Urban Property Taxation: Some Reflections for China

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The Questions

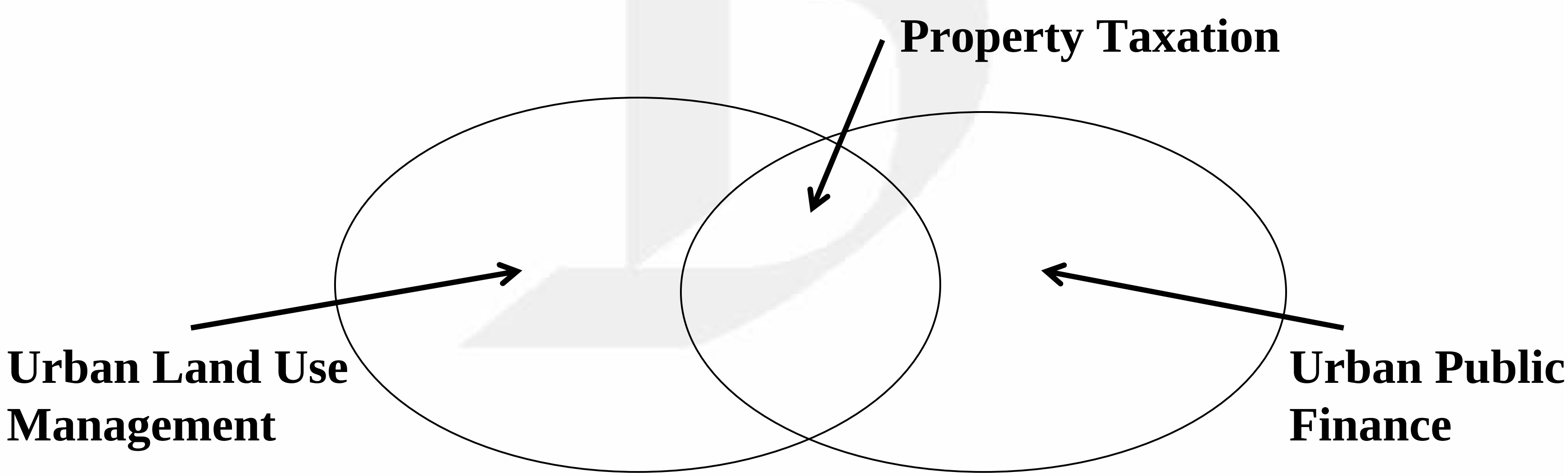
1. How important is revenue from property taxation in urban public finance around the world?
2. What are the pros and cons of property transfer taxes versus other property taxes?
3. Which type of property tax suits China best?
4. How best to handle transition issues in property tax reform?

Overview

1. The context: Links between urban land use management and property taxation
2. Some basic aspects of, and experiences with, urban property taxation
3. Pros and cons of property transfer taxation versus capital value taxes, in general and for China
4. Managing the transition in property tax reform
5. Some tentative conclusions

1. The Context: Links between Urban Land Use Management and Property Taxation

- **China has been facing a challenge of rapid urbanization.**
- **At heart of managing urban growth is the nexus between urban land use management and urban public finance.**
- **Property taxation lies at the intersection between urban land use management and urban public finance..**



Urban Land Use Management

- Land is the scarce factor of production in cities (aggravated in China by a perceived scarcity of agricultural land).
- Effective management of urban land is key to efficient and equitable growth of cities.
- This in turn requires that there is "a coherent system of land use regulations, infrastructure investments and land related taxes." (Bertaud and Malpezzi, 2004)

Urban Public Finance

- "China has the rare chance to 'get it right' by establishing the rules of urban finance in an economically rational way." (Bird, 2004)
- This requires clear, effective decentralization of expenditure responsibility and revenue authority to city governments.
- The main potential local revenue sources are: user charges for urban services, property taxation, automotive taxes, and transfers.
- Big cities should be mostly self-financing.

Property Taxation is at the Core

- Property taxes result in incentives that affect urban land use and land prices directly.
- Property taxes finance physical and social infrastructure services, which in turn affect land use and whose benefits are capitalized into property values and hence the property tax base.
- As “benefit taxes” property taxes are a good financing tool for decentralized, transparent, accountable and equitable urban government.
- An effective urban land registry (cadastre) is essential for urban land management and property taxation.

2. Some Basic Aspects of, and Experiences with, Urban Property Taxation

- <u>The basic types of property taxation</u>: annual value tax, capital value tax (CVT), site value tax, property transfer tax, land value increment tax → the world is moving to the CVT
- <u>Basic elements of property tax policy and administration</u>: base selection, identification of property, valuation, rate setting, collection and record keeping → a systemic approach is needed.

Some Tough Choices in Property Tax Policy and Administration

- <u>Tax base</u>: there are pros and cons for each option → a tough tradeoff which depends on country/city conditions, policy objectives and may change with time.
- <u>Identification</u>: often difficult with unclear property rights, demarcation, and titles.
- <u>Valuation</u>: difficult in practice, but a good cadastre has important benefits for land use planning, land and financial market development, other taxes.
- <u>Rate setting</u>: uniform or differentiated? flat or progressive? how high, how low?
- <u>Collection</u>: in personam or in rem? how to enforce?
- <u>Record keeping</u>: consistent records are essential!

