

POLICY BRIEF

Land and property taxes: exploiting untapped municipal revenues

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This brief outlines the importance of annual land and property tax as a source of municipal finance and explores trade-offs that policymakers face in implementing reform. It also identifies examples of best practice for reform from cities across the developing world.

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Exploiting untapped revenues from urban land

Taxing land and properties allows city authorities to capture the enormous wealth generated by the urbanisation, and use it for the public good.

For cities to become engines of growth, they require massive public investments. Yet too many developing cities lack the finances to make such investments, and consequently cities are becoming locked into sprawling, unplanned growth patterns.

In this context, annual taxes on land and physical properties represent the largest source of untapped municipal revenue for developing cities. As cities grow, the wealth they create becomes capitalised in the rising land values of the city. Parts of peri-urban land in Kigali, for example, have increased in value over 1000-fold in the last 10 years¹. Taxing these assets allows governments to capture these rising values to fund much-needed public investments. Alongside their potential to raise significant public revenues, these land and property taxes are also fairer and more efficient than other forms of tax.

Poorly designed and administered systems of taxations, alongside significant political resistance from owners of these assets, have meant these taxes have gained limited traction in developing cities. But at each stage of the design of a land and property tax system, policymakers can make decisions to harness the benefits of annual land and/or property taxation whilst addressing these associated challenges. Even modest investments in reform to land and property tax systems can help dramatically expand municipal revenues to enhance public service and infrastructure provision.

1 Land and property taxes offer a fair and efficient form of taxation for cities that can fuel a virtuous cycle of public investment.

These taxes have limited effects on urban investment, and allow governments to capture increases in land and property prices that are the direct result of public investment.

2 Complexity comes at a cost.

Policymakers will need to weigh up whether greater accuracy in valuation, and targeted rates and exemptions, justify the added complexity these bring to the tax system. In cities in Sierra Leone, implementing simpler valuation systems to match capacity have yielded higher revenues and greater public acceptance.

3 Registration and taxation are complementary.

Formal land and property ownership creates a legal basis for taxation and allows easy identification of those liable for taxes. Large scale titling through local parasurveyors using low cost technology can significantly expand the tax base.

4 Linking land and property taxation to public investment is key to increasing compliance.

In the long run, public support for land and property tax is linked to the tangible benefits such taxation provides. If closely linked to public investments, these taxes become legitimate price paid for services and infrastructure.

Why tax urban land and property? Four key reasons

1 Land and property taxes can yield substantial revenues for governments

Urban land, and the physical properties on this land, represent the largest source of untapped municipal revenues in many developing cities. Land and property fees only account for 0.5% of GDP across sub-Saharan African countries, as compared to around 2% in OECD countriesⁱⁱ.

Broad ownership of these assets means that taxing them can raise significant public revenues that can continue to rise as cities become more productive. In Kigali, for example, estimates suggest that levying a 1% tax on land and property could generate over \$60 million per year under full tax complianceⁱⁱⁱ - over four times the city's own source revenues. These taxes can have a significant impact on the ability of municipal government to deliver public infrastructure and services. In Lagos, reforms to property taxes under governors Tinubu and Fashola that have been implemented since 1999 have helped the state to increase public revenues from taxes five-fold to over \$1 billion in 2011^{iv}.

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2 Taxing land and property is fairer than other forms of tax

