionary tax on capital

or is a non-distortionary benefit tax, and the role of relief programmes in altering the distribution of the property tax burden.

The two aspects of the property tax that are perhaps most central to its implementation concern the choices over the types of property that are going to be taxed and the basis on which the tax liability is determined. Riël Franzsen and William McCluskey explore these key policy decisions in Chapter 2 in the context of value-based property tax systems. As Franzsen and McCluskey point out, there are many different types of property that might be included in the property tax base, many different ways that property value might be defined, for example, annual value, capital value, land value, etc., and alternative methods for determining market value. The authors provide an extensive discussion of the many issues associated with making decisions among these alternatives, along with a presentation of the advantages and disadvantages of each alternative. Franzsen and McCluskey explain the many conditions that must be present in order for a value-based system to be successfully implemented. To illustrate the options, the authors present many examples of the choice that specific countries have made.

Public finance economists and others who study the property tax have some 'ideal' system in mind that they use as a standard in evaluating existing property tax systems. It is not exactly earth shattering to note that to the extent decisions regarding the structure of the property tax are made by government officials who are influenced by the views of citizens; politics affects the policies associated with the property tax. In Chapter 3, Enid Slack considers the features of a good or ideal property tax system and describes how politics has resulted in a property tax that does not correspond to what students of the property tax-consider the best structure. Slack explores why and how

politics has influenced the design of the property tax and how its unpopularity has led to 'property tax revolts'. Slack discusses the policy choices that have been made as a result of these revolts and the resulting implications for the property tax systems. As Slack points out, this conflict between what is considered the ideal system and what politics demands must be recognized in designing or reforming the property tax.

A major issue that countries face is whether the property tax should be administered centrally or locally. This is a very important question since it goes to the heart of fiscal decentralization and to the quality of tax administration. In Chapter 4, John Mikesell extensively explores the advantages, disadvantages and experiences with centralized and decentralized administration of the property tax. He first considers the reasons why centralized administration might be preferred, giving examples of how various countries administer the property tax. He then discusses decentralized administration, giving examples of countries in which local governments have successfully administered the property tax. Based on his analysis Mikesell concludes that local administration is preferred, but points out the major dilemma associated with decentralization of administration, namely, the presumed greater competency associated with the central administration offset by the lack of incentive for the central government to perform well since there are no revenue consequences. The solution, in Mikesell's view, is to provide the training and technical assistance to local governments necessary for them to become competent.

Establishment of the tax rate or rates is a critical issue and involves addressing two questions. First, should the tax rate be set centrally or locally? Second, should there be one rate, or should the rate be allowed to differ between types, uses, ownership or value of property? These are the issues that

Kurt Zorn addresses in Chapter 5, which also includes a survey of how these questions are answered in various countries. For each question, Zorn discusses the issues involved and presents the arguments for and against having the tax set centrally and having multiple tax rates. Zorn concludes that for fiscal decentralization to be successful, local governments need to have control over the property tax rate. Regarding the second question, Zorn comes down on the side of a one-rate system, pointing out how simplicity and transparency are compromised with classification systems.

Once the tax rate has been set, the next step in administering the property tax is the politically difficult one of collecting the revenue. Ultimately, the objective of the property tax system is the mobilization of revenue. Some see the key to collection being a mechanism for the enforcement of the collection of the revenue, e.g., penalties and ultimately foreclosure for non-payment. But in Chapter 6, Roy Kelly takes a much broader view of revenue collection and enforcement, positing that in performing all of the administrative steps, property tax agencies should view themselves as tax collectors. Kelly makes the case that the collection process should begin with property tax administration that is seen as efficient and high quality, that yields tax liabilities that are considered fair and equitable and that ends with the appropriate methods to enforce-collection. Kelly identifies the steps that governments can take to improve the mobilization of property tax revenue, and provides rich details on how to design an effective property tax collection system, from assessing the tax-liability to the process for seizing property for non-payment of the property tax. He also describes how various countries have done this, and points out the pitfalls to avoid in trying to implement such a system.

