Working paper

International Growth Centre

Enhancing Own Revenues of Decentralised Entitites in Rwanda

Policy Challenges and Options in Reforming the Fixed-Asset Tax System

Mihaly Kopanyi

February 2015

When citing this paper, please use the title and the following reference number:
S-38211-RWA-1

DIRECTED BY

FUNDED BY

Table of Contents

Enhancing Own Revenues of Decentralized Entities in Rwanda 2
Executive summary 2
Introduction 4
The salient features of the FAT reform 4
Policy Implications of the FAT Reform 5
Broadening the tax base 5
Policy issues and challenges 6
Increasing tax rate 8
Tax-base and Valuation Options 10
Market value and single property valuation by the owners 10
Policy issues and challenges 11
Market value of fixed assets with banded value estimates 12
Market value of fixed assets with Mass valuation 13
Establishing value zones and unit taxes 14
Market value of Land 15
Policy Challenges 15
Area based property tax 16
Policy challenges 16
Tax Administration Issues 17
The roles of the RRA 17
The fiscal cadaster 18
Policy challenges 19
Valuation 21
Policy challenges 21
Billing 22
Policy challenges 22
Collection and enforcement 22
Policy challenges 23
Remedies 23
The role of the Districts 24
Policy challenges 24
Corrective measures 24
Conclusions 25
References 26

Enhancing Own Revenues of Decentralized Entities in Rwanda[1]

Executive summary

Fiscal decentralization is among the highest priorities of the Government of Rwanda; the decentralization policy adopted in 2006 has been generally implemented. However, local entities remained overwhelmingly relied on central transfers since local own revenues and in particular local tax collection has not increased as expected and hinders fiscal decentralization. The government has no capacity or intention to increase the volume of transfers to the local entities, thus increasing own-source revenue collection is a vital step.

The overarching objective of this tax reform is to substantially increase local own revenues by well tapping into the revenue potential equitably via broadening tax base; increasing tax rates; centralized collection of local taxes by the Rwanda Revenue Authority (RRA); and establishing a cost efficient tax administration with computerized databases and state of the art filing and collection instruments.

Substantial progress has been made to-date and the reform is on track in general; but implementation is behind schedule and substantial preparatory actions are required for timely commencing the reform. This note addresses specific issues and actions. The most substantial challenges include the followings:

Combined area- and value-based taxation: The planned combination of value-based fixed asset tax (VFAT) and area-based (AFAT) taxes represent an uncommon approach in property taxation, albeit the vast majority of properties will be taxed based on area. The combined AFAT/VFAT taxation aims to tax the high-value fixed assets (VFAT) higher than the common fixed assets (AFAT), since buildings and improvements rather than land generate the higher value of properties in a booming economy. For this to happen, however, a proper calibration of the VFAT tax rate (planned as 0.2 percent), the value separation limit (planned as RWF40million), and the AFAT unit value taxes is vital; and informed decisions should be supported by simulation and mass valuation instruments.

The single-property valuation of market value of fixed assets by the owners and self-filing seems suboptimal; but offers a scenario that enables commencing the tax reform in 2015. Other scenarios could be cheaper and easier to manage, but may need longer preparation and postponement of the reform. If VFAT remains, considering modalities including using banded value system and application of mass valuation instruments are highly recommended. The full implementation of this reform may require most of the coming four-year valuation cycle.

The technical, financial, and human capacities of the RRA should be developed in the view of and in harmony with the need of managing a very large unified AFAT/VFAT fiscal cadaster; as compared to the present 3,850 registered FAT tax net. The computerized revenue system well supports this objective, but requires proper data and scope of the Fiscal Cadaster.

Collection efficiency should be increased: The present collection efficiency of property taxes seem to be very low, thus it is vital to well regulate collection and enforcement rules and procedures. These should include customers-friendly billing, collection, and payment system; but also good communication of the use of the tax revenues.

The role of districts should be increased: This tax reform includes a major unintended negative side-effect, namely drastic reduction of the role of districts in collecting own-source revenues. It is vital to ensure strong involvement and substantial responsibilities of the Districts in own-source revenue administration and collection to ensure strong ownership in planning and managing own-source revenues. There are numerous areas and several key functions where the districts should play substantial role; some are already ruled in the draft Law, but more functions should be legislated or regulated.

[1] This note has been prepared by Mihaly Kopanyi international consultant, municipal finance adviser with the generous support of the International Growth Center Rwanda. The study reflects the author’s view and he is solely responsible for the analysis, key findings, and the suggested reform actions.

Key specific actions recommended:

- Developing appropriate Fiscal Cadaster based on the land cadaster (LAIS) but supplemented with detailed data technical data on buildings, value zones, property values, and taxation records;
- Issuing Valuation Manual with detailed instructions for single market valuation, using mass valuation instruments, defining value zones, and guiding revaluation of AFAT unit taxes;
- Defining value zones with revised AFAT unit-taxes in each district. Expanded number of value categories (5-8 category) is strongly advisable;
- Calibrating the VFAT tax rate and the AFAT unit taxes based on simulation of the potential impacts and using broad market samples, when the AFAT unit tax should reflect the reference market value of the land, building and improvements the same way as VFAT;
- Providing RRA with sufficient budget for covering cost of valuation and revisions;
- Initial valuation should be considered as a one-time investment and the districts with RRA or the Government should cover the cost of initial valuation and revisions and recover these investment costs from property tax revenues over years;
- Ministerial Decree should regulate main tax administration issues, including but not limited to valuation, billing, collection; but remedies and enforcements should be better regulated by the Law;
- The role of the Districts should be strongly improved; measures may include:
    - The MoUs between Districts and RRA should go beyond the mere frame document to formalize the RRA's function to collect revenues on behalf of and for the Districts, but also should include indicators for and reward measurable performance.
    - The RRA should provide the districts with a formal *tax-role* of the registered tax-payers that the *District Councils should approve* and may publish or make publicly accessible annually;
    - The RRA should estimate the collectible taxes and the Councils should include these estimates in the budget reports both in the budget plans and in reporting performance in the final accounts with clear comparison of budgeted/actual ratios in main revenue categories.
    - The District Councils should demarcate and publish the urban areas/sectors within each district.
    - The district councils should define, approve, and publish FAT value zones in the urban areas based on market proxies of land, buildings, and improvements identified and valued in close cooperation with RRA and the RNRA and maybe supported by expert valuers.
    - District Councils should approve and publish the list of property clusters by use: agricultural land, residential, commercial, and industrial.
    - Districts should timely identify properties for appreciation based on available records like building and use permits and field verification of alterations; but also should initiate revaluation if major infrastructure investments substantially increase property values.
    - Districts should actively cooperate with RRA in tax collection.
    - District should actively develop and implement communication campaign to inform tax payers about the use of revenues collected from local taxes.
    - District Councils should play major role in enforcement, especially in attempts to identifying unknown property owners, in court procedures for repossession of properties after all possible measures completed to identify the property owner or his proxy; but also in collecting unpaid taxes and arrears.

Introduction

Fiscal decentralization is among the highest priorities of the Government of Rwanda; the decentralization policy adopted in 2006 has been generally implemented. However, local entities remained overwhelmingly relied on central transfers since local own revenues and in particular local tax collection has not increased as expected and hinders fiscal decentralization. The underlying reasons include: the low human capacities at the district level for managing and collecting local revenues; inadequate revenue databases, narrow revenue base; and low tax-rates. Early 2014 the Government has commenced a "*Fiscal Decentralization Project*" aiming at fixing the above mentioned shortcomings by: (i) mandating the Rwanda Revenue Authority (RRA) to collect decentralized taxes and fees for and on behalf of the districts; (ii) appointing a fiscal decentralization project management team; (iii) establishing a Project Steering Committee; (iv) commencing a legislation review and amending the Law No 59/2011 on *Establishing the Source of Revenue and property of decentralized entities and governing their management* [Law No …../2015 – here thereof the *draft Law*]; and (v) acquiring a software to manage local governments' revenues on a centralized data platform.

This policy note summarizes the progress in this fiscal decentralization reform project with critical analysis to compare the objectives, the legislative framework, the prepared, drafted, or foreseen instruments, and identify the challenges the RRA will be facing in fulfilling the tasks for collecting decentralized taxes with special focus on the fixed asset tax (FAT). The key issues we like to address include: the policy implications of the planned measures, options for reducing policy challenges; and the instruments the Government or RRA may need to introduce to support implementation.

The salient features of the FAT reform

There is a univocal agreement among stakeholders and experts on key issues Rwanda and the RRA has been facing[2]. Key issues and challenges: the local own revenues are far below (about 20 percent) of the revenue potential (Cyan at al 2013); the tax base is narrow, about 3 percent of properties are subject of Fixed Asset Tax (Grote at al 2014); the tax rates are low (property tax (FAT) rate is 0.1 percent, a tenth of the mean international rates); the collection efficiency is very low (percent is unknown due to lack of solid data, but anecdotal evidences suggest 30 percent); the local revenues are in the range of 10-15 percent of total district revenues (Irwin at al 2014 and World Bank 2014); local entities require much more revenues to respond to rapid urbanization and there are unutilized sources (Kopanyi 2014); the government has no capacity or intention to increase the volume of transfers to the local entities; and the local entities have low capacity to administer the local revenues and to collect substantially higher revenues locally.

