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**Property Tax System in India: Problems and Prospects of Reform**

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## **Introduction**

The design and implementation issues relating to property tax is one of the relatively less researched areas. This is particularly so in developing countries where the property market is largely unorganized and therefore, valuations are extremely difficult, information available to the tax authorities is restricted, extent of decentralization is limited, the local elite or “distributional coalitions”<sup>1</sup> are powerful and there are serious capacity limitations for the levy designing and implementing the property tax. In fact, in most of the developing countries, the vicious cycle of low service quality, low tax compliance leading to further low level of local public services continues to persist. While it is acknowledged that the metropolitan areas are the places which generate economic dynamism, breaking this vicious cycle is at the heart of creating this in developing countries. As property tax is the most suitable source of revenue of local governments, its reform is critical to breaking this vicious cycle.

As stated in Rao and Bird (2011), cities are the leading edges of economic dynamism in every country. They generate agglomeration and network economies for enterprises and individuals, generating externalities that facilitate transactions, production, and distribution activities. However, the degree of success in this task depends on their ability to ensure sustained provision of a wide range of urban public services that promote both private sector activities and the well-being of the urban population such as water, sewers, garbage collection and disposal, drainage systems, police and fire protection, and transportation. Underlying all this, a ‘good’ city needs a political and governance system that can respond to the changing requirements and needs of its people swiftly, flexibly, and efficiently.

India is a country in which over 377 million people live in 7935 urban areas, which has 53 cities with over a million people including the three of the 10 largest

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<sup>1</sup> The term “distributional coalitions” owes its origin to Mancur Olson who used it to describe the special interest groups who strive to redistribute the resources/incomes in their favour rather than contributing to the generation of new resources/incomes. See, Olson (1982).

metropolises in the world (Mumbai, Delhi and Kolkata). Although India's urban population growth has been decelerating over the past 3 decades, this deceleration is not expected to continue in the years ahead as India enters into a phase of rapid growth and major structural transformation in favour of labor-intensive industry and services sectors in the years ahead. The urban sector contributes about two-thirds of GDP in 2009-10 and this share is likely to increase to 75 percent by 2031 (HPEC 2011).

In terms of both governance, finance and service delivery, Indian cities have considerable catching up to do as detailed in the Report of the High Powered Expert Committee (HPEC) on Urban Infrastructure and Services (HPEC, 2011). Only 70.6 per cent of urban population has access to individual water taps, about 81 per cent of urban households have access to any form of latrine facility, 71 per cent of urban households have a drinking water facility within their premises, and only 62 per cent of waste is treated before disposal. Urban transportation problems are similarly acute; public transportation is congested and inefficient. Housing too is problematic, with almost 25 per cent of the urban population of India living in slums. The HPEC (2011) estimates the cumulative capital investment requirements for urban infrastructure at 2009-10 prices for the period 2012-31 at over Rs.39000 billion (excluding investment in primary education, health, and electricity distribution. This figure also does not include the cost of acquiring land for new infrastructure). An additional Rs 20000 billion is estimated as the requirement for the operation and maintenance of the old and new assets.

The exponentially growing urban infrastructure and service requirement would require augmenting resources from a variety of sources. The HPEC has analyzed the issue of financing urban infrastructure and finances in detail, estimated the volume of investments needed to enable the urban local governments to provide a certain acceptable standards of services and infrastructure and pointed out a number of areas where reforms have to be undertaken to impart dynamism to the cities to make them the engines of growth. This includes mobilizing revenues through higher user charges on urban services, providing urban local governments with additional revenue handles including piggy-backing on the goods and services tax, higher transfers linked to market based reforms, levy of developmental charges to finance improvements in urban infrastructure. Given that property tax is the most suitable tax handle with the local governments, enhancing its revenue productivity is one of the most important items in the reform agenda. This is also an important conditionality in the ongoing mission on which provides substantial assistance to the cities for improving their infrastructure and services namely, the Jawaharlal Nehru Urban Renewal Mission (JNURM).

As stated by the HPEC (2011; p. XXVII), "Urban local governments in India are among the weakest in the world both in terms of capacity to raise resources.....the tax bases of ULBs are narrow and inflexible and lack buoyancy...." Unfortunately, reliable information on the collection of revenue from property tax in the country is not available. The available anecdotal information shows that as compared to the developing country average of about 0.7 per cent of GDP, the revenue realized through property taxation is estimated at about 0.2 per cent of GDP. Considering the poor revenue collection from the tax, the HPEC (2011; p. 133) recommended that a "...time bound comprehensive reform of property tax should be undertaken by all states.

This paper analyses the property tax system in India, examines the reasons for its low revenue productivity, reviews the recent reform initiatives and identifies further reform areas. Section 2 analyzes theoretical rationale for levying property taxes at the

local level and its role and revenue importance in developed and developing countries. Section 3 reviews the evolution of the systems of property tax in India, identifies their shortcomings and analyses its revenue importance in different states. Section 4 reviews some of the recent initiatives and identifies reform areas. The concluding remarks are presented in the last section.

