PROPERTY TAXATION: ISSUES IN IMPLEMENTATION[1]

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A. INTRODUCTION

Property taxation is the backbone of municipal finance in a number of developed countries. Over the years, however, it has not been without controversy on a number of implementation issues. For example, discussion has often emerged over the role that property taxes should play in financing municipal services. This is discussed in part B of this paper. Part C covers a number of implementation issues on such things as identifying taxable properties, choosing an appropriate tax base, setting up a proper assessment system and establishing property tax rates. Part D briefly summarizes the current and proposed property tax system in Russia and offers suggestions for improving it to achieve greater efficiency, accountability and fairness in the implementation of a property tax system.

B. WHAT IS THE ROLE FOR A PROPERTY TAX?

Local governments in developed countries supply a range of services – from those that exhibit mainly private goods characteristics (water, sewers, solid waste collection and disposal, public transit, public recreation and so) to those that exhibit mainly public goods characteristics[2] (local streets and roads, street lighting, fire and police protection, neighbourhood parks, etc.). For services with mainly private goods characteristics, individual beneficiaries can be identified, income redistribution is not a goal, spillovers are unlikely to exist, and operating and capital costs can be measured and recorded. Here, a user fee would be relatively easy to administer and would be the best financing instrument for satisfying the principles of efficiency, accountability, transparency, and fairness.[3]

For services providing mainly collective or 'public goods' benefits (specific beneficiaries cannot be identified), user fees are inappropriate. Instead, these should be funded from a local tax imposed on residents (or exported to the same extent services are) with necessary adjustments through the use of grants to account for spillovers; that is, benefits from these services that spill over into neighbouring communities should be funded from something other than a local tax. While there may be some debate over the criteria that should be satisfied in setting a local tax, it is generally agreed that the following criteria[4] should be met as closely as possible.

- The tax base should be relatively immobile, thus permitting local governments to vary their tax rate without losing much, if any, of the tax base.

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[1] This paper was first prepared under the auspices of The Consortium for Economic Policy Research and Advice (CEPRA) in November 2003 -- a project of cooperation and technical assistance sponsored by the Canadian International Development Agency (CIDA). The project is being carried out by the Association of Universities and Colleges of Canada (AUCC), working in conjunction with experts in academia, government and the non-governmental sector in both Canada and the Russian Federation.

[2] For a more detailed discussion, see Harry Kitchen (2003), "Local Taxation in Selected Countries: A Comparative Examination", a paper prepared for CEPRA II, part C.

[3] For a discussion of these principles, see Ibid, pp. 17-19.

[4] Charles, E. McClure Jr. (2001), "The Tax Assignment Problem: Ruminations on How Theory and Practice Depend on History." *National Tax Journal*, Vol. LIV, No. 2, 339-363; Richard M. Bird (2001), "Subnational Revenues: Realities and Prospects", (Washington: World Bank Institute), mimeograph; Richard M. Bird (1999), "Rethinking Tax Assignment: The Need for Better Subnational Taxes", draft paper, Fiscal Affairs Department, (Washington: International Monetary Fund); Richard M. Bird (2000), "Intergovernmental Fiscal Relations in Latin America: Policy Design and Outcomes," (Washington, D.C.: Inter-American Development Bank), pp. 16-24; and Wallace E. Oates (1998), "Federalism and Government Finance", in Wallace E. Oates (ed.), *The Economics of Fiscal Federalism and Local Finance* (Cheltenham, UK: An Elgar Reference Collection).

- The tax yield should be stable and predictable over time.
- The tax should not be one that is easy to export to non-residents (in other words, should be borne by taxpayers in the taxing jurisdiction).
- The tax should be visible to ensure accountability and transparency.
- Taxpayers should see the tax as being reasonably fair.
- The tax should not create harmonization problems with taxes of senior levels of government nor should it create harmful competition between local governments.
- The tax should be easy to administer.

Of possible tax alternatives for local governments, the property tax meets these criteria better than any other tax. Its tax base is largely immobile. Revenue is generally predictable and stable in that it does not vary with the cyclical swings in economic activity as much as personal income and consumption based tax revenues. The part of the tax that is on residential property is unlikely to be exported. It is highly visible and fair as long is it covers the cost of providing those services that provide collective benefits to the local community. If the property tax is a local tax only (senior levels of government not involved), harmonization problems and wasteful tax competition should not be a problem. Finally, it is likely to be more expensive to administer than a local tax that is piggybacked onto an existing federal or regional tax, but this may be a small price to pay if local governments are to have autonomy and flexibility in setting tax policy, both important ingredients of responsible, efficient and accountable local government.[5]

C. IMPLEMENTATION ISSUES

Recognizing that a property tax is a good local tax, there are a number of implementation issues that must be decided. These are discussed in the remainder of this paper.

C.1 Property Identification

The following steps are required in the taxation of real property.[6] All taxable properties must be identified and described on the assessment roll with each property assigned a roll number. This number is important for linking assessment information with tax billing and property transfer records.

The assessment roll should include the address of the property, its owner, building and lot size in square metres or hectares, the age of the building and information on renovations or improvements. This information will be used to assign an assessed value to the property, especially if the tax base is market value and the property has not recently been sold. Furthermore, this information should be reported in a consistent way and a process should be established to update assessment annually[7] or as frequently as administratively possible. Once assessed values have been determined, local tax rates must be set, tax bills issued, responses must be made to assessment appeals, taxes must be collected, and arrears must be addressed.

Property identification is often more difficult in developing countries and transitional economies.[8] For example, maps for property identification may not exist; property ownership data may not be provided because of disputes over who owns what; information on improvements may be missing; building permit information may not be provided to the taxing authority; tax records may be identified by taxpayer and not by property; land and building records may be maintained by different agencies

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[5] Bird (2001), supra footnote 3, p. 3.

[6] Enid Slack (2001), "Alternative Approaches to Taxing Land and Real Property", a paper prepared for the World Bank Institute, Washington, D.C., p. 5.

[7] Enid Slack, John LaFaver, and Ihor Shpak (1998), "Property Tax in Ukraine: Third Attempt", in *Budget and Fiscal Review*, Second Quarter, pp. 41-2.

[8] For more detail, see William Dillinger (2002), "Urban Property Tax Reform Guidelines and Recommendations" (Washington, D.C.: The World Bank), p. 11; and Jane H. Malme and Joan M. Youngman (2000), "The Development of Property Taxation in Economies in Transition." Case Studies (Washington, D.C.: The World Bank), p. 15.

and not linked; and tax records may be considered secret.

C.2 Choice of Tax Base

There is no uniform tax base that applies everywhere. In some countries, the property tax is based on property value as determined by market value, site value, and rental value. In other countries, the tax is based on building area and property area - this is referred to as unit value. In a few countries, a mix of these approaches is employed. Each of these systems is considered below.

a. Market Value Assessment

Market value is the price that is determined between a willing buyer and a willing seller in an arms length deal. Market value estimates the value that the market places on individual properties. For properties that sell in any year, market value is the selling price. For properties that do not change hands in the year, market value must be estimated. There are at least three estimation methods that may be used. First, when markets are active and similar properties are being sold in the same or comparable neighbourhoods, a comparative sales approach could be used. This assigns a market value to an unsold property by looking at valid selling prices of similar or comparable properties.

Second, a depreciated cost approach is sometimes used. This is most appropriate when properties are relatively new, there are no comparable sales, and improvements are relatively unique. Here, the property is valued by assigning a value to the land as if it were vacant and adding the cost of replacing the buildings and other improvements.

Third, a capitalized income approach may be used. This is primarily for properties that generate actual rental income. Here, the annual net rental income (gross annual rental income minus annual operating expenses) is estimated with this annual net income subsequently converted to a capitalized property value (market value) using a capitalization factor. To illustrate, if net annual rental income from a specific property is $10,000 and if the current interest rate is 5 percent (current rate of return on a bond, for example), the capitalized value of the property would be $200,000 (net rent divided by interest rate or $10,000/.05). This is also the market value because an individual would be willing to pay $200,000 for a property that generates an annual net rent of $10,000 – this is a 5 percent return and is identical to the return on bonds.