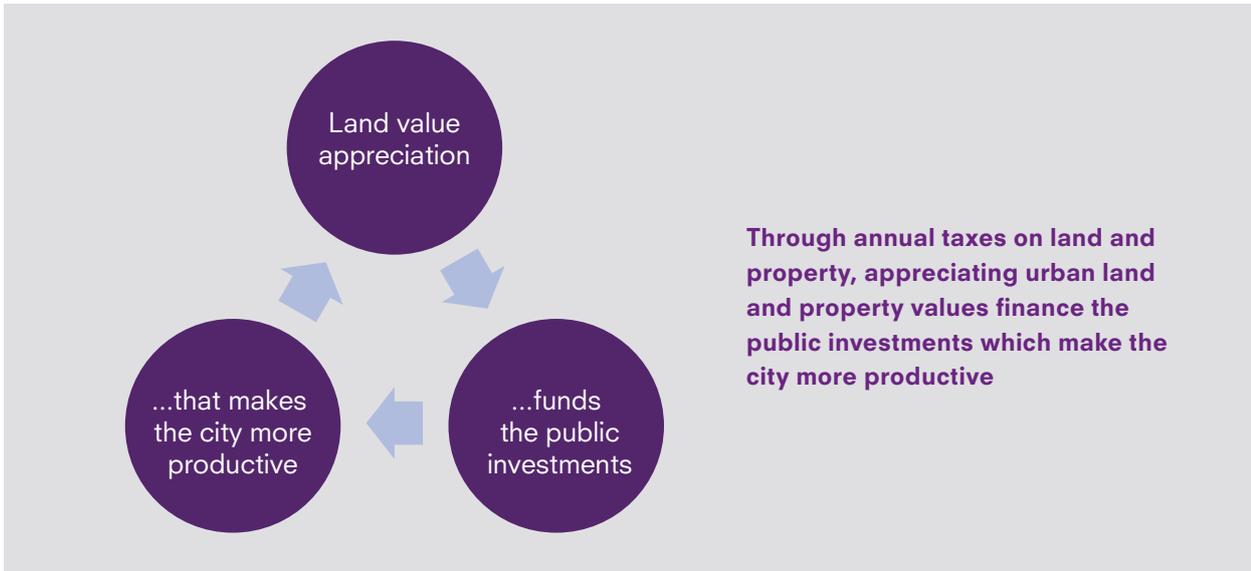
When local governments invest in building a road, or a school near a property, the price of this property significantly increases. In Accra, for example, properties that benefit from public investment in tarred roads and concrete drains are 1.8 times more valuable than those without^v. At the same time, the value of land and property in a city is increasing all the time due to urban population growth that places higher demand on land. These increases are not small – in Kigali, for example, peri-urban land has appreciated 1000-fold in the last ten years^{vi}.

Taxing land and property allows governments to capture increases in land and property prices that are in part the direct result of public investment

Taxing land and properties allows governments to capture some of these increases in land and property prices that result from forces outside of the owner's control and are in part the **direct result of public investment**. If designed appropriately, those individuals who gain more from public services and population growth can be taxed for the benefit of the wider community.

3 Land and property taxes can provide a self-sustaining return on investment

Related to this, annual land and property taxes can allow governments to obtain **returns on their investments in public services and infrastructure** that raise the value of nearby land and/or property. These taxes enable a virtuous cycle where appreciating urban land and property values finance the public investments which make the city more productive.



Implementing these taxes therefore provide governments with higher future income streams, on the basis of which it may be possible to **finance current projects through capital markets**.

4 Land and property taxes are more efficient than other forms of taxation

The fixed supply of land in a city means that taxing this asset **does not negatively affect urban investment** and in some cases **can encourage more efficient land use**. This is unlike taxation on work or savings that can incentivize individuals to work or save less (see below on the benefits of land tax in defining the tax base for more on this). Taxing land and property, though less efficient than taxing land alone, has been found to be less harmful to investment and growth than other taxes such as income and corporate tax^{vi}.

ASSET RICH BUT CASH POOR?

Annual taxation on land and property, rather than more irregular forms of taxation such as transfer taxes or capital gains tax, can be particularly valuable. Not only do annual taxes provide a steady stream of income to governments, they do not impede the transfer of land and property towards their most efficient use.

However, the one key disadvantage of annual taxation is that they are a tax on the stock of assets, rather than income flows. As such, these taxes may be difficult to pay for certain groups that own high value assets but do not earn commensurately high incomes, such as retired seniors or low income earners.

In order to address this, policymakers can employ **tax deferral schemes**, which limit the amount of tax current land/property owners pay, with the outstanding amount taken as a transfer tax on the asset when it is sold or inherited. Governments can also provide **exemptions** to allow for long term low-income housing in central areas of cities.

Policy trade-offs in designing a tax system

There are three main decisions policymakers will need to take in reforming or introducing land and/or property taxes:

What exactly to tax?

When a property is sold on the market, the value of this property is usually the sum of value of land and the value of the immovable property on this land.

Policymakers can choose to tax land but not immovable properties, immovable properties alone, or some combination of land and immovable properties. In Tanzania, for example, the value of immovable properties is isolated and only this is taxed, whilst in Rwanda, Malawi, Zambia and Botswana, the value of land and property are isolated but both taxed separately. In Kenya, the value of land without immovable properties is isolated and taxed. In Lagos, three different rates on land and property have been consolidated into one land use charge.

Taxing the value of immovable properties alone lacks many of the benefits of taxing land, or land and property together. As the value of buildings is not affected by public investments or population growth, but only on the cost of construction and years of depreciation, this does not allow governments to capture rising land values that are publicly created. At the same time, these taxes are less efficient than taxing land alone, as they may discourage investment in properties. Taxing land alone may *encourage* landowners to use their land more intensively by raising the cost of holding underdeveloped land. High levels of land taxation, alongside lower taxes on productive sectors, have reduced land speculation and encouraged manufacturing investment in many East Asian countries^{viii}.