## **II. Property Tax at Local Level: Theoretical Issues**

In the Musgrave-Oates tradition, in a multilevel fiscal system, assignment of functions and sources of finances according to comparative advantage implies that macroeconomic stabilization and redistribution should be predominantly a central responsibility and local governments would have principal role in the allocation function (Oates, 1972). This implies that all broad based and progressive tax bases go the Central government and local governments will have to carry out large and growing expenditure responsibilities. This could result in excessive dependence on federal transfers resulting in softening of the budget constraints and severing of the relationship between revenue-expenditure decisions or local governments carrying on unfunded mandates resulting in poor service delivery. Either of these outcomes would imply adverse implications for efficiency and accountability.

Empowering local governments would imply avoidance of heavy transfer dependency, imposing a hard budget constraint and ensuring adequate resource handles for the provision of public services the local governments are mandated to provide. Therefore, an important implementation rule of fiscal decentralization is that there should be a strong 'Wicksellian linkage' – the linkage between revenue and expenditure decisions (Breton, 1996). This linkage ensures transparency and the taxpayers force the governments to provide public services commensurate with the tax payments.

Thus, according to the principles of fiscal federalism, local services, by and large, should be paid for by the beneficiaries who are the local residents. User charges are appropriate for financing locally provided services of a 'private good' nature. Local public goods should be financed paid for by the residents and the cost of financing services whose benefits spill over jurisdictions should be shared through specific purpose transfers.

A local tax designed to satisfy these requirements should in principle have the following characteristics (Bird 2006):

- (i) The base should be relatively immobile to allow the local authorities to vary the rates without losing the base.
- (ii) The tax should yield adequate revenues to meet local needs and should be sufficiently buoyant over time.
- (iii) The tax should be stable and predictable over time.
- (iv) It should not be possible to export the tax burden to non-residents except to the extent that such burdens capture benefits non-residents obtain from local services.
- (v) The tax base should be visible to ensure accountability.
- (vi) The taxpayers should perceive the tax to be reasonably fair.
- (vii) The tax should be relatively easy to administer.

Based on the above considerations, Bird and Slack (2007) review the various possible candidates for local taxes and consider that the most appropriate tax at the local level is the tax on real properties. There are a number of advantages of assigning the property tax to local governments<sup>2</sup>. These are relatively (physically) immobile and therefore less distorting, visible and relatively simple and easy to administer at the local level. In fact, at the local level it is easy to identify the tax base and compile the information on it and therefore, local governments have comparative advantage in levying the tax. The tax base is large and if properly designed, these can be elastic and productive. The tax assumes the role of a quasi-benefit charge and therefore, is more acceptable and thus evokes greater degree of compliance. The property tax takes the character of a benefit tax as owners of property benefit from public services provided by the local governments. It is also argued in the literature that fiscal differentials at the local levels get capitalized into property values (Oates, 1969). This characteristic of the tax also makes it a progressive tax.

Despite these advantages, levying property tax in developing countries has not been easy as determination of the tax base as well as enforcement of the levy is best with a number of difficulties. The advantages of revenue productivity as well as equity can be realized only when the size of the tax base is captured accurately. There are severe problems associated with determining the values of immovable properties, particularly in developing countries. Visibility of the tax and often, lack of association between the tax paid and benefits from local public service received makes the tax unpopular. The cost of valuation may be high resulting in high cost of collection and as the markets for immovable properties is often nascent, officials may have the discretion to determine the tax base and this could result in rent seeking and high compliance cost. Given that public goods always induce 'free-riding' behaviour, it is often difficult to enforce the tax on local elites who are the owners of large immovable properties.

While much of the arguments about the suitability of property as a neutral (Immobile) tax base and a real local tax may be applicable to the tax on residential properties, tax on non-residential properties can be distorting (Slack, 2011). From economic efficiency point of view, it is argued that less responsive (to taxes) tax bases should be taxed at higher rate. The businesses are more responsive (mobile) than the residents and therefore, should be taxed at lower rates. However, most municipal governments find it easier to levy heavier taxes on non-residential properties as this is an easy way to shift the tax burden to non-residents. The levy of the tax on commercial and industrial immovable properties may be shifted forward to the consumers of the products or backward to labour and this could cause both distortions and inequity.

In addition to being a tax on the beneficiaries of the local public services, it is argued that the property tax has a progressive distribution of the burden. Given that there is a high correlation between property ownership and income levels, if properly designed, the distribution of the tax burden could be progressive. Thus, it is argued that tax on immovable properties satisfies both the 'benefit' and 'ability to pay' principles of taxation. The general equilibrium incidence view on property taxation is that capital is mobile, but is fixed in supply and therefore, the incidence falls on the owners of capital

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<sup>2</sup> For a detailed analysis of the qualities of property taxation, see, Bahl, Martinez-Vazquez and Youngman (2008).

(Mieszkowski and Zodrow, 1989). However, in the long term, capital immobility is not extreme and it is possible to shift a part of the burden. Furthermore, when the tax is levied on non-residential (commercial and industrial) properties, the tax may be shifted forward to the consumers of products or shifted backward to labour depending upon price elasticity of demand for the products and factor intensity and substitution. In this situation, it is not possible to conclude that property tax is definitely progressive<sup>3</sup>. It is also possible that the local governments may use the non-residential property taxes more heavily to export a part of their tax burden to non-residents and the incidence of this component is difficult to ascertain.

