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**REAL PROPERTY TAXATION AND INEQUALITY**

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## **REAL PROPERTY TAXATION AND INEQUALITY**

### **1.0 BACKGROUND**

Very few countries, outside industrial Anglophone countries, raise significant amount of tax revenue from real property taxes despite their theoretical appeal in terms of efficiency. In that regard it is widely recommended that property taxes may represent the best choice as source of steady revenue, in particular, at the local government level. This is further enhanced by the need by these countries to find ways to maximize domestic resource mobilization in this time of global economic financial turbulence. However, property tax on the other hand is regarded as regressive tax and may become a source of unfair taxation, hence inequitable. The levels of collecting real property taxes by governments differ world-wide. In some countries, especially the Eastern European countries, the tax is collected by national governments while in most other countries including the majority of developing countries; property tax is collected by local governments.

The vivid advantages of property tax are:

- Most important autonomous revenue source of local governments.
- Can provide access to broad and expanding tax base.
- Compared to indirect taxes and grants, it promotes broader efficiency aspects and is easy to administer, as it is highly visible, thereby ensuring accountability and transparency.
- The property tax relevance as appropriate local tax includes the following:
  - ✓ Satisfies theoretical requirements of a local tax- which are; immobility and non-exploitative since it cannot be moved and fair as long as it is

used to finance public services that reflect the need of local communities.

- ✓ Properties are primary source of storing accumulated wealth, hence a clear indicator of wealth.
- ✓ Real property is visible and immobile, and therefore easy to administer.
- ✓ Space-specific and not subject to fluctuations.
- ✓ Most appropriate tax for generating local revenues.
- ✓ Provides realistic and stable revenue base/flows.

## **2.0 REAL PROPERTY TAX, ITS DETERMINATION AND TAX UNIT**

Real Property for the purposes of taxation is defined as land and permanent structures (developments) attached to it and it is based on the value of real property. Real property includes land and buildings.

The kind of properties assessed to the Real Property Tax is the parcel of real property in an assessing unit no matter how big or small the unit assessed. Though all real properties in an assessing unit are assessed in terms of determination of taxable value among others, not all of it is taxable. Some real properties, such as religious or government-owned properties are completely exempt from paying property taxes.

The amount of Real Property Tax is determined by two things; the properties assessment (valuation) and the tax rates of the taxing jurisdiction in which the property is located. For example, the use of flat rate system which introduces the number of adjustments –differentiating the flat rate by size, building use and location.

While public attention to Real Property Taxes is usually focused on the tax paid by real properties owners, Real Property taxes also affect taxpayers who rent, rather than own properties, who ultimately pay the property taxes levied on rental properties imputed. Some economists believe that real property taxation is mostly borne by the landlords who own those properties. Others argue that it is mostly passed over to tenants in the form of higher rents. It is generally agreed that the answer partially depends on the rental property market. When residential rental property is in short supply, landlords are more likely to pass their real property tax over to the tenants in the form of higher rents. But if rental property is abundant, landlords may find this more difficult; hence bear the whole or part of the tax. The matter is confused further as many rental units markets cross municipal boundaries so that taxes may vary on rental units in different parts of the market. Hence, landlords in higher tax jurisdictions cannot simply raise rent to pay their property tax if they have to compete with apartments in nearby lower tax jurisdictions.

### **3.0 ARGUMENTS IN FAVOR OF REAL PROPERTY TAXATION**

Although the personal income tax is best suited to fulfill the “the ability to pay principle” the Real Property tax is considered best suited tax and is known as containing a number of basic and positive characteristics. In particular, it also fulfills the “ability to pay principle” by taxing those people with large quantities of wealth more heavily than those without such accumulation of wealth. As such, property tax is rooted in the “benefit principle of taxation”. It is further perceived that real property tax based on the value of land and buildings (immovable assets), is stable and easily enforceable hence a legitimate target for taxation. Consequent upon this characteristic, real property tax is recommended as being among the best options available for providing additional source of revenue particularly those required to finance the local governments.