Either the comparative sales or depreciated cost approach appears to be superior to net rental income (gross rental income minus expenses) in determining market value. For properties such as vacant land and those subject to rent controls, there may not be a reliable measure of net rental income at market rates. Second, rental income may be difficult, perhaps impossible, to estimate for unique commercial and industrial properties including steel mills, mining operations and so on. Third, assessors may not have access to rental income information because this information is not publicly available in the same way as are sales prices.[9] In spite of these problems, rental value assessment is used in France, India, and Morocco (Table 1).

Canadian and U.S. municipalities tend to rely on market value assessment (mainly comparative sales and depreciated cost approach) as do Australia, Indonesia and Japan (Table 1). Differences in the application of market value exist across these countries, however. In Canada, for example, there are no restrictions on assessment increases or local general tax rates or tax rate increases[10] – assessment values are intended to reflect market values and general tax rates are set to raise necessary municipal revenues. In some states in the United States, by comparison, restrictions on assessment exist.[11] In California, reassessment of properties can only

[9] Slack (2001), supra footnote 5, p. 12.

[10] There may be restrictions on the differential that may exist between municipal tax rates applied to residential properties versus those applied to commercial and industrial properties.

[11] Arthur O'Sullivan, "Limits on Local Property Taxation: The United States Experience", in Wallace E. Oates (2001), *Property Taxation and Local Government Finance*) Cambridge, Mass.: Lincoln Institute of Land Policy), pp. 177-200, at 180-81.

Table 1: Base for property Taxes			
Tax Base	Definition	Measure Used	Examples of countries where used
Market Value	Price struck between a willing buyer and seller in arm's length transaction	Comparative sales; depreciated costs; or capitalized income	Canada, United States, Australia, Indonesia, Japan
Site Value	Price struck between a willing buyer and seller in arm's length transaction	Comparative sales; subtract improvements from total property value	Kenya, New Zealand, Jamaica, South Africa
Rental Value	Value in current use	Net rental income	France, Morocco, India
Unit Value	Size of property adjusted to reflect location, quality, or other factors	Square metres of land and building area, adjusted	Israel, Poland, Estonia, Czech Republic, Slovakia, Armenia, Russia
Source: Enid Slack (2001), "Alternative Approaches to Taxing Land and Real Property", a paper prepared for the World Bank Institute, Washington, D.C., p. 15.			

occur at the time of sale or resale. Between sales, assessment may only increase by 2 percent per year. In Michigan, reassessment is restricted to the lesser of 5 percent or the inflation rate. Other states have imposed limits on the property tax rate (Massachusetts at 2.5 percent) and/or the growth rate of property tax revenue (Massachusetts also at 2.5 percent and Illinois at the lesser of 5 percent or the inflation rate). Nine states now limit both the property tax rate and the growth rate of assessed property values.[12]

Where fully functioning property and real estate markets exist, market value assessment has distinct advantages over area based assessment systems. For example, market value is able to capture the amenities of the neighbourhood, amenities that are often created by local government policies (zoning legislation, for example). Area based assessment is unlikely to capture these amenities. To illustrate, assume two properties of identical size (that is, identical in building size and land area) and age but located in different places. One is adjacent to a greenbelt while the other is next to an abattoir. Under unit assessment, both would be assessed in an identical fashion, whereas the two properties would be assessed differently under market value assessment.[13] It is unlikely that many would argue that unit assessment would be fair in such an instance.

In addition, benefits from local public services are more closely reflected in property values than in the size of the property. For example, properties close to parks and public transit systems benefit more from public services than do properties located some distance away. Furthermore, these benefits are reflected in higher property values for neighbouring properties. Market value assessment would capture these benefits whereas, area based assessment would not.

b. Site Value Assessment

In its purest form, site value assessment (SVA) is a special case of market value assessment where only land is assessed. All capital improvements (buildings, for example) are excluded from the assessment base. Under a graded SVA system, capital improvements are included in the base and taxed at lower rates (sometimes significantly lower) than land, with the level of gradation varying according to the

[12] Ibid.

[13] Harry Kitchen (1992), *Property Taxation in Canada* (Toronto: Canadian Tax Foundation), p. 127-128.

taxing jurisdiction's policies and practices. A form of site value assessment is used in New Zealand, Kenya, Jamaica, and South Africa (Table 1).

There are two potential problems with site value assessment. First, accurately separating land from improvements may be more difficult than it sounds. It is almost certain to be easier to determine market value for a piece of property than it is to estimate values for the components that constitute market value.[14] Second, since the base for site value taxation is smaller than the base for market value taxation, it would be necessary to impose a higher tax rate under site value taxation to raise the same amount of revenue. It may be perceived to be easier politically to levy a lower tax rate on market value than a higher tax rate on value of land only.[15]

Advocates of site value or graded assessment have argued that the practice of taxing land and buildings at the same rate (as under market assessment) discourages property improvements, since improvements lead to higher assessed values. Graded assessment would reduce this disincentive and thereby, foster growth and development - whether it be infilling vacant or under used land in the city centre or whether it be development at the city boundaries. The incentive would be all the greater because the value attached to a piece of land for tax purposes would refer not to the land's actual use - that is, the current use that would provide the highest rate of return. Indeed, it has been demonstrated that in certain circumstances greater reliance on land taxation may result in a level of economic development that is excessive in efficiency terms.[16]

To be more specific, the tendency under a graded assessment system for land to be put into higher use than it would otherwise be put may not be socially desirable, especially if preservation of heritage buildings, neighbourhood parks, and/or lower density development is to be encouraged. Furthermore, any incentive to speed up development may lead to congestion or sprawl if the development proceeds more rapidly that the city or city-region can plan and coordinate its objectives.[17] In theory, these concerns can be addressed by zoning legislation; in practice, however, there may be considerable pressure for zoning changes, given the increased benefits (to the owner) that arise from more intensively developed land.

Evidence is scarce on the effects of a system that taxes land more intensively than it taxes buildings. A recent study has evaluated economic development in Pittsburgh after the City's decision in 1979-80 to adopt a graded system and apply a rate to land that was more than five times the rate on structures.[18] The study concluded that Pittsburgh did experience a dramatic increase in building activity, one far in excess of any increases in other cities in the region, but it stopped short of concluding that the change in tax policy had caused the boom. Instead, it suggested that the primary cause was a shortage of

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14 At least one author has suggested the opposite - the valuation of land may be easier than the valuation of property. See Dick Netzer, "The Relevance and Feasibility of Land Value Taxation in the Rich Countries" in Dick Netzer, *Land Value Taxation: Can it and will it work today?* (Cambridge, Mass.: Lincoln Institute of Land Policy, 1998), p. 123.

15 Roy Bahl, "Land Taxes Versus Property Taxes in Developing and Transition Countries", in Dick Netzer, *Land Value Taxation: Can it and will it work today?* (Cambridge, Mass.: Lincoln Institute of Land Policy, 1998), p. 144.

16 Brian L. Bentick, "The Impact of Taxation and Valuation Practices on the Timing and Efficiency of Land Use" (1979), *Journal of Political Economy*, vol. 87, no. 4, 859-68; and David E. Mills, "The Non-Neutrality of Land Value Taxation" (1981), *National Tax Journal*, vol. 34, no. 1, 125-9.

17 For an expression of concern over the way in which hasty, unplanned and uncoordinated development can severely limit a municipality's policy options, see Toronto. *Final Report of the Joint Committee on Property Tax Reform* (Toronto: the committee, 1982).

