Verité Research
Strategic Analysis for Asia

PROPOSAL TO RAISE MORE REVENUE FROM THE PROPERTY RATING SYSTEM BY CHANGING THE VALUATION METHOD

DETAILS OF THE SUBMITTER

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This proposal is submitted by Prof. Mick Moore through Verité Research. Prof. Moore is a political economist and Professorial Fellow at the Institute of Development Studies, with research interests in governance in developing countries, particularly taxation and governance. From 2010 to 2020, he was the founding Chief Executive Officer of the International Centre for Tax and Development. He is also a non-resident fellow at Verité Research and a member of the Verité Research Sri Lanka Economic Policy Group.

THE PROPOSAL (SUMMARY OF THE REVENUE MEASURE)

The proposal is to reform the property rate system and turn it into a significant source of government revenue by changing just one of its features: the method used to value and revalue properties. No changes in the law are required.

SHORT ABSTRACT

Property rate revenues are very low because valuations are far below market rental values, revaluations are infrequent, and local councils have little incentive to raise assessments that appear unfair. Automated Valuation would change the valuation method: using digital technologies to collect external property images, convert them into numerical scores, and calibrate those scores with local capital or rental values. The method is cheaper, less subjective and can allow continuous revaluation. The reform should be pursued only with an intention to increase property rate revenues five-fold within about two years.

TOPLINE VIEW

Objective of the Proposal

- ☐ Economic Growth
- ☒ Governance
- ☐ Justice and Rights
- ☒ Social Welfare
- ☐ Other: ....

Implementing Agency:	Local councils; Government Valuation Department
Primary Beneficiaries:	Local councils and general public
Fiscal Impact:	Five-fold increase in property rate revenues
Policy Type:	Revenue Increasing

HOW IT ADVANCES THE OBJECTIVES

1) **Governance:** - Strengthens the capacity of local councils to raise their own revenue rather than relying almost entirely on transfers from the national government. It also creates a more regular and objective basis for valuing properties.

2) **Social Welfare:** - A property tax is a tax on wealth, which is more unequally distributed in favour of the rich. Increasing property rate revenues therefore shifts the burden of taxation towards the rich and can help improve local services.

CASE FOR THE PROPOSAL

Local councils raise very little own revenue

Local councils (Municipal, Urban and Pradeshiya Sabhas) depend on transfers from the national government for nearly all their spending. They raise very little revenue themselves.

Property rate revenues are the largest single source of 'own revenue' for local councils. But the actual level of property rate revenue collection is extremely low. It is one of the lowest in the world (relative to GDP). With the exception of the Colombo Municipal Council, property rate revenues probably are all absorbed in administering the system. They generate little or no net revenue.

Property records are good, but valuations are too low

By contrast, the records associated with the property rating system are good. In particular, nearly all the residential and commercial buildings that are liable to pay rates are recorded in local rate registers and have a valuation. That valuation, which is in principle the potential annual rental value, is known as the Annual Value. Annual rate bills are the result of applying a percentage figure to the Annual Value.

There are three interlocking reasons why actual revenues are so very small. One is that a significant fraction of property owners do not pay and, because their liabilities are so small, local councils do not make much effort to pursue them. A more important reason is that actual property valuations are on average extremely low. They are typically only a fraction of market rental values. Finally, local councils are very reluctant to increase assessments to collect more revenue when (a) it is possible to get revenue through transfers from central government and (b) when the relative valuations of similar properties in the same area are often very different because revaluations are done only after delays of a decade or more. It is hard to persuade property owners to agree to a tax that seems unfair to many of them

The current valuation method is the weakest link

The weakest links in the current system are the infrequency of general revaluations for rating purposes and, even more, the ways in which revaluations are done. Revaluations are done by trained Valuers from the Government Valuation Department. They inspect each property individually, and make a valuation according to a check list of the attributes and facilities of each property.