Despite the difficulties and sometimes, the unpopularity of the levy, the world over, taxes on immovable properties have been the mainstay in financing municipal services. The study by Bahl and Martinez-Vazquez (2008) shows that (i) property tax is a significant source of revenue for local governments both in developed, developing countries as well as transitional countries (Table 1). (ii) In terms of percentage to GDP, the contribution of property tax in OECD countries was over 2 per cent, whereas, it was about 0.6 to 0.7 per cent in developing and transitional countries. (iii) In the case of developing countries, the contribution of property tax remained has not shown any appreciable increase both as a ratio of GDP and as percentage of total expenditures of local governments. However, in OECD countries, the property tax revenue as a percentage of GDP, after remaining stable for two decades, showed a significant increase after 1990s. Similarly, the transitional countries were able to virtually double the contribution from property tax in 2000 from the level prevailing in 1970.

Empirical studies show that the volume of property tax collection depends on the level of development of the country and the extent of its fiscal decentralization (Bahl and Martinez-Vazquez, 2008). The level of development determines, *inter alia*, the extent of organized market development for immovable properties, improved capacity of tax administration and better information on values of properties. The degree of fiscal decentralization determines the intensity in the use of property tax handle. However, it is also seen that fiscal decentralization is positively correlated with the level of development. Furthermore, there can be a two-way relationship between property tax collections and fiscal decentralization.

**Table 1: Per Cent of Property Tax Revenue in GDP**

	<b>1970s</b>	<b>1980s</b>	<b>1990s</b>	<b>2000s</b>
OECD	1.24 (9.7)	1.31 (9.9)	1.44 (13.65)	2.12 (12.40)
Developing	0.42 (18.7)	0.36 (15.97)	0.42 (13.49)	0.60 (18.37)
Transitional	0.34 (3.67)	0.59 (4.92)	0.54 (7.75)	0.68 (9.43)
ALL	0.77 (14.49)	0.73 (12.89)	0.75 (11.63)	1.04 (3.40)

(Figures in the parenthesis show percentage of property tax in total revenues of municipal bodies)  
**Source:** Bahl and Martinez-Vazquez, 2008).

<sup>3</sup> Sennoga, Sjoquist and Wallace (2008), using a computable general equilibrium model with a large informal sector and less than perfect mobility of capital – the structural features to represent developing and transitional countries show that the burden of property taxes is primarily borne by owners of land and capital and thereby the distribution of tax burden is progressive.

Despite visibility, localized nature, correspondence of the tax with the beneficiaries of public services and progressivity, the tax on immovable properties has not been successful in many developing and transitional countries as seen by the revenue performance<sup>4</sup>. There are a number of reasons for the poor revenue productivity of the tax in these countries and these include (i) ambiguity in ownership and poor information and records about the properties; (ii) predominance of the informal sector in the market for immovable properties and poor information system; (iii) low capacity, lack of interest in reforms and high cost of tax administration in developing and transitional countries to design and enforce the tax; (iv) Visibility of the tax and its unpopularity with the voters as the benefits received are generally not commensurate with the tax paid, and other forms of properties do not attract a similar tax; (v) predominance of vested interests and large scale exemptions and concessions; (vi) arbitrary, uncertain and mysterious ways of determining the tax base; (vii) static nature of the tax base and political difficulties in undertaking periodic valuations; (viii) Wide discretion to the tax officers and high compliance cost associated with the tax; (ix) to add the values of additions and improvements to properties to make the tax base responsive to changes in the values of property in the tax base. Not surprisingly, the actual revenue realization has not been commensurate with the potential.

### **III. Property Tax Systems in India**

In Indian federation, the Seventh Schedule of the Constitution assigns the legislative powers of the Union and State governments. Entry 4 in the state list empowers the state governments in all matters relating to local governments, including "...the constitution of powers of municipal corporations, improvement trusts, district boards, mining settlement authorities, and other local authorities for the purpose of local self-government or village administration". Under Article 243-W, the legislature of a State, at its discretion, is authorised to devolve powers to the municipal governments on functions listed in Schedule 12 of the Constitution. Similarly Article 243-X authorises the State governments to devolve the power to levy taxes, duties, fees, tolls according to the limits set and procedure laid down by the legislature of the State government.

The above assignment system has entailed three important features. First, while there is a separate schedule indicated for the devolution of functions of municipal governments, though the specific function to be devolved and the extent of devolution lies with the state government, there is no separate list of taxes indicated in the Constitution for assignment to the municipal governments. As there is no separate list for local governments, the State governments are required to assign the tax powers to local governments from the State List in the Seventh Schedule. Second, the assignment of functions and sources of finance to municipal bodies is to be done at the complete discretion of State governments. Finally, the local governments are given the power to levy taxes, duties, fees and tolls in accordance with the procedures and limits specified the State governments.

