4 Reforming recurrent taxes on immovable property

Recurrent taxes on immovable property tend to be unpopular among taxpayers for numerous reasons, including their visibility, indirect relation to income, perceived regressivity, potential for tax hikes and lack of sensitivity to economic growth. These challenges can be addressed through a combination of having frequent property reassessments, coupling tax reform to improvements in local services, allowing payment in instalments, provision of tax benefits and taxpayer education. It is also crucial to consider the impact of the reform across regions and levels of government – these reforms may exacerbate regional inequalities, which can be minimised with changes to equalisation systems. Gradual introduction of the reform can also be valuable to avoid abrupt and distortionary changes in tax obligations, as well as bundling the property tax with the reform of other related taxes. Lastly, timing can be crucial, with booming housing markets often being an ideal period to put forward such a reform.

Key messages

1. Recurrent taxes on immovable property have six main characteristics that usually create resistance for reforms: their visibility, presumptive nature, erratic volatility, indirect relation to income, perceived regressivity and lack of sensitivity to economic activity. These issues can be approached by specific design features.
2. The most promising approaches used to deal with unpopular features of recurrent taxes on immovable property include: payment in instalments, withholding tax at source, allowing payments to be made in conjunction with other payments, tax deferrals for seniors, tax reliefs for low-income households, taxpayer education and consultation, accessible appeal process, frequent reassessments, phased increases and indexing.
3. Certain countries employ solutions that, despite solving the underlying issue, create other distortions that can cause more harm than good. These potentially problematic approaches are assessment limits, property tax capping, banding, classified tax rates and self-assessments.
4. Bundling is a powerful tool that is commonly employed in recurrent property tax reforms as a way to overcome political resistance through compensation of losers and improvements in distributional effects. For instance, occasionally property tax reforms are bundled with inter-governmental fiscal relations reforms to alleviate problems related to the distribution of revenue across and within levels of government.
5. Engaging a wide range of stakeholders, obtaining a consensus on a reform's broad long-term goals and focusing the discussions on the systematic rather than individual impact of the reform are good communication strategies that can be adopted to reduce resistance to a tax reform.
6. Transitional measures can be useful to alleviate short-term effects of a tax hike, nevertheless reformers need to design and implement these measures in a manner such that the full implementation of the reform is secured so the reform can achieve its initial goals.
7. Timing is crucial in tax reforms. In general, most property tax reforms are made during economic upswings since governments tend to be in a better financial situation to compensate losers and since a potential reduction in house prices would lead to a stabilisation rather than an attenuation of price movements.

Introduction

Tax reforms in OECD countries are seldom implemented with ease and without political and/or popular opposition. Often tax reforms are discussed for years and yet they fail to reach the Congress/Parliament floor (Brys, 2011[1]). Sometimes they stall in the proposal phase. In other situations, the implemented reform differs significantly from the initial drafts. In the latter situation the reform may fail to accomplish the intended goals. Making tax reforms happen in a manner that it fulfils its goals is a challenge.

A successful tax reform normally takes into consideration potential conflicting public finance, economic, administrative, institutional and political factors and objectives. A tax reform is never completely neutral or Pareto optimal since at least a small group of actors will be worse off after its implementation. Even when the "losers" of the reform form a small group, they tend to organise themselves and, sometimes, have substantial political power. Conversely, people who benefit from the tax reform tend to be significantly less vocal (Blöchliger and Vammalle, 2012[2]). Concessions unrelated to the purpose of the reform at hand might be necessary to secure its approval and, therefore, other topics not directly related to the specific tax being reformed are commonly involved in the tax reform's discussion (Brys, 2011[1]).

Usually the reasons for reforming recurrent taxes on immovable property are to build on its strengths or ameliorate its shortcomings. To recap, at the local level, recurrent taxes on immovable property are particularly good for boosting local revenues, improving local autonomy and accountability and reducing vertical fiscal gaps. With regard to the tax system, neutral shifts towards recurrent taxes on immovable property can improve economic efficiency and, depending on the tax design, distribution of income. Other reasons to implement these taxes refers to their role in reducing the volatility of house prices and underpinning land-use policies. Reforms focused on the administrative process of the recurrent property tax system can be made so as to reduce costs and inequities generated by unequal treatment of taxpayers and to increase compliance.

Most tax reforms typically face common obstacles in addition to tax-specific hurdles. Factors that can undermine a reform's implementation are, among others, the impact on the revenue of multiple levels of government, the popularity of the tax, uncertainty about their distributional consequences, transitional costs and timing – Brys (2011[1]) and Slack & Bird (2014[3]). In general, efficiency gains, whose effects are mostly felt in the long term, are less of a concern while, in contrast, distributional effects that are felt in the short-term can generate resistance from the groups that become worse off (Brys, 2011[1]). Besides, regarding the particularities of recurrent taxes on immovable properties, special attention should be given to features that makes it unpopular, such as their salience, liquidity constraints, perceived regressively, erratic volatility, presumptive nature and small buoyancy (Slack and Bird, 2014[3]).

This chapter's goal is to analyse general guidelines/good practices that are followed/employed in OECD countries to reform recurrent taxes on immovable property. It is divided into three sections. The first section focuses on the specific hurdles to reforms of recurrent taxes on immovable property; the second discusses common strategies that are used in all types of tax reforms; and, lastly, the third examines how specific problems related to fiscal federalism and inter-governmental relations can be handled.

Hurdles in reforms of recurrent taxes on immovable property

Recurrent taxes on immovable property have six main problems that create resistance for reforms: their visibility, presumptive nature, erratic volatility, potential non-relation to taxpayers' income, perceived regressivity and small buoyancy (Slack and Bird, 2014[3]). The first five make these taxes unpopular among taxpayers while the last affect governments. This section explores solutions employed by OECD countries to approach these problems. Table 4.1, below, summarises potentially successful and problematic strategies to deal with these issues.

Table 4.1. Strategies for property tax reform

Issues and Problems	Promising Approaches	Potentially Problematic Approaches
Salience: property tax is more visible than other taxes	• Couple tax reform with improvements in local services • Tax paid in several instalments • Withhold tax at source/payment in conjunction with other payments	• Assessment limits • Property tax capping • Banding • Classified tax rates • Self-assessment • Sole use of indexation
Liquidity constraints: tax is a burden for the housing-rich but income poor, especially seniors	• Tax deferrals • Tax reliefs • More payment options	
Perceived regressivity: Taxes can be higher as a percentage of income for low-income taxpayers	• Progressive tax rates[1] • Tax reliefs • Bundle with other tax reforms	
Presumptive tax: tax base is inherently arbitrary	• Taxpayer education • Consultation • Accessible appeal process • Conservative valuations	
Erratic volatility: potentially sudden large swings in taxes for some taxpayers	• Frequent reassessment • Indexing between reassessments • Phased increases	
Small buoyancy inelasticity: taxes do not increase with economic growth	• Frequent reassessments • Indexing between reassessments	

1. This solution is not recommended by some authors, such as Slack and Bird (2014[3]). Among other problems, levying progressive rates alone can aggravate the problem of asset-rich income-poor households.

Source: Authors, primarily based on Blöchliger (2015[4]), Slack and Bird (2014[3]) and UN-Habitat (2013[5]).

Salience improves accountability and transparency at the cost of popular resistance

Recurrent taxes on immovable property are very salient and transparent, unlike most other taxes. The most relevant taxes in terms of revenue-raising capacity are levied on income, consumption or payroll (i.e. mostly as social security contributions). All these taxes are, in most cases, collected automatically through payments and/or withheld at source, which requires the taxpayer to take no additional action to pay them. In contrast, in most cases taxpayers need to take action to pay their recurrent property taxes. Furthermore, taxes levied on income, consumption and payroll are paid "continuously" throughout a fiscal year whereas the recurrent taxes on immovable property are often paid in a (a couple of) relatively larger lump-sum payment(s).

On one hand this salience and transparency can improve efficiency and government accountability but, on the other hand, they create fierce opposition to tax hikes. In principle it is good for taxpayers to be aware of their tax payments so they can demand an appropriate supply of public service. Since recurrent taxes on immovable property are usually accrued to local governments and since public local services tend to be more visible than public services provided by upper levels of government, it is possible to directly link payments to a visible improvement in the supply of public services. There is evidence that when taxpayers can visualise the benefits that they receive from paying taxes, they are more willing to pay them (Slack and Bird, 2014[3]).

Offering the option for taxpayers to pay the tax in several instalments, withholding the tax at source and coupling the tax reform with improvements in local services are among the most common solutions to overcome the problem related to property tax salience. Although payment in instalments neither reduces the tax burden nor the transparency, the payment in multiple instalments reduces the value of each payment, which reduces its salience. Withholding the tax at source or coupling the tax payment with other payments can also help in reducing its salience but in this case at the cost of a reduction in transparency. For instance, property taxes can be paid in the same bill as mortgages and utilities. In some cases, it can also be withheld directly from income (e.g. see Box 4.1 in the Irish case). Lastly, coupling the tax reform with improvements in local services follows the benefit principle of taxation in which the tax payment serves as the payment of a public service, improving accountability. Nevertheless, it is also the most difficult to implement because it depends on activities beyond the scope of tax policy and because service improvements often require some time to become apparent whereas tax levies are immediate.[1]

Liquidity: the imperfect link between property values and income can create liquidity problems

Unlike other taxes, taxes levied on properties are often based on a stock rather than a flow. Although the value of properties is indeed correlated with the income of taxpayers, these two numbers are not perfectly associated. Thus, the tax obligation might be particularly large as a proportion of taxpayers' income for asset-rich income-poor households. Usually pensioners are in that group, which might be one of the reasons why they tend to oppose recurrent property tax reforms.

Not only pensioners suffer this problem though – other taxpayers that lose either temporarily or permanently their source of income may also have liquidity problems to pay their property tax obligations. In 2020 this problem occurred in many countries due the COVID-19 outbreak. The outbreak reduced the income of some households but not the value of their properties (at least in the short term), creating a temporary mismatch between their property tax obligations and their financial situation. To cope with this problem, some countries decided to defer or even exempt a portion of property tax payments, such as Chile and Italy (OECD, 2020[6]).

