Role of Property Tax in Developing Countries

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Crossref

Abstract

Purpose: The aim of the study is to examine the role of property tax in developing countries.

Methodology: This study adopted a desk methodology. The study looked into already published studies and reports as the data was easily accessed through online journals and libraries

Findings: The study established that provision of improved public services, operational debt recovery, sanctions and penalties, provision of discounts and waivers on interests and penalties, social pressure, and reducing compliance cost as tools of enforcement were found to be effective in ensuring compliance in rates payment.

Unique Contribution to Theory, Practice and Policy: The study used Cary Brown Model and Agglomeration Economies Theory. The study recommend that tax authorities should adopt improvements in rating to capture the values of the properties, adopts one regime of taxation and regularly updates the property values to benefit from increase in revenue because of rising property values.

Keywords: *Property Tax, Developing Countries, Taxation, Property Values*

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INTRODUCTION

Property Tax

The strengthening of the property tax and its administration continues to receive significant funding from international donors and national governments. Despite all of this focus and the hard effort that has been put into creating more effective property tax structures and administrations, property tax revenues still represent less than 1% of global GDP and less than 4% of all tax revenues in developing nations (Alm, 2019). The situation is only marginally better in Central and Eastern European transitional nations and former Soviet republics.

Notwithstanding these disappointing revenue results, property tax reform is still a top priority in many emerging and transitioning nations. Analysts and government officials are still interested in its income potential, and they are constantly looking for the ground-breaking reform that will increase its revenue productivity. And with good reason. In many ways, it is the perfect tax for local governments in low-income nations (Fjeldstad, 2019). It can function as a benefit levy, distributes the cost gradually, and has a substantial revenue potential. Additionally, local governments typically have access to it and the legal framework for its application is typically in place. The key to a successful property tax in developing and transitional nations is to structure it according to local conditions and then have a strategy for letting it mature into an appropriate levy on property values. It is difficult to define such a system, but it might be aided by understanding why the property tax has not yet taken off in many low-income nations.

Although they may not use the property tax as substantially as OECD nations do, developing nations frequently rely more heavily on it to pay for local government expenses (Awasthi, 2021). For instance, the property tax contributes 25% of local government revenue in Kenya (Nyabwengi, 2019), 36% of local government revenue in Chile, and 40% of local government revenue in Poland, while the home and structures tax makes up roughly 80% of local government revenue in Thailand (Morgan, 2017). Property taxes make up 28% of the local income in the 36 biggest cities in India. According to a survey of 52 Latin American towns, the property tax represents an average of 27% of local government tax revenue (Franz, 2017). The same is true in transition countries. For instance, in Central and Eastern European nations, property taxes were 8% of local own source income (Hoque, 2019). This offers an alternative viewpoint on the matter, namely that the property tax in emerging and transitional nations is a crucial component of the fiscal decentralization plan even though it is not a crucial component of the strategy for mobilizing overall government revenue.

One of the most prevalent arguments for the property tax's persistently poor performance in lower-income nations is that the tax is administered in an ineffective manner (Moore, 2020). The lack of a thorough and current survey of all land (urban and rural), title documents that would allow for the determination of tax due, and trustworthy information on the sale prices of properties are among the obstacles to efficient administration. It costs money to set up the human resource infrastructure and data base needed to manage the property tax effectively. It would be impossible for the federal or subnational levels of government to justify such expenditures at the existing property tax revenues (Bahl and Bird, 2018). As a result, rather of implementing thorough reforms, the majority of developing nations make minor administration improvements. It implies that revenue growth is similarly minimal.

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Property Tax in Developing Countries

The adoption of techniques to strengthen the dependence of local authorities on own source financing and heighten the accountability of local officials to voters has been a result of the democratization and decentralization of government across the transition economies of Central and Eastern Europe. For instance, local administrations have been given the ability to set tax rates within certain bounds in Estonia and Poland. The municipal administrations in Hungary now have the option of taxing real estate. In certain nations, like Lithuania, municipalities lack the authority to set property tax rates (Moore, 2020). The Baltic States recently gave local governments more freedom to choose their own policies.