The Government and key stakeholders have well responded to the above challenges with fast and notable courses of actions. Progress to-date include: a draft law is in final preparation phase, the revenue software has been acquired, installed and testing is well underway; the RRA started local tax collection in March 17, 2014; the project team and the Project Steering Committee is operational; RRA adopted a very ambitious roadmap for implementing this reform (RRA 2014); RRA has signed MoUs with most districts for revenue collection; and the RRA has hired about 200 staff to boost administration and

[2] This reform program and the author of this note has greatly benefited from various background studies and donor's advices, including but not limited to the reports from IMF, World Bank, and other consulting studies, including Grote at al 2014, Irwin at al 2014, Cyan at al. 2013, World Bank 2014 and 2013.

collection capacity. Not surprisingly further challenges have revealed/emerged during preparation and implementation of this very ambitious reform project.

The overarching objective of this reform is to substantially increase local own revenues by boosting and well tapping into the revenue potential equitably. These goals can be achieved via broadening tax base by introducing a combination of value-based and area-based FAT; increasing tax rates; collecting local taxes and fees effectively and efficiently; establishing a cost efficient tax administration with computerized databases and state of the art filing and collection instruments (e-filing and e-payment); and utilizing the supporting databases like the electronic land-records (LAIS), banking data, and city data.

Policy Implications of the FAT Reform

In this advance stage of preparation and midway towards implementation, it is useful to analyze the policy implication of the above objectives, the drafted measures, and the planned instruments. Preliminary findings suggest that the reform is generally on track, the changes are moving towards good directions; and the Government has adopted many key recommendations learned from the international experts in particularly the IMF (Grote at al. 2014). Nonetheless, there are still areas that need further refinement and analysis; some areas may need reconsideration of goals and testing of alternatives; and there is a need for preparation or adoption of a number of specific measures or instruments in order to enhance or complete implementation. The following sections will review the various measures and instruments by confronting them with the said reform objectives with strong emphasis on policy implications.

Broadening the tax base

The tax-base conceptually is determined by three important factors: the base in narrow sense is a *legal definition* of the *taxable assets*. In broader economic sense, however, the *way and means of valuation* of the taxable assets defines the *economic base* or *tax capacity* i.e. the volume of collectible taxes, and finally *exemptions narrow* the economic base. All these factors are in power in this reform. The *draft Law* changes the definition and expands the base, it also initiates new valuation cycle with updated market value which should expand tax capacity in a booming economy.

Fixed asset tax base: The draft Law first defines the tax base as the *market value of the fixed assets* defined as immovable properties including land, buildings, and improvements (Article 2 and 7). This tax base that virtually includes all real properties in Rwanda is reduced by exemptions based on: function, ownership, use, and authority (Article 17). *Functional exemptions*: agricultural land below 2 hectares size and plots reserved for housing in unserved rural area are exempt; Ownership exemption: fixed assets owned by national or local government entities or other public entities; Use exemption: fixed assets used by charitable, religious, diplomatic, or not-for-profit research purposes; Authority exemption: any land (or fixed asset?) the local council rules as exempt.

Two forms of FATs: The draft Law establishes the *market value as the general tax base*, however, defines two forms of taxes: a) value-based FAT (here thereof VFAT) and b) area-based FAT (here thereof AFAT) which is linked to market value indirectly. The *draft Law* limits VFAT to properties with value equal to or greater than RWF40 million (Article 10 (1) and (2)). The *draft Law* reflects a major policy shift: a) by declaring all fixed assets as subject of FAT, and b) by cutting the legal gridlock by declaring all fixed assets as subject of AFAT regardless of legal status i.e. regardless if personal ownership has been

registered or not[3]. This is a major improvement of the property taxation that improves fairness and has a capacity to boost local revenues. The following policy implications are important:

- ***Improved fairness***: *The present property tax system* comprised of two taxes: the Land Lease Fees (LLF) and the Fixed Asset Tax. The LLF is levied with a per-square-meter fee (varies typically between RWF70, RWF30, RWF5 or zero per square meter) with no charge for improvements. In contrast, the FAT levied only on *registered personal properties*[4] and combines the value of land, building, and improvement and charged 0.1 percent of market value. The IMF team exposed a case that suggests that the FAT might charge as high as fivefold of tax burden compared to LLF (Grote at al pg. 67). This leads to a fairness issue, namely that two identical size of parcels with similar size of buildings or improvements could be neighbors close by or even with one joint border, while pay 5 times different taxes because different registration. Thus, it is understandable while the property owners have preferred paying LLF instead of FAT and they could do so by simple leaving their property ownership unregistered. With this they also saved a noticeable registry fee (RWF20,000). The new Law makes all properties liable for FAT regardless of legal status. This is a big improvement on fairness and increases the tax capacity.

- ***Expanding the number of FAT tax payers***: First, there will be formal expansion of the FAT, since by definition all properties will be subject of FAT (AFAT or VFAT). But also, a large number of properties may migrate from LLF to AFAT; if not, then the RWF40million value limit is inadequate. It would be important to well estimate the magnitude of changes as soon as possible. Districts and RRA can work on this jointly, by defining the urban zones (all Kigali and in the 6 largest secondary cities – the 9 districts here thereof).

- ***Expanding the taxable value***: There are two factors that will contribute to expanding the taxable value i.e. the revenue base of the districts. The new valuation that will happen years after the last valuation. Given the dynamic economic growth and the active real-estate market[5] in Rwanda, the market value of fixed assets is expected to show substantial increase. But the more significant change will happen to the properties that migrate from LLF to VFAT with expected multifold value change as said before. Therefore, it is worthwhile to approach the *valuation as a one-time investment* and invest the adequate amount of money in order to ensure capturing the value and tapping into this revenue stream properly and equitably. Discussions with stakeholders, however, suggest that maybe a good number of properties could move back from the current FAT (move out from VFAT) to the AFAT, since the estimated market value of many *registered properties* could be below RWF40million.

Policy issues and challenges

- ***Magnitude of changes***: We have projected the potential magnitude of changes from various information bases with various proxies and compared results to the fact that 3,548 properties were on the FAT net in 2012 (Grote at al.). Results suggest a quantum leap, thus the RRA seems to be facing with enormous challenges in managing the AFAT with large number of properties. Thus, procedures, capacities, and budgets in RRA need to be prepared in light of this potential jump in number of AFAT taxpayers. The

[3] The current regulation reads: "T*he market value of buildings and all improvements thereto registered with the Land Registration Center and for which the owner has obtained a title deed..: (Art 6 (2) of Law No 59/2011)*

[4] With substantial challenges in itself (Binda-Daale-Kairaba 2012)

[5] There were 75,000 real estate transactions in 2014, albeit a good share land only (source RNRA consultation)

following ballpark calculations are based on population and urbanization figures from Census 2012 (NISR) and from IMF survey.

a) ***Proxy 1: Taking the current LLF.*** There are 1.1 million properties in LLF; of that about 570,000 properties are in the said 9 districts (Grote pg 67). There is no information about the values of the LLF properties, but a fair share of the 570,000 properties will migrate to AFAT. The 20% urbanization rate suggests that about 114,000 LLF may migrate to AFAT with taxable properties.

b) ***Proxy 2: Taking the population and family size***: The urban population of the 9 districts is about 1.6 million that suggests about 400,000 households in urban areas[6]. We do not know the coincidence of households and taxable properties, but one can assume that a quarter of them will be subject of AFAT. This also suggests that maybe 100,000 LLF payers will migrate to AFAT with taxable properties.

- ***Filing rules are critical to capture taxable properties fairly and effectively:*** The draft Law suggests that registering and filing the value of the properties will be mandatory regardless of the value of the properties. The major challenge for the districts and RRA may emerge, namely to screen and verify the existence, the technical characteristics, and the value of about 1.5 million taxable properties. A critical challenge is that the *draft Law* (Article 13) requires registration and value declaration by December 31st; this may result in hundreds of thousands of filings in December. An earlier date for registration say June 30 would be more appropriate. Verification will also take time and may span over the next 4 year valuation cycle.

- ***Segregation of AFAT and VFAT***: The self-declared value[7] will be the decisive factor in initial registering a property in the AFAT or VFAT database. Cleaver calculation may motivate owners to declare either AFAT or VFAT in order to minimize tax payment; this weakens the market value principle.

  It may happen that self-valuations make the value range of properties very crowded between RWF30 and 40 million or between RWF40 and 50 million. Two errors: a) Leaving high-value properties out from the VFAT tax net is not advisable, since a revised valuation by RRA may move substantial number of properties from say RWF30million AFAT to the RWF40million VFAT clusters. An honest self-valuation with honest mistake may estimate the value of a given fixed asset as RWF39million that makes the owner exempt from VFAT, while a similar property in the same street may be reported as RFW41million and the owner of the latter pays VFAT. b) Large land-size properties with basic improvements may be reported overvalued to pay less in from of VFAT than in form of AFAT. These are all equity issues and demand attention of the RRA. Specific procedures can be adopted to mitigate these kinds of valuation risks.