There are multiple ways to solve this problem such as by granting: deferrals for seniors, tax exemptions or rebates based on income and more payment options. The case for deferrals is strong since they do not change the tax obligation, they only match the tax obligation payment with the period in which the taxpayer is expected to have a better ability to pay for it. Nevertheless, such schemes are not particularly popular among taxpayers and are thus not popular politically, given that the elderly, which compose the group of asset-rich income poor households, typically wish to leave their property for their heirs without substantial amounts of obligations (Slack and Bird, 2014[3]). As a result, taxpayers might be disinclined to take advantage of tax deferral programmes, which don't solve the problem of the mismatch between property tax liabilities and current income. For these reasons, which could be the most economically efficient solution has limited power to weaken the resistance of the elderly against recurrent taxes on immovable property. Countries usually handle this problem through tax reliefs programmes. Some focus directly on pensioners (e.g. in Australia, Chile, Estonia, the Slovak Republic and some U.S states) while others on low-income households (e.g. in Estonia, Italy, Japan, Portugal, the Slovak Republic and the United States).[2]

Box 4.1. Irish property tax reform of 2013: A tax reform from scratch

Ireland levies two separate types of recurrent property taxes, one mainly on commercial property (Commercial Rates and non-Principal Private Residence Tax – NPPR) and the other on residential property (Local Property Tax – LPT). This box discusses the latter type.

The levy on residential property was introduced in a phased manner. In 2012, Ireland introduced an annual lump sum household charge (EUR 100 per house regardless of size) but only for one year. In 2013, the annual household charge was replaced by the residential property tax. Specifically in 2013 the property tax applied only for half of the year (since it was implemented in July) and from 2014 onwards it started to apply on a full-year basis. The Irish case has interesting peculiarities that makes it relevant for countries that aim at implementing a reform nearly from scratch.

The tax base of the LPT is wide: it is liable on any residential property. For LPT purposes, residential property is defined any building or structure which is in use as, or is suitable for use as, a dwelling and includes any shed, outhouse, garage or other building or structure and any yard, garden or other land, appurtenant to or usually enjoyed with that building, save that so much of any such yard, garden or other land that exceeds one acre shall not be taken into account for the purposes of this definition. Even residential portions of business premises are taxable. Exemptions include charities, properties situated in unfinished housing estates, nursing homes, properties vacated by their owners due to illness, diplomatic properties and property purchased, built or adapted to make it suitable for occupation by a permanently and totally incapacitated individual.

Regarding tax rates, they are progressive and the level of government responsible for setting them changed throughout the years. The LPT started as a central tax but, in 2015, new powers were conferred to local authorities. The incremental reform of 2015 let local governments vary the annual rate by up to 15%. The goal of this incremental reform was to boost local autonomy.

One of the main problems that the Irish had to overcome regards the fact that property values were not updated since 1845 – the Irish government relied on a banding system and self-assessments, both potentially problematic approaches. A banding system with 19 bands was used to determine properties' values in conjunction with self-assessments, which were planned to be used in the first three years of the implementation. Taxpayers (i.e. in this case property owners) must select a band based on their own estimation of their property market value. In order to increase the accuracy of taxpayers' estimations, the Irish government provided at least three options for determining a property's value: 1) An online interactive guide that gives data on market values of properties in a given locality, considering property's characteristics such as age, type of property (e.g. apartment, house) and others; 2) The use of the value of the property registered for the purpose of the stamp duty; and 3) Hire a professional valuer. The central government can raise cadastral values in case it is believed that the valuation was not accurate enough.

To deal with the unpopularity of property taxes' salience, the Irish government allowed the LPT to be deducted at source. Property owners were given the choice of 1) paying their tax obligations in one single payment; or 2) having the tax deducted at source from salary or occupational pensions. The Irish government required employers and pension providers to make this second option available. As a result of these measures, the compliance rate for 2013 was nearly 90%.

Efforts were also made to solve the issue of the asset rich cash poor households (i.e. with income below a threshold) by letting taxpayers opt to defer, or partially defer, LPT's payment to when the property is sold. This threshold varies with, for instance, whether the taxpayer took out mortgages at the height of the property boom. Interest at a rate of 4% per annum is charged on deferred amounts.

Source: Slack and Bird (2014[3]), OECD Revenue Statistics and OECD Survey on Recurrent Taxes on Immovable Property.

Perceived regressivity of recurrent taxes on immovable property can be minimised with tax rate progressivity, tax reliefs to low-income households and bundling strategies

Recurrent taxes on immovable property are normally perceived to be regressive. As discussed in the second chapter, the empirical research on tax incidence suggests that the property tax can indeed be anything from progressive to regressive because the redistributive effect of property taxation hinges on various factors, such as the distribution of home ownership and tax design. In addition, recurrent taxes on immovable property are considered to have a smaller impact on the income distribution than other important taxes, notably income taxes. As a result, recurrent property taxation can be seen as regressive even if their impacts are not necessarily so.

Most countries aim at making their recurrent taxes on immovable property more progressive/less regressive by either levying progressive tax rates or by granting tax reliefs or exemptions to low-income households (to recap see Figures 2.4 and 2.5) It is worth noting that, in the latter case, the problem of asset rich and income poor households is also alleviated. Progressive rates can indeed increase the progressivity of a property tax system but, in some situations, it can aggravate the problem of asset rich income poor households.

Another potential solution is bundling a reform of recurrent taxes on immovable property with other taxes (e.g. income tax, wealth tax and inheritance tax) in a manner that the overall impact of the reform improves the income distribution even if the impact of the reform of recurrent property taxes alone would not. Property tax reforms can also be bundled with policies outside the realm of taxation – for instance, the reform can be bundled with an income-transfer programme targeted to the poor and, thus, although the property tax will not be progressive, the overall fiscal system will be (Kitchen, 2012[7]) or with provision of other public services, such as education (Ahmad, 2021[8]). Cash transfers to low-income households tend to be among the best tools to reduce income inequality (see Chapter 2).

In China's case, recurrent taxes on the ownership of properties tend to be more progressive than for other countries. As discussed in the second chapter, since real estate represents most of the wealth of Chinese households, recurrent taxes on immovable property can have a greater effect in reducing income inequalities (OECD, 2019[9]). This prominence of real estate in household wealth can be highlighted in the discussions about the reform, potentially raising its popular appeal. Linking the reform to the provision of public services can have, though, greater redistributive effects.

The presumptive nature of recurrent taxes on immovable property can lead to unfair assessments or perception of unfairness – both of which can be mitigated with a good tax administration

Property values are a relative concept – different buyers may value the same property differently and, thus, rarely can one estimate a value for a property that is considered fair by everyone. In recurrent taxes on immovable property, property values have to be estimated to serve as a basis for the tax obligation. This problem does not occur, for instance, in transaction taxes in which the taxable value is the value agreed between the buyer and seller. The necessity of having an estimation of the tax basis can lead to the situation in which taxpayers believe that the value of their properties is not being correctly assessed. can contribute to the tax being perceived as unfair, which may create problems in property tax reforms (see Box 4.2 on Latvia's case).

Multiple tools can be put to use to reduce the perceived unfairness in property assessments – for instance, taxpayer education, involvement of the taxpayer in the valuation process, accessible appeal process and conservative valuations. All these solutions involve a continuous effort from the tax administration. A transparent administrative process that timely makes information available to taxpayers is crucial for the tax system to be perceived as fair. For that purpose, tax bill notifications may serve as a communication channel, in addition to other channels such as television, newspapers and posters advertisements.

Communication can focus not only on explaining the process of the tax collection but also on explaining the role of the property tax in funding public services (Box 3.5, in the previous chapter, covered this issue in more detail). Communication should also occur both ways, by giving room for the taxpayer to ask questions and query the tax department, potentially leading to changes in assessments if the taxpayer has a strong point.

Lastly, conservative valuations[3] (i.e. that aim at estimating a value slightly below properties' values) might also significantly reduce appeals since when taxpayers believe that the assessed value is below market values they are less likely to appeal. Although this practice can reduce tax revenues,[4] it can also increase compliance and reduce the appeal rate, both of which are costly to the tax administration.

Box 4.2. Latvia's property tax revolt

Latvia is one of the three Baltic states located in the Baltic region of Northern Europe with an estimated population of 1.93 million as of 2018. The country introduced recurrent taxes on immovable property (Real Property Taxation – RET) in 1997 and has been incrementally improving their design and administration since then.

RET accrues to local government but its administration is shared across levels of government

RET administration is shared across levels of government and agencies. The Ministry of Finance is responsible for defining the general principles. The Ministry of Justice was responsible for defining guidelines for property valuation, cadastre, and ownership registration. An Executive body (State Land Service) is responsible for the maintenance of the cadastre, cadastral valuation and surveying buildings. Local governments are the executive body and beneficiary of the RET, being responsible for revenue collection in their jurisdiction, determination of land use for taxation purposes, development of local and spatial planning documents and issuance of building permissions. In addition, local governments can set tax rates and grant reliefs for residential estates of "politically repressed persons" (up to 50% of the tax obligation) and for vulnerable groups (up to 90%).

The RET levies on land and buildings (different tax rate may apply to both) and exempts government buildings, property owned by a foreign state, graveyards, property owned by religious organisations, land in special natural reserves, transport infrastructure, among others. The incidence is on owners or persons with possession rights and users of state or municipal real property.

Recent reforms have increased RET's tax burden

The fiscal crisis of 2008 led local governments to improve their fiscal sustainability through, among other measures, a property tax hike. From 2008 until 2016 many incremental reforms increased the property tax burden. In 2010 rates applied to land increased from 1.0% to 1.5%; in 2011, a housing tax was introduced and some types of residential property that were previously exempted (e.g. detached houses, apartments, summer cottages) became taxable. In 2012 tax rates applied to housing were doubled. Since 2013, a rate of 1.5% has been applied to vacant residential buildings.

The legislation gives local governments room for applying different tax rates to different types of property, and since 2014 this flexibility has been used by many Latvia's municipalities with the purpose of attracting residents through the offer of tax reliefs (usually 50%) on owner occupied dwellings. In addition, tax rates differ for an owner's inhabited and uninhabited properties. Higher tax rates are also applied to second homes regardless of taxpayers' income. The purpose of these tax treatments is to reverse Latvia's shrinking population by incentivising people to move to inhabited houses, whose share as a percentage of total houses approached 20.6% in 2011. This high rate is explained by the fact that many people own several residential properties and that the house ownership rates reach 80% (one of the highest numbers in Europe).

For instance, in Latvia's capital, Riga, the RET rate applied to buildings in unoccupied properties increased, in some cases, sevenfold. At the same time, the municipality of Riga offers RET discounts to persons that own only one property. This policy achieved the desired results in the capital: the number of Riga's residents in 2015–2016, for the first time in many years, showed a growth tendency. As a result, other municipalities of the agglomeration of Riga later followed Riga's example.

Public resistance and protests

Despite the success of these reforms in increasing the number of dwellers, they were heavily criticised by a group of taxpayers. One of the reasons for the criticism is not directly related to this specific reform but to the fact that cadastral values supposedly did not reflect market values, as suggested by reports and audits. Thus, issues in property valuation eroded taxpayers' confidence and brought resistance to the tax reform, regardless of its noble objective.