#### **4.0 HORIZONTAL AND VERTICAL EQUITY IN REAL PROPERTY TAXATION**

Equity is one of the fundamental criteria used by public finance experts to evaluate individual taxes and tax systems. Most taxpayers and policy makers consider equity or fairness to be extremely important. However, equity is an inherently subjective concept with individual and societal perceptions of what constitutes tax fairness changing over time. For tax policy makers, most of this debate revolves around vertical equity, which refers to how taxpayers with differing ability to pay are treated by the tax system. Most agree that higher income or wealthier individuals should contribute more in taxes than those with lesser ability to pay, but how much more, is often the subject of fierce public debate. Horizontal equity, on the other hand, is generally less controversial. Horizontal equity means that equals are treated equally under the tax system, or those with the same ability to pay, pay the same amount of taxes.

Theoretically, property tax is a wealth-based tax with the value of property (usually restricted to real estate property) serving as the tax base or measure of ability to pay. This implies that under a horizontally equitable property tax, taxpayers with equally valued property pay the same amount of taxes. The implicit assumption is that real market value is the appropriate measure of wealth because it reflects the amount that the owner would receive if the property was liquidated or sold.

#### **5.0 REAL PROPERTY TAX AND FAIRNESS**

When compared to other taxes, such as sales or value added tax and excise taxes which are considered most regressive taxes, they are rarely maligned as the real property tax. The “sticker shock” effect of property tax is partly to blame on this: it is a large, very noticeable payment that is made once or twice a year, while sales tax or value added tax is spread throughout the year on hundreds of purchases. The property tax can seem more oppressive and more unfair than actually is, simply because it is more visible.

That said, there is no denying that property tax is generally regressive. The main reason being that it is based on property value rather than income levels- and real property values do not always vary directly with income levels. Real property values represent a much larger share of income for middle and lower income families than for wealthy ones. It is common for a middle-income family to own a home valued at two or three times their annual income. Examples of unfairness, hence inequities in property taxation include such circumstances as the ones listed below:

- Property tax is payable once or twice a year hence largely noticeable payment, the amount is usually paid on lump sum as opposed to other taxes that are paid on monthly or quarterly basis
- Property taxes are based on property values rather than on income levels and property values do not always vary directly with income levels. That is, it is common for a middle income family to own a property valued at two or three times their annual incomes
- Property taxes are not responsive to variation in taxpayers income, for example for one who loses a job will find that his property bill is generally unchanged even though his ability to pay has dramatically fallen
- Elderly taxpayers at the end of their working careers who find themselves “property rich but income poor “are not considered
- Value of property, in particular land or building is not an excellent measure of one’s wealth, because wealth might be held in other forms, e.g. Stock bonds, Shares, which are not taxed until when realized.
- Collectability; tax payment problem where one has no income, but has properties which have to be taxed.

## **6.0 REAL PROPERTY TAX AND LOCAL GOVERNMENT REVENUE**

Based on Tanzanian Experience, (Para 7.0) Real Property has some attractions as a local revenue base since it is imposed on immobile assets and therefore, difficult to avoid - at least in principle. However, it also has some obvious

weaknesses which need to be taken into consideration before heavy reliance is placed on it. For instance, problems of valuation and tax enforcement often occur due to political interventions and administrative weaknesses. Furthermore, harsh enforcement mechanisms may result in intervention from politicians facing complaints from their constituencies. Hence, experience advocates cautiousness when extending real property tax to local government. A fundamental requirement when designing a local tax system is to put greater emphasis on the cost-effectiveness of revenue collection, taking into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. In addition to this, collection of property tax by local governments is strongly supported by the following factors:

- As a result of limited revenue base by local governments, taxing property may provide a useful source of revenue to local governments.
- It is important that local governments are vested with the power to collect property tax in order to enhance their accountability to the local community.
- The need to improve fiscal autonomy of the local governments since local taxes are an important source to them hence the need to have own source of revenue. We should bear in mind that following decentralization by most governments that have seen central governments transfer certain powers and responsibilities to lower level governments, the need to fiscally empower these governments cannot be overemphasized.

## **7.0 REAL PROPERTY TAXATION, TANZANIAN EXPERIENCE:**

### **7.1 History of Real Property Taxation in Tanzania**

The imposition of property tax in the United Republic of Tanzania goes back to the colonial period when various forms of hut and house taxes were levied. Today, powers to levy property taxes are provided under the Local Government Finances Act of 1982. Nevertheless, it is the Urban

Authorities (Rating) Act of 1983 which sets out the modalities for the rating exercise itself.

