The imperative for property taxation in Bangladesh

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Table 1: Investment incentives in Bangladesh			
Investment options	Average gross annual rate of return	Rate of taxation	Net of tax rate of return
Bank fixed deposits	10-12 per cent	10 per cent	9-11 per cent (risk free)
Commerce Industry	20-30 per cent	28-38 per cent	15-23 per cent (with risk)
Stocks (2006-2011 average)	38 per cent	0	38 per cent (with risk)
Land holdings (1972-2010 average)	100-125 per cent	0-5 (limited taxation)	95-120 per cent (risk free)

There is a healthy ongoing debate in Bangladesh on the subject of the introduction of propertytaxation. Opponents of this tax argue that this is a difficult tax to administer and the yield would be low relative to the cost of collection. In this analysis, I will argue the critical need for introducing this taxationnot only with a view to making this a potent source of revenue for urban financing, but even more importantly to correct the severely distorted incentives for resource allocations and also to moderate the spiraling urban land prices. The tax is also highly recommended on equity grounds. The cost of collection argument in this twenty first century of information technology is overstated and to my mind it is more a convenient excuse to avoid taxation by the rich and powerful who own most of the property and have a huge presence in politics, business and government.

Economics of property taxation: Economists are well aware of the power, potential and elegance of land taxation. Being a fixed factor, land is bound to accumulate value over time as demand grows. The owners of this fixed factor therefore earn a huge rent that can and should be taxed at a reasonable rate both to finance government spending on public goods and also to avoid providing a tax haven for idle accumulation. Being a tax on rent, this taxationis very efficient because the tax incidence cannot be shifted by the land holders for whom the tax is intended. This was the argument used by the well known classical economists Adam Smith and David Ricardo in advocating the case for land taxation. Subsequent economic thinking has refined this argument to allow for the fact that capital improvements on land can add value and therefore excessive taxation could hurt these capital investments and reduce incentives to enhance the productivity of land. Modern propertytaxation therefore makes a distinction between pure land and capital invested in land to make it productive (farming, commercial structure, housing, etc.). The taxation is basically aimed at taxing the rent accruing to pure land owing to scarcity value.

Economists also argue for land taxation because in the absence of taxation, investment incentives can easily be distorted in favour of land holdings and real estate and away from taxed assets and activities that have a more positive effect on growth and employment. Indeed, without taxation there will be an excess demand for land and real estate that can easily have a spiral effect on prices especially in a densely populated economy like Bangladesh with extremely limited land resources. So, properly designed property taxation can have a hugely positive effect in checking the growth of prices of urban properties in Bangladesh. Indeed, international evidence suggests that fiscal policy is one of the most potent instruments for influencing land pricing and land use.

Equity considerations can also be incorporated in the design of proper property taxation. In countries like Bangladesh much of the land holdings in rural areas are small and the farmers are mostly poor. Land taxation is not advocated for small holding farmers. The primary target for land and propertytaxation is land holdings and real estate in urban areas that have accumulated huge rents with no taxation. Much of the urban land owners are very rich and their wealth has soared with no effort simply through rocketing land prices. Even so, the property tax design could exempt the tax on owners of low-cost housing.

The Bangladesh situation: Let me now move to the situation in Bangladesh. Even as early as in 1972 the average population density was high–estimated at 474 people per kilometer. Today, this has swelled to over 1100 people per kilometer. The distribution between urban and rural areas and within cities of urban areas is much more telling. For example, the average density in Dhaka city has surged four-fold from 6250 people per square kilometre in 1974 to 25,000 in 2010. The impact of this demographic factor alone on the scarcity value of the fixed factor of production — land — is easy to see. Add to this the growth of real income that has caused per capita income of Bangladesh to expand by more than 150 per cent, from Taka 9172 in constant price of 1995/96 in 1972 to Taka 23, 380 in 2010. The effects of these factors on the growth of demand for land and consequently on land prices can be well expected to be substantial.

How have land prices grown in Bangladesh? Unfortunately reliable time series data on land prices are not available. I have developed an illustrative picture for Dhaka city based on piecing together fragmented data from various sources available from the internet and from studies done by the students and faculty of the urban planning department at the Bangladesh University of Engineering and Technology (BUET).