The unpopularity of the reform has led Latvia to freeze cadastral values until the Ministry of Finance develops a solution for this problem. It is worth noting that although the group that is against the property tax reform was very vocal, the activity of the group in social networks and the volume of protest activity were limited, suggesting that the group was not very large. This makes sense considering that only 2% of all properties were heavily affected by the tax hike since the boost in tax rates were accompanied by discounts for more vulnerable groups (e.g. poverty stricken, families with three children, poverty-stricken pensioners, politically repressed persons). Furthermore, increasingly often opinions are voiced that RET is a necessary disciplinary tax and that taxpayers agree that higher RET rates should be applied to second homes.

Conclusion

Despite reform's noble objectives (i.e. to increase local government revenue and to reverse a shrinking population) and their progressive features (i.e. taxing more second and vacant homes and granting reliefs to vulnerable groups), Latvia's recent property tax reform faced a vocal opposition. Although the group that opposed the reforms is not numerous, its resistance was sufficient to make the government freeze cadastral values, at least temporarily. The resistance movement was helped significantly by the fact that cadastral values were considered unfair in the eyes of taxpayers. Indeed, it seems that the process of property revaluation was not adapted on time to keep up with the changes in legislation.

This case offers interesting lessons. First, despite achieving a reform's objectives (i.e. Riga was successful in increasing its population) and despite the fact that most taxpayers pay a low tax rate, a small but vocal opposition can influence and damage a reform's implementation. Second, when cadastral values are unfair in the eyes of taxpayers, the opposition of a tax reform is inflated (see also Box 3.1 that showed how horizontal inequities can lead to a complete discontinuation of a property tax). Third, taxpayers' education can boost popular support and help the implementation of reforms.

Source: Barvika (2020[10]).

Erratic volatility: tax obligations can vary abruptly when cadastral values are rarely updated, creating resistance against property revaluations

Although property values tend to change over time, unless they are updated in the fiscal cadastre, tax obligations are not going to reflect properties' value. The longer the period in between reassessments, the greater the mismatch. And the greater the mismatch, the greater the tax hike when properties are reassessed. Abrupt tax hikes are unpopular. The end result is a reinforcing feedback loop, in which the more cadastral values are outdated, the more likely for their update to be unpopular, reducing the likelihood of a reform's approval and implementation, perpetuating distortions.

Tax hikes caused by property revaluations are also not uniform: shifts in taxes depend on the movement in housing prices that can differ markedly by region or even neighbourhood. Thus, even if the average house has not appreciated much, the tax hike can be significant for some taxpayers. And, again, since income and property values are not perfectly linked, this increase in tax obligation can lead to liquidity problems and face fierce opposition, as was the case in many reforms (Slack and Bird, 2014[3]).

In principle, the best solution for this problem is to keep cadastral values updated. This requires frequent reassessments that can be costly. Indexing between reassessments can also help but if used alone may lead to distortions since indexing, by definition, uses an index that represents an overall price change and house prices' movements are asymmetrical by region, infrastructure, among others. Therefore, indexing can be used as a palliative solution but, if used alone, will lead to horizontal inequities and, in the long run, a tax hike for houses that experienced a greater increase in their market values in comparison to their cadastral values may still lead to abrupt tax hikes. Phased increases can also help but, again, should be very well structured to not create distortions (see Box 4.3 on Denmark's case).

On the one hand, inelasticity with regard to the cycle can create a mismatch between tax revenues and government expenditures but, on the other hand, can serve as a cushion in times of crisis

The fact that property tax bases are relatively inelastic with respect to economic activity can create long-term mismatches between property tax revenues and government expenditures. Belinga et al. (2014[11]) estimated the buoyancy of different types of taxes in OECD countries and concluded that, with regard to property taxes, their short-run buoyancy is the only one that is not statistically significant, and that their long-run buoyancy is the lowest among other taxes (i.e. personal income tax, social security contributions, corporate income tax, and good and service tax). This can be explained by three factors: 1) the imperfect link between property values and economic activity; 2) the mismatch between house prices and cadastral values; and 3) local policy makers in some countries (more notably in the United States) often reduce statutory tax rates when properties' market values are raising in order to not increase the tax burden on dwellers while maintaining their property tax revenues.

Despite these factors, policy makers and tax administrators can make property taxes more buoyant through different means. First, regarding the imperfect link between property tax bases and economic activity, policy makers can select a more "buoyant tax base" – property taxes applied to capital and rental values tend to be more buoyant than area-based ones, since the latter has no significant link with the economic activity while it is expected that a booming economy would increase house prices and rents (Almy, 2014[12]). Second, the mismatch between house prices and cadastral values can be minimised if cadastral values are indexed in-between reassessments and/or properties value are reassessed frequently (see Figure 3.3, in the previous chapter, to see examples of countries that implemented such measures). Third, tax rates should, ideally, not be reduced in times of house price booms.

This last recommendation is disputable and it is worth digging into it further since inelasticity with regard to the economic cycle reduces the impact of crises on property tax revenues. As a result, all other things held equal, the higher the share of recurrent taxes on immovable property revenues in government revenues, the less they are impacted by economic crises – see OECD (2020[13]). Given that local governments tend to have less access to financial markets than central governments, which raises their vulnerability to liquidity crisis, this feature of recurrent taxes on immovable property is especially valuable for them.

In that light, Belinga et al. (2014[11]) suggested that municipalities might aim at keeping property tax revenues stable, regardless of what happens to GDP (and house prices). Norregaard (2013[14]) showed that even in periods of very rapid property price appreciation, property tax buoyancy still remains low.

Lutz (2008[15]) performed empirical research for US states and concluded that the elasticity of property tax revenues with respect to home prices equals 0.4, indicating that statutory tax rates are probably adjusted downwards when house prices rise, reducing the tax buoyancy and stabilising property tax revenues. Norregaard (2013[14]) also found that SNGs in the United States tend to compensate for revenues losses in times of crisis by increasing property tax rates. In this situation, property tax rates tend to behave counter-cyclically – they increase in times of crisis and decrease during economic upswings.

Despite these benefits that stem from having a stable revenue source, it cannot be overstated that the main goal of a tax is to raise revenues for governments. Taxation is the main means through which governments can fund public services. Thus, the long-run buoyancy of property taxes should, ideally, not be very small. Very small long-run buoyancy would reduce the capacity of property taxes to raise revenues and, thus, would harm the funding of essential public services. In case other taxes are adjusted upwards to offset this small buoyancy of property taxes, there will be a neutral shift towards these other types of taxes, changing the properties of the tax system, potentially in an undesired manner since this change was driven only by the necessity to raise more revenues. The use of a more buoyant tax base and frequent property revaluation (possibly with the use of indexed cadastral values between revaluations if they are not frequent enough) are, thus, recommended.

Box 4.3. Denmark's ending the property valuation freeze in place since 2002

In 2001-02, the Danish Government implemented a "tax freeze" policy with the goal of controlling public spending by freezing tax revenues. The tax freeze applied to multiple types of taxes. For taxes that are stated in percentages, their rates were capped, while for taxes that are stated as nominal amounts, their amounts were frozen. In the case of recurrent property taxes (i.e. Denmark levies a land tax, commercial building tax and a residential property tax), the increase in cadastral values was capped at 5% of the 2001's values.

Nonetheless, in addition to the intended effects of controlling expenditure, the property tax freeze also impacted the housing market in a negative manner. With cadastral values capped, property taxes failed to alleviate the abrupt increase in house prices that occurred in the mid-2000s, potentially leading to a more volatile economic and financial cycle. Furthermore, a tax deduction for mortgage interest rates also encouraged house purchases, contributing to the housing market boom of that decade. As discussed in the second chapter of this report, favourable tax treatment of owner-occupied housing can create distortions in investment allocation, favouring housing investments over others.

In order to alleviate these undesirable effects, Denmark recently made significant changes to its housing taxation. From 2021 onwards, cadastral values – for the property value tax and for the land tax – are expected to reflect market values, thereby ending the property valuation freeze in place since 2002, which has led to falling effective tax rates for houses experiencing increases in value. These changes can lead to an abrupt tax hike and, thus, can significantly affect taxpayers. To alleviate this expected increase in tax obligations, Denmark coupled the cadastral values updated with other changes in its property tax system. First, statutory tax rates will be lowered. Second, a tax rebate will be granted to taxpayers in order to compensate for increases in tax obligations. Third, in an effort to protect homeowners from tax increases while they occupy their own home, increases in tax obligations can also be deferred until the property is sold.

In essence, Denmark is bundling the de-freeze with other property tax measures, creating, to some extent, a "phased-in" reform. As a result, Denmark will be able to lift its property tax freeze that was in place for nearly two decades, which is typically unpopular and politically challenging. Although the property tax revenue might be mildly affected in the short-term, the reform will reduce horizontal inequities and inefficiencies generated by the tax freeze.

Source: OECD (2018[16]), Smidova (2016[17]) and OECD (2005[18]).

The use of assessment limits, property tax capping, banding, classified tax rates and self-assessments can create distortions that, in the end, might cause more harm than good

Some countries employ solutions that do solve one of these specific problems but at the cost of creating others. Caution is advised when employing these palliative solutions. Among them there are the imposition of assessment limits, property tax capping, banding, classified tax rates, use of self-assessments for property assessments and the sole use of indexation for updating cadastral values. The reasons are provided below – based on Slack & Bird (2014[3]):