## **7.2 Legal framework**

**7.2.1** Under the Local Government Finances Act of 1982, a local government may levy flat rate Real Property tax through issuing of local by-laws which must be approved by the Minister responsible for the local government administration. In its simplest form, the flat rate property tax system would apply a single tax amount to be paid on each ratable building. The rating system although simple to administer would create inequity given the differences in size, location, and the value of properties within a jurisdiction. The flat rate system is used in Tanzania for buildings that are not yet valued. The flat rate system has evolved to introduce a number of adjustments which differentiate the flat rate by size, property use and location of property. In addition to flat rate, the local government, with the approval of the responsible Minister, may levy a special rate (betterment tax) to cover the costs of special capital work schemes, such as layout and construction of new streets, upgrading sidewalks or increasing the value of land by actions other than those of landlords, which benefits the owner of the property.

**7.2.2** The Urban Authority (Rating) Act of 1983 stipulates that all properties should be valued according to the open market value of the property or where the market value cannot be ascertained, the replacement cost of the building, structure, and other developments adjusted for depreciation. In Tanzania Real Property tax is applied to buildings only, categorized into four basic groups:



- Residential,
- Commercial,
- Industrial and
- Hotels.

Within each category there are three sub-categories of building types, e.g. Commercial properties, such as Business office buildings, banks, Retail stores, Shops, Petrol stations etc. may be categorized as , Category A; Constructed to very high standard of fittings and finishes.. Category B; Constructed to acceptable standards; Category C, Single storey, constructed to average or poor specification, each within an established range of costs per square meter. In addition, a separate category is established for site works with a percentage of adjustment to be applied to the basic cost figure. There are three percentage adjustments, namely 0, 5, and 10 percent, depending on the quality of the site works. Also, four depreciation adjustments ranging from 0 to 25 are prescribed depending on the physical condition, functional obsolescence, and remaining economic life of the property. The law further provides allowable depreciation rate of 25 per cent.

In Tanzania, land is not taxed under the property rating system both in the rural and urban areas because it belongs to the State, except for land rent collected by the Central Government. Exemption to tax is granted to a property personally occupied by the President, properties used for public utilities or public worship, public libraries and museums, cemeteries and crematoria, civil and military airdromes, sporting facilities, railway properties and any such properties as prescribed by the Minister responsible for Local Authorities to be tax exempt.

### **7.3 Problems affecting Real Property Tax administration in Tanzania and its impact on equity:**

#### **7.3.1 Inconsistency in valuation/assessment of properties**

However, due to various factors the property tax system in Tanzania is affected by a number of problems particularly,

- The inconsistency in valuation/assessment of properties, such as failure to maintain the valuation and revaluation on time schedule and use of different valuation methods,
- Time lag between valuations,
- Lack of effective statutory rates of property tax, and use of arbitrary flat rate and adjustments which do not consider the altered values and costs of benefits granted,
- Overall inadequate property tax administration.

The combination of these factors becomes and creates inequities in the country's property taxation system. For the property rate to be effective it requires a proper valuation system. This is a very key ingredient to both horizontal and vertical equity considerations.

For lack of properly valued properties, people feel inequitable burden distribution resulting from inability by the property tax administrators to have all the properties valued so that the rates are based on assessed retable values. Under the current system, some properties are taxed based on valuation rolls, and others on flat rate. It is also common to find properties of different sizes and quality subjected to same rate. This is because properties are not valued and are subjected to flat rate based on incomplete information provided by valuers who actually have not carried out actual valuation. Thus it is a challenge that all properties are properly and timely valued and assessed. This in turn creates equitable, fair and uniform assessment factors which are prerequisites of the tax equity cardinal. The system of valuation is a

challenging area in Tanzania, notably, due to lack of sufficient financial resources and enough valuers to perform valuation, leaving a lot of property unvalued at all or valued after a passage of a long time. The result of this being failure to achieve horizontal equity where equals are treated equally.

### **7.3.2 Time lag in Valuation**

The property tax law in Tanzania requires that revaluation of properties be undertaken after every five years. During this exercise, it is envisaged that all properties listed in the existing valuation rolls would be re-assessed to depict the correct market value as well as the additional value due to various improvements on those properties. This is not what is exactly happening on the ground, as the revaluation is not undertaken in time, and new constructions and improvement are missing in the existing valuation rolls, resulting into most of assessed properties paying rates below their proportionate amounts relative to their market value leading to vertical inequities in our property tax system. As it is now, most properties values are always not reconciling between taxable and market values. Long time lag in valuation also not only causes inequity in property taxation, but is equally a big source of revenue leakage which negatively impacts the revenue collected from source.