- ***Low migration from LLF to VFAT tax could be a challenge***. Should the migration from LLF to VFAT remain low, then the RWF40 million value-limit should be considered as too high that contradicts with the aim to broaden the tax base. This risk supports the need for proper simulation/analysis and eventually lowering the taxable value below RFW40

[6] The mean of household size is 3.8 in Kigali, 4.2 in other districts and 4.1 in national (ESPHS 2012)

[7] Article 9 d) reads: "…the taxpayer shall make his/her own estimation based on his/her best judgment. He/she shall indicate the value for which he/she would be willing to sell the fixed asset to a third party."

million. Furthermore, the RWF40 million is about USD57,000 is a value range that represent valuable housing and well taxable property even in middle income European countries. From this perspective the RWF40 million VFAT limit reflects a cautious policy that tries to avoid moving large number of tax-payers into VFAT; however, this policy contradicts the core objective to expand tax-base by eliminating the registration condition. Revisiting this tax-limit issue is advisable!

- ***Increase of tax burden could be a policy challenge***. Rough calculations suggest a three to five fold increase of tax burden by migrating from LLF to FAT is likely to happen (a case in IMF 2014 pg. 67 estimates fivefold increase of tax burden). This burden will be combined with the rate increase (double rate) that may make tax burden for sum to increase by tenfold. These rough estimates should be verified with real sample numbers. Should AFAT fail to increase tax burden substantially, the migration to AFAT might have not been calibrated well.

- ***Taxing joint ownership properties***: The draft Law maintains the rule of taxing fixed assets in joint ownership, but leaves an important policy issue unclear; namely how to tax properties when the land and the buildings are in different ownership, typical in high-rise condominiums and informal settlements where a land parcel is owned by a person but several housing units are built on that parcel on leasehold bases[8]. The combined/aggregate value of the parcel and the houses might make the property subject of AFAT. It looks logical that the owner of the land parcel is responsible for the AFAT and should collect the due charges from the owners of the housing units in line with Article 8. Needless to mention, that even with a lower taxing limit, the majority of the properties in informal settlements would not be subject of VFAT; so this rule could be harmless to poor families.

  The joint ownership taxation issue applies also for multistory condominiums when joint taxation of land and buildings would make the property subject of VFAT, while individual valuation might make many of the apartment subjects of payment of a negligible AFAT based on small land-share proportion. This issue should be regulated either in the Law or in the Ministerial decree that will set rules and procedures for implementing this Law.

Increasing tax rate

The combined use of AFAT and VFAT and particularly the fact that the vast majority of the properties will be taxed in the AFAT segment makes the calibration of the tax-rate complicated and challenging. The draft Law defines the tax rate in two ways: a) *"0.2% [2/1000–MK][9] of the market value of immovable property equal or greater than forty million [40,000,000] Rwandan francs"* (Article 10. 1); b) *"Immovable property with market value less than forty million [40,000,000], Rwandan francs shall pay tax basing the fixed rate per square meter as determined by the district council basing on the market value of land and its location"* (Article 10.2). The definition of the b) tax rate is implicit and requires clever calibration the Councils may not be prepared for. The Ministerial decree and the Valuation Manual the MINECOFIN plans to issue should provide detailed instructions for not only the VFAT valuation, but also for the calculation of the unit-taxes in AFAT segment (about 1.4 million or more properties!). A critical challenge is that the AFAT and

[8] The definition of the tax base in the *new Law* (article 7) makes clear that the FAT not only applies all properties, including the informal settlements.

[9] There is a typo in the law that suggests 0.02%=0.0002=2/10,000; the correct number presumably is 0.02=0.2%;

the VFAT are linked together and improper calibration of the market rate (0.2%) and the unit taxes (currently RWF70-30-5 and 0 under LLF) create arbitrage and challenge fairness. An in-depth revision of the AFAT unit-taxes is vital for establishing consistent links to market values and for harmonizing the AFAT and VFAT rates. The RRA may support districts with external experts and mass valuation procedures in well calibrating the unit taxes and ensuring unified valuation (and fairness) across districts in AFAT. The experiences of Bangalore (Bengaluru) India may offer valuable lessons (McCluskey-Franzsen 2013 and Rao 2008).

VFAT rate: The rate of the current FAT (0.1 percent) is low by international comparison; the mean of international rates is about 1 percent, tenfold higher than the Rwandan rate. This fact justifies the planned increase of the VFAT tax rate to 0.2 percent and above in medium to long term. The only question is the sequence, since experiences strongly suggest that starting with broadening the base before increasing the rate is very advisable. The simple reason is that starting with the higher rate would make the taxation more inequitable, since more taxes would be collected from those who are already in the tax net and or already active payers, while would leave the others unattended as free-riders for some time. Another issue is, that updating the valuation of properties (and moving from LLF to VFAT in Rwanda) should also precede the rate increase, since a fair market valuation may increase the taxable value so substantially that the adjacent rate increase may make the tax burden increase politically challenging. An opposite challenge is if the VFAT tax appears to be still lower than the AFAT. MINECOFIN has made some rough calculations to estimate impacts, but a more precise simulation is well justified for testing the 0.2% VFAT rate, the RWF40million limit, and in line testing the AFAT unit taxes.

Political challenge and affordability: Scholars univocal agree that social issues and affordability should not be a direct factor in property taxation; however, affordability and the magnitude of the changes can be considered as political risk factors. The *new Law* doubles the FAT rate in parallel with the expansion of the tax net with migration from LLF to VFAT and new market valuation. The VFAT rate is very low and the burden may fit to the family income though. For instance the 0.2 percent FAT tax of a RWF40million property would be RWF80,000 for a year that is about one percent of the annual salary of a tax officer (RRA2014 pg 5). The jump of tax burden still might be politically challenging in some social strata. A common mitigation of these challenges and political risk factors is to complete a sample based simulation and project impacts to support informed decision about the appropriate rate increase in parallel with the changes in tax base and tax valuation. Tempering the valuation in order to harmonize the rate is the least appropriate mitigation.

Revenue target may not be considered in setting the new rates. Textbook solutions but also the practices in developed countries with well-established property tax systems[10] and databases would suggest that the tax base is given or well set by historic factors, thus the first step is for a council to decide the amount of budget revenues he wants to gain from property taxes in the upcoming year. The second step is to set the rates (VFAT rate and AFAT unit taxes) that ensure the aimed volume of revenue with high (say 95 percent) collection efficiency. This formula is rarely followed in developing countries and it is particularly not applicable when such a substantial change of tax base is planned in Rwanda. Since the tax capacity is hardly known in Rwanda at this stage of the reform the revenues the districts

[10] The Fairfax County Virginia US has a mass valuation system that revalues properties annually. When the property values dropped after 2008, the budget did not try collecting the same amount of taxes, yet the rate was changed from 1.0 to 1.1 percent to reduce the revenue shortfall caused by the property market. This was well communicated to the taxpayers in information letter sent annually on property tax changes. After 5 years the rate went back to 1.0 percent.

want to gain from FAT is hardly predictable; thus the status quo and other policy considerations need to be factored in when the adequate rates are decided.

Tax-base and Valuation Options

There have been several tax-base and valuation options considered or discussed in the background documents and in dialogues around this tax reform. Discussions briefly touched upon the capital and rental value based options, including: *capital improved value*, a *combined value for land and improvement*; *unimproved land value* when only the site is valued; *land and improvement* valued separately; and *taxing building value* only. The area based option was very briefly mentioned but substantially not discussed. The IMF team (Grote at al 2014) discussed the single land-value option in more detail since found it as a strong alternative against the "market value for land and improvement" in current Rwandan circumstances. There were brief discussions on valuation methodologies, but the single property valuation was seen as a viable option, while both the banded valuation and mass valuation options and methodologies were left unattended.

The *draft Law* finally left the fundamental attributes unchanged; namely the AFAT will be levied on per square meter land area with unit taxes linked to market value, and VFAT will be levied based on market value; value is estimated on single property; and the property owners are responsible for initial valuation and self-filing for both AFAT and VFAT. With introduction of the parallel VFAT and AFAT taxation, the area-based taxation becomes (or remains) the dominant taxation in Rwanda, since about 1.4 million properties will be subject of AFAT and a few tens of thousands or maybe 100,000 properties subject of VFAT. A major change is that the AFAT (former LLF) unit taxes should now be calibrated more precisely with market value analysis (Article 9). The main supporting argument could be that AFAT and VFAT represent the generally accepted present practices in Rwanda. The present practice argument is somewhat questionable though, because the majority of future payers will presumably have no experiences in estimating the fair market value of their own properties. Thus valid reservations support revisiting the value base and valuation issues; lets' start this with the approach prescribed in the *draft Law* and see other options afterwards.

Market value and single property valuation by the owners

The Rwandan capital and real estate market at best can be seen as an emerging market. Experts emphasize the very low share of market transaction (low percent of total property sold/transferred annually[11]); poor albeit improving records of transfer transactions, and generally limited market information. Based on these some may conclude that there is no adequate basis for market-based property taxation in Rwanda, so area base apply. Some also argued that the local governments (districts) have no data to establish or estimate market value of the properties themselves (Cyan at al. Grote at al.). Thus we may conclude from the above, that mass valuation and banded market value approach would provide cost-effective and politically well acceptable solution to mitigate the challenges emerged from this market situation. Against this background, the *draft Law* legislate the tax base as the market value estimated in singe properties by the owners for VFAT, and/or estimated by the Councils for AFAT. The councils got high responsibility in establishing AFAT unit taxes for 90% of taxable properties; the use of mass valuation instruments and hiring valuation experts are highly advisable.