18 Wallace E. Oates and Robert M. Schwab, "The impact of Urban Land Taxation: The Pittsburgh Experience" (1997), *The National Tax Journal*, vol. L, no. 1, 1-21.

commercial space; the increase in land taxation had, however, enabled the city to avoid increases in other taxes, increases that might have impeded development. An earlier study had concluded that Pittsburgh's modified form of site value tax did not constitute a sufficient penalty to encourage owners of under-developed or undeveloped property to develop. The city's development boom was instead a response to market conditions (demand for office space or buildings for corporate headquarters) and government incentives, including tax abatements and federal income tax credits. In general, moreover, property taxes were not a factor in firms' decisions to locate in Pittsburgh.[19]

Some cities have claimed that a switch to graded assessment has brought them new development, but the evidence put forward to support these claims must be treated with caution. The usual practice is to claim that all new development is a consequence of the adoption of the graded tax system and to ignore factors such as changing market conditions, changes in the local labour market, the receipt of state or federal grants - factors that appear to have been important in driving the development in Pittsburgh's case. To the extent that a graded system does encourage development, much of this development tends to be at the expense of neighbouring communities that have not adopted a similar system.

Replacement of the current property tax system with either a system that taxed land alone or a graded system would generate windfall gains and losses in the short run as tax bills rise for certain properties and fall for others.[20] One study has suggested that the reduction in taxes on buildings that accompanies a shift to a graded system will be capitalized into higher property values and the offsetting increase in the tax on land will be capitalized into lower values.[21]

c. Unit-Value or Area Assessment

Under unit-value or area assessment, the tax base is a combination of building area and lot area. For each property, assessed value is the sum of lot area times an assessment rate per square metre of lot area plus building area times an assessment rate per square metre of building area.[22] In its purest form, unit assessment does not take into consideration any variation in the assessment base to reflect location, market conditions, or quality of structures. In less than pure form, unit assessment may introduce variation to reflect location, zoning, use of property and other factors deemed appropriate. Achieving differentials in property type or location, however, is best handled through the use of variable tax rates rather than through the creation of differentials in the tax base (see discussion later).

Support for unit-value or area assessment (based on size of property and buildings) has emerged in a couple of instances. First, it would be superior to value based assessment systems in countries or areas of countries that do not have fully functioning and operational real estate markets. Estonia, Poland, Czech Republic, Slovakia, Russia, and Armenia use it for this reason.[23] Similarly, it may make sense to use it in parts of countries (Canada and Russia, for example) where there are isolated hamlets and no clearly functional market for property values

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19 This study involved an analysis of real estate and assessment data in Pittsburgh from 1975 to 1985. See Michael Weir and Lillian E. Peters, "Development, Equity and the Graded Tax in the City of Pittsburgh" (June 1986), 5, *Property Tax Journal*, 71-84.

20 Richard Bird and Enid Slack, *Urban Public Finance in Canada*, 2nd edition, (Toronto: Wiley, 1993), at 82-83.

21 Jan K. Brueckner, "A Modern Analysis of the Effects of Site Value Taxation" (March 1986), 29 *National Tax Journal,* 49-58.

22 Harry Kitchen, "Alternative Methods of Taxation and Assessment", a report prepared for the Task Force on Reassessment in Metropolitan Toronto (mimeograph, Toronto, August 1989), part VII.

23 See Joan Youngman and Jane Malme (2000), *An International Survey of Taxes on Land and Buildings* (Netherlands: Kluwer Law and Taxation Publishers), p.18.

because the government owns most of the housing and rents it to occupants.[24]

Second, support has also emerged in response to perceived shortcomings of market value assessment even where fully functioning real property and estate markets exist. First, the market value for tax purposes of a property that has not been sold is a matter of the assessor's judgment and will, inevitably, vary with the competence and experience of the assessor. The result, critics argue, is a property tax system that is often arbitrary and unfair. Unit or area assessment, it is claimed, is free of the subjectivity of market value assessment.

A second argument is that market value assessment penalizes homeowners who improve their properties by imposing higher property taxes on the basis of the improvements. Assessment on the basis of unit value does not generate penalties of this kind.

Finally, market value assessment has been criticized on the ground that rapid increases in market values may increase property taxes beyond taxpayers' ability to pay them. California has addressed this problem of volatility by updating assessments to market value only when the property is sold and increasing assessment, thereafter, by 2 percent annually (noted above). In the United Kingdom, every property was assessed at its market value in April 1991 and placed into one of eight valuation bands.[25] The higher the band, the higher was the tax rate. A property is not reassessed again once it has been placed in a higher band. Changes in value do not affect a property's assignment to a given band unless the size of the property changes. Proponents of unit assessment, however, argue that it is superior to all such modifications of market value assessment, since unlike them it entirely eliminates cyclical swings in taxes and thus creates more certainty for taxpayers.

These claims in favour of unit assessment are themselves subject to criticism. It is not entirely fair, for example, to suggest that unit assessment is more objective than market value assessment. The assignment of values to land and buildings separately would be just as much a matter of judgment as the assignment of a single value to both of them together, and the determination of the different assessment rates for land and buildings would be a matter of judgment as well. In general, it is difficult to imagine that the problem of evaluation would be any less severe under unit assessment than it is under market value assessment.

The argument that market value assessment is inferior to unit assessment because it deters owners from improving their properties raises an empirical question that cannot be answered here. It is likely, however, that improvements invariably increase property (market) values, and hence the owner's equity, by an amount greatly in excess of the annual increase in property taxes. In other words, no increase in property tax is unlikely to be large enough to deter a property owner from attempting to increase his wealth (through higher house prices and increased owner's equity).

It is also unfair to favour unit assessment over market value assessment on the ground that in rising property markets the latter may push levels of taxation beyond taxpayers' ability to pay. Clearly, when properties are sold in rising property markets, capital gains (sometimes substantial) ensue and the seller's ability to pay increases. The fact that a given property is not sold does not change the case: the increase in value increases the taxpayer's capacity to consume and, hence, his or her ability to pay. If increases in assessed value create financial hardships for the taxpayer, tax relief schemes could be made available to alleviate them.

Quite apart from their failure to demonstrate the inferiority of market value assessment to unit-value assessment, the champions of the latter frequently overlook major shortcomings in their favoured approach. Unit assessment requires both an initial determination of value per square foot or square metre and, as circumstances change,

[24] Harry Kitchen and Enid Slack (December 18, 2001), "Providing Public Services in Remote Areas", a paper prepared for the World Bank Institute, Washington, D.C., p. 9.

[25] Slack, supra footnote 5, p. 7.

subsequent adjustments of this value. How is this initial value to be determined and how will the adjustments be made? Is the determination to be made by a bureaucrat or is to be left to the market? If it is made by a bureaucrat, it may be arbitrary and unfair. If it is made by the market, why not simply use the market value of the property instead - as in market value assessment?

d. Summary

Valued based assessment systems and market value, more specifically, are deemed to be superior to area based systems in countries where there are fully operational property or real estate markets. Here, market values can be determined. Where property or real estate markets do not exist or where there are a number of impediments to their operation, area based assessment is likely to be superior.

C.3 Issues in Assessment

Regardless of the assessment base chosen, the success of any assessment system will depend on three critical parts of the assessment process - the importance of achieving uniformity in assessment; responsibility for undertaking assessment; and the frequency of reassessment.

a. Uniformity in Assessment

If property taxes are to be fair in their application, they must be based on assessments that are uniform within each taxing jurisdiction. Uniformity in assessment practices is especially important if the assessment base in a two-tier local government system is used to apportion the costs of upper tier services consumed by residents and businesses in the lower tier municipalities. Here, failure to assess all lower tier municipalities in a uniform manner will lead to inequities and distortions in local tax practices because the lower tier municipalities that are over assessed will very likely be taxed for public services used by those lower tier municipalities that are under assessed. As well, if a role of provincial/ state/regional grants to municipalities is to redistribute income, then the assessed value of property within the municipality is likely to be the major, if not sole, component of the grant base. If assessment practices are not uniform, the redistributive mechanism inherent in these grants will not work as intended.

