SUCCESS FACTORS FOR A SYSTEM FOR PROPERTY TAXATION AND THE CONSEQUENT RISKS

Ben P.P. Bervoets, Ruud M. Kathmann and Marco Kuijper

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1.   INTRODUCTION

It is estimated that over 140 countries know some form of property taxation. Although it is not always considered popular, the common consensus amongst researchers is that property is an adequate base for levying taxes that takes differences in wealth into account and yet does not heavily distort economic decisions or consumption.

In the Netherlands three different levels of government have the authority to levy an *ad valorem* property tax: the state, municipalities and polder boards. To do so, these three levels of government make use of the same valuation of properties that is executed on a decentralised level by the 388 municipalities. Although the decentralised government is responsible for the valuation, central legislation has been put in place in order to enforce uniform and equitable valuations. Our valuation system started twenty years ago in 1997, but never stopped developing. The following characteristics provide an overview of the actual system in the Netherlands:

- Decentralised execution of the valuation;
- Central supervision of the quality;
- Annual valuation of market value;
- Computer assisted mass appraisal;
- Standardised working processes;
- Use of available data sources where possible;
- Uniform and comprehensive standards;
- Adequate information for and interaction with taxpayers.

The Netherlands Council for Real Estate Assessment is an independent governmental body which statutory duty is to supervise the quality of the valuation and the underlying processes. Judging from the organisation's monitoring results, in general the municipalities in the Netherlands perform well on their tasks.

Ever since the introduction of the Special Act for Real Estate Assessment, which governs the valuations, there has been a decrease in the number of objections and appeals from 8% for residential properties in 1997 down to 1% in 2016. In the same period of time the yearly total costs for the valuation has declined from € 190 million down to € 150 million a year (around € 15,50 per property per year). Starting in 1997 with a revaluation every four years, the law now states that valuations have to be done annually with a valuation date one year prior to the year the assessed value is used for taxation. Compared with the early years, the assessed market value is more accurate because of the annual valuation and this has led to the use of the assessed value for other non-tax related purposes.

Based on these numbers it is more than tempting to describe a best-practice that would serve as a model for other jurisdictions to compare with, adjust to or that should be implemented. We of course agree that it is appropriate for jurisdictions that are considering to implement a system of property tax and property valuation to study and learn from systems that function well. However we won't suggest "blind" copying a best practice. Rather than focussing on what the best system is that others should copy, we propose to analyse the choices that have been made in shaping and developing our systems and to explore the environment in which our system has evolved. Along with these choices come the associated risks. In our paper we describe the (in our view most important) fundamental choices that have to be made and the choices we made in the Netherlands. These choices deal with aspects of the environment in which the property taxes are to be levied and with the risks that are inevitably related to these choices. Regarding our background and expertise we focus on the valuation system, which of course is essential when setting up a property tax system. By doing so we hope to be able to contribute to effective implementation and improvement of systems for property taxes in different circumstances. Parts of this paper are also published in [1], [2] and [3].

## 2.	CHOOSING THE BASIS FOR TAXATION

Introduction

When introducing a property tax one of the most fundamental choices that have to be made is the basis for taxation that is used. There are many possibilities for this. In some jurisdictions there is a taxation based on the plot area, without assessing the improvements. Some use a system in which the floor area of the building forms the basis of taxation. Others use some form of valuation, such as the rental value or the capital value of the property or solely of the land. Each chosen basis for taxation has its pros and cons. Considering the difficulty to adjust the basis of taxation in a later stage, it is very important that a deliberate choice is been made. Of course the choice for the basis of taxation is dependent of the data that is available and the quality of this data. Other variables that influence the decision are: the skills and knowledge of involved employees, the transparency of real estate markets, the extent to which the government is equipped with an IT-environment, and the willingness of taxpayers to pay taxes. Finally the position of the judicial power is important to take into account. If there is limited technical knowledge present, the a basis for taxation that can easily be measured or calculated may be preferred over a basis that could lead to much dispute.

The choices made in the Netherlands

In the Netherlands the formal base for the definition and documentation of real estate property values is the Special Act for Real Estate Assessment (in Dutch: Wet WOZ). In the Netherlands the values that are assessed on base of the special act are called "the WOZ-values".

Up until 1995, when the Special Act for Real Estate Assessment entered into force, different governments in the Netherlands each had the power to set their own basis of taxation. With the introduction of the Special Act for Real Estate Assessment, a clear decision has been made to levy tax on a uniform basis: the market value of a property (i.e. the total capital value of the plot and its improvements). This means that after 1995 there is an "ad valorem" property tax. The two main argument for this this decision were to:

- connect to the perception of the taxpayer as closely as possible;
- make it possible to use the "WOZ-value" for other purposes.