[11] The RNRA registered 75,000 land and other real estate transactions in 2014. This is a promising size of database for analysis, albeit represents about less than one percent of total urban and agricultural properties.

Policy issues and challenges

1. ***Single property valuation*** that is to estimate an exact market value for a property combined of land, building, and improvements (VFAT) is by far the most expensive valuation procedure. It is important in some specific purposes such as mortgage based lending. This is a historically common practice for property tax purposes in many well-developed countries like Canada, UK, and USA, albeit *mass valuation is increasingly used in the USA*. Policy challenges in Rwanda include the capacity of valuers, the time, and the cost. First, it is a question if the capacity of the RRA or the Real Property Valuers of Rwanda (RPVR) is sufficient for completing this exercise in a magnitude of few hundred thousands of properties (number depends on exemptions). Neither the RRA nor the districts have such expert capacity. The RPVR is doubtful to have sufficient capacity for this. Thus, the completion of individual valuations would take excessive time with current or foreseeable capacities in Rwanda.

   Second, experts (Groete at al pg.70) say that single property valuation fees are excessive for property tax purposes[12]. Using the example provided (ibid pg.70) the cost of single property valuation could be in Rwanda around RWF1,000 (about USD1.4) per square meter. One can assume that the taxable properties includes about minimum 70 square meter dwellings but the average could well be in the tune of 100m^2. This suggests RWF70,000-100,000 (USD100-140) valuation fee per dwellings that makes a total cost for the said 100,000 VFAT properties as RWF7.0-10.0billion (USD 10.0-14.0million) total investment cost. Needless to say that the first large scale valuation is typically considered as an initial investment cost which is covered by the taxing entities (districts) and recovered shortly from the property taxes. Mass valuation cost of valuing one property would be about a quarter or one fifth of the cost of single property valuation maybe around 10-15 dollars (RWF7,000-10,000) per properties (World Bank 2014b).

   Self-reporting and self-valuation: While self-reporting for property tax purposes is common in many taxation systems that collects main factual technical data from the owners or other taxpayers; self-valuation of single properties is quite uncommon. The *draft Law* maintains the previous practice of self-reporting the property value by the owners. Against the Rwanda situation described above, one can ask, how do we expect that hundreds of thousands of uneducated property owners are able to provide reasonable market value estimate, when the authorities (RRA, districts) with some expert capacities (RPVR) are unable to obtain data from an underdeveloped property market. Let's take a closer look at the policy implications! Discussions suggest two possible reactions:

   a) Owners hire professional valuers if feel unable to estimate the value of their own properties – it is too expensive and thus unfair to expect owners to cover the cost of initial valuation;

   b) The RRA as a tax authority (not as a collecting agent!) will revise tax reports and initiate revision if the reported value appears to be inadequate; but also need to commence initial valuation for properties the owners failed to declare value;

2. ***Self-reporting challenges and corrective measures:*** There are several specific challenges with this approach, but also there are mitigation measures too.

[12] Whilst these fees may be suitable for loan or other financial purposes they are excessive in terms of property tax valuation which normally involves the valuation of large numbers of properties (Grote et al pg.70).

a. ***Challenge 1–political support***: Self-reporting may seem attractive since it has been tested in Rwanda and gained political acceptance among the 3,850 current FAT payers. The first challenge is that self-valuation in much larger scale may change this support though because the 1.5 million owners who became subject of self-reporting might feel this task excessive and unfair. It will happen particularly, if tens of thousands need to ask professional valuers and learn the cost and feel that the taxing authority should bear the cost not the taxpayer. International experiences suggest that the central or local governments cover the cost of initial valuation, not the taxpayers.

   Mitigation: There are two possible instruments to mitigate this challenge: First, the government or districts cover the cost of valuation, but this automatically requires replacing self-valuation with other methods. Second, the taxpayer covers the cost but reimburses the valuation cost from the due taxes. This may seem easy to implement, but would eliminate tax revenues for two-three years. Further, many taxpayer would require reimbursement without becoming liable for paying VFAT due to estimated property value below RWF40million.

b. ***Challenge 2–Reliability of value and tax estimates***: RRA and MINECFIN expect that the majority of the VFAT filings will be supported by hard evidences (within 4 year valuation for loan, sale transactions, and new construction cost). This is a rational rule (Article 9), but a) these filings still require verification, b) tens of thousands of properties built before the year of 2000, thus require fresh valuation. The latter taxpayers may react by providing their *best honest estimates* without using any professional support and with multitude of honest mistakes (Article 9 d.); some mistakes might not be so honest though because of arbitrage between AFAT and VFAT. It is most likely that without specific rules of the game the *reported values will be unreliable guestimates* and the owners cannot be charged on tax evasion, rather should be considered as honest. The policy challenges include a *likely deterioration of the tax base and reduction of tax capacity and tax revenues for the coming four years*. This is a very likely scenario, if the number of VFAT payers jumps from 3.8 thousand to tens of thousands or over 100 thousand. The incorrect market value proxies for AFAT payers are less harmful for the revenue base, but still need verification since would distort the information base for estimating the AFAT unit taxes.

   Mitigation: The RRA may follow soft or hard reaction policy. Soft reaction would be to assume that the majority of the filings as reliable and pick out a small manageable number of filings maybe on sample basis. Harder reaction would be accepting filings as they are in 2015, but introducing a systematic revision methodology that may use some mass valuation modality to *revise each filing over the next 2-4 years*. For this to happen, the *rules and contents of filings should be tailored adequately*; like requesting reporting not only personal data and property value, but also key technical characteristics like material, floor number, number of rooms; aggregate floor size, age of the buildings, and structures. Details will be discussed later in RRA administration section.

Market value of fixed assets with banded value estimates

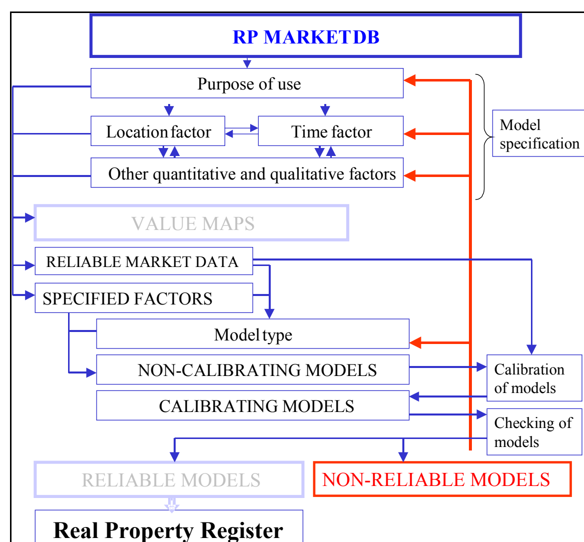
This option has not been discussed in the policy dialogue around the Rwanda property tax reform, albeit it might represent a viable and cost-effective alternative to the single property valuation option. The concept is to establish value bands of the property market and estimate only say RWF10 million value

ranges of the properties instead of estimating "exact" property values with RWF1000 precise sums. This would in itself simplify the valuation and save time and money. Banded valuation is well used in the UK and often advised by expert agencies as an alternative to single property valuation (World Bank 2014c), and it is possible to apply in Rwanda circumstances! One alternative to this is that owners declare market value, but the RRA use banded values for filtering data for revisions, i.e. RRA estimates only the value bands and leaves the single property self-valuation unchanged if it is within the estimated band, and commence revision and change value only if the revision establishes a higher value-band. This would be a cost effective procedure particularly if tens of thousands of properties need revision.

Market value of fixed assets with Mass valuation

This option has not been in the policy dialogue around the Rwanda property tax reform, albeit it might represent a viable and cost-effective alternative to the single property value option. This option would still maintain the market value approach, but would use modern technology in estimating the market value in scientific way but much cheaper than any single-property valuation system. The computer aided mass valuation system (CAMA) or automated valuation models (AVMs) would represent departure from the self-valuation albeit maintain self-reporting, since it requires centralized procedures and utilizes the modern instruments like the digitalized land records and the GIS mapping, but also needs technical details from owners (IAAO 2013). Experts have stated that the Rwanda sporadic real estate market information does not provide RRA with sufficient evidences for market-based estimates (does not support owners' estimates either sic.!); but recent CAMA experiences in transition economies like in Moldova and in the Baltic countries in the early 2000s has proven the merits of CAMA and the viability of these applications in emerging real-estate markets (Malme, 2004) that were not better at that time than the present Rwanda real estate market.

Figure 1: Conceptual Model for Mass Valuation in Lithuania (Bagdanovic Viciu-Deveikis pg. 7 2011)



The Lithuania experiences would be particularly useful to learn from (Bagdona Vicius – Deveikis 2010). CAMA were used initially for land valuation only starting in 2001, and after few years of experiences CAMA was legislated as the basic method for real estate valuation including land, buildings, and improvements. The CAMA improved valuation tremendously, but not surprisingly owners reacted with hundreds of appeals; many though appealed without counter-valuation since were just desperate to reduce taxes at any price. The major challenge was that the CAMA estimated values were substantially

higher than the previous value estimates which were based on vague value proxies. In a country of 3 million populations in Lithuania 3 million properties were assessed, and there were 1600 appeals of which 458 (0.02%) resulted in changing the estimated property value (Bagdona Viciu-Deveikis 2011). The chart below provides for a birds-eye-view on the CAMA procedure. We do not discuss details of this chart, since it is just a brief illustration of the procedure that gives, however, a good impression of main steps and key interlinks between the various databases and actions.