- Assessment limits (i.e. restrictions to how much properties' cadastral values can increase) and property tax capping (i.e. restrictions to how much tax obligations can increase) both aim at cushioning property tax hikes and, thus, they also have a role in reducing the chances of causing liquidity problems to taxpayers when tax obligations increase. Nevertheless, these benefits come at the cost of horizontal inequities. By capping increases in property values, some properties are going to be undervalued in comparison to others (see Box 4.4 on the Californian case). More specifically, properties whose values are growing rapidly will be undervalued in comparison to properties whose values are either stable, growing slowly or decreasing. As a result, taxpayers that are having their assets appreciating the most are the ones who benefit the most from these restrictions, which may create distortions that reduce the progressivity of the tax.
- A similar outcome occurs when tax obligations are capped: taxpayers who should be taxed the most are those with higher property values and, thus, they benefit the most from tax capping. Moreover, capping taxes obligations, either directly or through limits on assessments, are also capping tax revenues. In the long run, limits to tax revenues can create mismatch between tax revenues and government expenditures. In addition, paradoxically, because such measures reduce the elasticity of property tax revenues, they likely increase the pressure for future property tax reforms (Slack and Bird, 2014[3]).
- Banding, which is used, for instance, in the United Kingdom and Ireland, can alleviate the impact of property value hikes and reduce administrative costs since banding systems are rather simple to understand and to administer. Nevertheless, banding creates horizontal inequities caused by the impossibility of valuing properties in such a discrete manner – the range of values (or values per square meters) of houses vary markedly, which is not captured by the small number of bands (e.g. eight values in the United Kingdom and nineteen in Ireland).[5] This discrete nature of this system is particularly perverse for taxpayers located in a boundary of a band, leading to appeals and discontent.
- Self-assessments are useful for dealing with the presumptive nature of the property tax and also for reducing administrative costs but these benefits come at the cost of precision. Self-assessments should not be confused with consultation. The former regards the situation in which taxpayers provide the value of their property whereas the latter refers to the case in which taxpayers provide additional pieces of information that are used in the appraisal. Consultation is a good tool to gather data in a relatively cheap way while improving the credibility of the appraisals in the eyes of the taxpayers given that they participate in the valuation process. Self-assessments can also be useful when employed temporally, but when employed permanently and as the only means to gather properties' information, they are likely to lead to inaccurate estimates of property values, with a tendency toward under-estimation[6] (Slack and Bird, 2014[3]). In case governments are to audit self-assessments to handle these issues, they might significantly increase costs and create discontent, defeating the purpose of setting a self-assessment system.
- Classified tax rates (i.e. the situation in which multiple tax rates are applied to different "classes" of properties) can be used to increase progressivity in case tax rates vary with variables linked to income. When varying tax rates apply to different properties whose incidence rests on taxpayers

in a manner that the higher the rate the higher taxpayers' ability to pay, in theory, we have a progressive tax system. Nevertheless, classification of properties can significantly increase the complexity of the tax system and create room for arbitrary classifications (see Box 4.4 on the Ontario's case, below, and Box 3.6, on the Israeli case, in the previous chapter). The higher the complexity of the tax system the lower its transparency and the higher its compliance costs, and the higher the room for governors/policy makers to classify properties and to define tax rates to each type of property, the more the tax system can be exploited to benefit some taxpayers due to political reasons, generating horizontal inequities.

- Indexation, as discussed throughout this section, can yield good results if used in between frequent reassessments. It does increase buoyancy and it also averages out strong tax hikes. Nevertheless, the sole use of indexation will create horizontal inequities in the long term since the effect captured by the index represents an average and not individual house prices. House prices' movements vary markedly depending on many aspects of a property such as its region, neighbourhood, infrastructure, among others and, thus, cadastral values that were only updated though indexing will lead to unfair assessments in the long term.

Box 4.4. The cases of California/United States and Ontario/Canada

Ontario's classified property tax system

In 1998 the province of Ontario, Canada, implemented a significant fiscal reform, which involved a property tax reform along with a fiscal reform that covered the delineation of responsibilities across municipal and provincial governments, the state-local transfer system, and a reduction in the number of municipalities from 800 to 445. The property tax reform had two pillars: a uniform assessment system based on properties' market values and a classified tax rate system. Municipalities were allowed to levy different tax rates on seven classes of property (residential, multi-residential, commercial, industrial, pipelines, farms and managed forests). At the same time, they could 1) establish additional classes in case they wish so (e.g. new multi-residential, office buildings, shopping centres, parking lots, large industrial properties); 2) reduce tax rates for specific subclasses of property (e.g. vacant commercial, vacant industrial, farmland pending development, theatres); 3) create more subclasses for some specific classes (i.e. commercial and industrial) depending on properties' values; and 4) establish progressive tax rates within classes. The final outcome was that there were dozens of classes of properties and the respective tax rates could vary across classes, across properties' values and across the 445 municipalities in Ontario.

In subsequent years, Ontario introduced new pieces of legislation to reduce the burden of property taxes on housing and business. For instance, tax deferrals, phase-ins, caps on tax increases and claw backs were introduced. The valuation cycle was enlarged from annual to every four years. All these measures in conjunction made Ontario's tax system very complex and inefficient with regard to revenue-raising capacity.

California's tax limits and horizontal inequities

The classic example of a property tax limitation arising from a tax revolt is Proposition 13, which was passed by referendum in California in 1978 and remains in place. Proposition 13 is an amendment of the Constitution of California aimed at limiting property taxation burden on residential and commercial properties. Among other elements, it limits the tax rate for real estate to 1% and restricts annual increases of cadastral values to inflation, limited to an annual increase of 2%. In the cases of change in ownership or completion of new construction the property can be fully reassessed (i.e. the transaction price becomes the cadastral value in case of a sale), updating the cadastral values with the new reassessed values. It is worth noting that California house prices have grown much faster than inflation – a house price index for California estimates that house prices have grown by a multiple of seven from 1980 to 2020.[1] As a result, Proposition 13 granted huge tax benefits for properties whose ownership did not change throughout the years.

Proposition 13 was successful in providing the desired tax burden stability for taxpayers who stay in their homes. Nevertheless, this came in exchange for economic efficiency and fairness. Under Proposition 13, virtually identical properties can have a vastly different tax burden depending on a property's last transaction date. The transaction date is not correlated with taxpayers' ability to pay and, thus, in some circumstances, Proposition 13 can have strong regressive impacts. In addition, it discourages property transactions that are necessary to improve the allocation of resources. For instance, a family might decide not to move closer to its work because of the higher property tax obligation, which causes an increase in their commuting time and transport costs, negatively impacting the traffic and the environment. Similar situations also apply to business. Moreover, Proposition 13 limits the revenue-raising capacity of the property tax, resulting in reductions in local spending.

Despite these issues, Proposition 13 remains popular. Proposition 15, which would have switched commercial property value assessments to market value, was narrowly defeated in the 2020 election. It is likely that repealing Proposition 13 altogether would be even less popular.

1. See https://fred.stlouisfed.org/series/CASTHPI (accessed on 20 February 2021)
Source: Slack and Bird (2014[3]) and McCluskey and Franzsen (2012[19]).

General strategies in tax reforms

A successful implementation of a tax reform usually involves a sound plan that takes into consideration not only the design aspects of the tax but also operational and political aspects such as timing, a transition phase and communication (Brys, 2011[1]). Without a sound strategy, the ability of special interests to influence the reform or administrative problems can create impediments to a reform's full implementation. This section discusses strategies that can be employed to most tax reforms (i.e. not restricted to recurrent taxes on immovable property) given that regardless of the type of tax, tax reforms face a set of similar challenges.

Brys (2011[1]) explored multiple challenges and strategies related to tax reforms, several of which are summarised here. First, the approval of fundamental reforms depends greatly on the political context of a given period. Usually, policy makers discuss and prepare a reform in a given time and wait for the proper timing to put it forward. Second, the impact of a tax reform can change over time – the losers at the initial phase of a reform might be winners at a later stage. Furthermore, efficiency gains usually arise only in the medium to long term while distributional impacts can be immediate. As a result, for some time a reform can leave many people worse off and a phased reform or transitory measures might be necessary to alleviate these impacts. Third, a reform can greatly affect the tax administration process, and, therefore, a reform's pace should depend on the pace in which the tax administration can implement it. Fourth, communication is crucial to minimise changes in a reform's design throughout its approval and implementation phases. A proper communication can greatly improve a reform's success likelihood through, among others, explicitly establishing its priorities, reduction of uncertainty about its effect and creating public awareness of and support for the reform. These challenges and strategies are approached in more detail throughout this section.

Timing: economic upswings and booming housing markets can create an opportune moment for putting forward a property tax reform, yet reforms following downturns can also be successfully implemented

Kingdon (2014[20]) created a theory that explains the process through which a policy is designed and implemented – the Multiple Streams Framework. This framework outlines that a solution to a problem in the format of a policy is only implemented when three different streams come together at the same moment: the problem, policy and political streams. The problem stream refers to the public and media attention given to a specific problem. The policy stream refers to the existence of solutions to address this particular problem. The political stream regards the policy makers' motivation to implement a project with such a solution. Therefore, according to this theory, a policy is only implemented when, at the same moment, the people/media are giving attention to a particular problem for which there are available solutions that can solve the issue and the policy makers have incentives to turn at least one proposed solution into an implemented policy. This moment when these three streams come together is called a policy window.

Policy windows are not necessarily created in a spontaneous manner Kingdon (2014[20]). In fact, "policy entrepreneurs" are actors whose role is to create policy windows so a policy can be successfully launched into the political arena. Tax reforms are no different. Tax reforms that are well-designed to solve the underlying issue and that are backed by the general public and policy makers have greater chances of approval. As a result, it is crucial to put the reform forward only when these elements are in favour of the tax reforms. For these reasons, reforms are prepared in advance and usually wait for a good timing to be put forward (Brys, 2011[1]). Besides, there are multiple aspects of a reform that depend on timing such as when the reform is discussed with policy makers, when it should be discussed with the general public, when it should come into force, among others. Regarding the latter (the implementation), it is worth highlighting that the implementation of a tax reform can have multiple phases, and the implementation of each phase also depends on good timing to be successful. Not rarely reforms are phased and there is no support for the latter incremental stages of a reform, leading to an incomplete reform (see Box 4.6 on the Korean case at the end of this section).

Some particularly relevant issues for timing a property tax reform are the states of public finances, economy and housing market. Experience shows that it might be easier to implement fundamental tax reform when a country is running budget surpluses that could absorb possible revenue losses or could be used to partly compensate the "losers" from the tax reform (Brys, 2011[1]). Regarding the economy, due to the salience of property taxes, introducing revenue raising property tax reforms in economic downturns can harm households whose income have shrunk and, thus, not able to pay the taxes. In other words, the reform would not only have less compliance but could also have an undesired pro-cyclical effect. Therefore, there are incentives for governments to engage in property tax reforms in good times.

For instance, Blöchliger and Vammalle (2012[2]), in a study on fiscal federalism and subnational government reforms covering ten OECD countries (Australia, Austria, Belgium, Canada, Denmark, Finland, Italy, Portugal, Spain and Switzerland), found evidence that a reform succeeds if implemented at times of economic upswings and healthy fiscal conditions. As the authors put it *"while a few reforms were initiated when the economic situation was weak or driven by consolidation needs, implementation of virtually all reforms took place when central and – to a lesser extent – sub-central public finances were in good shape. A sound fiscal position allows the central government to compensate sub-central governments, while reform resistance tends to be stiffer and reform failure more likely without central government support."*

Concerning the housing market, evidence shows that recurrent taxes on immovable property can be used as a policy instrument for asset price stabilisation (Blöchliger et al., 2015[21]) and can also influence the share of housing investments in total investments through different tax treatment (Millar-Powell et al., 2022[22]). Rapid tax increases during a slowdown – or tax reductions during a boom – seem to make property taxation strongly destabilising (Blöchliger, 2015[4]). In that light, when the housing market is in a downturn, the potential contraction caused by revenue-raising property tax reforms can attenuate the contraction, which is undesirable. On the other hand, when the housing market is booming, a reduction in the growth pace can be desirable.