Uniformity is most easily achieved when the assessment function is centralized at the regional/state/provincial level if not at the central or federal level. At the very minimum, this means that all assessors must use a standard assessment manual where all details of the assessment practice and procedures are spelled out. As well, assessors should be required to attend training courses and pass clearly defined educational standards before becoming property assessors. This is the current practice in Canada as it is in other countries that have fully developed property assessment systems.

Uniformity in assessment means that all properties must be assessed in the same way; that is, residential, commercial, industrial, farm, government, properties of charitable organizations and not-for-profit agencies, and so on. In most countries, the practice of exempting certain properties or applying differential assessment rates to others lowers the tax base and creates potential problems. Lower assessment rates are often used to provide special treatment for farms, forests, and mines. Properties owned by charitable organizations and not-for-profit agencies including churches are generally exempt from assessment. Properties owned by senior levels of government, schools, universities, colleges and public hospitals are usually exempt. For some of these properties, however, payments-in-lieu of property taxes[26] may be provided. Where they exist, they are not without criticism. Local officials frequently complain about these payments because they are often deemed to be less than what the property tax would collect if it could be levied.

The policy of exempting properties or assessing them at a value that is less than other properties favours certain property types and organizations. Not only is this discriminatory and potentially unfair, it can lead to a mix of land use that may be different from the mix that would exist under equal treatment of all properties. If it is possible to make a sound case for preferential

[26] For a discussion of payments-in-lieu of property taxes in the Canada, see Kitchen (1992), supra footnote 12, chapter 7.

treatment of certain properties, then these properties should either be rewarded directly through a system of grants or through the application of differential tax rates (discussed below) applied to a uniform assessment base. In either case, subsidization would be more transparent and subject to review and amendment by the elected representatives according to their interpretation of the public interest.

b. Responsibility for Assessment

Reliance on a centralized uniform assessment manual is critical but the way in which the assessment is carried out may also be important. In Canada, for example, assessors work for a variety of employers. In some provinces, they work for the province; in others, they work for an independent province-wide assessment authority; in another province, they work for a province-wide non-profit corporation; and in a couple of provinces, municipalities hire their own assessors. To emphasize what was noted above and regardless of who carries out the actual assessing, assessors in every province work from a standard province-wide assessment manual. Although the ability of these different agencies/governments to secure uniformity in assessment has not been studied in Canada, one U.S. study concluded that county or regional rather than local assessors leads to more uniform residential assessments.[27]

In addition, a centralized agency (region-wide) responsible for assessment has a further advantage. It is able to benefit from economies of scale that would otherwise not be available to each municipality if each were to carry out its own assessment.[28]

c. Frequency of Assessment

If the assessment base is to be fair and productive, periodic valuations and revaluations must be undertaken to ensure that assessment bases are kept up to date. Frequent reassessments reduce the risk of sudden and dramatic changes in tax burdens that often arise when reassessments are conducted sporadically and infrequently. In Canada over the past decade, every province has moved towards more frequent and up-to-date reassessments – some provinces now complete them annually, most others every three or four years but many of them are moving towards annual reassessment.[29] In most countries, a three to five year cycle is the norm[30] and in some countries, values are indexed (by a price index) in intervening years.

d. Summary

A uniform assessment system is necessary if one is to establish a tax base that is fair, transparent and accountable. Uniformity is more likely achieved if a few practices are followed. First, within a region, state, or province, all assessors work from a standard and uniform assessment manual that is updated frequently to reflect changing market conditions. Second, they should be required to pass specific education and training programs on assessment practices and procedures. Third, although the evidence is sketchy, assessors working for centralized assessment agencies seem to be more successful (because they are more likely to work at arms-length) than those working for municipalities in achieving uniformity in assessment. Fourth, the more frequent the reassessment, the fairer the assessment system leading to fewer surprises for taxpayers, fewer complaints, and fewer appeals.

C.4 Property Tax Rates

Setting the local tax rate is the second major component of the property tax system. Here, there are a variety of issues. These are discussed below.

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[27] Robert P. Strauss and Sean Sullivan (December 21, 1998), "The Political Economy of the Property Tax: Assessor Authority and Assessment Uniformity", *State Tax Notes*.

[28] David L. Sjoquist and Mary B. Walker (1999), "Economies of Scale in Property Tax Assessment", *National Tax Journal*, Volume 52, Issue Number 2, pp. 207-220.

[29] Harry Kitchen (2002), *Municipal Revenue and Expenditure Issues in Canada* (Toronto: Canadian Tax Foundation), p. 67.

[30] Michael Bell (1999), "An Optimal Property Tax: Concepts and Practices", a paper prepared for the World Bank, Washington, D.C.

a. Should municipalities use variable tax rates or uniform rates?

The issue here is whether a local taxing jurisdiction should apply a single uniform property tax rate to all properties within its taxing jurisdiction or whether variable tax rates should be used; that is tax rates that vary with the cost of servicing different properties by type or by location within a municipality. Traditionally and historically in Canada as in most other countries with a history of property taxation based on property values, the practice has been to apply a single tax rate to all residential properties and a higher tax rate to all commercial and industrial properties. More recently in Canada, but not everywhere, this practice has changed. All municipalities in the provinces of Alberta, British Columbia, and Ontario are now permitted to use variable property tax rates. Other countries have also moved in this direction.

Variable tax rates should be designed to capture cost differences across properties, property types and municipalities or neighbourhoods within a city or city-region. For example, if some properties or property types are more expensive to service, a case can be made for using differential property tax rates. Here, higher tax rates are assigned to properties that are more expensive to service.

Variable tax rates have a number of advantages.[31] First, they are fair on the basis of benefits received as long as the rates are set to capture the cost of municipal services used up by different property types or property location. Second, they are efficient if designed to recover the cost of local public services consumed - no incentive would exist for a household or firm to alter its behaviour or location to avoid the tax as long as it matched the cost of services consumed. Third, variable tax rates have a further advantage in that they could be used to distort decisions deliberately to achieve certain municipal land use objectives. For example, if higher tax rates slow development and lower tax rates speed up development, a deliberate policy to develop certain neighbourhoods instead of others might be achieved through different tax rates for different locations.

b. Should business properties be taxed at higher rates than residential properties?

The taxation of business properties (commercial and industrial) at higher tax rates than residential properties is generally done in one of two ways; either through the practice of assessing business properties at higher values than residential properties with the same tax rate applied to both property types; or through the simple application of higher tax rates on business properties. Higher taxation of business properties creates a number of efficiency and equity concerns. Efficiency in municipal service levels will not be achieved if revenues collected from property taxes on business properties are used to subsidize services consumed by the residential sector. Since service levels in any municipality are driven primarily by the demands of the residential sector (they vote), their subsidization means that the residential tax rate will be less than it would be in the absence of the subsidy and an oversupply of municipal services could follow. Equity is not achieved either if those benefiting from the services are not paying full costs.

This over-taxation of the non-residential sector has been addressed in two empirical studies in Canada and one in the United States. Both Canadian studies compared the property tax paid by business properties with the cost of municipal services used by them. The first study included a number of municipalities in the province of Ontario in the early nineties.[32] It concluded that the residential sector when compared with the business sector is the recipient of proportionately more benefits from local government services (social services in Ontario, elementary and secondary education, libraries, recreational facilities, etc.). When combined with higher effective property tax rates paid by the

[31] Enid Slack (2002), "Property Tax Reform in Ontario: What Have We Learned?" vol. 50., No. 2 *Canadian Tax Journal,* pp. 576-85.

[32] Harry M. Kitchen and Enid Slack, *Business Property Taxation*, Government and Competitiveness Project Discussion Paper no. 93-24 (Kingston, Ont.: Queen's University, School of Policy Studies, 1993).

business sector, it concluded that the latter is over-taxed and the residential sector under-taxed.