The CAMA models are well regulated and can handle well the information from the computerized land cadaster and the GIS. CAMAs uses the same information as the single property valuation and able to handle and mix the various valuation methodologies, including the market value, the cost based, and the income based valuations (IAAO 2013). CAMA system stores cadastral records, increases analytical capabilities, makes routine calculations, and produces reports, including property records, assessment rolls, assessment notices, and tax bills. (Gloudemans, R.–Almy, R. 2011) Mass appraisal systems would well support the property valuation in Rwanda in a cost effective manner; the only drawback is that it would require time to procure, install, test, and implement any CAMA system. It would be useful to inquire, if the revenue management system the RRA has procured and has been testing is compatible with and can be supported with CAMA modules.

Establishing value zones and unit taxes

Establishing value zones are equally important in various valuation methodologies, but particularly useful in implementing CAMA valuation. The IMF study also emphasizes the need for establishing value zones in each district (Grote at al. 2014 pg 69), albeit they limit suggestion to the land-value zones. The focus can be broadened including combined value zones for land, buildings, and improvements. One can add, further, that establishing value zones would be a prime task for in-depth cooperation between RRA and districts (with help of experts) that would make the district involved and responsible for their own constituencies rather than becoming free riders who receive the monthly transfer of collected tax revenues from RRA. Furthermore, value zones will be inevitable for establishing the AFAT unit taxes; a responsibility of the Districts in the *draft Law*.

Challenge and Mitigation

It will be a big challenge if the market value, single property valuation, and self-valuation remain the basis of the AFAT and the RRA will receive hundreds of thousands of property filings. The challenge will be: when and how will the RRA be able to sort out the properties for revision and how to complete revisions. Utilizing CAMA instruments and methodology would help RRA in quick revision of all filings and sorting out clusters a) no change, b) detailed revision. After enactment of market value and self-filing, the RRA could immediately start procuring CAMA modules and gathering information for filling up the CAMA system and finally complete revision on the following 2 years or so.

Establishing value zones and setting the unit-taxes for main property categories is a joint sampling process that requires good cooperation between RRA and districts and maybe the support of professional valuers. It is also vital, to use the combined value of land, buildings, and improvements of the reference sample for defining AFAT unit taxes. AFAT may be seen as a land-only tax, but it is important to establish AFAT unit taxes based on combined market value of land, buildings, and improvements in order to harmonize AFAT and VFAT and avoid massive arbitrage. To illustrate the issue: let’s assume a property with RWF15mo land and RWF23mo building. This property would be taxed in VFAT since the total value is RWF38mo. Its neighbor property might use same land but RWF25mo building, thus will be subject of VFAT. Should the

AFAT unit tax reflect only the land value (RWF15mo), there would be a big jump between paying AFAT or VFAT. Furthermore, the draft Law states that the market value of the fixed assets is the base of the property tax that implies that the AFAT unit tax also should reflect the combined value of land, building and improvement, rather than just land.

Market value of Land

Addressing the question of sustainability of the FAT, the IMF team found that the single property valuation is complex and expensive regardless if it is born by the owners or by the government. Further, the administration is weak and there is no quality assurance built into the system to ensure fairness to the taxpayers. If FAT remains the valuation approach, it needs to be simplified and regulated; publishing a valuation manual is required that would prescribe land value and building costs that must be used for appraisal (valuation). They eventually advise to consider *replacing FAT with single land value taxation*, because–let's quote the arguments (ibid page 69)–"the existing valuation approach is complex, difficult to administer, lacks any oversight or quality control and is expensive. Typical valuation reports required for a reassessment demonstrate the point.

The valuation of the land parcel is typically simple, straightforward, and involves only two inputs and within all valuation reports reviewed involved a three line approach as follows:

- Size of the parcel in m^2
- Rate per m^2 x the parcel size
- Value of the parcel

If the recommendation is followed to make eligible all urban property liable to the FAT then adopting a land value approach would be feasible. The size of all land parcels is already known (the Lands and Mapping Department have these data) and simplified land value zones could be developed. The land values in a zone would be prescriptive and could be differentiated according to size, road frontage, slope etc. As a short term measure this option could be rolled out almost immediately. A legislative change would be required to amend the basis of valuation to land value although the current legislation does state that the FAT shall be levied on *the market value of parcels of land*" (Grote at al. pg 69).

Policy Challenges

This option is merit-full and worth serious consideration, first of all because it brings simplicity and therefore a cost-effective valuation alternative. But three policy challenges deserve attention:

- It would be a big step backward by ignoring the superstructures, namely the buildings in a booming economy where the real-estate market develops by new buildings not by new land parcels. This also leads to a major policy challenge of fairness, since this system would provide enormous benefits for the developers and owners of large buildings and large family homes. In other words, land value taxation would levy the same tax for a 1000 square meter of building lot regardless if a three-store building with 600 square meter total floor size or a small house of 100 square meter floor size is hosted, provided that these two parcels are in the same value zone with similar geographic characteristics. On the positive side this would strongly support developers; on the negative it would be unfair for the owners and taxpayers of small buildings.
- This system has a distance from the market that makes easier to calculate land value; however, there is still need for establishing the link to markets by defining and appraising the value zones. The unit rate for the parcel (RWF per square meter) should be established in a procedure very similar to the methods used in area based property tax system (discussed later).

Area based property tax

The above summarized land-only taxation is basically a hybrid area-based taxation with strong market proxies. Thus one can consider making one step further down along this logic and suggesting *universal hybrid area-based AFAT system* with strong links to market proxies for both the land and the buildings[13] but without combining AFAT with VFAT. This is equally doable in short term. CAMA methodology can be used to establish connections between the value zones and the market values (or construction costs or income), and estimate unit tax for both land and buildings on per square meter basis for various property clusters (residential, commercial, industrial) and various value zones. The fact that 90 percent or more of the taxable properties will be taxed by the area-based AFAT; eliminating VFAT worth consideration.

The big difference from the current VFAT would be that neither the owner, nor the RRA would declare the value of the buildings or land, but only declare and publish the unit tax tables for all property clusters and by value zones. It would make the system easy to understand by uneducated owners who are aware of the size of their land and their building. A similar system has been used in Pakistan (Ellis-Kopanyi-Lee 2007), albeit unit taxes are very outdated not because lack of information or technology, but because of lack of political will. However, the government of Punjab has recently implemented computerized data bases with GIS mapping and CAMA supported analysis of unit values in pilot medium cities (The Urban Unit 2014).

Policy challenges

The area based taxation would be a pragmatic short-term but also strategic solution for Rwanda. The hybrid area-based system uses strong and systematic links to the market values. This would presumably provide the most cost effective alternative that the taxpayers easily understand; but also they can be made legally responsible for correctly reporting the required technical characteristics of the buildings, like size, material, age (as opposed to the reported value that cannot be legally questioned). Meanwhile the land cadaster would provide solid data for location and size of the parcels and would support establishment of value-zones.

- The political challenge could be that the scientifically calculated values and therefore the tax burden could be substantially higher than the current tax (like in the quoted Lithuania case). Using the unit-tax tables it would be harder to explain and defend reservations that the burdens have increased because of the high property values rather than because of the increased taxation. However, the vast majority of properties will be taxed in the AFAT system already, thus replacing the VFAT with the universal AFAT seems politically very feasible.
- Furthermore, it is important to mention that in any taxation system the effective tax burden is a policy issue and unrelated from the value of the properties[14] or the valuation methodology. The definition of the tax base, the exemptions, and the set tax-rate are the key instruments to determine the tax burden, which does not come from the size or value of the properties in any

[13] Bell at all (2008) report area based tax used in 44 developing and transition countries; variations include: "Area-based systems range from a "pure" form where the tax is actually imposed on physical area irrespective of value, to a hybrid where physical area is used as a key input in mass appraisals of value" (Bahl 2009).

[14] A good example of this is that the politicians were shocked and resisted changes when learned that the team of Roy Bahl estimated that the tax base was so narrow and the collection was low that the volume of property tax revenues could be increased by twentyfold in Punjab province of Pakistan (Bahl-Wallace-Cyan 2008); and a recent IGC study found no progress till 2014 (Nabi and Sheik 2014).

direct manner, rather it is a result of policy decisions and eventual calibration of the tax coefficients.

Tax Administration Issues

Establishing effective tax administration is as important as adopting adequate taxation system and tax policies. The current local revenue reform aims to make substantial progress in all of these fronts. The *draft Law* sets the legal foundation of a reformed revenue system with built in key policy decisions (like tax rate and tax exemptions)[15], but leaves many tax administration procedure issues (like billing, collection, enforcement, remedies) unattended. This is in line with the legislator's objective namely that "the intention is to separate tax procedure Law from the Substantive Law" (RRA 2014 pg. 3). Thus it is expected that separate *MINECOFIN Ministerial Order* and/or supplementary RRA regulation will be issued later to set clear framework for all detailed mandates and procedures.