As Slack suggests in Chapter 3, scholars of the property tax can design an ideal property tax system but that actual systems differ from the ideal. Furthermore, changes come through reform of existing property tax systems rather than implementation of a new system *de novo*. Reforming existing tax systems is not a matter of waving a magic wand and transforming the current system into one that scholars consider the ideal. Jay Rosengard has thought deeply about not just what the characteristics of an ideal system are, but also about the practical aspects of reforming existing property tax systems. In Chapter 7, Rosengard explores how to go about reforming existing property tax systems, or in his words, how 'to make an existing property tax less taxing'. Rosengard discusses the primary rationales for reform, namely improving fiscal performance, social equity, economic efficiency and administrative cost-effectiveness, and presents four guidelines that should be followed in conducting property tax reform, for example, simple trumps optimal. He also discusses the principal strategic choices that reformers face. To assist those who might engage in a property tax reform, he documents the frequent mistakes in reforming the property tax and the common elements of successful reform, and presents a review of what has been learned from several attempted reforms. Rosengard notes that while there is no formula for ensuring success in attempting to reform a property tax system, past efforts provide guidance to future attempts.

While it is common for students of the property tax to think in terms of policies and administrative structures and procedures, it is important to realize that the property tax must be enshrined in law. What the law says about what is-taxable property, about the definition of property, about the rights of taxpayers and so on has important ramifications for the performance of the property tax, including the consistency of the application of the tax, its fairness,

bureaucratic discretion, and so on. In Chapter 8, Frances Plimmer explores the issues associated with enshrining the property tax in law and the relationship between the law, regulations and the desired outcomes of the property tax systems, including fairness, behavioural changes, economic growth and so on. These legal issues include the definition of property, the meaning of value, the identification of ownership, the application of tax relief and the treatment of land occupied by squatter populations (a topic discussed in detail in Chapter 12). As Plimmer points out, all aspects of the property tax must be contained in law, they cannot be inferred and the legislation must be such that the tax achieves the desired outcomes. Getting the tax right starts with getting the law right.

While the first eight chapters discuss practical aspects of the design of the property tax and its administration, Chapter 9, by Gary Cornia, provides an extensive discussion of the principles or criteria that should be used in deciding on how reliant a government should be on the property, and used as guides in designing property tax policies and administration. The list of criteria that Cornia provides goes well beyond the typical list of principles for a good tax that includes equity, efficiency and simplicity. Cornia's list adds such factors as the need for subnational governments to have a revenue source for which they can control the design and implementation; the need for revenue that is stable and permanent; and a tax that captures some of the benefits from improved infrastructure. These criteria are fundamental to decisions regarding the use and design of the property tax. Cornia develops the arguments as to why these criteria should be adhered to in designing or reforming the property tax, and discusses the advantages and disadvantages of the property tax in the context of the criteria.

The first nine chapters are concerned with relatively broad topics associated with the design, implementation and administration of the property tax. Chapters 10-15, on the other hand, each focus on relatively specific or specialized matters concerning the property tax. In the first of these chapters, Lawrence Walters explains how to estimate the revenue potential of the property tax. In a jurisdiction or country in which there are assurances that the value of taxable property is accurately measured, forecasting revenue or revenue potential is relatively simple. But in countries in which property escapes the tax net, or assessed values are not a reliable measure of actual property values, measuring revenue potential is much more complex and difficult. It is the task of estimating the potential revenue in such situation, both for the country and for local governments, that Walters considers in Chapter 10. After explaining the concepts of fiscal capacity and fiscal effort, Walters presents and discusses each of the steps - and the required data associated with each step - that are necessary to derive an estimate of the revenue potential of the property tax. Knowing the revenue potential of the property tax is important in evaluating the design and administration of the property tax, and thus the estimation methods that Walters presents are a key to the evaluation process.

Chapters 11 and 12 discuss the treatment of what might be considered unique property. In Chapter 11, Yu-Hung Hong considers the largely overlooked issue of the taxation of public leasehold property in transitional countries, while in Chapter 12 Martin Smolka and Claudia De Cesare consider informal property in developing countries. In transitional countries, it is a common practice to lease public property to the private sector. A major question is whether the government can impose a tax on such leased property. Consideration of this issue is complicated by the fact that