The second study was completed in the mid-nineties on properties in the City of Vancouver (province of British Columbia). This study concluded that business properties used fewer services than residential properties but paid more in taxes.[33] This result prompted city council in Vancouver to shift property taxes away from business properties and onto residential properties in a series of steps in subsequent years.

A more recent study in the United States found similar results. Specifically, it was estimated that the "business related" share of combined state and local expenditures in the United States is about 13 percent, although there is considerable variation from state to state.[34] These businesses, however, pay proportionately more of the state and local taxes.

Further concerns with the over-taxation of the commercial/industrial sector arise because this tax represents a fixed charge that must be paid. The tax is fixed in the sense that it is unrelated to the value of municipal services used or profits earned. As long as the tax rate is more than necessary to cover the marginal cost of municipal services consumed or if there are no economic rents for it to capture, resources will be allocated inefficiently. This over-taxation of the non-residential sector can lead to less economic activity, lower output, fewer jobs and a less competitive business environment.[35]

Finally, there is the issue of whether this over-taxation plays a role in location decisions. Since firms and businesses generally locate where they can maximize their profits, the provision of fiscal inducements such as lower property taxes can influence a firm's location decision in the same way as the reduction in other production costs may play a role. The impact of property tax differentials depends on a number of factors including the size of the differential between competing municipalities and whether this differential is sufficient to offset differentials in other costs or market factors.

While it is uniformly accepted that the cost of doing business is an important factor in location decisions, there is less consensus on the role played by property taxes in this decision. The evidence, most of which is drawn from the United States, suggests that property tax differentials are relatively unimportant in inter-municipal or inter-regional location decisions but do play an important role in intra-municipal or intra-regional location decisions.[36] Higher effective property tax rates on commercial and industrial properties in one municipality within a region or area when compared with neighbouring municipalities create an incentive for firms and businesses to locate in the lower taxed municipalities. In the extreme, one might expect these property tax differentials to produce a heavy (why not all) concentration of all firms and businesses in the lower taxed jurisdictions. In other words, intra-municipal tax competition could be potentially destructive if it led to a race to have the lowest tax rates. A recent study on municipalities in the province of British Columbia (Canada) examined this issue and concluded that while there is some evidence that municipalities react to tax increases of their neighbours, there is no widespread destructive competition for capital.[37] Similar studies in the U.S., however, have concluded that property tax competition among neighbouring

[33] KPMG, "Study of Consumption of Tax Supported City Services", a report for the City of Vancouver, mimeograph, 1995.

[34] William H. Oakland and William A. Testa (1995), *Community Development-Fiscal Interactions: Theory and Evidence from the Chicago Area*, Working Paper 95-7 (Chicago: Federal Reserve Bank of Chicago).

[35] *Report of the Technical Committee on Business Taxation*, (Ottawa: Department of Finance, April 1998) at chapter 2.

[36] Kitchen and Slack (1993), supra footnote 31. Similar comments were made by officials of the Greater Toronto Marketing Agency in December 2000.

[37] Craig Brett and Joris Pinkse (2000), "The determinants of municipal tax rates in British Columbia", *Canadian Journal of Economics*, vol. 33, no. 3, 695-714.

municipalities is much more prevalent and wide spread.[38]

In reality, the extent to which firms and businesses respond to property tax differentials depends on many factors. These include, for example, the importance of being in the core of the region or area for business reasons; the opportunity to shift the tax differential on to consumers (of the final service or product), employees and owners; and the enhanced amenities that may be offered by a 'downtown location.'

In a U.S. study of individual office buildings in downtown Chicago, it was found that 45 percent of property tax differentials were shifted forward onto tenants as higher gross rents per square foot and 55 percent were borne by owners.[39] The reality that some firms are willing to pay a premium to locate in the downtown core suggests that those firms benefit from "economic rents" created by that location. For example, large financial institutions may benefit from a downtown location. Taxing these rents is efficient from an economics standpoint because it will not impact on the location decision. It is difficult to know, however, the extent of the economic rent. In other words, it is difficult to know at what rent (or property tax) a firm will choose to move out of the downtown location.

There are at least two more positive effects that would arise from shifting the relative tax burden away from the business sector.[40] First, a reduction in the relative property tax burden on this sector reduces the potential for exporting the property tax to non-residents (see discussion in next section). Second, since there is some evidence suggesting that capital invested in real property is, on average, taxed at higher rates than capital invested in other factors of production at least in Canada, the variation in capital tax rates is reduced if this burden is altered. On balance, the reduction in tax exporting (discussed below) and the decrease in the variance in tax rates could result in an improved allocation of resources for the Canadian economy as a whole and overall efficiency gains.[41]

A major defence of the over-taxation of business properties is provided by municipal officials and some taxpayers and it is as follows. Since businesses can deduct all expenses incurred in earning income (including business taxes) and since owner-occupiers of residential dwellings are not allowed similar deductions, it has been suggested that an extra tax on business is legitimate in that it attempts to even out the disparities in taxes that would otherwise exist on these two different categories of taxable property. While it is true that owner-occupiers are not able to deduct property taxes, it is also the case that owner-occupiers are not required to include in taxable income either imputed income from their owner-occupied dwellings or in most countries, capital gains earned on the disposal of their principal residences.[42] Such exclusion is similar to a deduction from income for tax purposes (as in the case of the tax on businesses) in that both reduce the taxable economic income of the taxpaying unit. On this basis, it is difficult to make a case for a higher tax rate on commercial and industrial properties.

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[38] Jan K. Brueckner and Luz A. Saavedra (2001), "Do Local Governments Engage in Strategic Property-Tax Competition?" *National Tax Journal*, Vol. LIV, No. 2, 203-229.

[39] McDonald, John F. "Incidence of the Property Tax on Commercial Real Estate: The Case of Downtown Chicago (1993)*," National Tax Journal*, 109-120.

[40] Sylvester Damus, Paul Hobson and Wayne Thirsk, *The Welfare Effects of the Property Tax in an Open Economy*, Discussion Paper No. 320 (Ottawa: Economic Council of Canada, 1987); and Shantayanan Devarajan, Don Fullerton, and Richard A. Musgrave, "Estimating the Distribution of Tax burdens: A Comparison of Different Approaches," (April 1980), 13 *Journal of Public Economics*, 155-82.

[41] Economic Council of Canada, *The Taxation of Savings and Investment*, A Research Report Prepared for the Economic Council of Canada (Ottawa the council, 1987), at 103 and 146.

[42] For a discussion of capital gains and imputed rent on owner occupied dwellings, see Robin W. Boadway and Harry M. Kitchen (1999), *Canadian Tax Policy*, third edition (Toronto: Canadian Tax Foundation), chapter 3

Concern over the kinds of distortions noted above with the property tax on commercial and industrial properties has prompted at least one suggestion for reform in Canada.[43] Specifically, it has been argued that revenues from a portion of the non-residential property tax should be replaced with revenues from a new business value tax (BVT). This BVT would be a value-added tax.[44] It would be levied on business income. It would be on production and not consumption. This would make it an origin, not destination based tax; hence, it would tax exports and not imports. Further, it is suggested that it be a provincial tax with municipalities having the opportunity to set local rates that are 'piggy-backed' onto the provincial rate. The province could even impose limits on local surcharges to prevent excessive locational distortions. Because the BVT is a value-added tax (essentially sales less cost of goods purchased), it would eliminate a number of the distortions created by the current over-taxation of business property. This type of local business is used in Germany and Japan.

c. Should property taxes on commercial and industrial properties be exported?