The former Yugoslav republics have noticed similar developments. Municipalities were permitted to levy and collect property taxes in Montenegro at rates that fell within a predetermined range (Kaluerovi, 2017). Property tax administration is decentralized in Croatia and Serbia. While Croatia permits local governments to select a tax rate from a range, Serbia allows local governments to determine their own rates (Alibegovi, 2019). While the National Tax Authority has taken over the local governments' collection duties, Slovenia's property tax statute still gives local governments some latitude in setting the rates (Klun, 2018). The reforms have made it so that property tax earnings are used to pay for local government expenses in the majority of the region's countries, and they are often distributed through local government budgets.

One actually cannot refer to the practice because the legal framework and manner in which property taxation is implemented vary so greatly between developing and transitional nations. The tax may be imposed by local governments (such as in Brazil), state-provincial governments (such as in India), or in many situations it is mandated by central government law (Chile, Lithuania, and Indonesia, to name a few). The tax base may be the annual rental value, capital value of the land and improvements, capital or rental value of the land, or land/improvement area, depending on the nation. (Baba, 2018).

There are not many instances of such hybrid systems (Bell, 2018). For instance, a method based on municipal land use maps that include a property's purpose and location in Chile determines the tax base by factoring in a value per square meter for each zone. In Indonesia, a comparable system is in place. In Romania, cities are divided into categories, apparently based on the caliber of services they offer, and a rent gradient is then established for each category, which also reflects service accessibility. The tax rate is determined by this and then applied to the land area. Hence, the tax rate incorporates a notion of value.

Property taxes are expensive to administer, complex to impose, and unpopular with taxpayers. It is well knowledge that many nations fail to generate any sizable amounts of income from this tax source. These issues are more common in developing nations, and in Latin America in particular, property taxes continue to be a top concern for politicians. With very few exceptions, Latin American nations have not been able to create property tax systems that generate money. Moreover, Latin America has been noted in the economic literature as an area with relatively low tax effort and lower tax revenue performance than the average in emerging and transition countries (Bird et al., 2006). (Bird et al., 2008; Ahmad and Brosio, 2008). In the case of the property tax, the issues of low tax effort and revenue success are particularly serious and difficult.

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Sub-Saharan African developing nations are hardly an exception. The central government is reluctant to provide local governments administrative and policy control over property taxes while also doing nothing to advance property tax reform (Evans, 2020). In other instances, even when authority is granted or the central government is interested in reform, progress is sluggish due to unfavorable incentives, an inappropriate property tax policy, a lack of proper administrative systems, a lack of trained personnel, and a failure to coordinate local service delivery improvements with increased resource mobilization.

Government policy determines the tax base in terms of what is taxed and what is not. A country's land and building stock often depends heavily on its administrative and historical viability. Certain nations, including Jamaica, Bermuda, Kenya, and New Zealand, exclusively tax land, while Tanzania and Ghana only tax buildings. the majority tax both buildings and land (Countries of North America, Western Europe, Latin America, East and Southeast Asia). Some nations that have state-level property tax laws permit different tax base options (Bahl, 2018). For instance, local governments in South Africa may only tax land, but other local governments may tax both land and structures.

In most of the countries of Latin America and in the OECD, the capital value of land and improvements serves as the main taxation base (Ahmad, 2019). A capital value system bases its calculations on the market value of the property, or the price at which the land and improvements would sell on a free market. The whole market value of the property is occasionally the legal, taxable base; other times, it is discounted according to a predetermined ratio of assessed to full value. Some of the practical problems that beset rental value systems are avoided by capital value systems. Conceptual issues with establishing the basis in circumstances of vacant property, rent-controlled properties, and determining the taxable value for land utilized for non-residential purposes are largely resolved because the legal base is the genuine market value. Although property sales are reported, they are typically not reported accurately.

The actual valuation is calculated using a different methodology for land and buildings in the majority of developing nations. The market value in Porto Alegre, Brazil, is determined by adding the land value and the building costs (Junior, 2022). In order to determine land values (per unit of local area), recent transactions of unoccupied property in a number of the city's reasonably homogeneous zones are referred to. Depending on the physical attributes of the site and the accessibility of infrastructure services, this land value is modified for each location. The average cost per construction unit for various types of buildings is used to estimate building costs, which are then reduced by a depreciation rate. The strategy used in Brazil is replicated in a large number of emerging nations. For instance, Botswana values improvements and land separately, although it has more misgivings about utilizing information on land values from declared transactions of land in Kenya. Estimating land value gradients in an urban region can possibly be done rather well by the correct professionals using a methodical technique.