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<sup>4</sup> In fact, even in OECD countries, the property tax is considered to be the "most hated tax" (Brunori, 2003. P. 7)

Entry 49 empowers the State governments to levy 'taxes on land and buildings' which has been devolved to the local governments. However, in the statutes governing the municipal governments, the State governments lay down the procedures for valuation, exemptions and concessions, the floor and ceiling rates of tax and administrative and enforcement mechanisms on matters such as delays, arrears, and evasion. Thus, although taxes on immovable properties are considered to be a local levy, local governments have very limited autonomy in determining the base, fixing the rates and enforcing the tax. In fact, the State government of Rajasthan abolished the house tax in 2006 and Haryana abolished the tax on self-occupied residential properties in 2008, but re-imposed it after the grants for urban development by the Central government was linked to property tax reform. The state of Punjab although agreed to withdraw the exemptions by December 2008, to fulfil the conditionality under a central grant programme, did not do so (HPEC, 2011). These states did not care even to inform these states about their decision to abolish the tax, leave alone providing alternative revenue sources to them. The lack of revenue autonomy and arbitrary actions of abolishing the local taxes by the State governments without providing alternative revenue source leaves the local governments with unfunded mandates with adverse impact on service delivery.

According to 2011 census, In India, 377 million people constituting 31.2 per cent of population were spread over 475 urban agglomerations, 981 outgrowths and 7935 towns of various population sizes. As many as 53 cities and towns have a population of million plus. Three of the largest metropolises in the world (Mumbai, Delhi and Kolkata) are in India. Urban areas generate about 65 per cent of the GDP in the country<sup>5</sup>. During the last decade, urban population has shown an average annual growth of 2.4 per cent and this is expected to accelerate in the coming years with significant migration of rural population to urban areas.

Unfortunately reliable data on revenue collections from property tax by various municipal bodies is not available in India. Both the 13<sup>th</sup> Finance Commission and the HPEC, in their reports, have used the estimates made by Mathur et. al (2008) which has questions of reliability. In their study, data on property tax collections were collected for 36 large municipal corporations for the year 2006 and this is blown up to estimate the revenue collection for the country by making three alternative assumptions. The three assumptions were (i) the collections in the remaining 5125 small municipalities would be equivalent to the average collections of four municipalities with the smallest populations in the large city sample; (ii) The collection in these municipalities would be equivalent to those showing the poorest collection among the 36 largest cities; and (iii) Poorest per capita collection among 36 large cities in the sample in each of the states would apply to all the municipalities in the State. The most optimistic estimate made on the basis of the above assumptions shows that in 2006-07, on an average, per capita property tax collections was Rs. 486 (about USD.10.6) and total collections ranged from 0.16 per cent to 0.24 per cent of GDP.

The lack of reliable information on the base and revenue collections from property tax is a major shortcoming in designing and implementing property taxes by municipal governments in India. The State Finance Commissions which are supposed to recommend transfers from the State to local governments do not seem to have bothered

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<sup>5</sup> According to the Mid-Term Appraisal of the Eleventh Five Year Plan the urban share of GDP was 62-63 per cent. See, India (2010).

to compile the figures, nor has the State government taken in putting together these estimates. As shown above, in the absence of any other alternative, even the official committees have simply taken the estimates made in Mathur et.al uncritically<sup>6</sup>. Each of the state governments has a full-fledged urban development department, but they do not compile fiscal information on the urban local bodies.

While reliable estimates of the revenue from the tax are not available and it is important to build these estimates for calibrating policy relating to property taxation, the available information on 36 largest municipal bodies shows that property tax contributes very small amounts to the finances of municipal bodies in India. The more recent information collected for a sample of 32 municipalities for the period 2004-2008 with population ranging from 0.057 million (Baramati) to 98 million (Mumbai) to shows that per capita collections in 2008 was Rs. 457 and in 2006, it was Rs. 269. This includes collections from current demand as well as arrears, which implies that, on average, per capita property tax collection in Indian urban areas in 2006 was less than Rs. 1 per day.

There are a number of shortcomings in the prevailing property tax system. The first important issue is the low revenue productivity. As mentioned earlier, the per capita tax collection in 36 large municipal corporations in 2006 was just about Rs. 486 and the annual growth rate observed during the three year period (2003-2006) was 7.9 per cent which is marginally higher than the inflation rate which implies that revenues in real terms were virtually stagnant. With the nominal GDP increasing at over 14 per cent during this period, the revenue from the tax as a ratio of GDP has actually shown a decline.

Second, it is difficult to state that the prevailing property tax system promotes either vertical or horizontal equity. The violation of equity considerations arise from the poor coverage of the tax, wide ranging exemptions, low collection efficiency and the failure to revise the tax base from time to time to take into account the changes in the status of the properties and improvements to the properties. Third, the claim that property tax is a local tax and is neutral is considerably diluted by the fact that a significant portion of the tax falls on non-residential properties. In Bangalore Municipal Corporation, for example, revenue collection from non-residential properties during 2008-11, constituted about 38-40 per cent and residential cum non-residential properties contributed to another 7-9 per cent. The situation is similar with other municipal corporations. This implies that the property tax is far from being neutral in Indian context and a considerable proportion of the tax is exported to non-residents.