The WOZ-value, is primarily the real (100%) market value of a real estate property on a given date, the date of valuation (or valuation date). For a definition of the market value we refer to the EVS and IVS definition of the term market value.

"The estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion." [4] (TEGoVA, 2016)

The WOZ-value always equals the market value based on the assumption (assessment instruction) that all rights on the real estate property belong to one party. This means, for example, that in case of assessment it is not taken into account that the tax payer is lease holder instead of owner or that the real estate property is being rented out.

For non-residential properties that have no market, the Special Act for Real Estate Assessment determines that the corrected replacement costs must be issued as WOZ-value. The depreciated replacement costs reflect the value for the current owner in a situation where there is no potential buyer who is willing to purchase this object (on the market).

The market value is being based on the "highest and best use", appropriate in the context of the formal possibility as described in the zoning plan. Furthermore the actual state of the real estate property on the value reference date is decisive for the assessment. However, when after the value reference date and before the year in which the WOZ-value will be assessed the state of the

property changes drastically (new construction, demolition, renovation, etc.) the actual state on January 1st of the year in which the WOZ-value will be assessed, shall be considered normative.

In general, three methods within the systems of mass appraisal are being used for the valuation process. The sales comparison approach is being used (mandatory) for the assessment of residential properties. For a non-residential property the value needs to be assessed based on the market value and on the depreciated replacement costs. The highest value must be applied. Usually it is known in advance for which category (unsaleable) non-residential properties the depreciated replacement costs are applicable. The market value for an non-residential property can be assessed in three different ways, namely: through the sales comparison approach, the income approach (capitalization of the rental value) or the discounted-cash-flow method, depending on the kind of market data available.

The consequent risks

The main risk in the choice for the market value as a tax base for property tax is that it sets a high standard for the underlying work procedures and the registrations. This is being expressed for example in the market analysis. Changing market situations may lead to the necessity to register new object characteristics than before, as the analysis may indicate that other variables are needed in the valuation models in order to be able to value correctly. This requires not only alertness to identify the changing importance of variables but also the ability and capacity to systematically collect and register object characteristics. In our experience this is an expensive part of the valuation process. In later paragraph we will focus more on the registration of property characteristics.

Another risk that comes with the choice for an ad valorem tax occurs in a faulty or even collapsing real estate market. This was for instance the case in period during the financial crisis which started in 2008. During this period in some areas in the Netherlands there were practically no transactions of properties that were needed to adequately value all properties and to calibrate the valuation models.

Finally we consider a risk that might occur in less transparent markets, for instance when sales prices are not publicly available, the assessed market value might not be recognised by taxpayers. Moreover taxpayers in this situation do not have the opportunity to scrutinize the assessed value, which will lead to less acceptance by taxpayers. Other bases of taxation, such as the plot area, are probably subject to less discussion, because they are easier to check. This of course does not implicate that the plot area is considered to be a an equally fair or equally appropriate tax base for taxation as the value of a property, because the latter reflects taxpayers' wealth [5].

3.   THE VALUATION FREQUENCY

Introduction

In a system of property taxation that has the value of a property as its tax base, an important element is the valuation frequency that is used. Where some jurisdictions do not have a set period in which a revaluation has to be done, others have a cycle of some years or have an annual revaluation. When the appropriate frequency is chosen it is important to consider the aim of the assessments and the accuracy that is demanded.

Obviously a high frequency (i.e. an annual valuation) puts higher demands of the executing government than a lower frequency in revaluation and will most likely will lead to higher costs in the period of introduction. However a high frequency has some clear advantages. First of all, a high frequency leads to an frequent adjustment of the property value to the current market situations. If market conditions change the value of a property, and with that the wealth of a taxpayer, may also change. With a high frequency in revaluation, the changes in wealth are taken into account in the taxation sooner than when a low frequency is applied. In our experience this is not only considered to be more fair it also gives the opportunity to use the assessed value for more purposes than just property taxation.

The choices made in The Netherlands

Starting in 1997 with a revaluation every four years, there has been a gradual change towards an annual valuation of all properties that started in 2007 (see figure 1 below).

For this annual valuation a valuation date that lays one year prior to the current year is being used. By doing so the assessed value is up-to-date, but yet enough market data can be analysed in order to carefully perform the valuation, since both sales transactions prior to the valuation date and transactions after the valuation date are included. In the near future we will probably examine a shift of the valuation date from one year in the past towards January 1st of the current year.

Year/period	Valuation date
1997 – 2001	January 1st 1995
2001 – 2005	January 1st 1999
2005 – 2006	January 1st 2003
2007	January 1st 2005
2008	January 1st 2007
2009	January 1st 2008
Etc.	Etc.