Some nations base their evaluation on the property's entire worth (land and improvements included). In Cyprus, the assessed value is based on reported open market sales rather than an independent valuation of the land and improvements (Demetriou, 2017). Sales information is utilized directly in the appraisal of residential properties in South Africa (Inchauste, 2017). Using a computer model that can account for the features of specific properties to find the factors that

influence property values is an intriguing potential in a capital value system. The issue with such models is that they need precise information on property sales values, which is something that not many emerging and transitional nations can provide.

Statement of the Problem

Property tax is a component of total property tax on the value of assets, which is established yearly based on the combined market value of land and buildings. Different property kinds are subject to varied tax rates, which may change depending on the anticipated budget expense and the corresponding tax base. The rates of property tax are set unilaterally by the authorities. While the current analysis will concentrate on the role of property tax, Naburi (2017) and Rukungu (2015) argue that there is a contextual gap because their studies concentrate on the property collection rates and enforcement as well as the impact of the new capital gains tax on asset allocation. So, it is necessary to conduct a study to evaluate how much property taxes contribute to economies.

Theoretical Framework

Cary Brown Model

The argument, which Cary Brown developed in 1948, contends that by providing tax incentives to a corporation, the government invests in the enterprise and boosts its potential future revenue from the enterprise. This is predicated on the notion that taxes lower expected investment profits (Avi-Yonah, 2020). According to Cary Brown, the use of tax incentives causes an organization to revert to its pre-tax level and causes the government to make an investment as though the business had just begun. Tax incentives that reduce the time needed to recoup the cost of an asset improve the government's present value of taxes collected (Avi-Yonah, 2020). This happens because the government doesn't restrict the investor's ability to deduct the full cost of their investment; rather, it simply permits them to pump the full cost of their investment into the company. By doing this, the government will merely have boosted future total revenue and spread investment earnings over a longer time period.

This is accomplished by encouraging the company to boost productivity without raising prices. The government's involvement in the company serves as the drive. The government invests the entire investment into the investor's business by allowing the company to deduct the full cost of the investment (Avi-Yonah, 2020). The philosophy that underlies the application of capital allowance incentives is described. Governments essentially permit businesses to gradually deduct their capital investment costs from their net profits before taxes. If this is permitted, it lowers the amount of tax that the company must pay to the government. This boosts the company's available cash and capacity for investment in new possibilities. This theory aids in our comprehension of the elements and property taxation procedure, which is useful in examining the function of taxes in an economy.

Agglomeration Economies Theory

The thesis, first forth by Garcia-Mila and McGuire in 1996, contends that communities ought to entice businesses that produce agglomeration economies. Agglomeration economies relate to the advantages a society and enterprises experience when certain variables draw individuals, groups, and organizations to a certain area (Wangu, 2018). When these types of economic powerhouses are drawn to a certain area by the availability of the resources or incentives to stimulate production

and growth, a phenomenon known as agglomeration economies results (Wangu, 2018). Countries have supported the idea that incentives could lead to the formation of agglomeration economies. As a result, governments utilize incentives to entice FDIs to export processing zones in an effort to draw additional investors and resources there and promote growth and productivity.

Because of rising wages and skill levels, increased investments and other production factors also lead to higher per capita income. According to contemporary urban literature, small businesses are prevalent in areas with high growth. This suggests a direct connection between the development and expansion of small businesses. According to the theory of agglomeration economies, in order to promote growth, governments must offer incentives to sectors of the economy that widen the range of activities that are conducted there. This theory is pertinent to the study because it will aid in understanding how this tax affects the economy by explaining why business people invest in real estate and buildings when resources like rentals and buildings are available.

Empirical Review

Nyabwengi (2019) determined how property valuation affects equity in local government in Kenya. In Nairobi, case study locations were employed in the study. Ratios were employed in the study to analyze the data. The study found that several factors have an impact on property tax equity, including the use of the Unimproved Site Value (USV) and area rating as the tax bases, numerous exemptions and omissions from taxation, a lack of established procedures for updating the valuation roll, and an outdated valuation roll that is unrelated to current market values. According to the report, Nairobi City should implement an improvement rating system to account for property values, adopt a single taxing regime, and update property values on a regular basis to increase revenue.