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<sup>6</sup> The information compiled for 23 municipalities with less than one million population in different states for a more recent study shows that the average per capita tax collections for the year was Rs. 66.5 which is higher than the average of 4 lowest collecting municipal bodies (Rs. 40) which is one of the three options adopted in Mathur's estimates. If the average of 73 is taken, the tax – GDP ratio works out to

**Table 2 : Property Tax Revenue from Residential and Non-Residential Properties**

	<b>Non-Residential</b>	<b>Residential</b>	<b>Vacant Land</b>	<b>Residential cum Non-Residential</b>	<b>Total</b>
2008-09	2844.6 (38.02)	3845.6 (51.41)	243.7 (3.26)	547.0 (7.31)	7480.9 (100.0)
2009-10	3259.5 (40.9)	3592.7 (45.08)	375.2 (4.71)	742.6 (9.32)	7970.0 (100.0)
2010-11	4028.7 (36.36)	5341.0 (48.2)	815.6 (7.36)	894.7 (8.07)	11080.0 (100.0)
2011-12	4400.6 (36.37)	5721.6 (47.29)	979.0 (8.09)	998.8 (8.25)	12100.0 (100.0)

**Note:** Figures in parenthesis denote percent of total.

**Source:** Brihat Bangalore Mahanagara Palike.

There are a number of reasons for the low revenue collections from the property tax and its slow growth. The most important reason for the low collections is the poor coverage of the tax and its low collection efficiency. Poor coverage is due to (i) wide ranging exemptions; (ii) poor information system and lack of up-to-date registry of land and properties by municipal bodies; (iii) existence of vacant properties. Exemptions vary from state to state and from one municipal body to another, but there are some common exemptions. Article 285 of the Constitution provides exemption to all properties belonging to the Union government<sup>7</sup>. The adverse revenue impact of this is particularly severe in capital city like Delhi. One major reason why the Municipal Corporation of Delhi could not increase its revenue yield even after the reforms is the exemption to central government properties including the sprawling residences of important bureaucrats and politicians. While the demand and ensure high standards of municipal services, there is no commensurate payments by way of property tax and the service charges cover only a small fraction of the cost. The big metropolitan cities also have large unauthorized buildings and properties not included in the municipal register which, while availing the municipal services do not pay the tax. Other important exemptions include places of religious worship, educational institutions, charitable institutions, ancient and historical monuments, burial and cremation grounds, government land and buildings set apart for free recreational purposes, offices of trade union associations, buildings and lands of urban development authority constituted under the respective state government acts, institutions providing free medical relief and education and certain types of vacant lands and buildings<sup>8</sup>. In addition, there may be exemptions and concessions for the properties owned by ex-servicemen and their families. The volume of exemption, thus vary from one local government to another. In Delhi for example, the exemption will be large due to the overwhelming proportion of Union government properties, unauthorized buildings and addition to buildings which may not be the case in other places.

A major problem with the property tax administration in municipal bodies is the poor information on property tax base with them. The important pre-requisites for efficient property tax system are that there should be clarity in property ownership or tenancy rights and a cadaster that uniquely identifies properties and their owners. In addition, there should be appropriate mechanisms for periodic market based valuation of

<sup>7</sup> The municipal bodies can, however, levy service charges.

<sup>8</sup> In Delhi, for example, exemptions are govern to vacant lands and buildings exclusively used for agricultural purposes, small properties (less than 100 sq.mtrs), owned by original owners

properties and systems and processes for tax collection and enforcement (Smoke, 2008). Ambiguity in ownership and tenancy rights and inability to adopt market based valuation are severe constraints in increasing the revenue productivity of the tax. More importantly, most municipal bodies have not made attempts to update the registers relating to property ownership and tenancies not do they coordinate with the registration department for getting information on the properties transferred and their values.

In addition to lack of clarity on ownership and tenancy rights, in Indian context, for a long time the rent control laws have been a major constraint in realizing the potential of the tax. Although there were inconsistent judgments, Supreme Court in the case of Municipal Corporation of Indore *versus* Rathna Prabha in 1976 clearly observed the need to move away from the rental valuation principle as per the rent control acts. However, there are always problems in adopting valuation according to market rents whenever the rental valuation is adopted as the base of the tax.

Market based valuation and its periodic updating has been a problem not just in developing and transitional countries but also in OECD countries. Very few municipal governments in the world update the property values for taxation purposes every year (Slack, 2011). The simple fact is that whoever is the base taken – the annual letting value, capital value or an area based value, the value finally taken as the base is presumptive. Given that a ‘representative’ value has to be taken for each locality, the value chosen will be the minimum rather than average. In other words, any presumptive value of the tax base will be accepted only when this is substantially lower than the actual value of the properties. Furthermore, increases in the market values for the property owners is only an accrual and will not be realized unless they sell their properties and therefore, it will be difficult to include higher value of the property that has accrued and not realized in the tax base. Not surprisingly, even as the immovable property values in urban areas have been increasing at a rate much faster than general inflation rate and even as there has been significant increase in the number of houses in urban areas, the revenue productivity of property tax has continued to be low.