The *draft Law* formally authorizes the RRA to fulfill the tax administrator and chief regulator functions with the right of the Government to appoint any other administrator. The regulation of the tax administration issues starts with the definition that the *tax administration is the RRA* which is authorized for review tax declarations and commence re-assessment of property (Article 20); the Law prescribes the substance of the tax assessment notice (Article 21.), the Law rules that the tax payment should be made in set time to the tax administrator (RRA) based on self-assessment or against tax assessment notice (Article 18); RRA is authorized to issue tax clearance certificate that permits transfer of ownership of a property (Article 16); owner may request RRA for a deferral of tax payment (Article 20); owner can request a waiver of tax liability by sending request to RRA which after validation will forward the request to the respective District Council for decision (Article 21).

The roles of the RRA

In this section we discuss issues of tax administration functions unregulated in the *draft Law* but the RRA needs to fulfill in collecting the taxes efficiently for and on behalf of the Districts. The roles and functions depend on the final form of property taxation and the administration modalities, yet several policy issues can be identified and responses proposed. We assume that the general direction and progress in the current reform will move in line with the base scenario set in the *draft Law*; and other scenarios discussed[16], albeit could be effective, are no longer relevant, unless the reform program is substantially reconsidered and implementation is postponed. Thus, the roles of the RRA should be analyzed against the functions RRA should fulfill in the base scenario, but with the policy implications discussed above.

Fundamental assumptions of the base scenario include: (i) the property taxation will include the VFAT for properties with value equal to or greater than RWF40million, and AFAT for properties below the RWF40million limit; (ii) self-valuation and self-filings by the property owners are mandatory, but RRA may revise declarations; (iii) VFAT is levied based on market value of land, buildings, and improvements; (i) AFAT is levied based on area-unit-taxes established based on market value of land, buildings, and improvements in defined value zones; and (iv) a general local revenue software has been procured with modules for taxes and fees. This raises the issue, if elements of CAMA systems might be utilized with or without procuring some CAMA modules.

[15] This note as said focuses on the Property tax issues (FAT and LLF) and does not deal with other local revenues.
[16] Other scenarios include: FAT with banded market value, land value taxation, and area-based taxation.

The most critical roles with policy implications to discuss include: establishing a fiscal cadaster and revenue databases; revising, clearing tax declarations and re-assessing fixed assets; managing billing, collection, enforcement, and remedies; reporting; and interacting as *agent* with the Districts the *principal* beneficiaries of the property tax system.

The fiscal cadaster

The fiscal cadaster is a taxpayers' database that includes all kinds of data deemed to be required to perform the property taxation; thus its substance somewhat depends on the definition of the tax base[17]. The fixed asset taxation with combined value of land, buildings, and improvements requires the most sophisticated and most demanding database. Some might feel that by introducing mandatory self-valuation and self-filings the database can be made simple: payers identify the property and the value and RRA records the value; however, this simplicity is not advisable as discussed above. In fact the fiscal cadaster should be sufficiently detailed similar to the requirements of centralized single property valuations, which is definitely required in revisions of declared values.

From LAIS to Fiscal Cadaster: The parcel cadaster and the land identification system (LAIS) maintained by the RNRA provide an excellent basis for the RRA fiscal cadaster. Parcel data include: parcel ID, Region, District, Sector, Cell and Parcel identification formed in the unified parcel identification (UPI) number. Then the LAIS uses the same UPI but includes also, area, land-use, title/rights, approval data, owner ID, Owner name, and phone. The missing information for a well-functioning AFAT should include but are not limited to: technical information of the buildings and improvements, geology, value zone, last recorded value with date of record, and taxation records. Establishing and maintaining the above explained fiscal cadaster is vital for ensuring cost-effective, well-functioning, and equitable tax administration.

Computerized database: One most significant improvement in this reform is to replace the former manual and often paper-based revenue databases (of the Districts) with a state of the art, reliable, computerized national database. The RRA has mobilized the reputable CMC TATA Consultancy services company and procured and have been testing the *Local Government Revenue Management software* with separate modules for the property taxation, other taxes, and fees. The heart of the set of property tax modules should be the fiscal cadaster with critical links to several other modules and external databases LAIS cadaster from the Land Bureau; local government data-bases (building permit, master plan, and GIS maps); Taxpayers registration module; Billing and collection; Audit; Enforcement; and Reporting, just to name a few.

The CMC TATA is presumably well taking care of the software design, installation, and testing, thus it is better to focus here on policy implications associated with the fiscal cadaster and the specific roles the RRA needs to fulfill. The key policy challenges regarding the fiscal cadaster include: the identification of the taxable properties; the scope of the cadaster; and the key information to store in the cadaster.

- ***Identification of taxable properties*** is planned to start with RRA importing from RNRA the UPI and LAIS information. Then RRA adds tax-payer information and value information by using the *mandatory self-registration* and *self-declaration of property value* that can be made with the support of the registration module SW via electronic registration or by the District offices (one-stop-centers?)–important for those who have no access to e-filing. There might be, however, tens of thousands of owners who fail to timely register and/or to declare the property value.

[17] There are different data required for area based versus value based taxation, or for capital value based or rental value based, likewise for land value based versus market value of land, buildings, and improvements.

Thus, the RRA should adopt procedure for identification or verification of owners those missed self-registering. .

- ***Property value in the Cadaster–Valuation of the property for taxation purposes:*** Property values are the most important information in the fiscal cadaster. The base scenario aims to use the value estimates by the owners declared via mandatory self-filing of the market value of their properties. Given substantial expansion of the value reports (from few thousands to the tune of 1.5 million declarations) and the limited information and experiences of the owners, it is very likely that many declared values will be unreliable in 2015. The *draft Law* mandates RRA to review and reassess of the tax "…based on the nature and general state of the fixed asset, its location and its actual use" (Article 20 and 21)–this is a vague definition that should be operationalized in the Ministerial Decree. As said it is vital to add to the database technical information on the buildings and improvements, geology, value zone with particular unit-tax in order to equip RRA for impartial, quick, cheap, and large-scale revisions.

Policy challenges

- ***Property registering***: The draft Law prescribes mandatory registering all properties in the unified FAT fiscal cadaster regardless of value i.e. *establishing a joint fiscal cadaster* for AFAT and VFAT. At the registration phase neither the owners nor the authorities (RRA, District) will be sufficiently informed about the value of the properties and thus whether the AFAT or VFAT applies. But also as said, the segregation by the RWF40million value line is artificial and reflects a policy decision that may change over time.

  However, a clear segregation of the agricultural properties and those used for residential, commercial, or industrial purposes should be a prime responsibility of the District Councils and can be done in cooperation with the RNRA. The preferred option would be that all properties that are not registered as agricultural properties should be in the FAT fiscal cadaster regardless of their value or exemption status[18].

  The identification challenge for RRA is to build adequate capacity for identification and verification of owners that failed to register themselves for property taxation. This may include a large number of owners that reside abroad and failed to appoint a proxy for property tax purposes. A good cooperation with districts and good communication is vital to mitigate this challenge.

- ***Self-filing*** of property value should be made mandatory for all properties regardless of value except those registered for agricultural use. This may seem to overburden RRA with extremely large database, but the Rwanda number of cases is not big in international comparison and the modern software easily handles the foreseen magnitude of around one and a half million properties. The number per se should not be a problem if adequate procedures are used to analyze the database and cluster the properties.
- ***Revision:*** The major challenge emerges from self-filing is that the RRA needs to build robust revision capacity. The RRA Risk Department is planned to manage the revisions by using various supplementary information that has value estimate or proxies

[18] In many cities in developed countries the councils approve the exemptions and are informed about the estimated volume of revenues lost because of the exemptions; the numbers could be surprisingly high.

including: Land Bureau files on Deeds and leans; bank lending records, building and use permits when the properties built within the last 5 years, and registered ownership transfers if happened within 5 years. Finally RRA may hire private valuers to complete independent valuation as may deemed necessary; a quite expensive solution. The IMF team pointed the importance for *publishing a Valuation Manual* to streamline and unify the valuation methodology to improve fairness.

- ***Scope of the revision:*** The planned supplementary information is useful, but the next challenge is what properties are subject of revision? A policy issue is that the RRA revision should not be limited to the properties voluntarily registered by owners for VFAT by declaring value RWF40million or greater; but also properties registered for AFAT with value in close proximity (say RWF10-15million range) below the VFAT taxation limit. Furthermore, along the same logic the value of the AFAT properties should also be declared, screened, and stored in the fiscal cadaster.
- ***Triggers for revision***: The next challenge for RRA is how to sort out from tens or hundreds of thousands value declarations those that require revision. Computerized procedures can be used provided that adequate data are recorded in the fiscal cadaster. As said, beyond the LAIS data the most important information should include: defining value zones in each districts, requesting residential owners to file not only the personal data and the value estimate, but also key characteristics of the buildings such as total floor size, number of floors, number of rooms, key amenities, age of building, and few structural factors (material). These are not only regular part of self-reported data around the Globe, but are vital for RRA to sort out properties for value revision easily.

  The revision trigger could be simplified by calculating a per square meter value from the declared market price and comparing these unit values within each value zone, comparing also the external reference values (obtained from Banks etc.); and then commencing revisions of the outstanding cases that appear to have reported substantially lower values than comparative properties. Needless to say, this is a brief explanation, not a specific valuation model. But the main message is that the fiscal cadaster and the self-reporting should be defined adequately to ensure that RRA timely obtains all necessary information and filters properties.