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However, taxation on properties can play an important role in redistributing wealth as a tax on assets. This, alongside certain practical considerations, may mean that taxing land and properties together is the best option for policymakers. Two such considerations are data availability and taxpayer understanding. If there is insufficient data on transactions of land and property, or on the current value of buildings alone, it is difficult to isolate the separate values of land or property. It may therefore be easier to value and tax land and property together. Taxpayers are also far more likely to understand a tax system based on the composite value of land and property because they are likely to be more aware of the market value of the two assets combined.

What assets are exempt from taxation?

A major factor affecting revenues from land and/or property taxes is whether or not exemptions are introduced, which can be based on land or property use, value, or ownership. In a number of developing cities, exemptions to land and/or property tax systems are a significant source of revenue loss. Exemptions can be divided into five main groups:

- 1 Those based on socially desirable land and/or property use, such as schools and hospitals;
- 2 Those targeting owners with lower value assets in order to reduce inequality, based on the value of land or properties;
- 3 Those targeting owners who would not be able to afford to remain on their land/ property if taxed based on its value, e.g., low income households;
- 4 Those given for political reasons, such as owner-occupancy exemptions to garner political support from homeowners;
- 5 Exemptions for government-owned properties and non-profit enterprises.

There are benefits to implementing land and/or property tax exemptions. The first three types of exemptions outlined above can be useful in achieving different goals for urban development. At the same time, exemptions to low value land/and property may be sensible if administrative costs outweigh potential revenues. Low-income exemptions may also be necessary in the short run, to reduce political resistance to reforms that displace low-income groups without alternative living arrangements.

But there are also significant downsides, as experienced in many developing cities. A well-functioning tax system is one that applies a low tax rate across a broad tax base. Exempting some properties from the tax base does not reduce overall demand for public investment in services and infrastructure, and therefore **either reduces tax intake or places a higher tax burden on all other individuals.**

In addition, by introducing any kind of exemption, land and property tax systems are made more complex. This creates the opportunity for fraudulent behaviour. Exemptions for owner-occupancy, for example, can be exploited by owners of multiple plots of land by dividing ownership titles among family members to avoid taxation. With greater complexity comes greater administrative burdens on local governments to monitor and evaluate requirements for exemptions. Any attempts to increase the range of exemptions should be carefully **weighed against administrative capacity to monitor qualification for such exemptions.**



Left: Land used for schools are often exempted - School in Kigali, Rwanda (Photograph: Brian Dolinger)

TAX RATES ACROSS THE WORLD

Land and property taxes across Europe and in the USA are typically set somewhere between 0.5-1% of market value^{ix}. In East Asian countries such as China and the Philippines, property tax rates are approximately 1-2%^x whilst annual property taxation in South Korea is levied between 0.15 and 0.5% of property values^{xi}.

In many sub-Saharan African countries, high tax rates are applied to outdated asset values. In Kenya, for example, land taxes can reach over 30% - but because some valuation rolls date back to the 1980s and current values are around 20-30 times these, the 'real' rate property tax is around 1%^{xii}.

How to set land and property tax rates?

Setting a tax rate is a difficult policy decision since it involves weighing the need to raise municipal revenues against the ability of taxpayers to pay. Given the tax base, and how much a government aims to raise from land or property tax, a tax rate can be determined – as long as it satisfies affordability constraints for taxed individuals.

The affordability of land and/or property taxes depends on a range of factors, including taxpayer incomes and other taxes they pay – including other taxes on land and/or property, such as capital gains tax. Given that a house is typically seen as affordable if it is 2-3 times the owner's annual income^{xiii}, property values can give a rough idea of owner incomes, which can be used to estimate what percentage of incomes would go towards any particular tax rate.

In many developing cities, different rates are often applied to land and property based on whether they are used for residential, commercial, or industrial purposes. At the same time, tax rates are sometimes differentiated by area if there are certain public services that only benefit particular areas in a city^{xiv}. Variable tax rates can be beneficial in a number of cases. Higher tax rates on vacant or underdeveloped land alone, for example, can be key to reducing land speculation, where land is bought by investors as a short-term investment with no intentions to develop it. In Gaborone City in Botswana, for example, land tax rates on underdeveloped plots are four times higher than on developed plots, in order to discourage speculation and encourage rapid development^{xv}. Policymakers may also want to capture a greater proportion of the value of residential properties that generally make greater use of public services and infrastructure than non-residential properties.