### **7.3.3 Unrealistic Tax rates**

Consideration of effective tax structure in property taxation is very essential. In most cases local authorities tend to set tax rates that are unrealistically low and have little regard to the actual cost of valuation and other areas of administration. In addition, minimum and maximum taxes for particular classes or sectors of properties are inappropriately set.

For example, owner-occupied property is often under-taxed. The policy rationale for this form of a special tax treatment is not always clear and in many ways not sustainable, given that owner-occupiers would tend to have higher income and wealth profiles than tenants. If nominal tax rates remain at low levels then any gains realized in terms of new valuations, supplementary rolls and revaluations can well be negated, as the improvements will have little revenue impact in real terms. For example, it is quite normal to tax commercial and industrial properties at a higher rate than, for example, residential properties. The tax rates should reflect the fact that commercial and industrial properties are intensive users of local government services than residential property owners should pay more. A further argument in taxing such sectors is the legal right for the owners of commercial/industrial enterprises to offset property taxes as a legitimate business expense for purposes of calculating income tax liability.

#### **7.3.4 Untapped/not registered Properties**

Inequitable property taxation is also found experienced through taxing of properties which have been identified. The identified properties comprise those captured in the valuation roll and other local government registers. Property owners whose properties have not been identified and registered safely escape the property taxation. In spite of the fact Tanzania is experiencing rapid urban growth among its cities and towns; the growth has always not matched the property valuation rolls, neither is the pace for valuation of new properties kept pace with the urban expansions. As a result of the increase in number of unregistered properties, the property taxation coverage base is very low since a good number of properties remain unregistered, leading to a large amount of untapped property tax potential. This problem besides creating discrimination among payers it is also a source of lost revenue.

For example, Dar es Salaam Region which has three Municipal Councils of Ilala, Kinondoni and Temeke, property valuation Report made by a team of Property valuation firms in March 2011, showed that out of 572,405 properties, only 330,928 properties were valued equivalent to 58% of all taxable properties.

Distribution of taxable properties in Dar-es-salaam

<b>Zone</b>	<b>Estimated No of Properties</b>	<b>Valued</b>	<b>Not Valued</b>	<b>Valued Total</b>
Temeke A	116,301	48,108	68,193	41%
Temeke B	53,628	65,682	7,622	123%
Kinondoni A	160,096	104,531	68,868	65%
Kinondoni B	101,650	58,756	42,894	58%
Ilala	140,740	53,851	86,889	38%
<b>Total</b>	<b>572,405</b>	<b>330,928</b>	<b>241,477</b>	<b>58%</b>

Source Prime Minister's Office Report

### **7.3.5 Inadequate property tax administration system**

An effective property tax system is considered necessary in addressing issues pertaining to a country's property tax policy. Administration of property tax should address such issues like realistic tax rates, appropriate exemption and relief measures, as well as assessment and revaluation frequencies which are key features of any property tax administration system. Because of inadequacies in property tax administration, it is always common to find delinquent taxpayers left unpunished or least punished. Because of this, compliant taxpayers feel unfairly treated as they do not see the reasons why they should pay tax while others are not paying and go scotch free.

In an ideal situation, real property tax administration should ensure a uniform, fair, transparent and rational taxation of real property and provision of expected Local authority services like better roads, water supply and waste collection which will enhance compliance

The principles of an adequate property tax administration system are:-

- Regardless of ownership, all property shall be taxed.
- In principle, taxable persons shall be the owners of real property.
- The revenue from real property shall remain with the local government authorities.
- The method for tax base (i.e. market value) determination shall be uniform.
- Tax rates shall be realistic.

In Tanzania the main problems are:

- exemptions from payment of the property rate by certain owners
- different methods for determination of tax base between valued
- flat rate (unvalued) properties, late service of tax bills
- Low compliance in general.

The above problems significantly contribute to inequity in property taxation. In order to address the inequity in the property tax we intend to focus on the following:

### **Taxpayer Education:**

The eventual taxpayers must be kept well informed of their likely liability, rights and obligations.

### **Sustainability**

Must develop a property tax systems and administrative procedures that are sustainable overtime

### **Capacity building and capability**

There is need to build capacity and capability of the tax administrators including the people working in the properties valuation.

### **Realistic tax rates**

Consideration should be given to the tax rate structure such that the rates are realistic.