  Furthermore, the revision will take time and RRA may need two years to complete all revisions after these fundamental changes of property taxation and large scale migration from LLF to VFAT. Thus the *daft Law* should be amended and the 6 month revision limit eliminated for the first valuation cycle (Article 14).

- ***Appreciation or depreciation:*** The RRA should build capacity also to monitor events that trigger appreciation, since the owners have wasted interest to postpone reporting appreciation. This is again a sphere where strong cooperation with the Districts is vital. Indeed, the District should take the lead on monitoring factors of appreciation, since in most of the cases remodeling or expansion of buildings that naturally requires building permits and issuance of user permit after completion are in the radar screen of the District (one-shop-center). Thus the District should be made responsible for timely modification of the property value by encouraging the owners to file the value increase if it is estimated to be over 20 percent (Article 15). The districts should initiate

appreciation, if large infrastructure projects increase property values substantially in a zone of the city[19].

Valuation

The rule of self-valuation and self-declaration of property value does not prevent RRA from mandatory initial valuation of large number of properties. Given the tremendous changes in property taxation and migration from LLF to VFAT in 2015, a large cluster of property owners might react by submitting no tax value declaration rather waiting for *a tax assessment notice* by the RRA. A policy issue is, thus if the RRA has capacity to initiate and finance large scale tax assessments after the owners have failed to declare property values. The *dart Law* in poses on the RRA the ultimate responsibility for valuation or verification of property values.

Policy challenges

- ***Valuation by RRA***: RRA will face with options to evaluate residential properties: it can do in-house by a group of valuers hired and trained for this particular exercise; or RRA may hire professional valuers (RAVP) to complete property valuation, as said with using a valuation manual to ensure unified valuation and fairness across property owners. Establishing value zones could be instrumental in facilitating and simplifying this exercise. Regardless of the valuation modality, the RRA should have adequate budget to complete the valuation exercises.
- ***Valuation of commercial and industrial properties***, provided that self-declaration remains, valuation of commercial and industrial properties may follow a very different route and owners may hire independent valuation by professional valuers and using cost-based or income-based valuation. It is important, however, that the cost (or half of the cost) of this valuation should be made reimbursable from the due property taxes.
- ***Banded value***: Property values are planned to be estimated with great accuracy, which again is questionable given the general information level of the property owners and the limited market information for the authorities. Identification of the value band of a property (say between RWF50 to RWF60 million) instead of exact individual value, would make RRA's work easier and cheaper.
- ***Market reference database***: The RRA may develop and maintain a database with specific data on market transactions and evidences of market values. These data would be instrumental in completing property valuations, in revisions of self-declarations, and in establishing value zones. The RNRA registered[20] 75,000 property transactions in 2015. Thus, there might be well over 200,000 transactions registered in the last 4 years. This is a rich database, that currently excludes value and building information, but provides for a solid base for impact simulations and for establishing value zones. Value information can be added easily, while building information might be more difficult, still possible to obtain.
- ***Value zones***: The IMF team also put high emphasis on establishing value and cost zones for land (Grote at al pg. 70) in each district. But, the value zones have an impact not only on the land values, but the market value of the buildings too since location is often explains more the market price than the material or building cost. Thus, for the matter

[19] A local officer explained that two-to-three fold value increase is often appears already when new road or water schemes are approved.
[20] Information from RNRA consultation

of simplicity, the value zone established based on land can be used as a proxy to factor in the value of the buildings. A simple initial solution would be to establish land value zones and use the same zone for comparative assessment of the building values too in establishing the unit-taxes for AFAT.

Establishing value zone should be a joint effort of RRA, experts, and the Districts and should be *approved and published by the District councils*. This would not only be productive factor for the effective property taxation, but would *improve the involvement, ownership, and responsibility of the Councils in managing the property taxation*.

Billing

Self-filing makes billing unconventional, since the taxpayers are expected to register themselves and declare the property value and the due tax by self-filing many via an internet message. This looks like a straight forward, modern, and elegant solution that saves a lot of time, energy, and money for the RRA. The *draft Law* does not include articles on billing, since these procedures will presumable be regulated in a ministerial order; but also, the self-filing may give the impression that there is no need for billing. However, the multifold expansion of the FAT tax net may result in tens of thousands of unregistered properties and/or undeclared property value and/or undeclared due tax. Thus formalized billing will be inevitable with key property information, key tax information like last payment, arrears and or penalties if any, and exemptions. The said billing would be also important for those who have timely registered and self-declared property values.

Policy challenges

- The first policy challenge for RRA is to ensure adequate capacity for identification of the undeclared property values and/or taxes and establish procedures, capacities, and budgets for timely assessment, notification, and billing. The RRA might face with tens of thousands of missing declarations, thus need to build robust capacity for notification and billing. The Local Revenue Software certainly includes billing module that makes the billing procedure easier. But this will still be a substantial work for the RRA.
- The draft Law prescribes actions for confiscating properties if the repeated attempts for identification of the owners fails (Article 11), certainly most of the cases when the owner resides abroad. Detailed and published procedures need to be adopted in order to ensure transparency and fairness in these politically and ethically sensitive movements. This procedure needs to include clear steps for attempting delivery of the assessment notice and the tax bill to the best known owner. Again, the role of the Districts should be substantial in managing these cases.

Collection and enforcement

The self-filing may give the impression that the property owners simply pay after submitting the tax declaration. Thus, collection may seem to be an easy step. But, collecting property taxes is never easy! The *draft Law* does not set procedure for collection; again it should be regulated by the Ministerial order. Three articles support or rule collection specifically: (i) property ownership cannot be formally transferred (registered) without clearance certificate issued by RRA that states that the property is free from tax obligations (Article 16). This is a strong motivation for tax payment at least for those who like to sell the property; but it has no effect for those tens of thousands of owners who do not intend to sell.

(ii) The owner can request deferred payment and avoid penalty, but not interest (Article 19). This is a mitigation of the payment that postpones but motivates collection/payments. (iii) The owner may ask waiver of tax liability that will be cleared by the RRA and approved by the council (Article 19).

Specific enforcement regulations are needed: The *draft Law* does not regulate actions for collection and enforcement beyond the said measures. Collection rules (like reminders) can be established by the MINECOFIN and published in Ministerial order or by RRA as internal regulation; but the enforcement actions, like legal procedures, attachment of properties, registering lean, or removal of owners and forced sale if this last option is deemed politically acceptable are substantial policy decisions and *should be clearly regulated in the Law* not in lower level of legislations!

Low collection efficiency by Districts: The reputation and expertise of RRA, but also transparency, reliable databases, easy filing, and easy payment methods, good communication of the property tax, and smooth and repeated reminders are key factors in improving collection efficiency. Collection efficiency is very high (often over 95%) in developed countries, while very low (below 50 percent) in most of developing countries. Evidences from some Kigali cells suggest wide variations in collection efficiencies from extreme low 2% to medium 33% and high 80%; this suggest an overall low nationwide collection maybe in the range of 30 percent in LLF (future AFAT). The local revenue software will certainly support collection with automatic generation of reminders and easy calculation of fines, interests, and forms/letter supporting communication with the taxpayers. But still, RRA will face substantial challenges in collection and enforcement to reach high say over 90 percent collection efficiency. It is hard to predict the taxpayers' reaction in Rwanda and during such substantial changes of the taxation and large scale migration from LLF to VFAT. Nevertheless, the property owners those fail to register and/or those fail to declare property values may also challenge collection.

Policy challenges

- A certain share of owners will definitely fail to timely pay property tax despite smooth and easy payment and deferred options used. Thus the RRA needs to develop capacities (both legal and business) to manage collection and enforcement.
- Strong communication and active involvement of the Districts are vital in making collection and enforcement effective and cost efficient.
- The enforcement needs higher level policy decisions, beyond the competency of the RRA, but also high level political support to ensure fairness, political acceptance, transparency, and effectiveness of the enforcement.

Remedies

The *draft Law* rules that the RRA resolves tax liability issues but offers the taxpayers a formal remedy. The logic behind is that a) the owner cannot dispute his own tax declaration; b) in case the owner fails to declare property value and due tax or the RRA finds necessary for revision, the RRA commences a "scientific" revaluation of the property by hiring a professional valuer who is assumed to be impartial. And then the RRA informs the property owner in *tax assessment notice* about the results with a reference to the taxpayers' right to complain and appeal (Article 21). However, no specific rules set (timing, conditions, entity and form of appeal) that would enable owners to easily protest and claim for refund if any.

The role of the Districts

The prime objective of this property tax (and local revenue) reform is to provide a legal and institutional framework for effective and cost-efficient collection of local revenues. Of the possible alternatives, the Government has selected the option of a centralized collection system and authorized the RRA to collect local taxes and fees on behalf and for the Districts. This is a major policy shift that is justified by the small size of the country, the low local capacities, and the good track records of the RRA in efficient revenue collection; albeit typically in indirect rather than direct taxation. The expected result is a substantial increase of local revenue collection, due to efficient administration, reliable databases, and change in tax base and rates.