However, introducing variable tax rates can, like exemptions, increase complexity of the tax system, and raise associated administrative costs in its implementation. Differentiating between types of land/property or their values substantially increases the data requirements, increases the opportunity for error in judgement, and face similar administrative challenges as implementing exemptions. In addition, the more complex the system of tax rates, the more difficult it is to communicate the system transparently to taxpayers. If administrative capacity is low, a single rate may be the best option for policymakers.

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In Gaborone City, Botswana, land tax rates on underdeveloped plots are four times higher than on developed plots, in order to discourage speculation and encourage rapid development

Learning from best practice

Successful reforms from a number of developing cities highlights that at each stage of the design of a land and property tax system, realistic reforms can harness the benefits of land and/or property taxation whilst addressing associated administrative and political challenges.

1 Low cost technologies and local parasurveyors to expand the tax base

Expanding the tax base for land and properties requires up-to-date information both on characteristics of land and properties, and on those liable for taxation - physical and legal 'cadasters' that are often developed by local authorities during **land right formalisation**. The challenge for many developing cities is that this information is often seriously incomplete, resulting in significant losses in revenues. Registration of land and property rights is often hampered by high titling costs and competing claims over these assets. In Tanzania, for example, complex surveying processes inflate titling costs to over \$3,000 for an individual land parcel – more than double per capita incomes^{xvi}.

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Successful registration in countries like Rwanda, where all land in the country was registered at only \$6 per parcel between 2009 and 2013, highlights some ways in which these administrative and political costs can be overcome. Instead of employing highly trained professional cadastral surveyors to conduct individual site visits, local para-surveyors demarcated plot boundaries in the presence of the whole community using simple methods of demarcation, and recorded plots using satellite and aerial photographs. The use of local parasurveyors not only reduced costs but ensured that those responsible for demarcating the land were known to the claimants. By encouraging entire communities to participate in resolving boundary disputes, competing claims were resolved openly and cost-effectively.

Where identifying land ownership is not possible, data collection on occupancy can form the basis of a land/ and property tax base. In Hargeisa, Somaliland, land ownership registration was virtually nonexistent in 2005 after years of conflict. Limited revenues from property taxation were insufficient to cover even essential municipal services. The local government in Hargeisa developed basic cadasters using satellite data and surveys to collect data on physical characteristics of properties and the occupier(s) of those properties. Over eight months between 2004 and 2005, properties registered for taxation increased from 15,850 to 59,000. Alongside changes to implement a more complex valuation process and automate property tax billing, this new system of taxation increased revenue by 248%^{xvii}.

In Rwanda, low-cost boundary demarcation by local parasurveyors resulted in all land in the country registered at only \$6 per parcel between 2009 and 2013

2 Matching valuation methods to administrative capacity

There are a range of methods for land and/or property valuation, from complex computer aided assessments based on market values, to simplified area-based assessments. Tax valuation based on capital market values is the most accurate way of capturing the true taxable value of land and property, but administratively, it is extremely demanding. It requires significant data

on market transactions of land and property, data on the contents and characteristics of plots, and the capacity to estimate land and property values based on existing data. In order to accurately reflect market values, it also requires frequent revaluation. The success of such complex tax value assessment across local governments in South Africa and Namibia has been largely based on mature real estate markets, adequate local resources, and substantial valuation assistance and training from provincial authorities^{xviii}.

By contrast, area-based tax value assessment offers the simplest form of standardised assessment of land and/or property. Many developing countries, including Ethiopia and Mozambique, have adopted this method of valuation that raise taxes based on the size and location of buildings. In countries like Sierra Leone and Malawi, additional factors that affect relative property values, such as access to roads, are taken into account in developing a ‘points’ based valuation system.

Key to effective valuation is **matching valuation to current or projected capacity**. In cities such as Kigali, where land registration levels are high and land market transactions are recorded, evidence suggests that a computer aided mass appraisal based valuation that would increase accuracy of valuation by over 40% compared with less accurate methods could be developed within a year of investment^{xix}. By contrast, in cities in Sierra Leone, implementing a simplified points based valuation systems based on observable construction type, structure, location and access to services enhanced the legitimacy of new local government structures whilst allowing local authorities to increase local revenues by 200-450% between 2007 and 2011^{xx}.

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3 Automation and digitisation of billing and payment

Automation of billing and computerised payment systems can be key to improving tax collection by allowing for efficient monitoring and collection of payments and reducing opportunities for corruption. In Arusha, property tax collection was done through an electronic revenue collection system that updates to show compliance when taxes are paid and a receipt is generated. This updated revenue collection system, launched in December 2013, allowed the city to expand its property tax revenues by 107% in the first three months of operation^{xxi}. More broadly, linking computerised records of registration, valuation and collection can significantly improve administrative efficiency at each stage, whilst reducing the potential for corruption and discretion in the tax system.

