Why Value-Based Property Taxation?

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OUTLINE

- Why the property tax?
- Economics principles for designing a good tax
- Why value-based property taxes?
- What are the problems?
WHY THE PROPERTY TAX?
THE PROPERTY TAX IS A GOOD TAX FOR LOCAL GOVERNMENT

- Supports local autonomy; important component of fiscal decentralization
- Difficult to avoid and easy to enforce
- Connection between municipal services and property values
- Visible and accountable
- Roughly progressive
- Allows public sector to derive share of private sector windfall gains from public investment in infrastructure
THE PROPERTY IS ALSO IMPORTANT BECAUSE ...

- **Impact on land use**
  - Property tax can shape urban development patterns

- **Impact on other economic and social goals**
  - Property tax can influence business location
  - Property tax relief can help relieve property tax burden on low-income taxpayers
BUT THERE ARE PROBLEMS ...

- Visibility means taxpayer awareness and taxpayer resistance: the tax everyone loves to hate

- Citizens resent enforcement of taxes which threaten their homes

- Property valuations have a subjective component which is often disputed; need appeals system
ECONOMIC PRINCIPLES FOR DESIGNING A GOOD LOCAL TAX
ECONOMIC PRINCIPLES

- Equity based on benefits received
- Equity based on ability to pay
- Efficiency
- Accountability
- Stability and predictability
- Ease of administration
“Tax policy is the product of political decision making, with economic analysis playing a minor supporting role” (Randall Holcombe, 1998)

Political pressure to maintain the tax burden at or near its current level (e.g. not updating assessments) or to favour one group of taxpayers over another (e.g. over-taxation of business) often overrides economics principles
WHY VALUE-BASED PROPERTY TAXES?
ASSESSMENT METHODS

- Area-based assessment:
  - Unit
  - Unit value

- Value-based assessment:
  - Market value
  - Annual (rental) value
  - Land/site value

- Value-based in countries with long tradition of land markets; area-based where there is no formal land market
AREA-BASED ASSESSMENT

- Per unit assessment: rate is levied per m² of land area, building or a combination of the two
- Unit value assessment: assessment rate per m² is adjusted to reflect location or other factors
- Most common in countries in Central and Eastern Europe where there is an absence of developed property markets; also in parts of Germany, Chile, Kenya, Tunisia, India
- Bangalore: unit value system introduced in 2008; values regularly adjusted
MARKET VALUE ASSESSMENT

- Defined as price between a willing buyer and a willing seller in an arm’s length transaction

- Approaches to estimating market value
  - Comparable sales (residential)
  - Income (non-residential)
  - Depreciated cost (non-residential)
# MARKET VALUE ASSESSMENT

<table>
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<tr>
<th>Approach</th>
<th>Tax Base</th>
<th>Property Types</th>
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<tr>
<td>Comparable sales</td>
<td>Estimate market value by comparing to recent sales of similar properties</td>
<td>Residential; need transactions to get objective sales values</td>
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<tr>
<td>Income</td>
<td>Convert future returns from ownership of property into present value equivalent</td>
<td>Income-producing properties e.g. non-residential and commercial</td>
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<tr>
<td>Replacement cost</td>
<td>Estimate value based on land value, building cost, depreciation</td>
<td>Unique properties with no comparable sales and which do not generate income</td>
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MARKET VALUE ASSESSMENT

- Requires active property market

- Used in many OECD countries (e.g. Canada, US, Japan); used in Indonesia and Philippines

- Variation of market value used for residential property tax (council tax) in UK
ANNUAL (RENTAL VALUE) ASSESSMENT

- In theory, tax on rental value should be equivalent to a tax on market value
- In practice, rents reflect current use and not highest and best use
- Needs active rental market
- Difficult to estimate rental value when there are rent controls (e.g. India); issues around vacant land
- Used in several countries: Australia, UK (for non-residential property), India, Thailand, Malaysia, Singapore, Hong Kong
SITE VALUE

- Popular tax with economists on efficiency grounds: tax on land is less distortionary than tax on improvements

- Problems with moving from tax on land and improvements to tax on land only
  - Assessment problems – few land sales
  - Revenue adequacy – need higher tax rates
  - Winners and losers

- Declining use around the world as more and more countries move to capital value taxation
AREA-BASED VERSUS VALUE-BASED ASSESSMENT

- Market value is preferred because it:
  - Reflects benefits from local services
  - Captures neighbourhood amenities
  - Less regressive than area-based
  - Less inequitable over time
  - Revenues more buoyant than area-based

- Can move from area to value-based
WHAT ARE THE PROBLEMS WITH THE VALUE-BASED PROPERTY TAXES?
PROBLEMS WITH MARKET VALUE BASE

- Can be volatile (not stable and predictable for taxpayers)
- Costly administration (identification, assessment, collection, and enforcement)
HOW TO ADDRESS VOLATILITY

- Avoid assessment limitations (e.g. Proposition 13 in California)
  - Breaks the link between taxes and market value
  - Inequitable ... for generations
  - Decreases household mobility
  - Favours those whose property values have increased at expense of those whose values are stagnant
  - Can’t get out of it
HOW TO ADDRESS VOLATILITY

Better options to address volatility:

- Annual reassessment
- Phase ins
- Tax credits
- Tax deferrals
Properties do not sell in a market transaction each year --- valuation is thus an estimating process

Assessment can be costly

But, virtually no compliance costs (on the part of taxpayers) associated with property tax

Techniques of mass appraisal (formula-based valuations driven by observable features of property with valuation coefficients based on a sample of market transactions)

Need appeal process
FINAL COMMENTS

- The property tax is a good tax for local governments.
- Appropriate role of property taxes, design, and implementation differ in different countries and change over time in any one country --- “no one size fits all.”
- *Where possible*, market value assessment is the best base for the tax.
- Need to address issues of volatility and administration.