Policy challenges

This fundamental reform brings, however, not only expected very positive changes and results, but one major policy challenge, namely the drastic reduction of the role of districts in collecting own-source revenues. As a result, all local revenues will appear like central transfers, regardless of the fact that the RRA will serve as a collection agent that works on behalf and for the districts and this relation is formalized by the MoUs that will be signed annually between the RRA and the districts. An unintended negative side effect of this tax reform might be that many districts may start behaving like free riders who just wait and see the inflow of the property taxes without taking any actions for own-source revenue collection. This situation should be avoided at any price, since it would undermine the decentralization principles and objectives.

Corrective measures

It is vital to ensure strong involvement and substantial responsibilities of the Districts in own-source revenue administration and collection. The above sections include several specific suggestions that would support active involvement of the districts, but there might be more, in particular on the area of other taxes and fees not discussed in this policy note. The key measures for inclusion and active involvement of districts include:

- The MoUs should go beyond the mere frame document to formalize the RRA’s function to collect revenues on behalf of and for the Districts, but also should include indicators and reward measurable performance.
- The RRA should provide the districts with a formal *tax-role* of the registered tax-payers that the *District Councils should approve* and may publish or make publicly accessible annually;
- The RRA should estimate the collectible taxes and the Councils should include these estimates in the budget reports both in the budget plans and in reporting performance in the final accounts with clear comparison of trends and budgeted/actual ratios in main revenue categories.
- The District Councils should demarcate and publish the urban areas/sectors within each district.
- The district councils should define, approve, and publish land value zones in the urban areas based on market proxies identified and valued in close cooperation with RRA and the RNRA.
- District Councils should approve the list of property clusters by use: agricultural land, residential, commercial, and industrial.
- District councils should approve and publish valuation tables with AFAT unit taxes for main property clusters and quality categories.

- Districts should timely identify properties for appreciation based on available records like building and use permits and field verification of alterations; but also should initiate revaluation if main infrastructure development increases the property values in a zone.
- Districts should actively cooperate with RRA in tax collection.
- District should actively develop and implement communication campaign to inform tax payers about the use of revenues collected from local taxes.
- District Councils should play major role in enforcement, especially in attempts to identifying unknown property owners, in court procedures for repossession of properties after all possible measures completed to identify the property owner or his proxy.

Conclusions

The Government of Rwanda's decision to reform the property taxation is a historic opportunity in a historic momentum. The reform is on track in general; but implementation is behind schedule and substantial policy decisions and further preparatory actions are required. This note has addressed a long list of specific actions.

The planned combination of value-based (VFAT) and area-based (AFAT) taxes represent an uncommon approach in property taxation, albeit the vast majority of properties will face with AFAT. The combined AFAT/VFAT taxation aims to tax the high-value fixed assets proportionately higher than the common fixed assets. For this to happen, however, a proper calibration of the VFAT tax rate (planned as 0.2 percent), the value separation (planned as RWF40million), and the AFAT unit value taxes are vital and should be supported by simulation of impacts and mass valuation instruments.

The single-property valuation of market value of fixed assets by the owners and self-filing seems suboptimal; but offers a scenario that enables commencing the tax reform in 2015. Other scenarios could be cheaper and easier to manage, but may need longer preparation and postponement of the reform. Considering discussed modalities including banded value system and application of mass valuation instruments are highly recommended to improve RRA managing capacity. The full implementation of this reform may require most of the coming 4-year valuation cycle.

The RRA technical, financial, and human capacities should be developed in the view of and in harmony with a very large unified AFAT/VFAT tax-net; as compared to the present 3,850 registered FAT properties. The computerized revenue system well supports this objective, but requires proper scope of the Fiscal Cadaster.

Drastic reduction of the role of districts in collecting own-source revenues is a major unintended negative side-effect. There are numerous areas and several key functions discussed where the districts should play substantial role; many of these should be legislated or regulated.

References

Bahl, R. – Wallace, S. 2010: A New paradigm for Property Taxation in Developing Countries; in Challenging the Conventional Wisdom of Property Tax; ed. Bahl, R.–Martinez-Vazquez, J.–Youngman, J.; Lincoln Institute, Cambridge MA 2010;

Bahl, R. 2009: Property Tax Reform in Developing and Transition Countries; USAID 2009;

Bahl, R. – Wallace, S. – Cyan, M. 2008: Pakistan: Provincial Government Taxation, Andrew Young School of Policy Studies, Georgia State University, and World Bank 2008

Bell at al 2008: Bell, Michael, Ning Yuan, and Katrina Connolly, A Compendium of Countries with An Area-Based Property Tax; Lincoln Institute of Land Policy, 2008.

Binda, E. M – Daale, J. – Kairaba, A. 2012: The Impact of Land-lease Fee on Land owners – Rwanda Case study, GIZ-RISD-Landnet, 2012;

Bagdona Vicius, A – Deveikis, S. 2010: Automated Valuation models in Lithuania; State Enterprise Center of Registers (STEDE), 2010, www.registrucentrals.lt;

Cyan at al 2013: Cyan, M. – Karuranga C. – Vaillancourt, F.: Local Government Revenue Potential in Rwanda, Andrew Young School of Policy Studies, Georgia State University, 2013;

Ellis-Kopanyi-Lee 2007: Ellis, P. – Kopanyi, M. – Lee, A.G.: Property Taxes in the Large Cities in Punjab, Pakistan, Journal of Property Tax Assessment and Administration, vol 4, issue 2. 2007.

ESPHS 2012: Estimating the Size of Populations through a Household Survey (ESPHS) Rwanda 2011; Rwanda Biometric Center, UNAIDS, School of Public Health (SPH) University of Rwanda, and ICF International Calverton, Maryland, USA;

EU 2012: Housing Market Demand, Housing Finance, and Housing Preferences for the ?City of Kigli; Planet Consortium, EuropeAid/127054/2012

Grote at al 2014: Grote, M. – McCluskey, W. – McPherson, M. – Shah, A.: Expanding Tax Capacity to Sustain Development – Taxation of Agriculture, Mining, and Immovable Property (IMF, March 2014);

Gloudemans, R. – Almy, R. (2011): Fundamentals of Mass Appraisal; International Association of Assessing Officers, Kansas City, Missouri, 2011;

IAAO 2013: Standard on Mass Appraisal of Real Property; International Association of Assessing Officers (IAAO), April, 2013;

Irwin at al 2014: Irwin, T. – Fisher, L. – Pigey, J.: Fiscal Decentralization: Review of Grants to Local Governments and Local Financial Management; (IMF, September, 2014);

Kopanyi 2014: Kopanyi, M.: Financing Expansion and Delivery of Urban Services: International Experiences and Rwanda Challenges; International Growth Center, London School of Economics, 2014 (www.theigc.org);

Law No.59 2012: Law N° 59/2011 of 31/12/2011: establishing the sources of revenue and property of decentralized entities and governing their management; Rwanda Official Gazette 2012

Draft Law: Draft Law (No xxx 2015) on establishing the sources of revenue and property of decentralized entities and governing their management; RRA;

Malme, J. H. 2004: Mass Valuation for Land Taxation in Transition Economies; Landlines vol 16, 2004; The Lincoln Institute;

McCluskey-Franzsen 2013: McCluskey, W.- Franzsen, R: Property Taxes in Metropolitan Cities, chapter 7 in Financing metropolitan governments in developing countries; edited by Roy W. Bahl, Johannes F. Linn, Deborah L. Wetzel; Lincoln Institute of Land Policy, Cambridge, MA, 2013;

Nabi, I. – Sheik, H. 2014: Reforming the Urban Property Tax in Pakistan's Punjab; IGC note, www.theigc.org

Rao 2008: Rao, Vasanth. 2008. Is area-based assessment an alternative, an intermediate step or an impediment to value based taxation in India? in *Making the property tax work: Experiences in developing and transitional countries*; ed. Roy Bahl, Jorge Martinez- Vazquez, and Joan Youngman, 241–267. Lincoln Institute of Land Policy, Cambridge, MA;

RRA 2014: Fiscal Decentralization Project Strategy Paper, May 2014;

The Urban Unit 2014: GIS - Transforming the way we live, The Urban Unit, Government of Punjab, Pakistan, http://www.pakistantoday.com.pk/…/gis-transforming-the-way…/

World Bank 2014: Urban Development Project Aide Memoire: Identification Mission; December, 2014

World Bank 2014b: Valuation and Property Taxation Serbia; Concept Note for a mass valuation pilot study, World Bank, 2014.

World Bank 2014c: Wangari Muikia, William McCluskey, Patrick Doherty, David Solomon, Riel Franzsen, Michael Wright: Kenya–Options for Reform of the Property Rates for Nairobi City County Government, World Bank Study, March 2014;

World Bank 2013: Program Document for a Proposed Policy Grant for a *Quality of Decentralized Service Delivery Support Development Policy Operation*; World Bank, April 2013;

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

Find out more about our work on our website
www.theigc.org

For media or communications enquiries, please contact
mail@theigc.org

Subscribe to our newsletter and topic updates
www.theigc.org/newsletter

Follow us on Twitter
@the_igc

Contact us
International Growth Centre,
London School of Economic and Political Science,
Houghton Street,
London WC2A 2AE

IGC
International Growth Centre

DIRECTED BY

FUNDED BY

Designed by soapbox.co.uk