Naburi (2017) did a study on Property Rates Collection and Enforcement in Devolved Systems of Government. The research method employed in the study was descriptive. Data were gathered for the study using a semi-structured questionnaire. Tables, charts, and percentages were used to represent the data that was gathered. According to the study, the collection ratio has been declining over the past few years. The study also identified the methods for collecting property taxes and the means of enforcing them, which include giving discounts and waivers on property tax interest; enforcing sanctions and penalties; and using social pressure, such as publishing defaulters' names. In order to ensure rates are paid in a timely manner, it has been found that providing better public services, operational debt recovery, sanctions and penalties, providing discounts and waivers on interests and penalties, social pressure, and reducing compliance costs are effective enforcement tools.

Rukungu (2015) determined how the new capital gains tax might affect the asset allocation of investment groups in Nairobi County, Kenya, conducted a study. A descriptive research design was employed in the study. Questionnaires were used to gather the information. The study also found a favorable and statistically significant association between asset allocation choices and investment group decisions in Nairobi County and knowledge of capital gains taxes. The study came to the conclusion that investment groups' decisions about the distribution of assets have an inverse relationship with the amount of capital gain tax that must be paid. The report suggested that in order to educate investors on the various investments that qualify for capital gain tax, the

Kenya Revenue Authority and the government at large should start training programs on capital gains taxation.

Mbaka (2019) examines the effect of the real estate sector's expansion on Kenya's rise in tax receipts. The study's foundation was secondary time series data gathered from 1984 to 2017. The findings also demonstrated that growth in tax revenue was not significantly impacted by GDP or external sector growth. As a result of the positive and large impact, the study advises the Kenya Revenue Authority (KRA) to keep developing new strategies for raising tax income from the real estate sector.

Villaroman (2017) conducted research on the variables influencing actual tax collection in the Nueva Ecija provincial treasurer's office in the Philippines. There were 27 municipal treasurers in total. The study was governed by the tenets of taxation theories. A combination of qualitative and quantitative methods were employed in the investigation. Also, through observation and analysis of the information acquired and observed, efficiency was described and determined. The study demonstrated the importance of adhering strictly to the fundamentals of a sound tax system.

Madrigal-Delgado (2021) conducted research to examine the property tax as a percentage of the local GDP in terms of own income and entity participation. Eight wealth tax, property, local GDP, and other indicators are employed in a quantitative manner. The findings demonstrate that five entities including Mexico City, which gather more than 70% of the national collection of the property, provide support. The analysis of the tax as a percentage of the regional GDP and comparison with the reports on the allocation of shares to municipalities are what give the work its originality.

METHODOLOGY

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries

FINDINGS

The results were analyzed into various research gap categories, that is, contextual and methodological gaps.

Contextual Gaps and Methodological Gaps

Nyabwengi (2019); Rukungu (2015); Naburi (2017) and Villaroman (2017) posits a contextual gap as these studies discusses on property tax valuation, property rate collection and factors affecting collection of property tax while the current study focusses on the role of property tax in developing country. Rukungu (2015);Mbaka (2019)and Madrigal-Delgado (2021) have a methodological gap as these study uses descriptive research design, qualitative and quantative method while current study adopts desktop study research design.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The impact on property tax equity is caused by a variety of factors, including the use of the Unimproved Site Value (USV) and area rating as the tax bases, numerous exemptions and omissions from taxation, a lack of established procedures for updating the valuation roll, and an outdated valuation roll that is unrelated to current market values.

According to the study, providing better public services, operational debt recovery, fines and penalties, offering discounts and waivers on interests and penalties, social pressure, and lowering compliance costs were determined to be effective enforcement measures for ensuring rates payment compliance.

The study also found that growth in tax income was not significantly impacted by GDP or external sector growth. Although the impact is favorable and large, the Kenya Revenue Authority (KRA) should keep coming up with new strategies for increasing tax collection from the real estate sector.

Recommendations

According to the study, tax authorities should use better rating systems to accurately reflect property values, create a single taxation regime, and periodically update property values in order to boost revenue due to rising property values.
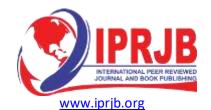
To educate investors on the many investments that qualify for capital gain tax, the revenue collecting agencies and the government as a whole should start training programs.

The study suggests that rigorous commitment to the fundamentals of a sound tax system is necessary.

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