The Role of Property Taxes in Raising Revenues

Property taxes are not necessarily a gold mine, and require hard work and patience:

- They're a small source of taxes at the country-level (0.4% of GDP and 2% of total taxes in developing countries (DCs), 1% and 4% for OECD)
- They're an important subnational revenue source (20% in DCs, 40% of DC subnational taxes; 18% and 35% for OECD)
- Property tax revenues increase with urbanization and incomes (Bird and Slack, 2002), decentral-ization and lower transfers (Bahl and Linn, 1992)
- Tax rates, assessment and collection ratios are low in developing countries (Bahl and Linn, 1992)

Subnational Property Tax as Share of GDP
(percent)

	1970's	1980's	1990's
OECD Countries (number of countries)	1.24 (16)	1.31 (18)	1.44 (16)
Developing Countries (number of countries)	0.42 (20)	0.36 (27)	0.42 (23)
Transition Countries (number of countries)	0.34 (1)	0.59 (4)	0.54 (20)
All Countries (number of countries)	0.77 (37)	0.73 (49)	0.75 (58)

***Source*: Roy Bahl, " The Property Tax in Developing Countries: Where are we in 2002?"**
Land Lines (Lincoln Institute of Land Policy, Cambridge, MA, 2002. Calculated from data in IMF, *Government Finance Statistics Yearbook, 2001;*
Quoted in Bird and Slack, 2002

Subnational Property Tax as Share of Subnational Revenue

(percent)

	1970's	1980's	1990's
OECD Countries (number of countries)	17.4 (16)	17.0 (17)	17.9 (16)
Developing Countries (number of countries)	27.6 (21)	24.3 (27)	19.1 (24)
Transition Countries (number of countries)	6.7 (1)	8.51 (4)	8.8 (20)
All Countries (number of countries)	22.8 (38)	20.4 (48)	15.6 (59)

***Source*: Calculated by Roy Bahl and Bayar Tumennasan, Andrew Young School of Public Policy, Georgia State University, from data in IMF** *Government Finance Statistics Yearbook, 2001*
Quoted in Bird and Slack, 2002

3. Pros and Cons of Property Transfer Taxation versus Capital Value Tax

<u>Property transfer tax</u>

- Pros: relatively easy to assess, collect; may help reduce land prices
- Cons: owner has incentive to hold property off market, understate sales price; limited tax base requires high rates

<u>Capital Value Tax</u>

- Pros: large tax base keeps rates and hence distortions down; reduces land prices; reflects benefits of changing urban services over time
- Cons: difficult to administer; may delay development

China: Taxing Land Conversion?

"First tier land market" involves the sale of land use rights (for 40-70 years) to private parties on conversion of public land from rural to urban use

- Private "purchaser" should pay for the use right based on its market value (this is not a tax!).
- Public "seller" (rural collective?) should receive that payment.
- Farmers that had previously the use right should be indemnified at least at fair rural use value.
- There is no need for a transfer tax or "fees."
- Urban government should charge a property tax on all urban land reflecting the cost/value of public services provided.

China: Some Possible Issues with Land Conversion

- With tight control over expansion of urban land, scarcity premium on urban land can result in large financial gains as conversions are selectively allowed. (This is not uncommon also in Europe.)
- Property tax will reduce this premium since it lowers the market value of the urban use right by reducing expected future earnings stream.
- Transparent, competitive, arms-length process of sale at conversion is essential.
- Two tracks of conversion (administrative transfer v. first tier land market sale) may cause problems of arbitrage/corruption.

China: Some Possible Issues with Urban Property Taxation

- Capital value tax may be difficult to levy on a use-right that is limited in time, since its value will progressively decline to zero at expiration.
- Therefore, an annual value tax on presumptive income/rent may be preferable (as in some other countries with predominant lease hold property rights).
- It will be important to clarify early what procedures will be followed to renew use-rights upon expiration, with a clear distinction drawn between the price of use-right renewal and the recurrent property tax before and after renewal.

4. Managing the Transition in Property Tax Reform

- Start early: obligation of tax should be clear to use-right holder when acquiring it
- Start simple and keep it simple (undifferentiated, flat rates; no or few exemptions; uniform valuation).
- Apply the Chinese two-track approach in phasing out the old and bringing in the new ("grandfathering" acquired rights is one option).
- Experiment with pilots (*a la* cities of Novgorod, Tver in Russia).
- Take a systemic approach, and be sure to invest in a good cadastre (land registration, etc.).
- Educate the public on the new system and its rationale.

5. Some Tentative Conclusions

- Property taxation has a potentially important role to play in financing the growth of self-reliant, efficient and equitable cities in China.
- The approach to property tax reform should be experimental, gradual, adaptive to the country's special circumstances – in short, it should be "Chinese style."
- Invest early in a high-quality, transparent cadastre.
- An early review/revision of the "tier-one land market" conversion process is advisable.

Thank you!