The opportunity[45] for the commercial/industrial sector to export its property tax burden onto residents of other municipalities has the potential for misallocating resources and lowering municipal accountability. Tax exporting refers to situations in which some portion of the local tax burden is borne by people who live elsewhere either through changes in relative commodity prices or in a change in the net return to non-locally owned factors of production (inputs in the production process). For example, if higher effective tax rates on commercial and industrial properties lead to relatively higher prices charged on the sale of that community's exports to other communities, the taxing jurisdiction will have effectively shifted part of its tax burden onto residents of other communities. If the commercial/industrial property tax in every jurisdiction is exported to some extent, those jurisdictions exporting relatively more of the tax will be better off than those jurisdictions exporting relatively less. In particular, if the burden of this tax is shifted from residents of high income jurisdictions to those of low income jurisdictions, the distribution of income among jurisdictions is worsened. Furthermore, this runs counter to equalization schemes of senior levels of government that are aimed at redistributing resources (income) from relatively high income jurisdictions to relatively low income jurisdictions.

There is limited evidence on tax exportation. One Canadian study on a sample of large municipalities in Ontario[46] is somewhat dated. Nevertheless, it concluded that the degree of exportation ranged from a low of 16% of the commercial/industrial tax burden to a high of 106%. More than this, relatively rich municipalities had relatively high exporting rates whereas relatively poor municipalities had relatively low tax exporting rates. This tax exporting resulted in an implicit transfer from relatively low income municipalities to relatively high income municipalities.

Furthermore, when the commercial/industrial sector exports its tax burden, municipal government accountability is weakened because the direct link between the municipal government responsible for local services and the ultimate person/agency/body paying the tax is missing.

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[43] Richard M. Bird and Jack M. Mintz " Tax Assignment in Canada: A Modest proposal" in Harvey Lazar, editor, *Canada: the State of the Federation 1999/2000*, (Kingston: Queen's University, Institute of Intergovernmental Relations, 2000) at 261-292.

[44] For an evaluation of value added taxes, see Boadway and Kitchen (1999), supra footnote 41, chapter 5.

[45] Of course, the ability of a firm to export will depend on the elasticity of demand for the exported product.

[46] For further elaboration on this material, see Wayne R. Thirsk (1982), "Political Sensitivity Versus Economic Sensibility: A Tale of Two Property Taxes," in Wayne R. Thirsk and John Whalley, eds., *Tax Policy Options in the 1980s* Canadian Tax Paper no. 66 (Toronto: Canadian Tax Foundation), pp. 384-40.

d. Can property taxes lead to sprawl?

Since the tax is levied on property, any investment that increases the value of the property (such as any improvements including an increase in density) will subject it to a higher tax. For this reason, higher property taxes are expected to discourage density. If, on the other hand, higher property taxes reflect higher levels of service, it is unlikely that there would be any impact on location or land use. To the extent that the allocation of service costs is based on property values and not on services consumed, some taxpayers pay more or less for services than the benefits they receive.

An extensive literature in Canada and the U.S. suggests that spatial factors do affect the costs of development.[47] In particular, the density of development and its location with respect to existing services influence the costs of providing services. For example, “hard” services such as sidewalks, roads, and water and sewer mains cost less to provide in denser neighbourhoods. With water, a pipe is laid down the centre of a street and individual service lines extend from the water main to each building. In high-density neighbourhoods, there are more dwelling units per kilometre of water main over which to spread the costs. Furthermore, increasing the distance from central infrastructure facilities such as water and sewage treatment plants will increase costs.

An efficient property tax would thus reflect the higher costs associated with providing services in less dense developments. This would generally mean that property taxes based on services received should be higher in suburban municipalities than in the core. If property taxes are higher in the core and service provision less costly, the property tax creates an incentive to move to less dense developments.[48]

e. Who should set property tax rates?

In developed countries, municipal governments are responsible for setting their own tax rates although limits are sometimes imposed on them by senior levels of government (discussed below). In many transitional countries, by comparison, the national government often sets the tax rate. Two exceptions are Estonia and Poland where municipalities set their own rates within limits imposed by a senior level of government.[49]

Following on the established theme that the most transparent, efficient and accountable local government is one that is responsible for raising its own revenue, it follows that local governments should be responsible for setting their own tax rates.[50] Failure to permit and require this means that the close link between decisions over revenue generation and expenditure decisions is lost.

Where two tier systems of local government exist, the upper tier should set its tax rate independently of the tax rate set by the lower tier. For each level of government, the tax rate should be high enough to generate sufficient revenues (beyond those generated by user fees, grants from senior levels of government, and other local revenues including permits, licences, and so on) to cover the cost of local public services that each level provides. As noted earlier in this paper, each tier should also use variable tax rates if service levels and standards vary across the municipality or jurisdictional area.

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[47] For a review of this literature, see Marchand, Claude and Janine Charland, “The Rural Urban Fringe: A Review of Patterns and Development Costs,” Toronto: Intergovernmental Committee on Urban and Rural Research, 1992 or Transit Cooperative Research Program, *The Costs of Sprawl -- Revisited*, Washington, D.C.: National Academy Press, 1998. For a theoretical discussion of how property taxation contributes to urban sprawl, see Jan K. Brueckner, “Property Taxation and Urban Sprawl”, in in *Property Taxation and Local Government Finance*, edited by Wallace E. Oates (Cambridge, Mass.: Lincoln Institute of Land Policy, 2001), 153-175.

[48] For a detailed discussion, see Enid Slack, “Municipal Finance and the Pattern of Urban Growth”, *Commentary* (Toronto: D.D. Howe Institute, 2002).

[49] Malme and Youngman (2000), supra footnote 7, p. 15.

[50] Bird (2001), supra footnote 3.

f. Should limits be imposed on property tax rates?

The practice of imposing tax limits on municipal governments by a senior level of government is more prominent in some countries than in others. In the U.S., for example, thirty-two states impose limits on tax rates for local government.[51] In Canada, provincial governments do not place limits on municipal tax rates, although there has been a recent call for tax and expenditure limits in Canada.[52]

These limits are intended to control and restrict the growth in municipal government spending and hence, property taxation. Recent research on the success of these limits has addressed three main questions. First, have property tax limits reduced property tax revenues? Based on the evidence, the answer is yes. Property tax revenues have declined in constant dollars if not in current dollars. In California, proposition 13 led to an immediate decrease of about 45 percent. In Massachusetts, the initial impact was a decrease of 18 percent.[53] Overall in the U.S., it has been estimated that local property taxes per capita fell by 3 percent after tax limits were imposed.[54]

Second, have reductions in property tax revenues been offset by increases in other local revenues? The evidence here is not as compelling but it does indicate that other local revenue sources have generally been substituted for property tax decreases.[55] Greater reliance is now placed on local user fees, permits, licences, and so on.

Third, have property tax limits affected input choices (administrative staff versus service providers such as police officers and fire fighters) and quantities of output produced by local governments? The evidence here is mixed. Some studies found that local governments responded to tax limits by cutting proportionately more of their administrative costs while others found that local governments responded by cutting proportionately more of their service costs. Similar variation in results was noted for output. Some studies found that municipalities produced roughly the same quantity of services with less revenue while other studies noted that private sector provision had replaced public provision of local services.[56]

Property tax limits also have another major impact. They curtail the decision-making power of municipal governments if they reduce the municipal sector's flexibility and capacity to raise its own revenue. This is particularly worrisome if it means that municipalities cannot provide sufficient revenues to provide local public services that are desired or wanted by local citizens.

Analytical arguments supporting property tax limits for local governments are generally weak. Locally elected councils should be responsible for setting local property tax rates. They are in the best position to determine what citizens want and need. Furthermore, if these councils are unresponsive to local wishes, they are likely to be voted out of office at the next municipal election. As well, the comparatively large number of municipalities in every country means that local tax rates are set in a competitive environment; that is, every municipality is aware of its neighbouring jurisdiction's tax rates and unwilling to have its rate differ from its neighbours for fear of losing businesses[57] and

[51] O'Sullivan, supra footnote 10, p. 178.