Despite this solid case for putting forward property tax reforms in economic upswings, downswings can also improve the political support for a tax reform through various channels (see Box 4.5 on the Italian case). Pro-growth reforms can gather more political and popular support in downswings since they can be employed to revert the situation. More specifically, recessions sometimes expose very clearly the weaknesses of the economy and, thus, the need for reforms, leading to a greater acceptance of the necessity of the reform from taxpayers and voters (Brys, 2011[1]).

The timing to start discussing with the general public and/or experts also varies greatly. One approach is to present the tax reform only when their main elements are already defined and there is little uncertainty about their impact. Combined with good communication, this strategy may increase the likelihood of a reform to resist political pressures due to the reform's maturity. Another approach is to start the discussion earlier and let the learning occur during the discussions. This approach is especially useful in the presence of high levels of uncertainty about the number of winners and losers and the extent to which they are (positively or negatively) affected by the tax reform. That is because in this situation policy makers might become more careful in making a decision to engage in tax reform (Brys, 2011[1]). Therefore, anticipating discussions can lead to a long period of debate with the purpose of answering the most difficult questions and criticisms. However, after this long period the reform may reach a maturity, leading to a quick implementation.

Administrative problems can also affect a reform's timing. In that regard, tax reforms in general have been most successful when they are least needed. Rosengard (2012[23]) explains that non-urgent reforms allow tax administrators to introduce new processes smoothly and, in that manner, the learning period for both taxpayers and administrators to familiarise themselves with the new system can last longer, enhancing the understanding of, and voluntary compliance with, the tax. Timing for taxpayers to familiarise with the tax is especially relevant for recurrent taxes on immovable property since taxpayers usually have to actively pay the taxes (in contrast to income or consumption taxes that are, in most cases, paid indirectly when receiving income or buying a product, respectively).

In light of this discussion, it can be stated that there seems to be no perfect time for putting forward a property tax reform. Despite that, we argue that introducing a recurrent levy on residential households in the near future can benefit China in many different ways. First, despite of COVID-19's contractionary effects, China is not facing a significant economic downturn – on the contrary, the Chinese economy is recovering at a strong pace, which is particularly important for the reform to not have pro-cyclical effects. Second, house prices in China have continued to rise throughout the last decade. Although the upswing movement was stronger in the early 2000s, prices are still growing in most regions. Third, the vertical fiscal gap is widening in China (CDRF, 2020[24]), and, thus, a new source of income could potentially revert this trend. Although Chinese local governments may not have the necessary income to compensate losers during the first phases of the implementation, these compensations can be temporarily made, if necessary, as a part of an agreement with upper levels of government. There are no guarantees that this positive outlook will continue in the coming decades and, thus, it is opportune for China to introduce recurrent taxes on immovable property relatively soon.

Box 4.5. Italy's case of property tax reforms in downswings

Italy has reformed its property tax system multiple times in the last decades. This section explores the two revenue-raising property tax reforms that occurred in 1992-93 and in 2011-12, both in times of crisis.

In Italy, the year of 1992 is known as the year of the Great Crisis. Investors' speculation against Italy's former currency (the Lira) led to its sharp devaluation. Between 1991 and 1995 the Lira lost almost a third of its external value on the foreign exchange markets and Italians domestic purchasing power decreased by one sixth (Rossi, 2010[25]). Rossi highlighted that a decrease in foreign investments was one of the reasons that led to the crisis.

As a part of a fiscal package to face this deep financial and economic crisis, the Italian government introduced a temporary levy on properties in 1992, which became permanent in 1993. The tax base was wide (residential, industrial and commercial buildings, and land both for agriculture and residential purposes) and local governments could set the tax rate within the range of 0.4-0.7% on cadastral values.

In 2008 the Italian property taxes suffered a hit: the government promised in an electoral campaign and honoured the promise of abolishing the levies on owner-occupied houses. This has led to a substantial loss in local revenues, in part counterbalanced by increased transfers from the Central Government.

In 2011-12, though, after the financial crisis of 2008-09, as a part of a major package of fiscal reforms aimed at improving fiscal sustainability, the Italian government again implemented a revenue-raising property tax reform. First, cadastral values that were outdated for more than 20 years were reassessed using a fixed multiplier that reflected market values. Second, primary residences were brought back into the tax base (it was excluded from it in 2008). Overall, the new measures resulted in a significant increase in property tax revenue (roughly 240%). It is worth noting though that in 2013, right after the adoption of these revenue raising reforms, the Italian government froze property tax obligations due to the unpopularity of this reform.

Longobardi (2013[26]) highlighted that these reforms had been discussed and prepared for a long time but were only implemented in times of acute crisis. Political consensus that could not be obtained in normal circumstances was obtained in difficult moments. Probably this political support was a consequence of the necessity of undertaking reforms to improve the fiscal sustainability of the government that was threatened by both financial crises. As a result, despite the solid case for implementing property tax reforms in economic upswings, political support might arise only in times of necessity.

Unfortunately, in the Italian case, the implementation of a revenue raising property tax reform in the aftermath of a severe crisis has made the tax unpopular, leading to further legislative changes in the following years aimed at substantially easing taxation of owner-occupied houses.

Source: Longobardi (2013[26]), Rossi (2010[25]) and Italian delegates.

Administrative hurdles: a collection-led strategy coupled with a focus on more valuable properties can help emerging economies to maximise tax revenues

Recurrent taxes on immovable property are among the taxes that depend the most on having an effective administration to translate tax laws and regulations into field realities (Slack and Bird, 2014[3]). In some cases, the scope of recurrent property tax reforms covers only administrative issues (e.g. in case of reforms focused on updating cadastral values). In other cases, the administration needs to be reformed to operationalise the design changes. Rarely a property tax reform does not include any administrative element.

Often administrative reforms involve costly changes that require time to mature, such as the development of digital systems and the training or hiring of human resources. In addition to these costs incurred by the tax administration, changes in tax administrations might also increase taxpayers' compliance costs, at least during the period when they are adapting to the reform (e.g. learning to fill new forms, understanding the new elements of the tax obligation, among others). In order to reduce such costs, reformers can implement the reform in a more gradual way through the use of a transition phase or through an incremental implementation of the reform (Slack and Bird, 2014[3]). Both strategies can be used to improve the link between taxpayers' and officials' learning curve with the reform's pace. When these strategies are employed, the reform is only fully implemented in the medium-term.

Especially for governments in developing economies that do not have the capacity to register, valuate and collect revenues from all types of properties in a short period of time, a particularly interesting gradual implementation strategy is to focus on properties that can raise more tax revenues (Rosengard, 2012[23]). Particularly in developing economies, the distribution of properties' values tends to be highly skewed, with a relatively small number of properties comprising the bulk of properties' values. As a result, narrowing a reform's focus to these small number of high-end properties can maximise tax revenues in the short term. In addition, administrative simplifications can be made in order to maximise net tax revenues from low valuable properties. For instance, self-reporting and a simplified CAMA can be employed for cheaper properties while individual valuations are only employed for more expensive real estate. This strategy can aid developing countries to raise tax revenues in a quicker manner. These revenues can then be used to provide the necessary local services to raise popular support for the reform and to finance the costs of the rest of the reform.

In China's case, administrative capacity is asymmetrically distributed across municipalities. For instance, Shenzhen already has an advanced property valuation system in place (for more on Shenzhen see Box 3.4). Shanghai and Chongqing already have some experience with recurrent property taxes on residential properties since they already have introduced this levy in a small scale due to a pilot programme. In this situation, the central government can allow local governments to implement the reform in different moments – the greater the administrative capacity, the earlier the levy can be introduced in a municipality. For municipalities that do not have the capacity to implement the reform, Liu (2019[27]) suggests that a financial incentive programme in the form of an inter-governmental transfer aimed at rewarding municipalities that make substantive efforts to roll out the new property tax can incentivise the introduction of the tax and help boost capacity. In addition, the implementation in each municipality can also be phased, with a stronger focus on high-end properties at first.

Another interesting option is to use a relatively simple tax base at the time of the introduction of the reform, when fiscal cadastres are not yet completed, and the administrative apparatus has not yet matured. Along these lines, Ahmad (2021[8]) suggests that China could introduce a recurrent tax on residential properties that uses area as the tax basis. Such a tax is relatively easy and cheap to implement, as it is not necessary to assess properties' values and, if combined with a linkage between revenues and local expenditures, could still increase the overall redistributive effects of China's fiscal system. This approach could be valuable for some regions and municipalities in which data on property transactions and characteristics are not available. By following this approach, the tax could be introduced sooner and, therefore, raise own revenues for SNGs sooner than waiting until property values are fully assessed. It would be important to clearly announce that the simplified approach is a transitory one, with the longer-term objective to use a value basis. Over time, then, depending on the maturity of the regional/local property tax administration and on the quality of the data collected on properties, the local/regional tax administration could move towards a value-based approach.

Transitional measures can be useful to alleviate short-term effects of a tax hike, nevertheless reformers need to design and implement these measures in a manner that the full implementation of the reform is secured in the long term

Tax reforms can change the status quo to which taxpayers have already adapted, leading to undesirable disruptive effects. In the case of a salient levy as recurrent property taxes, a sudden tax hike can catch households unprepared and may increase delinquency (Slack and Bird, 2014[3]). Furthermore, a sudden tax hike can also impact the real estate market in case tax obligations are capitalised into prices, potentially destabilising the state of the real estate market (Blöchliger, 2015[4]). As Slack and Bird (2014[3]) put it, "*failure to allow adequately for transitional problems and to cushion burden shifts adequately can be a fatal defect".* In addition, property tax reforms may change the relative tax power across jurisdictions and, in case they are revenue neutral, can cause a reduction in revenues in some jurisdictions. Examples of (temporary) transitional measures include reduction in tax rates and the provision of tax benefits/reliefs such as tax credits, tax deferrals, among others (Box 4.3, presented in the previous section, gives interesting examples of transitional measures employed by Denmark).

Blöchliger and Vammalle (2012[2]) in an overarching study on fiscal federalism and subnational government reforms covering ten OECD countries found that transitional compensation is almost always necessary. The target of these measures can be stakeholders or jurisdictions. In the cases analysed by these authors, the central government usually funded these transitional costs and opt-out clauses were provided. For instance, the Swiss established transitional "cohesion funds" to ensure that SNGs would suffer no losses in financial terms in the next 28 year after the reform.

One option to cushion the impact of a reform on taxpayers is by keeping effective tax rates low until the tax administration can have a good coverage (Rosengard, 2012[23]). When fiscal cadastres are not yet complete, properties' values were not assessed or the tax collection is not working properly in some specific regions, tax obligations across properties will shift greatly only due to administrative obstacles. In case this transitional period lasts long, these inequities may start to influence taxpayers' behaviour, creating economic distortions. Keeping effective tax rates low may minimise this risk.