Figure 1

The up-to-date assessed values are of such quality that legislators in the Netherlands have decided to use the assessed value for more purposes, such as for mortgage lending, inheritance tax, fighting fraud etc.

In The Netherlands we have learned that the transition from a four-year revaluation to a system of annual valuation has had a positive effect on:

- The number of taxes in which the WOZ-value plays a role. As a result of the annual valuation this has increased significantly;
- The number of applications of the appraisals, apart from taxation purposes. This has also increased as a result of the annual valuation. An additional effect is that other interests are arising, for example if the appraisal can be used when taking out a mortgage loan the taxpayer has an interest in a higher assessed value. This will make the system more balanced;
- The execution of the valuation. Compared to a four-year valuation, the valuation can be conducted more process-driven and thus more efficiently;
- The efficiency of the work process, in the period 1997 to 2014 the total annual costs being made for the valuation dropped from € 190 million to € 150 million;
- The number of complaint and appeal procedures. Through a system of annual valuation the appraised value, which is being taxed, better matches the perceived value of the taxpayer.

Furthermore we have learned that it was a good choice to not introduce a system of annual valuation at once. A gradual transition from a four-year to an annual valuation caused the work processes gradually to be tuned. Also, necessary improvements/optimizations in a system with a lesser revaluation frequency can be realized more easily. It also allowed to use the assessed value for other purposes. These purposes are partly defined by law, for instance the use of the assessed value to set a maximum rent price for social housing. The WOZ-value is also being used by notaries, banks and insurance companies for mortgages and preventing real estate fraud. It is expected that the wider use of the WOZ values will increase in the coming years because since October the 1st 2016 the assessed values (WOZ-values) for residential properties have been made publicy available.

The consequent risks

The annual valuation that has been introduced in the Netherlands has proved to be well accepted. There are however some risks that should be considered. First of all, the process-oriented approach has had positive effects like the more efficient execution of the valuation process. On the other hand it also made the municipalities more vulnerable to unforeseen problems. An

sudden increase in appeals for example could lead to an unexpected amount of work, that could cause serious delay in the valuation process. Other events such as IT-problems or the sudden loss of manpower can have the same effect. This means that municipalities have to deal with these risks. Comparing with former situation in the Netherlands where a revaluation every four year was performed, the annual revaluation allows less leeway in the annual schedule.

The risk of a valuation date close to moment on which the assessed value is presented to the taxpayer and is published, is the fact that the assessed value is no longer a result of market analyse, but the assessed value starts to influence the market, because both buyer and seller of the property know prior to the sale what the official market value of the property is.

4.   WHICH LAYER OF GOVERNMENT IS MADE RESPONSIBLE?

Introduction

A third fundamental decision that has to be made is which layer of government is made responsible for levying property taxes and will be entrusted with the underlying administration, such as the registration of real estate and the valuation process the taxation is depending on. Many different factors will affect the decision of which layer of government is made responsible, such as the current governmental structure, existing legislation, the organisational capacity of governmental bodies, the access to different sources of data and the average skills and knowledge of workers.

The choices made in The Netherlands

In the Netherlands, being a decentralised unitary state, the government consists of four different layers who each have their own authority and responsibilities. Based on the principle of subsidiarity the central government allocates tasks and responsibilities at the lowest appropriate level. Alongside its main responsibility of law-making, the state level government is also competent to divide responsibilities amongst itself and the decentralised governments. Depending on the size of a task, the extent to which a national, a regional or a local overview is required, the national government provides the local and regional governments with authorities.

In this administrative landscape, the decision was made to entrust the municipalities with the responsibility for the valuation process that forms the basis for the property taxation. Municipalities also have the competence to levy property taxes.

With respect to the valuation for taxation purposes, in the Netherlands there has been a clear decision to allocate this responsibilities to the lowest level of government, the municipalities. The

main reason for this was that municipalities are considered to be *'closest'* to the data and have the knowledge that is needed to perform good quality valuations. This consists of both data they already possess for example because of local registrations, such as addresses, zoning or building permits but also of insight in local real estate markets which is essential for the quality of the valuations. Municipalities are also the closest governmental organization to the taxpayers' and this has big advantages for the interaction or communication between the taxpayers and the valuator. This has a positive effect on the taxpayers' trust in the rightness of the valuation.

Yet a remarkable phenomenon is noticed. From the introduction of the Special Act for Real Estate Assessment onwards, the number of municipalities has decreased from 572 in 1997 to 388 in 2017. At the same time we see that those municipalities that do not merge with other municipalities increasingly participate in partnerships (shared service centres) of municipalities that jointly execute the valuation process. These shared service centres are mandated to levy property tax. This development might indicate that in particular small municipalities face challenges in executing their tasks.