there is substantial variation across countries in how lease payments are structured, including the relationship between the lease payment and market value, and whether the lease includes both land and improvements. Hong considers three significant issues associated with imposing property taxes on public lands and buildings that are leased to private firms and individuals. One of the basic issues is the conceptual consistency of applying a tax that is generally associated with private ownership of property to the lease of public property, and whether the public will find it acceptable and thus would actually pay the tax. The second issue is whether a tax on leasehold property would be borne by the private sector or would simply result in a reduction in lease payments. To address this question Hong presents a theoretical approach to the incidence of a tax on public leasehold property, noting that the answer depends on the extent to which the property tax is capitalized into the value of the leasehold property. The third issue that Hong explores is that taxing the lessee of public leasehold property requires valuing the lease and finding a way to establish taxable values using a technique equivalent to mass appraisal, an issue that has been given little previous attention. Hong notes that the value of the lease will depend on the terms of the lease, including its duration and whether rental value is based on fair market rent or the actual contract rent. Given the desire to use property taxation in transitional countries, Hong's analysis of these issues is important.

Major cities in developing countries contain large informal settlements, which pose difficult issues regarding the application of the property tax since tenure rights are at best obscure and the state of improvements is in continuous flux. In Chapter 12, Smolka and De Cesare document that process and magnitude of the development of informal settlements and then explore the questions and issues

associated with applying the property tax to these settlements. Smolka and De Cesare address the many facets of the most basic of questions, namely should these properties be taxed at all, given the presumptions that residents do not have an ability-to-pay and that determining the property's value and assigning liability are impossible. Smolka and De Cesare explore the feasibility of taxing these properties and conclude that is both possible and desirable, and thus should be part of the property tax base. They develop the argument that a well-designed property tax system that is applied to informal settlements could be a part of a more effective urban policy. In particular, the tax revenue generated from the settlement could be devoted to the provision of infrastructure and public services in the settlements, which now receive little in the way of public services or government investments. In addition, the property tax could reduce the land distortions that are observed in informal settlements.

In the mid-19th century, state governments in the USA changed their property taxes from a mixed system of per unit and *ad valorem* taxes to one based on market value. However, over the past four decades alternative concepts of value have been adopted, such as value in use and acquisition value. And, as transitional and developing countries have adopted property taxes they have relied on non-market property tax systems. In Chapter 13, William McCluskey and Riël Franzsen explore non-market value property tax systems, describing each of the alternatives, discussing the advantages and disadvantages of each and providing details of how such systems function in several different jurisdictions. Non-market value systems, which include systems in which the tax is based on the area and/or the use of the property, are generally adopted when reliable market values are not available. The chapter also explores hybrid systems, for example banding and acquisition value

systems, in which some monetary value other than current market value is used as the basis for the tax. While the major advantage of these systems is their simplicity, McCluskey and Franzsen point out the many drawbacks of such systems.

One of the primary objectives of property tax administration is to appraise property so that the resulting values closely reflect market value, and to do so in a cost-effective manner. The approach that is increasing being used to determine market value for property tax purpose is computed assisted mass appraisal (CAMA), which is the focus of Chapter 14, written by William McCluskey, Peadar Davis, Michael McCord, David McIlhatton and Martin Haran. The authors begin with a description of the main concepts that must be considered in using mass appraisal systems in general and CAMA in particular. There are many different modelling paradigms that can be used for property tax appraisal purposes. The authors explain each of these systems, which include automated appraisal systems including rule based expert systems, artificial neural networks, fuzzy rule-based systems, multiple regression techniques, comparable sales analysis and adaptive estimation procedure. Multiple regression modelling is the traditional approach used in CAMA systems. The authors provide a real world example of the application of CAMA system that uses multiple regression modelling and discuss the issues that have to be addressed in using this technique.

Chapter 15 by Peadar Davis, Michael McCord, David McIlhatton and Martin Haran examines the use of geographic information systems (GIS) in appraising property. While most people who study property taxation have some sense of what GIS is, it is likely that few know how GIS can be incorporated in CAMA systems. This chapter assists in closing that gap, by providing an extensive discussion of the

potential use of GIS in property tax appraisal and administration. After describing GIS, the authors explain how GIS can play an important role in CAMA systems. As they note, GIS systems are no longer just mapping methodologies, but now involve advanced analytical capabilities. Linking GIS and CAMA is not a trivial exercise, and the authors discuss the many issues associated with integrating GIS and CAMA. The authors describe the several benefits that GIS provides to appraisal systems, including increased efficiency and accuracy, and present an example that is helpful in seeing the benefit of using GIS in the mass appraisal of property.

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