Although cushioning the impact is desirable to avoid disruptive effects, measures employed for that purpose are neither costless nor risk free. First, the longer the cushioning mechanism stays in place the longer it takes to move to the desirable tax system. Second, some planned changes might never be put into place and, in numerous cases, temporary solutions are perpetuated (see Box 4.6 in the Korean case at the end of this section). Thus, although transitional measures might be politically important for the approval of a reform, reformers need to design and implement these measures in a manner that the full implementation of the reform is secured so it can achieve its initial goals (Slack and Bird, 2014[3]). One way to increase the chances of a full implementation is to include in the original legislation the expiry date of the transition period or the date in which incremental changes will enter into force (i.e. sunset provision or clause). In that manner, groups that benefit from the transitional measures would have to work harder to maintain their special treatment since it would require a change in the reform's plans, which were made transparent and were legitimised in the legislation (Brys, 2011[1]).

Two specific elements of the Chinese tax system are worth mentioning in the context of transitional measures. First, China already levies transaction taxes on immovable property and, thus, right after the introduction of recurrent taxes on residential property, taxpayers might feel that the new obligations are unfair since they just paid their transaction taxes. Second, Liu (2019[27]) pointed out that due to the very low carrying costs of housing investments in China, many households own multiple properties, and, in this case, the introduction of a recurrent property tax applied to these households could create a disruption. In order to alleviate this sense of unfairness and to give room for investment portfolio adjustment, transitional measures can be employed. Liu (2019[27]) and Brys et al. (2013[28]) suggested that authorities can mitigate these problems by phasing-in the property tax reform, granting a temporary high basic tax-free allowance for the recurrent taxes on immovable property and/or starting with a wide tax base and very low tax rate. In case the reform is bundled with a reduction of the levies on properties transactions, a tax credit can be given to taxpayers who recently paid transaction taxes so that the new recurrent levy on residential properties is not considered unfair to these taxpayers. Such a levy needs to be temporary and, ideally, phased-out gradually over a few years.[7]

Communication strategies for tax reforms: engaging a wide range of stakeholders, obtaining a consensus on a reform's broad long-term goals and focusing the discussions on the systematic rather than individual impact of the reform

Communication, when employed effectively, can help sustain the necessary political and popular support to ensure that the reform will be introduced and implemented in full. Slack and Bird (2014[3]) suggest that both policy makers and taxpayers are more likely to buy into a reform if they have been consulted and feel that their issues have been properly heard. In this light, a consultation previous to the announcement and implementation of the reform can reduce popular opposition.

A communication strategy that engages multiple stakeholders such as business, unions, special interest groups, academics and the broader public can create a feeling of ownership and reduce resistance (Brys, 2011[1]). Blöchliger and Vammalle (2012[2]) highlighted that external expertise can be particularly useful since they can provide impartial and unbiased scrutiny, raising the credibility among the public. These authors showed how external expertise was fruitful in reforming elements of the fiscal policy in several OECD countries such as Finland, Australia and Canada. It is worth noting that the language spoken by these experts are often different from the language spoken by the average citizen and officials. These authors found evidence that creating a credible independent panel consisting of experts and professionals who know how to communicate with non-experts can help the interpretation of the reform package by the general public.

Blöchliger and Vammalle (2012[2]) emphasised that although consultation is clearly beneficial, too much consultation can inflame opposition. From the cases analysed by these authors, the most successful consultation strategy involved parsimony with numbers related to the short-run impacts of the reform and a focus on discussing a reform's overall/long-term goals. In other words, the long-term objectives were the focus of the communication instead of short-term distributional impacts. These long-term benefits can be communicated to the general public through promotional slogans such as "better services" and "more autonomy". It is worth noting that although it is beneficial to highlight long-term benefits, reforms issues should not remain hidden – successful reforms often emphasise the long-term benefits without concealing negative impacts (Blöchliger and Vammalle, 2012[2]).

In the same vein, Brys (2011[1]) highlighted the importance of obtaining a consensus on these broad long-term goals of a reform and explored how this can be achieved through a clear communication focused on long-term objectives and trade-offs involved. Accepting specific constraints to the reform might also facilitate the reform's implementation since stakeholders are now aware of what is negotiable and what is not. In the absence of broad strategic consensus, the same author suggests that governments can reduce uncertainty and begin to guide debates by announcing aspirational tax reform's goals before presenting specific proposals. This announcement can 1) bring support to the reform from groups that are benefited by the reform; and 2) create a reputational cost for the government to change the reform's goals after an announcement.

Lastly on communication, Alt et al. (2010[29]) argue tax reforms should not be discussed in isolation. The general public often lacks understanding about the interplay between the tax being reformed and fiscal policy's goals and, thus, can make wrong assessments about the impacts of the tax reform. Keeping a narrow focus on an individual tax hinders comparisons and makes it easier for opposing groups to attack the reform by showing its negative impacts without comparing them to the impacts of other available options. For instance, according to these authors, one of the reasons for the abolition of the estate tax in the United States (i.e. inheritance tax) was a narrow-focused communication, which helped the organisation of opposing groups that focused the debate only on the tax's problems and not on its overall effect on the progressivity of the tax system and on its revenue-raising capacity that can raise funds for the provision of additional public services.

Bundling is commonly employed in recurrent property tax reforms as a way to overcome political resistance through compensation of losers and improving distributional effects

Bundling multiple reforms together is a good strategy to offset or alleviate negative impacts of individual reforms with the impact from other reforms. It is worth noting that bundling is not the same as transitional compensations as bundling may involve elements outside the original scope of the property taxation reform and in a permanent way. A bundling strategy can be designed in a manner to overcome political resistance and build popular support for the implementation of the reform. According to Olofsgård (2003[30]), bundling reforms may be especially useful in case there are many actors whose support is crucial – for instance, when multiple groups have veto power because each group should be satisfied in order for the reform to pass and, under these circumstances, bundling the reform with elements that satisfy each of these groups can secure a reform's approval. Blöchliger and Vammalle (2012[2]), on the other hand, although they recognise that bundling is typically employed and often fruitful, it can lead to an excessive focus on satisfying stakeholders, detracting the reform from its efficiency-enhancing aspects.

Brys (2011[1]) explored two important benefits that come from bundling. First, it may make it easier to address distributional issues, especially when a tax is bundled with measures from the expenditure side that have substantial impact on the income distribution, such as cash transfers to the poor (Joumard, Pisu and Bloch, 2012[31]). Second, bundling tax reforms with improvements in service delivery can increase the overall acceptance of and compliance with the tax being reformed – see Simonsen & Robbins (2003[32]). For the latter strategy, it is particularly interesting to phase in tax changes over several years so the pace at which services can be improved is linked to the pace at which citizens are being taxed.

In OECD countries it is common for countries to bundle reforms in recurrent taxes on immovable property with other tax reforms and with changes in the inter-governmental fiscal framework.[8] For instance, in 2005 Korea introduced a comprehensive real estate tax together with a reduction in property transaction taxes and with an introduction of a grant inversely related to property tax raising capacity (i.e. as a compensation for local revenue losses). Another example is Finland, which has, in less than 3 years, 1) reformed its property tax system; 2) increased the share of corporate income tax that is allocated to municipalities; and 3) discontinued its revenue equalisation transfer system (see Box 4.7 in the Finnish case for more details).

Box 4.6. Korea's property tax reform: success and failures

In 2005, Korea introduced the central government's "comprehensive real estate tax" on immovable property, thereby complementing the existing range of local immovable property taxes. The tax base covers residential and business property with land and improvements as taxable items, which are assessed in conjunction by market prices. Tax rates are progressive with respect to property values and vary between 0.15% and 0.5% of the overall value of a property. Local governments must use the same tax base for their own property tax (Korea has a central and a local property tax) and are allowed to set tax rates individually but, in practice, all municipalities set the standard rate recommended by the central government.

After the introduction of the comprehensive real estate tax, local and central property tax revenues combined rose from 0.5% of GDP in 2005 to almost 1% of GDP in 2007, before declining to around 0.8% after 2009. Nevertheless, the comprehensive real estate tax is still, as a proportion of total property tax revenues, much smaller than the average OECD country (see Figure 1.2, in the first chapter of this report).

Improving the chances of a successful implementation

The reform aimed at making Korea's property tax system fair in the eyes of taxpayers. Until 2005, Korea could be described as having a "narrow-tax-base, high-tax-rate" property tax system, which used to offset the undervaluation of properties with high and excessively progressive tax rates. As discussed throughout this report, compensating an adequate valuation process with tax rate setting is very likely to lead to horizontal and vertical distortions, making the tax system unfair. The reform reverted this situation by 1) broadening the tax base; 2) reducing tax rates; and 3) improving fairness by establishing an isonomic and fair valuation system based on both land and improvements assessed in conjunction by market prices. The result was an increase in the assessed value of 60% of the dwellings in the urban area, where about 80% of the Koreans live. This increase more than compensated the reduction in tax rates, increasing tax revenues while simultaneously creating trust that the underlying rules of property taxation were fair, progressive and equitable. In addition, many strategies aimed to improve the chances of a successful implementation covered in this section were put to use by the Korean government.

First, regarding communication and the perceived regressivity of recurrent property taxation, the government openly supported a reduction in income inequality and the reform was openly one of the means used to achieve this goal. Despite the fact that property tax rates in place before the reform were progressive, their overall distributive effects were minimised by distortions on cadastral values. These distortions greatly reduced the tax burden in an unfair and regressive manner. To solve this problem, the reform improved the valuation system along with a reduction in tax rates. More specifically, the range of tax rates was reduced from 0.2-7% to 0.15-0.5% and many taxpayers were charged with the lowest possible tax rate.

Second, the timing of the reform was very good. As with many successful reforms, the introduction of the comprehensive real estate tax took place during a period of strong economic growth, which averaged almost 3% annually between 2003 and 2007. Real house prices rose by 5 to 10% per annum during the same period. Also, the government finances were in good shape. The timing was important to reduce the resistance against the property tax reform. Taxpayers were aware of the disproportionate increase in property values in some areas and were in favour of a tax system that distributes the tax burden in a more equitable fashion. It is worth noting that the reform seemed to have temporarily stabilised soaring house prices – after the reform implementation's there was an inflection in house prices that started to decrease slightly, picking up again afterwards.