Many municipalities have simply not updated their property tax registers and many properties are simply not included in the tax base. The Administrative Reforms Commission has noted that only about 60-70 per cent of the properties in urban areas are actually assessed. Besides exempted properties and vacant lands, significant numbers of properties are not simply included in the registers of the local governments. A large number of property owners seem to be simply not paying the tax although they benefit from the local public services. The Commission recommended the matching of the properties paying the tax with those in the Geographical Information System (GIS) to identify those that are not paying the tax. Considering that the number of missing properties in the tax register is high, the Commission has recommended the use of GIS maps to verify the coverage and the recent reform initiatives under the Jawaharlal Nehru National Urban Renewal Mission (JNURM) have helped to improve the coverage by matching the tax paying properties with properties in the GIS maps.

The problem of low coverage of properties is compounded by poor collection efficiency. Low level of efficiency in revenue collection arises from the actual values of properties assessed are significantly lower than the market values and increases in properties on account of both improvements to existing properties and increase in prices of the properties is not adequately captured in the tax base. Mathur et.al. (2009) suggest that assessed values are as low as 8-10 per cent of the market values and on an average

about 30 per cent of the market values in 36 largest municipal corporations. Any attempt to increase the value from such a low base to resemble market values will meet with severe opposition.

Equally important cause of poor collection efficiency is the considerable gap between the tax demand raised and actual collections. The average collection rate for 36 largest municipal corporations was 37 per cent. Poor collection efficiency represents inadequate efforts at collecting the tax or alternatively lack of acceptability of the tax and the amount disputed.

#### **IV. Reform Initiatives on Property Tax in India**

The discussion in the previous section shows that municipal governments in India have failed to mobilize significant revenues from property tax to finance local public services with adverse effects on public service delivery. The HPEC has estimated the investment requirement for urban infrastructure and services for the next 20 years at Rs. 39000 billion at 2009-10 prices which is equivalent to USD. 780 and some proportion of this will have to be generated by reforming the property tax. If the cities have to function as leading edge of economic dynamism as has been the case in many countries, they will have to substantially augment local infrastructure and services for which, the municipal governments will have to undertake reforms in their property tax systems.

Although the general situation in regard to property tax, as analyzed in the previous section is far from being satisfactory, there have been interesting initiatives at reforms in recent years and it is important to review some of these initiatives. In this section, important reform initiatives are discussed. These, in the main include, more scientific/objective methods of determining the tax base, introduction of introduction of self-reporting/self-assessment system, ensuring ease of tax payment including on-line payment of the tax to significantly reduce the compliance cost. Successes of these reforms have not been even. Among the larger municipal corporations, Bangalore Municipal Corporation has been successful in substantially increasing the revenues from the tax in recent years and these experiences offer hope for others to adopt these reforms. There has been a significant increase in both the number of properties assessed leading to increase in the demand and percentage of actual collection from demand or increase in collection efficiency. However, reform in Municipal Corporation of Delhi has not been very successful in increasing revenues. In fact, there was a decline in the revenues after the introduction of reforms. Understanding the lessons from these reforms is necessary to avoid the shortcomings in the future.

Historically, property tax was levied on the rental values of properties. The method of valuation goes back to the Valuation (Metropolis) Act of 1869 in which, the 'annual vale' or 'rateable value' is determined on the basis of actual or presumptive rent or capital value<sup>9</sup>. In Independent India, as mentioned earlier, Entry 49 in the State List specifies the 'taxes on lands and buildings" and the municipal governments are authorized to levy the tax as laid down in the respective State Acts. These Acts list out the exemptions, indicate the floor and ceiling rates and lay down the procedure for

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<sup>9</sup> For a historical account of the developments in property tax, see (Rao, 2008).

administration and enforcement. Not surprisingly, there wide variations in the determination of the base, structure of rates as well as administration of the tax. Although the base was supposed to be rental value, the way it was determined hardly reflected the rental value and there were no attempts to make periodic revisions and not surprisingly, the tax bases hardly reflected the true market rents.

A major constraint in the determination of the 'true' tax base was the interpretation of the Courts that for determining the base of property tax, it is not the actual or presumptive rent, but the 'fair' rent as laid down in the Rent Control Acts of the respective State governments should form the basis of determining the annual rental value. A number of studies have analysed the adverse revenue implications arising from this decision (Pethe and Karnik, 2003). However, in later judgments, the Supreme Court interpreted the *non obstante* clause in the statutes and delinked the presumed rent for property tax purposes from the Rent Control Acts (Rao, 2008). The most important development, however, was the reform initiated by Patna Municipal Corporation which moved over to a completely presumptive area-based valuation taking into account the location, usage, built –up area and the type of construction. There were 3 norms for location (principal main roads, main roads and others), 3 construction types (*pucca* with reinforced concrete roof, *pucca* with asbestos or corrugated sheet and others) and three usage categories (commercial/industrial, residential and others), thus making 27 combinations. By fixing the annual rental value per sq.ft for each of the categories, the tax base was determined. The result of this reform was that the tax rate was reduced from the prevailing 43.75 per cent to 9 percent. Interestingly, the Supreme Court upheld the new method of valuation on the grounds that it eliminated arbitrariness and discretion (and corruption). Subsequently, a number of cities adopted the reform with varied degrees of success.

The more recent initiative for reforming the property taxation was mandated as a part of the conditionality in the central government's assistance programme for the municipal corporations for upgradation of their infrastructure and services. Named after the First Prime Minister, the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) mandated the reform of property tax systems. In addition, the standardized service levels stipulated for municipalities by the Ministry of Urban Development also mandate the on-line system for payment of property tax and the use of GIS system for the mapping of properties to ensure comprehensive coverage.