The evidence suggests the following:

Between 1972 and 2010, land prices in Dhaka city grew by an average of 100-125 per cent per year.

Allowing for the average inflation rate of 9.0 per cent between 1972 and 2010, real land prices in Dhaka have grown by a whopping 91 per cent per year. This is mind boggling and amongst the fastest growing land prices in real terms anywhere in the world.

Without proper research it is difficult to say with any degree of precision to what extent this price surge was due to growing demand owing to demographic and income growth factors and to what extent this resulted from excess demand due to the absence of taxation. Yet, the combined effects of a 3.8 per cent annual growth in population and 2.6 per cent growth in per capita income alone cannot fully explain the 91 per cent annual rise in the relative price of land in Dhaka. It is logical to expect that the absence of proper land taxation contributed substantially to the price spiral by fueling excess demand.

The impact on incentives and distortion of resource allocation owing to the absence of land taxation is easy to see from the stylized example of investment choices facing a potential investor in today’s Bangladesh. This is shown in Table 1. While highly simplified in nature, the picture painted in Table 1 about the investment incentives is fairly representative. It is obvious that the lack of property taxation and the taxation of capital gains from property transactions and stocks is major factor that distorts investor incentives in favour of land holdings and stock purchases when compared with real economic activities.

The massive growth of remittances has similarly facilitated the expansion of demand for land, especially in Dhaka. A yet another contributing factor is the frequent declaration of tax amnesty. People have used land and real estate holdings as a safe haven to park their liquid resources without paying taxes and with no questions asked. It is depressingly sad that policy attention has been so scant with no effort to close this massive tax loophole.

The adverse impact of distorted incentives on the quality of investment has been substantial. Given the incentive pattern illustrated in Table 1 it is hardly surprising that a huge amount of savings are parked in unproductive and speculative investments in land holdings and real estate. Investment in productive sectors has consequently suffered. Additionally, the spiraling land price, especially in the capital city of Dhaka, has made land a binding constraint to the growth of commercial and industrial activities.

The volume of foregone revenues from the absence of effective propertytaxation is obvious. While property transactions pay a nominal capital gain tax of 5.0% and other fees, these are assessed at artificially low official prices. The values were reset recently. Even so, these values are still four-five times below the market prices. Property owners also pay some minimal charges to the municipalities.

The way forward: The past cannot be changed but strong actions can be taken now to check the further growth of land prices, divert resources to productive sectors and provide substantial revenues to the government through a well designed urban land and property taxation. A number of factors will be important for the proper design of this taxation. First, a proper survey and computerisation of land and property ownership is needed. Second, property must be valued appropriately in line with current market prices. Third, capital gains tax must be implemented with no exception irrespective of the source of the gain, i.e. including gains from property ownership and stocks. Fourth, the tax rate must be set at a reasonable level both for capital gains when property is transacted and for property ownership. For example a rate of 15% on true capital gains from property transactions seems reasonable. Similarly an annual property tax of 1.0% on the market based value of property would appear to be a reasonable way to start. Low-cost home owners may be exempted. Other costs of property transactions must be streamlined to reduce transaction costs and promote the housing market.

Implementation will face challenge as the lobby against property taxation can be powerful in view of the ownership pattern of property. One way to address this challenge is to link property taxes with municipal services. Property taxes than become akin to betterment taxes. Municipal or city governments will typically be assigned this tax who will then use these resources to provide better urban services. A second challenge is the weak implementation capacity of city governments. To address this constraint, the property tax implementation can initially start with focus on the five major thanas of Dhaka encompassing the areas of Gulshan, Baridhara, Banani, Eskaton and Dhanmandi. Once proper valuation and ownership registration of properties in these areas are completed and lessons of the pilot are internalised, implementation can then be expanded to the rest of the urban centers of the country.

With modern information technology, registration, valuation and record keeping can be hugely simplified. Payments of taxation can be done online. The technology is simple and easily available and implementable. To avoid the risk of non-payment, capital gains on property taxation can be collected at the time of transaction involving registration of ownership transfer. If there is a strong political will, implementation of an effective system of property taxation need not be an impossible challenge.

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