### **Valuation and collection**

These should be the two main driving forces within a property tax administrative system. Correct and timely valuation will ensure maximum tax base, whereas realistic tax rate will maximize revenue collection within the jurisdiction.

### **The need for Information and Communication technology**

Use of Information Technology in keeping taxpayers records, valuation rolls, issue of tax assessments, collection and accounting for taxes and property information data base should be emphasized and encouraged.

### **7.3.6 Mismanagement of exemption and reliefs**

Lack of transparency in terms of proper procedures and basis for providing property tax exemptions and reliefs to eligible persons also cause dissatisfaction among the paying public. There have been instances where ineligible property owners have been exempted from payment of property taxes. This arises where property owners apply for relief and exemption on pretext of inability to pay, but the fact is that applicant are in

fact well-to-do people and are not supposed to receive any relief from payment of real property tax.

## **7.4 REAL PROPERTY TAX REVENUE USE AND IMPACT ON COMPLIANCE**

### **7.4.1 Property Tax Revenue Use**

Property taxes are in principle a very appropriate local government's revenue source owing to the linkage between services funded at the local government level and property taxes. In real situation, property tax is like a benefit tax because the taxes approximate the benefits received from local government services. To the extent that this is the case, property taxes administered by local governments finance the services provided and promote tax compliance.

The general duties and functions of local government authorities include the following:

- Maintenance of law, order and good governance;
- Promotion of social and economic welfare and well being of all persons in their areas.
- Furtherance of economic and social development in their areas.
- Effective collection and proper utilization of resources.
- Implementation of national and local policies.
- Consideration, regulation and coordination of development plans, projects and programs so as to ensure more beneficial development and mobilization of productive resources to combat poverty, diseases and ignorance and for the improvement of agriculture, trade and industry.



**Water and Sanitation:**

The Central Government agencies are responsible for the provision of water and sanitation in planned areas of towns. Local governments receive subventions from the Central Government for implementing water and sanitation programmes in peripheral urban areas but the services in almost all the local government authorities are not always satisfactory due to inadequacy of resources.

**Roads:**

Local Authorities are responsible for management of district urban and feeder roads from Roads Fund collections made by the Central Government. In addition to the Roads Fund, local Authorities use their own resources to develop and maintain roads. However, resources available are too little compared to the enormous task. This leaves roads poor state in many areas.

**Education:**

Provision of primary education is the responsibility of local Governments with funds from the Central Government. Local Governments are responsible for the provision of schools' infrastructure and maintenance, books and stationary. General observations indicate that there is inadequate physical infrastructure, human resource, books and stationary. Local Governments in Tanzania have insufficient resources to invest in education.

**Health:**

Local governments are also responsible for the provision of health services at the district hospitals, health centres and dispensaries levels including construction and maintenance of infrastructure. There is noted lack of good and adequate infrastructure and drugs.

### **Waste Management:**

Local governments are equally responsible for management of liquid and solid waste collection that originate from various sources such as households, industrial and business premises. Due to limited resources they cannot adequately undertake the management of wastes and create a safer environment.

### **7.4.2 Services Provision Impact On Real Property Tax Compliance:**

Voluntary compliance on property tax administered by local government authorities in Tanzania is generally low. Property tax compliance was high under the Dar es Salaam City Commission era when the revenue collection and provision of social services were under Urban Sector Reform Program a donor funded project which was not sustained after its expiry period. However, the current service levels are straining voluntary compliance because many people are not happy with the infrastructure and services provided in their areas.

Taxpayers also suspect that the local tax revenue is misused or diverted to other activities that are not of benefit to them. They claim that they receive very little in return for what they pay. This in turn results into resistance to pay the taxes.

## **8.0 CONCLUSION**

Although Real Property tax is seen as the most important autonomous revenue source of most local governments across the world it is highly under-utilized in most local governments. Also little emphasis is put in real property tax collection by most central governments besides the glaring fact that it is a good and stable source of revenue and a vital component in their resource mobilization strategy. As a mainstay of local finance source of revenue real property Taxes are besieged by a host of problems in developing countries; they suffer from low yield and stagnancy and inconsistently, growing at a lower rate than central

government revenues. Developing countries' local governments have to address the problem of loss of property tax revenue due to low assessed values or non-valuation of properties, wide scope of discretion in assessments, need to eliminate inequities, reciprocate benefits, i.e., provision of social services vs. tax paid, gross disparities in tax assessments and inordinate high tax rates to compensate for narrow base which induce evasion and create inequity.