The consequent risks

Although in general there are primarily good experiences with the principle of entrusting the local government (municipalities) with the valuation process, there are however some risks associated with this system.

One of the most striking risks we consider is related to the quality of work the municipalities provide. With over 250 organisations (municipalities and partnerships between municipalities) executing the work of collecting data, assessing properties and levying taxes, an inherently risk of differences in quality is present. Of course there is a demand for a uniform execution of the law with a uniform level of quality of the outcome as a result. This demand for uniformity is not only seen with the taxpayers, but also with other layers of government that are obliged to use the values assessed by municipalities. To combat the risk insufficient quality and of a lack of uniformity the Special Act for Real Estate Assessment in the Netherlands introduced an independent organization that supervises and monitors valuation. If municipalities do not meet the minimum quality standards as set by the organization, it is initially the municipal council which will be held accountable. If the necessary improvements are not being realized, the Minister of Finance may, in extreme cases, decide to have this Act executed by another party instead of by the municipality.

Secondly the decentralised approach has the important disadvantage that improvements and innovative developments are less easy to accomplish than in a centralised system. As always the

chain is only as strong as its weakest link. For a variety of reasons some municipalities can be less willing to embrace innovations in their work processes.

5. WHICH DATA IS BEING USED FOR THE TAXATION AND VALUATIONS?

Introduction

Another important aspect when shaping a system of property taxation is the data that will be used. First of all, the question is: which data is already available? Secondly the question may be asked which data is needed to perform? Crucial is the aim of the data. Setting up a system of registrations is often expensive and time consuming. There is always the dilemma between quality of data and accuracy of the assessed value at the one hand and costs of the data collection at the other hand.

But at the same time, introducing a system of property taxation can be a great opportunity to gather data that is wished in other processes. When considering which data will be used another very important question is, who is responsible to maintain the quality of data and by what means this must occur.

The choices made in The Netherlands

In the Netherlands there was so much data available that introducing an ad valorem property tax was relatively easy. First of all there is a reliable cadastral registration in which each parcel is registered with its owner and if available, its sales price. Secondly there is a very transparent real estate market, where the vast majority of properties are sold through publicly available advertisements. But despite of the availability of these data the high quality demands in the Netherlands makes it necessary that also data collection and improvement is done for the assessment.

Proper registration of object characteristics is essential for qualitative good valuation and for the trust of taxpayers. Therefore investments must be made and there has to be awareness about the way the registration of object characteristics can be kept up to date. The process-based continuous updating of a registration is less expensive than performing revaluations with frequent data collecting projects.

The consequent risks

Firstly, in a valuation process poor data quality will always lead to poor valuation results. This means that it is only allowed to use data of which the quality is objectively examined and proven in order.

On the second place it is important to realize the fact that the valuation process is a continuous process with large amounts of (geographical) data., Data of good quality today, can (and probably will) be outdated in the future. This means that it is essential to have a plan to systematically examine and maintain the quality of the data. Organizations that manage to improve the data quality in a process oriented way, are the organizations that can successfully execute a valuation process. Don't use data if you can't maintain the data quality.

Finally it is important to realize that it must be possible to communicate with taxpayers' about the way valuations are generated. That's why we prefer that the data that is being used also is recognizable for the taxpayers'. A valuation that can't be explained to the taxpayer is not suited to use for taxation.

6.   CONCLUDING REMARKS

When a system of property taxation is introduced, some fundamental choices have to be made considering the basis of taxation. In this article we described those we consider to be most important. We also explained which decisions were made with regard to these choices, when the system for property taxation in the Netherlands was shaped, what the arguments for these choices were and what the consequent risks are.

The most important lesson learned from this exercise is that a system for property taxation is never finished. Several developments in the real estate markets, or even in society at large may change the way a system of property taxation is received. This will inevitably change the demands that are imposed on the system. Every system therefore will need a certain level of manoeuvrability to adjust to a changing environment. Policy makers must also constantly be aware of ongoing developments and desired innovations. Only then, opportunities to improve the tax system can be seized. In general the most important lessons learned from the system of property taxation in the Netherlands are:

- The market value of a property is considered an appropriate and fair basis of taxation;
- A high frequency of revaluation is preferred especially if the assessed value is to be used for more purposes than just taxation;
- Access to data is essential for the organisations responsible;
- Limit the number of breaches of the assessed values as a tool for tax reductions, in order to value as much properties as possible;
- Benchmarking, innovating and adjusting the system for property assessment and taxation to new developments is a process that must be permanently present.

7. LITERATURE

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