Third, the property tax reform was bundled with other reforms, especially the reduction of property transaction taxes and a new inter-governmental grant. Transaction tax revenues were almost three times higher than recurrent tax revenues before 2005 and, after the reform, this proportion shrank to two. The comprehensive real estate tax was also coupled with the introduction of an inter-governmental grant inversely related to property tax raising capacity. This grant compensated local governments for losses in local revenue capacity because the new central tax affected other local taxes on property whose tax base became aligned with the new national tax. In addition, tax revenues from the new tax were distributed in favour of poor jurisdictions, doubling the channels through which the tax distributed income to the poor.

Conclusions

Korea offers a very interesting case of how an unpopular revenue-raising property tax reform can receive public support when the reform strategy is well implemented. The reform successfully improved Korea's property tax structure, which was based on unrealistically progressive rates with deliberate under-assessment of properties, which used to generate unfair charges. Having fair assessments, timing the reform well, bundling the reform with the reduction in transaction taxes and changes in the inter-government transfer system, and focusing on improving the distribution of income are all strategies that China can replicate to increase the popularity of such tax reform.

Nevertheless, despite this success, the reform was only partially implemented. The initial reform project foresaw an annual increase of the ratio of taxable to assessed property values by 3 percentage points each year until that ratio reached 100%, but this stepwise increase was soon abandoned, and the taxable ratio remained at 60% to 70% of assessed values. This example of transitional measures that last more than it should reveals the difficulties of securing the full implementation of phased reforms.

Source: OECD – Reforming Immovable Property Taxation in Korea (background note).

Leaseholds and collectively owned land can create problems for property tax reforms; nevertheless, these can be mitigated with bundling, communication and transitional strategies and with a clear distinction of the levies on land and buildings

When introducing recurrent taxes on immovable property in a country that has a leasehold system in place, taxpayers might oppose the reform on the grounds that they are being double taxed since they are paying both a lease fee and a recurrent property tax. Hong (2012[33]) raised interesting points, here highlighted, regarding the introduction of recurrent property taxes in such a context.

First, despite the convenience of combining all land related levies into one payment (i.e. lease and recurrent property taxes), taxpayers might confuse taxes with leasehold fees and, thus, these should be kept separate, so the taxpayer knows what he is paying for in each payment. The similarity of lessees and taxes payments without proper taxpayer education can create an expectation that the land is owned by the lessees. According to Hong (2012[33]) this has happened to some extent in Canberra/Australia and Israel, both of which have a leasehold system. In order to minimise this problem, lessees in Canberra must pay the entire leasehold value up front and the property tax afterwards on an annual basis (Neutze, 2003[34]). In addition to clearly separating the leaseholds fees and tax payments, taxpayers should be educated about property taxes and the leasehold system so they understand what the purposes of each charge are.

Second, when ownership of land and buildings are not the same (as in China, especially in the case of collectively-owned land), two different levies – one applied to buildings and other to land – can be created to tax these assets separately. These arrangements are not uncommon in OECD and partner countries.[9]

For instance, Hungary has a separate levy on land and improvements. Denmark and Slovenia have a separate land, building and immovable property tax. Greece, Ireland and the United Kingdom have a building tax plus an immovable property tax. Finally, Australia, Brazil, New Zealand, Poland and the Slovak Republic have a land tax plus an immovable property tax.

Third, as explored in the second chapter, tax liabilities can be capitalised into house prices[10] and, in case of taxes applied to leaseholds, this capitalisation can hurt leasing fees. In the most extreme scenario, the revenue obtained from recurrent property taxes can be fully offset by a reduction in leasing fees. Of course, the timing of the capitalisation is not immediate and depends greatly on many factors such as the date of leaseholds' renewals and the elasticity of supply and demand of properties. As a result, until the effect kicks in, it is possible for governments to use the revenues raised by the recurrent property taxes to improve the supply of public services and local infrastructure, among others. In that way, this improvement can also be capitalised into property prices, alleviating or potentially cancelling out the reduction in leasing fees. It also is worth noting that there is evidence that taxpayers are more inclined to pay property taxes when they rate the quality of public services highly (Simonsen and Robbins, 2003[32]).

Fourth, recurrent taxes on immovable property can be levied on the occupancy of the property – as suggested by Ahmad (2021[8]) – and, therefore, be interpreted as a tax on housing services or on capital or even as a fee for using land or local services. Although in essence the levy is applied to the same tax base, these different interpretations are particularly important in the context of leaseholds since some of these interpretations can minimise the impression of double taxation. Especially when property taxes are viewed as a fee charged to the occupant for using local services, this interpretation is implausible. That is because leasehold fees and local service fees clearly do not refer to the same charge. In that regard, one potential way to reduce the room for interpretation that recurrent taxes on immovable property lead to double taxation is to name the charge in a way that favours the interpretation of a fee for using local services. For instance, recurrent taxes on immovable property in the United Kingdom and in Australia are known as "council tax" and as "council rate", respectively.

As a result of the third and fourth points, a bundling strategy that combines the introduction of the levy on properties with improvement of local services may not only offset potential reductions in leasing fees but also makes it harder to interpret the levy as a form of "double taxation", reducing the resistance against the reform. In that context, Ahmad and Colenbrander (2020[35]) suggested that China could link property tax revenues with social benefits, such as free or subsidised transport for the elderly or support for basic education. These authors highlighted that this linkage could have many benefits such as: 1) improving the distributional impact of the tax; 2) enhancing accountability; 3) assuring a stream of funding for basic services; and 4) enabling access to private finance for investments. All these effects could increase the acceptability of the reform.

Fifth and lastly, the introduction of levies on leaseholds may be considered unfair to lessees who recently paid the entire leasehold fees, and thus, did not anticipate this future liability. In case leasing fees are reduced due to the introduction of the tax, this problem can become even more apparent. In that regard, transitional measures targeted at these taxpayers can be employed (the previous section covered this issue in more detail).

Tax reforms and fiscal decentralisation

Recurrent property tax reforms can affect the distribution of revenue across levels of government (vertically) and within levels of government (horizontally)

One last issue that is worth discussing in the context of property tax reforms regards their impacts on different levels of government and inter-governmental fiscal relations. As recurrent taxes on immovable property typically are an important source of revenue for subnational (mainly local) governments, property tax reforms can significantly affect the distribution of revenues across levels of government (i.e. vertically) and within the same level of government (i.e. horizontally). Therefore, in order to alleviate negative impacts on certain levels of government and/or jurisdictions, it is common for governments to bundle reforms on recurrent property taxation with reforms on inter-governmental relations (see, for instance, the Korean case in Box 4.6, above, and Box 4.7 and Box 4.8 on the Finish and Italian cases).

Regarding vertical relations, when recurrent taxes on immovable property accrue to SNGs, raising their share in total taxation will tend to increase the share of subnational revenues in general government revenues. This shift in the distribution of revenues across levels of government as a “by-product” of a property tax reform can be undesirable. In this situation, this relative increase in subnational revenues can be offset by a reduction in inter-governmental grants from upper levels of government. In case this shift is desirable, it might be convenient to reform other aspects of a country’s fiscal federalism framework. As a result, it is common for property tax reforms to be part of a comprehensive package on fiscal federalism reforms (Box 4.7, on Italy’s 2009 property tax reform, presents an interesting example of a joint reform of property taxation and fiscal federalism).

Box 4.7. Reshaping fiscal relations in Italy

Italy’s 2009 fiscal federalism reform offers an example of how reforms on recurrent taxes on immovable property can be bundled together with fiscal federalism reforms. The main goal of Italy’s 2009 reform was to increase both the efficiency and accountability of subnational governments through an increase in their own revenues and reduction in inter-governmental grants. The reform had four pillars: 1) alignment of subnational own revenues with their expenditures; 2) clarification of spending obligations; 3) equalisation of tax-raising capacity and costs; and 4) harmonisation of accounting principles.

Alignment of subnational own revenues with their expenditures: this reform entitled subnational governments to a set of own taxes and to shares in national taxes sufficient to cover their spending needs. Regions were entitled to 1) the tax on productive activities (i.e. a regional business-cum-value-added tax) and the personal income tax, with autonomy to set tax rates within pre-established limits; and 2) a share in the national value-added tax. Municipalities were entitled to 1) a recurrent levy on properties applied to properties that are not occupied by their owner; and 2) a share of the value-added tax and the personal income tax. These sources of revenue were granted to SNGs simultaneously with the discontinuation of inter-governmental grants. Only equalising grants and some special-purpose grants remained.

Clarification of spending obligations: responsibilities for public services at the subnational government level were divided into compulsory services (i.e. health care, education, social protection and local transport) and all other public services. While the central government has the responsibility of defining minimum standards for compulsory services, subnational governments are free to define standards and spending levels for the other services. All services not explicitly allocated to the central government level are of regions’ responsibility.

Equalisation of tax-raising capacity and standard cost: two different equalisation systems were introduced: 1) equalisation of the cost for essential and compulsory services, to be fully equalised and based on standard cost instead of historical cost; and 2) equalisation of tax-raising capacity, for which the equalisation rate gradually increases by 5% every year to reach 100% in 2030, leaving SNGs an incentive to develop their economic and fiscal base.

Harmonisation of accounting principles: accounting principles for regional and local levels of government (such as accounting and budget rules, the treatment of publicly owned enterprises, depreciation rules, etc.) were harmonised, so that regional and local accounts will be truly comparable and "creative accounting" minimised.

Source: Blöchliger and Vammalle (2012[2]).

Revenue equalisation can be employed to offset differences in tax revenue capacity – in this case it is important that upper levels of government prevent local governments from gaming the transfer system

Regarding horizontal relations within levels of government, property tax reforms can lead to an asymmetrical distribution of tax revenues across jurisdictions. This asymmetry can start with the reform's implementation and may grow over time in line with regional/local characteristics such as the regional/local housing market and administrative capacity. For instance, Färber et al. (2013[36]) found evidence that a reform of the German property valuation system would considerably change the relative tax capacity across Germany's states. Similarly, Ahmad et al. (2019[37]) simulated the impact of the introduction of a recurrent property tax in China and concluded that the distribution of revenues would be asymmetrical across and within provinces with bigger cities, like Guangzhou and Shanghai, raising significantly more revenues than smaller ones.

Due to these differences in tax revenue raising capacity across jurisdictions, it is common for OECD countries to establish a or to enhance their existing fiscal equalisation system, for a detailed view in equalisation systems see (Dougherty and Forman, 2021[38])). Fiscal equalisation is a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity and public service costs. This arrangement is adopted in most OECD countries. According to OECD (2020[13]), these funds, when considering both revenues and costs equalisation together, can amount to roughly 20% of the total subnational expenditure (e.g. in Japan, Austria, Ireland, Korea and Germany). In that regard, when property tax reforms create imbalances on revenue capacity, changes in the fiscal equalisation framework can be adapted to offset these re-distributional effects (see Box 4.7, above and Box 4.8, below).