Subsequently, there have been reform initiatives in a number of cities, though the results of these reforms have been varied. Furthermore, many of the reform initiatives have been recent and the revenue implications of these reforms are yet to be ascertained. The most reform attempts are to bring about clarity and transparency in the determination of tax base, reduce cost of collection, improve the ease of tax collection and reduce the compliance cost. The important measures in this direction include switching over to the area based valuation to determine the tax base, introduction of self-assessment (declaration) scheme, building a comprehensive data base containing the registry of the taxable properties, transparency and attempts at taking the taxpayer into confidence in the reform attempts, on-line payment of the tax and other measures to ensure ease of payments and better coverage of the tax by using GIS mapping.

A detailed study of the reforms in 10 cities by the National Institute of Urban Affairs (NIUA) brings out some interesting findings (NIUA, 2010). The study shows that the trend has been to move away from the annual rental vale based system to area

based system, though some of the municipalities continue with the old system but determine the rental values in a presumptive manner and many of them determine the values based on the recommendations of the Municipal Valuation Committees comprising of experts in urban administration, taxation, and representatives from the local body. In places where area based taxation is followed properties are classified in terms of factors such as location, usage, type of construction and age of the building. Most of the municipal corporations follow a progressive rate structure, but some of the municipal corporations like Bangalore and Ludhiana levy a flat rate of tax with rates differentiated between residential and non-residential dwellings and lower rates for owner occupied as compared to rented houses. Some of the municipal corporations levy the tax on vacant lands though while determining the total area. However, the plot size is not taken into account while determining the value in the case of independent houses/villas and this tends to reduce the progressivity in case of rich owners building houses in large plots of land. On the tax administration, some have computerized and adopted the property identification code, many still to act on this front. On using the GIS to identify the missing properties from the tax register, Bangalore has completed the exercise and the effort is going on in Ahmedabad. In most others, the initiative is yet to be taken. Many of the corporations have introduced the self-assessment scheme and a few like Bangalore have introduced on-line payment of the tax. As mentioned earlier the successes of reforms have been uneven. While the revenue productivity in Bangalore has shown a sharp increase, in many others including Delhi, the revenues have continued to be stagnant. Unfortunately, Patna, the first municipal corporation to introduce area based taxation has the lowest and most stagnant per capita collections. In most cases, while the initial effort yielded good results in terms of increasing revenues, over the years, stagnancy crept in as they were not able to undertake periodic revaluations. Bangalore is an exception even here as the municipal corporation undertook a revaluation exercise in 2008 to maintain the high buoyancy of the tax.

An important feature of the reforms is the replacement of annual rental value with values determined on the basis of floor area for the purpose of taxation. Even in the case of the area based value, imputed values will have to be based on either the market rents or the capital values. Bangalore Municipal Corporation has moved over to the capital value basis to determine the values of property within the area based taxation. As mentioned earlier, any presumptive taxation can succeed only when the actual base chosen is substantially lower than the market value not only because, the market value is not a realized value and there are limits to increase the tax payments on a property when the reform is done<sup>10</sup>.

The advantages of the area based taxation are stated as its objectivity, transparency, fairness and lower compliance cost. However, there is a major challenge in designing the tax that can fulfill all these qualities. Whichever method is taken it is necessary to initially determine the guidance values and it is not clear or transparent how these are determined. Taking the values of the properties transacted may not be realistic partly because, in most developing countries, the registered values of the properties transacted is substantially higher than the actual values at which these are transacted. Then fairness in taxation demands that several considerations that must be taken account of in determining the tax base. These relate to the location, age, type of construction, usage (residential, commercial/industrial), the type of residents (owner

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<sup>10</sup> The Bangalore Municipal Corporation limited it to two and a half times when it switched over to the area based taxation to ensure acceptability.

occupied versus tenants). More the categorization, better the differential values are captured, but more complex and non-transparent the tax base determination will be. Thus, there is a clear trade-off between fairness and complexity<sup>11</sup>. Too much of differentiation may defeat the cannon of simplicity.

Another major challenge of the area based system is the need to make the revision in the values from time to time to keep up with the changes in value to make the tax responsive to changes in nominal incomes. Changes in the value may be due to increase in the prices of property values (including capital gains), or additions/improvements done to properties. In the absence of periodic revisions, the revenue productivity of the tax will be low. At the same time, as mentioned earlier, there can be severe political opposition to periodic revisions and more importantly, capturing the unrealized capital gains in the base can pose severe problems in its acceptability.

## **V. Towards Reforming the Property Tax System in India**

Reforming the property tax system is critical to making the cities the leading edges of economic dynamism. This is particularly true of India where the backlog in urban infrastructure is large and the standards of urban services, poor. There is no doubt that contrary to the experience of many cities across the globe where the tax played an important role in financing urban services, property tax revenues have been inconsequential and have not played any significant role in financing urban services.

