Property Taxation and Sustainable Real Estate Markets

Richard Grover, UK

SUMMARY

When ecologists seek to discover the health of an eco-system, they sometimes study the top predator – tigers in an Indian jungle, polar bears in the Arctic, otters in an English river. If their populations are healthy and thriving, this should indicate that the whole eco-system that supports them is also in good shape. Recurrent (annual) property taxes can be argued to have similar totemic status with respect to real estate markets – if these taxes are working well and generating significant revenues, the real estate markets are likely to be functioning efficiently. This is because value-based recurrent property taxes not only require active real estate markets but also a number of pre-conditions to be in place before they are likely to be effective. These conditions are also the ones required for the efficient functioning of real estate markets.

Value-based property taxes are ones that are levied according to the market value of the property. Although recurrent property taxes are widely found – Almy (2014) has identified 166 countries that have them – they are also only lightly used in most cases. The arithmetic average percentage of Gross Domestic Product raised by recurrent property taxes for the EU is just 0.8 percent. Norregaard (2013) found that the proportion of GDP generated in this way by middle and low-income countries was only 0.4 percent. A minority of countries, such as the UK, USA, Canada, and France, by contrast, do make significant use of recurrent property taxes. The main reason for this low level of revenue is that in many countries recurrent property taxes are not based on the market value of the property but on their area, sometimes moderated by coefficients according to characteristics of the property, or on the depreciated historic costs of construction. The use of these taxes bases limits the extent to which recurrent property taxes can be levied since the government has little idea what the effective tax rate is and this must vary significantly between taxpayers as the tax burden is unrelated to the value of their assets.

Recent research by the World Bank undertaken in the Europe and Central Asia Region has suggested that there are various preconditions for efficient value-based recurrent property taxes. There needs to be active and transparent real estate markets with large numbers of transactions for each type of property and location. Value-based recurrent property taxes make use of evidence from those properties for which there is recent evidence of transaction prices and utilise these to derive estimated market prices of the population of properties for which there have been no transactions. This applies equally to mass valuation methods, where the properties for which there is transaction evidence are used to derive statistical relationships between market prices and the characteristics of properties, as well as to more traditional valuation methods. Limited market activity results in "empty cell" problems in which there is no market evidence for certain types of properties or locations, requiring interpolation with corresponding loss of accuracy.

The research has also indicated that there are certain institutional requirements for effective property taxes. Functioning real estate markets require well-defined property rights that are capable of being traded. However, just because there is private ownership of property, it should not be assumed that there is an efficient and active real estate market. One problem can be a lack of transparency in transaction prices. Such information is essential for the assessment value-based property taxes as well as to inform market participants. There may be incentives to declare inaccurate prices, for example, in order to evade taxes and fees. The

compilation of accurate tax rolls depends on the reliability and comprehensiveness of property registers and cadastres. Even where registration is mandatory, cadastres may not record each property or how parcels are sub-divided between users. There needs to be a valuation infrastructure, including standards, accepted methods of valuation, agreed qualifications for valuers, codes of practice, and means of enforcement compliance with standards. Even mass valuation needs qualified valuers to review models, assess the quality of data, value properties that are hard to model, and to hear appeals. A culture of tax compliance is unlikely to exist in isolation and is likely to be associated with compliance with registration, building control, and town planning requirements.

Ultimately the effort to develop value-based recurrent property taxes is worthwhile. They are the mainstay of local taxation and the financing or local services. Reliance instead on intergovernmental fiscal transfers can undermine the stability of public finances through increasing levels of borrowing and debt. Without them, a tax system lacks its most effective tool for tackling the erosion of tax bases through globalisation as well as being unduly dependent on taxes that tend to affect lower income groups disproportionately, like sales taxes, or which have distorting economic impacts, such as income, employment, and profits taxes.