Exemptions can also cause vertical or horizontal imbalances in property tax revenue capacity. In that case, exemptions granted by lower levels of governments should be treated differently than exemptions granted by upper levels of government. In the first case, the lower levels of government decided to give away their potential tax base and, thus, the potential tax base for equalisation purposes should include the exempted base (i.e. maintaining the revenue capacity of the SNG that granted the exemption identical to its revenue capacity before granting the exemption and, thus, keeping its equalisation fund share constant). In the second case, the exempted tax base should be excluded from the tax base used for computing the revenue capacity for equalisation purposes. That's because lower levels of government should not be harmed by a decision from upper levels of government, whose impacts are proportional to the asymmetrical distribution of tax-exempt properties across jurisdictions. In this manner, jurisdictions that are losing more revenue capacity are also going to be compensated more by the equalisation system. Lastly, exemptions granted by upper levels of government can also create vertical imbalances, creating resistance from lower levels of government to the exemption. For instance, in Poland local governments asked for compensation for their loss in property tax revenue capacity and demanded that the introduction of new centrally imposed exemptions should require local government consent (Swianiewicz and Lukomska, 2015[39]).

It is important for equalisation transfer systems to be designed in a way that they incentivise tax collection and prevent governments from obtaining a larger share of the equalisation funds than they deserve. In many countries, equalisation penalises tax collection (Blöchliger, 2015[4]) – that is, subnational governments can increase equalisation funds by under-taxing local taxpayers. Most countries minimise this issue by cutting the link between equalisation funds and actual subnational tax revenues through the use of revenue capacity instead of actual revenues in the equalisation formula. Some countries go even one step further by employing a system that rewards subnational governments for collecting more property tax revenue.

Some interesting examples of equalisation systems in which there are incentives for local governments to raise property tax revenues can be found in Norway, Germany, Ireland, among others. Property tax actual revenues of Norway's municipalities are not considered in the equalisation formula, while in Germany only 64% of municipal property tax revenues are included in the equalisation formula. In Ireland, a local property tax on residential properties (LPT) was introduced in 2013, in addition to the existing property tax levied commercial properties (commercial rates). 80% of LPT's revenues are retained locally for the funding of basic public services, while the remaining 20% are allocated to the equalisation fund (Slack and Bird, 2014[3]).

In case equalisation funds are based on revenue raising capacity, upper levels of governments should also hinder subnational governments to game the system by systematically under-assessing properties. One way to mitigate this problem is by ensuring that all jurisdictions maintain a specified average "assessed to market value ratios". Another way is to accept differences in this ratio and adjust the equalisation formula so that property values used for equalisation purpose take into account these differences. These measures minimise distortions in the equalisation base that are caused by differences in valuation policies.

Bundling property tax reforms with reforms in fiscal federalism can be challenging – characteristics of the fiscal system of the country should be carefully analysed

Lastly, despite the fact that bundling a property tax reform with reforms in fiscal federalism can yield benefits, the complexity of the reform can increase substantially. Fiscal federalism reforms are complex and need to be tailored to socioeconomic and institutional characteristics of a country[11] (Kim and Dougherty, 2018[40]). There are a myriad of fiscal federalism reforms, ranging from, for instance, a simple change in equalisation rules (e.g. Finnish case) to a more overarching change in subnational expenditure responsibilities and revenue assignments (e.g. Italian case). As a result, designing such a reform is far from trivial. It can also be a strategic choice to separate these two types of reforms (i.e. tax and fiscal federalism) in case this separation would facilitate the approval of important parts of the reform.

Box 4.8. The Finnish attempt to increase the role of recurrent taxes on immovable property

Recurrent property taxes in Finland

In Finland, the taxes on immovable property were introduced in 1993 when it replaced a set of small infrastructure and service-related local taxes. The tax base covers both land and buildings of residential and business properties. Agricultural land and forests are not taxed. While land is assessed on the basis of market prices, values of buildings are assessed on the basis of replacement cost and indexed to the national construction price index. The tax base is set by the central government, while municipalities set the tax rate within a lower and an upper limit. Tax rates are lower for residential buildings than for land and business estates. Municipalities have the option to tax vacant land at a higher rate; this is compulsory for municipalities in the metropolitan area.

Fiscal context

Finland is an unusual case with regard to fiscal decentralisation and property taxes. Finland has one of the most decentralised public sectors in the OECD (see Figure 1.7 in the first chapter of this report). Finnish municipalities enjoy ample fiscal autonomy and are responsible for providing a large array of public services, in particular education and health care. In order to finance these services, local governments can set a proportional tax rate on top of the progressive national income tax, which makes roughly 85% of their tax revenues. Most of the remaining 15% comes from property taxes and the local share in the corporate income taxes – both representing around 7% each.

Design and administrative aspects are relevant for explaining the reasons why property taxes in Finland generate relatively low revenues. First, the share of households that 1) are renting; 2) live in tax-exempt municipal houses; or 3) own a house in a property corporation where the residents pay the tax collectively is above 60%. Second, taxable values, which are updated by the Ministry of Finance, have tended to lag market values (Hagemann, 2018[41]).

In addition, Finnish local governments have more leeway in setting their local income tax rate than in setting their local property tax rates. Given that income taxes tend to generate substantially more revenues than property taxes, local governments can raise income more easily through an increase in tax rates that are applied to income rather than properties. Hagemann (2018[41]) pointed out that this system results in a counterproductive reluctance by municipalities to shift revenues toward immovable property taxation.

Recurrent property tax reforms in the last 10 years

The government has been trying to change these incentives and promote an increase in the role of recurrent taxes on immovable property in the country. Multiple reforms were implemented in the last ten years. Here most of their elements are highlighted. First, in 2010, 2016 and 2017 the government enlarged the limits at which local governments can set property tax rates. Second, governments have been updating cadastral values, which are expected to be fully updated in 2023. Third, in 2012 the property tax base was taken out of the inter-municipal equalisation system, with municipalities now fully benefiting from any effort to increase their tax base.

Source: Political Economy of Property Tax Reform in Finland (background note) and Hagemann (2018[41]).

In China's case, special attention should be given to vertical and horizontal disparities

Although China's regional and urban-rural disparities are declining, they are still significant and higher than the average OECD country. First, OECD (2019[9]) shows that regions differ substantially in many respects, such as medical staff per capita, infrastructure, and disposable income. Second, the Chinese tax system is designed in a manner in which tax yields tend to be more unequally distributed geographically than income. Third, in China vertical disparities between revenues and spending mandates are high, and the gap between own revenues and spending is the greatest at the lowest levels of government (OECD, 2019[9]).

Therefore, a reform that aims to introduce recurrent taxes on immovable property in China can be particularly important to reduce this vertical gap, but it needs to take into consideration these large regional disparities so as to not to further increase them. Such a reform can increase regional inequality for at least two reasons. First, richer local governments are more likely to succeed in the implementation of a well-functioning property tax administration structure that, as was explored throughout this report, has a fundamental importance for collecting property tax revenues. Second, property values are higher in richer jurisdictions, which directly affects their tax revenue capacity. Therefore, in case a fully decentralised property tax system is implemented and local governments do not have the necessary support from upper levels of government, such a tax reform is likely to increase regional disparities in local revenues.

Despite this challenge, OECD countries offer valuable examples of strategies that can be employed to deal with regional inequality. Based on OECD countries' experience, at least two strategies can be implemented by China: a boost in equalisation transfers and the provision of central support to SNGs. Although China already has in place a substantial equalisation system, the introduction of recurrent taxes on immovable property are likely to increase the disparities in revenue capacity across jurisdictions and, thus, an increase in equalisation funds can be necessary to offset that. It is worth noting that although boosting equalisation transfers is crucial to level differences in local revenue capacity, this solution alone might not be sufficient to level differences in local capacity to implement a sound property tax system. For that purpose, support from the central government can be especially important. This support can be provided in the form of (earmarked) funds, loans or even, in a more extreme situation, a temporary centralisation of the property tax administration. As mentioned before, in case a temporary solution is pursued, having a pre-established date, potentially enforced by law, can help setting expectations and securing that the reform will be implemented fully in the future.

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Notes

[1] This topic is further discussed in this chapter's transaction section.

[2] For an in-depth discussion on tax reliefs, see Chapter 2.

[3] As mentioned in Chapter 3, this practice is found in Denmark (who aims to produce values that are about 5 percent lower than actual market prices) and in some Canada and US states, which aim to estimate values up to 10% lower than market's (UN Habitat, 2013[5]).

[4] It is worth noting that a country can pursue this practice and, at the same time, raise the desired amount of property tax revenue by adjusting upward the nominal tax rate.

[5] See Slack and Bird (2014[3]).

[6] It is worth noting, though, that it is possible for governments to reduce incentives to under-value properties by penalising this action. For instance, it is possible to establish a system in which when the property owner wants to sell his or her property, the government retains the right of first refusal at the self-assessed price.

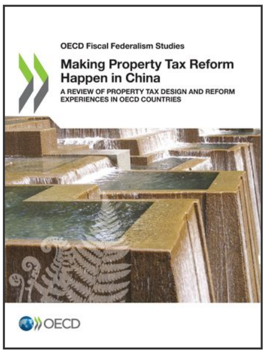
[7] Australia offers two interesting and recent examples of phase-outs of transitioning from transaction taxes towards recurrent taxes on immovable property. First, the Australian Capital Territory Government has, since 2012, gradually reduced the tax rates applied to property transactions, while increasing the annual tax on immovable property. This reduction has already led to the end of this charge on transactions of certain types of property such as commercial properties worth AUD 1.5 million or less (for more details, see www.revenue.act.gov.au/tax-reform). Second, the New South Wales Government is considering implementing a similar reform and, to avoid double taxation, is discussing the possibility to give the property buyer a choice as to whether, when purchasing a property, they enter the current regime (transaction taxes plus annual recurrent taxes) or, alternatively, the new regime without transaction taxes but higher recurrent taxes on immovable property. There are also discussions on extending this option to owners of recently purchased properties in a retrospective manner – in this case the transaction tax would be refunded if they elected to switch to the new regime (for details see www.nsw.gov.au/initiative/property-tax-reform).

[8] Due to the fact that recurrent taxes on immovable property are typically managed by local governments, bundling property tax reforms with changes in the inter-governmental framework is especially important and, therefore, deserves a more detailed discussion. The next section digs into this issue in a more detailed manner.

[9] For more see Almy (2014[12]).

[10] See Borge and Rattsø (2013[42]) for evidence.

[11] For more on reforming fiscal federalism see Blöchliger and Vammalle (2012[2]); Kim and Dougherty (2018[40]); as well as Kim and Dougherty (2019[43]). The latter is focused on potential and current fiscal federalism reforms in Asia.



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