The challenge of reforming property taxes in urban areas in India is, however, daunting. With the urban property owners having used to enjoying exemptions and concessions or paying very low levels of the tax, the revenues have been low and stagnant in absolute terms and declining as a ratio of GDP, ensuring larger payments from and imparting greater buoyancy to the tax is bound to be very challenging. Exploiting the large revenue potential of this tax should be an important agenda to facilitate urban renewal, but the challenge is formidable.

The reform of the property tax system should begin with having a separate tax powers to urban local bodies. As mentioned earlier, placing the local tax powers in the State List has denied them the power to determine the base, the rate structure and administrative and enforcement mechanism. Furthermore, it has given the State governments to abolish the property tax altogether for populist reasons without providing any alternative revenue source, thus denying them an important revenue source and leaving them with large unfunded mandates. While the state governments should provide autonomy to the local bodies to levy, collect and appropriate the revenues from property tax, it is important to undertake measures to build their capacity to design, implement and enforce the tax. The handholding is particularly important for smaller municipalities. It would be useful to create an advisory cell in the Urban Development department of each of the state governments to undertake this task.

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<sup>11</sup> Rao (2008; p. 251) shows that when all these factors are considered, there may be 240 different categories.

Wide ranging exemptions and concessions tend to erode the tax base significantly. It is therefore, necessary to have a relook at the exemptions. Furthermore, from the viewpoint of both equity and revenue, it is important to include the plot area along with the built up area in the tax base, though the tax rate on the latter may be lower. At present, the floor area of a bungalow and an apartment is treated alike. There should be an intelligence cell in every property tax department to focus on the additions and improvements to properties and getting information on the changes in property values.

The experience of reform with the property tax shows that transition from the annual rental value to area based taxation holds a lot of promise and if properly done, can bring in significant additional revenues. However, care should be taken while designing the tax base and assigning presumptive values. The first important precondition is the transparency to ensure acceptability of the tax. After making the categorizations in terms of different zones (zones need not be geographically contiguous but should reflect similar land values), type of construction and age, the presumptive values for each category must be published and the people should be made to walk through the calculations to work out their tax liability. Fairness requires that the people should see transparently the way in which tax has been designed. Besides wide publicity and taxpayer education, there should be a public relations cell that should deal satisfactorily with all questions and confusions relating to the tax in a clear manner.

The transition to area based valuation does that necessarily mean it will reflect market values and therefore, an end in itself. This should be construed only as a transitional measure. This is a presumptive base, it will be accepted only when the base quantified is substantially lower than the actual market value. In other words, even after significant differentiation in terms of location, types of use, type of construction, age of buildings etc., the quantified base could have only a distant relationship with the Market values of the property. In the ultimate analysis, presumptive values can have stronger relationship with the market values only when the urban property market is well developed and organized. This would require other important policy interventions including the abolition of legislations constraining the markets such as rent control acts, urban land ceiling acts as well as reforming the provisions relating to the taxation of capital gains and registration fees. At present, there is disincentive for both the seller and buyer to declare the true value of the properties transacted which is often used in formulating the guidance value. The seller would like to under report the value to evade capital gains taxation and the buyer would like under report the purchase price to evade registration fees. Taxing the capital gains at a lower rate and having a lower rate of stamp registration fees could help to develop organized markets for immovable properties.

The area based property tax tends to be relatively stagnant as it is unresponsive to changes in the prices of properties pending revaluations. The only source of increase in property tax is the increase in the number of properties. While there are inherent difficulties in imputing the capital gains over time as these gains are not realized until they are sold in the market, as increase in prices affects the cost of providing public services, it is necessary to introduce an element of indexation of the values. The estimate of property prices is made by the National Housing Bank at present for some major cities. If the guidance cell in each of the State Urban Development department works out the trends in property prices in different municipal areas using similar methodology, the

municipal bodies can automatically adjust the values of the tax bases to these indexes for the purpose of property taxation.

A major requirement for the tax reform is the ownership of the reform by the tax administration. It is important that the tax officials should not only understand the reform well, but also be prepared to undertake advocacy. Equally important is the need to have a high degree of coordination and exchange of information between the connected departments. Much can be gained by having information exchange between the property tax department and various departments that undertake valuation, public works and registration of property transactions.

An important problem constraining the reform is the absence of a comprehensive cadaster of properties in urban areas which should be computerized. Clear assignment of ownership or tenancy rights is extremely important to levy the tax. Most municipal governments do not have up to date register of property ownership and in many cases, there are ownership disputes. In many cases, due to rigid tenancy laws, the tenants have lived in the properties for long and the owners do not find it worthwhile paying the tax. In many case the enforcements have been ineffective. These can be remedied only when there is a strong leadership and political willingness at the municipal level. Comprehensiveness also requires mapping the taxpaying properties with the information contained in the GIS. In addition, the department can also resort to third party information. A mechanism should be found to incorporate the value of additions and improvements to the original buildings by having an intelligence network.

Computerized register of properties and taxpayer education helps to introduce on-line payment of the tax. This is extremely important to avoid a constant interface between the taxpayer and collector. This will improve tax compliance and significantly reduce the compliance cost. While some of the municipal corporations like Bangalore have facilitated the tax payments by having online payment tax, many others, including Delhi have not. It is important to ensure ease of tax payments including the online payments.

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