[52] Jason Clemens, Todd Fox, Amela Karabegovic, Sylvia LeRoy, and Niels Veldhuis, (October 2003) *Tax and Expenditure Limitations: The Next Step in Fiscal Discipline*, Critical Issues Bulletin (Vancouver: The Fraser Institute).

[53] Ibid, p. 189-190.

[54] Ronald J. Shadbegian (1999), "The effect of tax and expenditure limitations on the revenue structure of local government, 1962-1987", *National Tax Journal*, vol. 52, No. 2, PP. 221-238.

[55] O'Sullivan, supra footnote 10, p 189-191.

[56] O'Sullivan, supra footnote 10, p 191-196.

[57] The literature tells us that property tax differentials play a role in intra-regional location decisions; hence, the reason why municipal governments compete with their neighbours to restrict property taxes. See discussion earlier in this paper.

people. This type of tax competition works to control tax rates and it permits the municipality to make its own spending and taxation decisions without the restrictive controls of a senior level of government. Finally, the implementation and use of municipal performance measures would be much more effective and efficient in controlling the spending behaviour of local governments than are tax limitations.[58]

g. Property tax billing and collection – who should do it?

Before property taxes may be collected, each taxing jurisdiction is generally responsible for preparing the tax role, establishing tax liability for each property (the tax bill), and ensuring that the tax bills are mailed to all property owners. In some countries, all of these functions are handled by the jurisdiction that sets the tax rate. In other countries, municipalities set their own tax rates with the remainder of the activities handled by another level of government (regional or state) or a private sector institution (banks, for example). To illustrate, the tax role is often prepared by a region/state/province wide agency (see discussion on assessment above); tax billing and collection are often done by the taxing jurisdiction but there is no reason why this need be the case. Tax billing and collection benefit from economies of scale[59] – hence, these two functions could be handled by a private sector institution or by a larger unit of government. In the province of Ontario in Canada, for example, all regional and county governments (upper tier) set their own taxes independently of the tax rates set by the local municipalities (lower tier). The local municipalities then send out combined tax bills and collect both upper and lower tier taxes. This practice has been around for years and has been fiercely defended in the face of proposals to migrate billing and collection to the upper tier in order to take advantage of economies of scale. Furthermore, billing and collection is an administrative function and has nothing to do with policy setting or decision-making; hence, mo reason why billing and collection needs to rest with the taxing jurisdiction that sets the tax rate.

h. Should property tax relief programs be implemented and if so, what program?

Property tax relief programs are intended to reduce the property tax burden on specific individuals in specific circumstances. Reliance on one or more of these programs is motivated by a perception that the property tax is regressive (takes proportionately more income from low income individuals than from high income individuals) – an issue that has been the subject of many studies and debates for a number of years without any firm conclusion or direction.[60] In spite of the uncertainty over whether or not the property tax is regressive, municipal governments and their senior counterparts in countries where a property tax is used almost always assume that it is regressive. This has produced a variety of programs including those described here. While this description concentrates on the Canadian schemes or potential schemes, it is indicative of those also used in other countries.

Property tax credits are used in five Canadian provinces (Quebec, Ontario, Manitoba, Alberta, and British Columbia). The credit is designed so that its value varies inversely with personal income tax liability; that is, as income tax liability increases, the value of the credit, which is subtracted from personal income taxes payable, declines.

One comprehensive analysis of the Ontario refundable property tax credit program suggested that the property tax credit is progressive in its impact on taxpayers; that is, it provides relatively greater benefits to low income households vis-a-

[58] For a discussion of performance measures, see Harry Kitchen (September, 2002), “Municipalities: Status and Responsibilities, Budgeting and Accounting”, a paper prepared for CEPRA I, pp. 51-56.

[59] W. Douglas Armstrong and Harry Kitchen (May, 1997), *Peterborough County/City Municipal Review: Final Report*, (Peterborough: Joint Restructuring Steering committee), pp. 125-127.

[60] For a discussion of these studies, see Kitchen (2002) supra footnote 28, ch. 5; Kitchen, (1992), supra footnote 12, ch. 6; and William Duncombe and John Yinger (2001), “Alternative Paths to Property Tax Relief”, in Oates (2001), supra footnote 10, pp. 243-194.

vis high income households.[61] A similar conclusion was noted some years later in a study completed for the Fair Tax Commission in Ontario.[62] While property tax credits are likely to be progressive, especially if they are refundable[63], they are not problem free. For example, residents pay their property taxes during the year, yet they do not receive the tax credit until their income tax return has been filed on or before April 30 of the following year. This practice can create liquidity problems for income-poor taxpayers because of the relatively long wait between payment of property taxes and receipt of the tax credit.

Furthermore, given the uncertainty over whether or not the property tax is regressive, the property tax credit could more appropriately be analyzed as part of the general income-transfer program in province, region or state and not as a credit specifically designed to offset property tax liability. Indeed, it is unlikely that many taxpayers see any link between property taxes paid and the ensuing tax credit. After all, the credit for property taxes paid in one year is not available until the income tax return is filed in the following year.

When it is considered as a component of the provincial income-transfer system, one could question whether the property tax credit, which is designed to provide more relief to those with more wealth (higher property values), generates the desired income redistributional results. To some, it may seem strange to have an income distribution system that provides more relief for taxpayers with more wealth.

In summary, uncertainty over regressivity of the property tax and the tendency to provide relief that varies directly with property values argues strongly in favour of eliminating property tax credits[64] and using other components of the state, region, or provincial government's income-transfer system to improve inequities in the overall distribution of income. Indeed, the analysis of the province of Ontario's property tax credit program referred to above concluded that it is "difficult to argue convincingly that the property tax credit system ... has been either terribly successful or terribly needed."[65]

Tax deferral programs are not widely used, although local governments in some countries have the power to implement them for specific taxpayers. As well, they are sometimes implemented by a more senior level of government. For example, in the province of British Columbia in Canada, a province-wide tax deferral program for senior citizens and handicapped individuals operates. As well, in the province of Ontario, a deferral scheme is mandatory for low-income seniors and the disabled to alleviate any tax burden arising from increased taxes due to reassessment.

Under a tax deferral program, the owner of the property is permitted to defer some or all of his/her property taxes on an annual basis. Depending on the program, the lost revenue will be made up from revenue provided by a senior level of government or from general revenues of the municipality itself. The amount of the tax deferred becomes a lien against the property and is payable to the senior level of government or the municipality when the property is transferred. As well, there is usually, but not always, an interest charge applied to the deferred taxes.

There are a number of implications arising from the use of tax deferral schemes. First, if one's ability to pay taxes is measured by a combination of income and wealth where the property tax is viewed as a proxy for a tax on

[61] R.M. Bird and N.E. Slack (1978), *Residential Property Tax Relief in Ontario*, Ontario Economic Research Council Studies (Toronto: University of Toronto Press).

[62] Ontario (1993), *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press in cooperation with the Ontario Fair Tax Commission), p. 644.

[63] When a tax credit exceeds tax liability, the tax is refundable if the government reimburses the taxpayer for this difference. It is non-refundable if the government does not refund this difference.

[64] Tax credits inversely related to ability to pay are supported as a means of redistributing income.

[65] Bird and Slack (1978), supra footnote 60, p. 120.

wealth, then a taxpayer who is asset rich but income poor could use this scheme to reduce his/her tax burden. In fact, tax deferral schemes can be especially useful in alleviating cash flow problems for income deficient taxpayers.