4 Linking taxes to public investments

Public support for land and property tax reform is critical for its success. If reforms are closely linked to **tangible benefits**, such as public expenditure on roads and hospitals, they can become seen as the **legitimate price paid for public services and infrastructure**.

Surveys in Lagos, for example, suggest that greater levels of tax compliance are linked to the belief from taxpayers that their taxes have been well spent, which is largely the result of visible, costly, and popular infrastructure projects

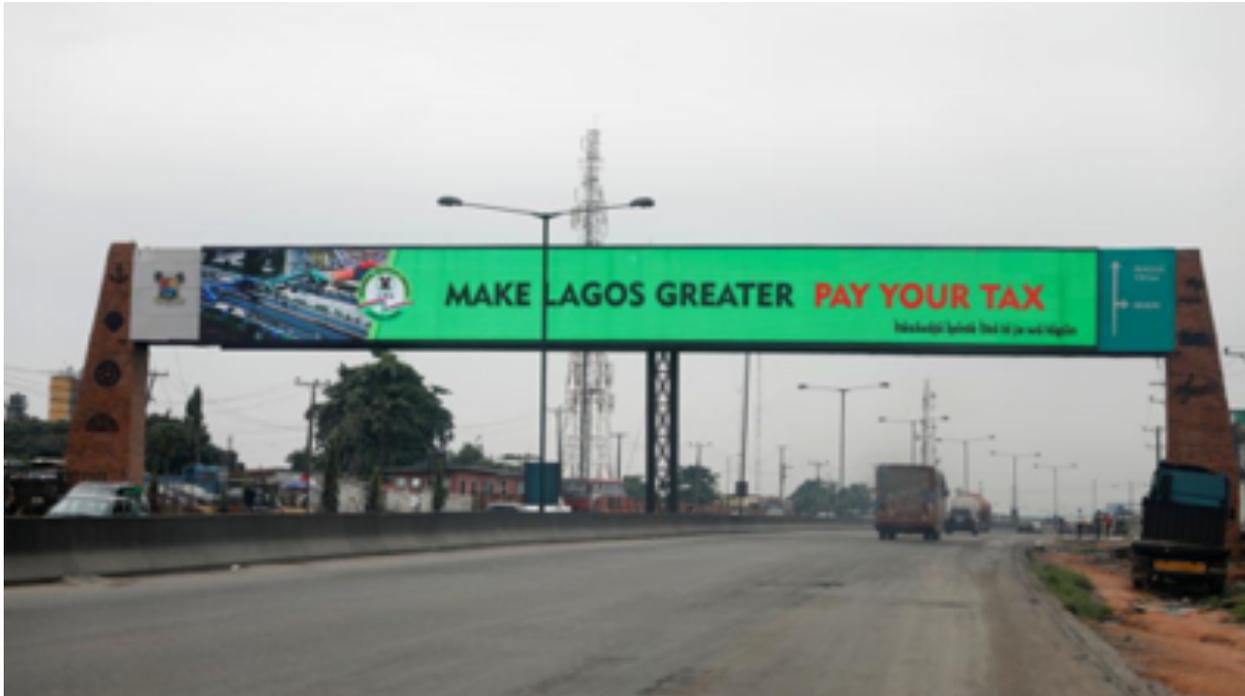
such as road improvements. In Fashola's first term in office, annual capital spending in Lagos rose from \$600 million in 2006 to \$1.7 billion in 2011 (in inflation adjusted 2012 figures)^{xxii}. These investments played an important part in Fashola's continued popularity and re-election.

To be successful, current or future investments must be matched with **efforts to raise awareness** of the link between land and/or property taxes and public investment. In Lagos, public signs to educate citizens about the benefits of paying taxes were placed at public works sites, and stakeholder forums were held to discuss tax obligations - coinciding with roll outs of public investment in infrastructure and transport^{xxiii}.

Posted on Thursday, 05 February 2013 11:17
Lagos proves Africa's Property Tax potential
Lagos generates N3bn from property tax in 2010
ON MAY 30, 2011 12:00 AM / IN **FINANCE** / 0 COMMENTS

Lagos, Edo Turn To Land, Property Tax To Shore-up Revenue

Highly visible and popular investments in infrastructure such as road improvements funded by property taxes have transformed Lagos City^{xxiii}.



FURTHER READING

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