While valuations are in principle annual local market rental values, the valuations given are not in practice calibrated with those market rental values, and are far below them. This way of valuing is costly relative to the revenues generated from rates. It typically involves direct face-to-face interactions between Valuers and property owners. This is undesirable for any kind of taxation.

Valuers from the Government Valuation Department have a very wide range of valuation tasks, some of them quasi-commercial. Revaluations for rating purposes are a low priority, and only undertaken occasionally. In the interim, the new valuations and revaluations that are required because of new building or property improvements are normally undertaken by local council staff.

The current rating system is in low level equilibrium. It generates very little revenue; the likely costs of turning it into a significant source of revenue for local councils seem high and no one has a strong incentive to reform it.

Mechanism of execution: change the valuation method, not the law

There is now an opportunity to reform the property rate system and turn it into a significant source of government revenue by changing just one of its features: the method used to value and revalue properties. No changes in the law are required.

This opportunity arises from the recent rapid spread of a new set of digital technologies for property valuation. These are variously known as AVM (Automated Valuation Models), CAMA (Computer-Assisted Mass Appraisal) or PBV (Points Based Valuation). Automated Valuation is already used successfully in cities in the Global South,such as Kuala Lampur and Bangkok.

Automated Valuation involves the use of digital technologies to (a) collect various kinds of external images of each property (b) translate them into a numerical score (points) that reflects the features that affect its market value (size, construction quality, facilities, services, location etc) and (c) convert the numerical score into a capital or rental value on the basis of data on actual capital or rental values from a sample of properties in the locality.

The big advantages of Automated Valuation over the current valuation system are: it is much cheaper; revaluation can be undertaken continuously; the personal and subjective element in valuations is eliminated; valuations can again be aligned with local rental markets through statistical analysis.

The technologies used for implementing Automated Valuation can be varied to suit local circumstances, as can the extent of detail collected on individual properties.

Further details on the steps needed to implement Automated Valuation are in a recent Verite Research briefing paper - Property Taxes in Sri Lanka: Proposal for a More Effective Valuation Method

Implementation can begin with Municipal Councils

The main requirements for implementation are that (a) one or more local councils are willing to experiment with Automated Valuation and (b) a way is found to support one or more local companies to develop the capacity to implement Automated Valuation. While Automated

Valuation seems not yet to have been used in Sri Lanka, there are local companies that have done related work and have the capacity to learn how to implement it.

The initial focus should be on adoption by Municipal Councils. They have greater capacity and are most likely to be able to use the additional revenue quickly to offer tangibly improved services to local populations.

Expected Fiscal and Administrative Impacts

The implementation of Automated Valuation will considerably increase Annual Values attributed to properties. The extent to which those increased valuations are used to increase property rate revenues is a policy decision. It would not be worth experimenting with these ideas without intending to increase property rate revenues five-fold within about 2 years.

Property rate revenues are by law assigned to local councils. Once the reform is successful and widely adopted, the national government would have the option of sharing in the revenue gains by reducing the level of fiscal transfers made to local councils.

RISKS TO IMPLEMENTING THE PROPOSED REVENUE STRATEGY, AND MITIGATION MEASURES

1) **Risk:** In the absence of specific evidence that the proposed technology will work and that supporting services are available, Municipal Councils may be reluctant to adopt.
   - ⇒ **Mitigation:** Small financial incentives for early adopters, such as some matching additional income from government for a limited period of time, would potentially have a big pay-off.

2) **Risk:** Increases in taxes are never popular. In Sri Lanka's case, most of the (necessary) increase in tax revenue has come from increases in income taxes or VAT, which is a tax on consumption.
   - ⇒ **Mitigation:** A property tax is a tax on wealth, which is more unequally distributed in favor of the rich. An increase in property rate revenues, therefore, shifts the burden of taxation towards the rich. The government could be supportive of the proposal administratively but encourage Municipal Councils to take the lead in adopting and defending the reform.