Second, and more critically, eligibility for most tax deferral programs is restricted by age (seniors) and sometimes, disability. While one may be critical of age or disability dependent eligibility requirements for any income transfer scheme, it may be administratively practical to impose restrictions of this sort. Otherwise, if this program were expanded to include everyone, there could be a significant increase in the number of applicants with the ensuing result that loans (tax deferrals plus interest charges on them) would be outstanding for a much longer period of time. According to some municipal officials, this would be administratively more complicated and costly.[66]

Grants, designed to remove some of the property tax burden, are provided to eligible homeowner's and/or renters in some countries. The value of the grant usually varies inversely with income and/or is given according to whether or not potential recipients are elderly or in receipt of welfare assistance. In the province of New Brunswick in Canada, for example, grants are the only property tax credit scheme while in other provinces (Alberta and Manitoba to name two), grants are used in conjunction with tax credits. In British Columbia and Ontario, tax credits, deferrals and grants are used for various purposes.

As a mechanism for transferring income, the grant should be evaluated in the same way as any other component of the overall provincial income-transfer scheme. By comparison with current property tax credit schemes, the disbursement of grants could be more directly linked with the payment of or reduction in property tax liability. As well, it is frequently easier to direct grants to specific individuals especially in smaller communities where hardship cases are more quickly identified, even though it may be more complex administratively to operate than the tax credit program.

Exempting individuals from property taxes as is done for certain taxpayers under specific circumstances in the provinces of Newfoundland and Nova Scotia in Canada effectively removes the burden of funding local services from these taxpayers and shifts the costs on to other taxpayers. This differs from grants in that the individuals do not receive actual cash payments from the province but its impact is similar to that where grants, reductions, cancellations or refunds completely offset property tax payments. Exempting property differs from tax deferrals in that taxes are simply postponed under the latter scheme while they are not payable under the former.

Where the exemption is available to people over a certain age only (senior citizens, for example), these exemptions, as a tax relief measure, may be deficient because they fail to consider the ability of the recipient to pay taxes. Similar deficiencies may exist where the criteria for exempting property for owner-occupiers is based strictly on taxpayer's income and ignores property values.

Reducing, cancelling or refunding property taxes is generally associated with special circumstances, usually with poverty or illness. These programs last for one year and taxpayers are required to apply for them annually. The lost revenues are absorbed out of general municipal revenues. These programs are used infrequently and appear to operate more appropriately in smaller municipalities where it is easier to identify worthy recipients.

Assessment credits are not used as widely as the other programs but they have been suggested as a possible mechanism for relieving the property tax burden on residential properties.[67] This scheme involves the removal of

[66] Enid Slack (1989), *An Analysis of Property Tax Relief Measures and Phase-in Mechanisms*, a Report prepared for the Task Force on Reassessment in Metropolitan Toronto (mimeograph, Toronto).

[67] For a discussion of this topic, see Metropolitan Toronto Advisory Task Force on Assessment

a fixed amount (determined by the local council) of market value assessment from property taxation. It works quite simply. After all properties are assessed at market value, a fixed amount of assessment is deducted form the total assessed value.[68] Use of assessment credits applied to each piece of property would convert the property tax into a progressive tax rate. While this may appear to have merit on the surface, it would be a suspect device unless all properties owned by any particular individual were aggregated. Use of assessment credits would also result in a reduced assessment base overall. When compared with the system before the assessment credit is introduced, an equivalent amount of property tax dollars would be generated, then, through the imposition of higher property tax rates. For those properties with relatively low assessed values, the value of the assessment exemption would offset the higher tax rates and these taxpayers would be better off financially. For properties with relatively high values, the higher tax rates would more than offset the taxes saved from the availability of the assessment credit and these taxpayers would be worse off financially. As a relief mechanism, the assessment credit, which is the same dollar value for all residential property owners, is deficient because it is based on the assessed value of property and not on the property owner's total ability to pay.[69]

Summary: While tax relief for people who are deemed to have insufficient ability to pay is an important policy objective of governments, there is some question whether local governments ought to be using property tax relief instruments for income redistribution purposes. There are at least three objections to these instruments at the municipal level. First, the available evidence is not conclusive on whether or not the property tax is regressive. If it is not regressive, there is little basis for providing relief to reduce any alleged regressivity.

Second, if the tax is considered as a tax on one component of wealth (namely, property values), there may be limited support for granting property tax relief on the basis of the taxpayers income. In other words, if some recipients are asset rich and income poor, the real issue is whether people with significant assets should get relief from property tax payments, under any circumstances. Third, if taxpayers are not required to pay for local services they use, there is every incentive for them to demand larger quantities than is allocatively efficient.

Briefly, then, greater dependence on province-wide, region-wide, state-wide or nation-wide income-transfer schemes could more appropriately handle the income distribution issue (greater over-all equity in the tax system based on ability to pay) while greater use of tax deferral schemes could handle the liquidity problem for asset wealthy homeowners.

D. Comments on Property Tax System in Russia

This discussion may be separated into two parts. The first part describes the existing system and proposed changes to it. The second part summarizes this paper by highlighting what could be done to improve the Russian property tax system.

D.1 Existing and Proposed System

Federal legislation in Russia permits local government to use specific taxes.[70] This includes a tax on land with municipalities having no control over the tax base and limited control over the tax rate. The latter is set within a narrow range established by the federal and regional governments.

Local governments are also authorized to levy individual property taxes. These apply to structures (houses, apartments, dachas, garages, and other buildings) owned by people and to

Reform (1987), *Report of the Sub-Committee on Implementation Mechanisms* (Toronto: The Task Force).

[68] This is similar to allowing personal income tax exemptions in a personal income tax system.

[69] Slack (1989), supra footnote 65, pp. 16-17.

[70] For a more detailed discussion, see Andrey Timofeev (2002) "Land and Property Taxes in Russia", mimeograph,

motorboats, aircraft, and other vehicles except automobiles, motorcycles and other self-propelled vehicles. Tax rates may vary by type of structure with the rates set by local governments but subject to (low) maximum federal limits. For vehicles, the tax is levied according to engine power.

The enterprise property tax applies to the annual average balance sheet value of assets (fixed, intangible, and inventories) of legal entities. Assets used for agricultural production are exempted from property taxation. Rates are set by regional legislatures and can vary by type of producing asset. The maximum tax rate is 2 percent with tax revenues being spilt between regional and local governments.

Tax reform has been on the agenda of the federal parliament in Russia since 1999. As part of this reform package, the draft *Tax Code* provides for the introduction of a western style real estate tax at the regional level with all revenues shared with local governments. Once enacted, this tax is intended to replace the three existing property taxes – land tax, individual property tax, and enterprise property tax.

D.2 Summary

From the discussion in this paper, it is apparent that the most efficient, uniform, accountable and transparent municipal property tax systems around the world exist where the following conditions are met.

- All taxable properties are identified, described and recorded on the assessment roll.
- The property tax base, whether assessed value or area value, is determined in a uniform and consistent manner across a region (as opposed to local) if not across an entire country.
- Assessment is updated as frequently as possible, ideally on an annual basis, so that the tax base is current, uniform, consistent and fair.
- Property assessment (determination of property values or property area) is the responsibility of an arms-length regional assessment authority in order to avoid local distortions created by local pressure groups.
- Each level of government using property tax revenues to fund expenditures is responsible for setting its own property tax rate(s).
- Variable tax rates are used when the cost of providing municipal services varies by property type and location.
- Variable rates, as opposed to a uniform rate, are more likely to discourage urban sprawl and to minimize the extent to which the local property tax is exported to other jurisdictions.
- Business properties (commercial and industrial) are not over taxed vis-à-vis residential properties.
- Limits (by a senior level of government) are not imposed on tax rates set by local governments unless it is to prevent local taxing authorities from imposing unnecessarily high rates on commercial and industrial properties vis-à-vis residential properties.
- The existence of a large number of municipalities in a region or country creates a competitive environment (where municipalities know what the tax rates are in neighbouring communities) that provides an incentive for all competing municipalities to set their tax rate at the lowest possible level.
- Tax billing and collection is an administrative function that benefits from economies of scale and should, therefore, be administered on a regional basis.
- Caution should be exercised in creating specific property tax relief schemes – a better approach comes from implementing a comprehensive tax relief scheme administered by the regional or central government.