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Property Taxation and Economic Development: Lessons from Rwanda and Ethiopia.

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Introduction

Since 1950 a rapid urban transition has occurred across the globe. At that time, more than two-thirds of the global population lived in rural areas and less than one-third in urban settlements. By 2050, the global population is predicted to be one-third rural and two-thirds urban, a reversal of the urban-rural balance in 100 years. Most of the world's fastest growing cities are in Asia and Africa, where the reversal is taking place even more rapidly and cities are expanding far more quickly than government capacities to cope with this transition.

Urbanisation is clearly correlated with economic growth, but that growth is often shared very unequally. Contemporary rapid urban growth in Africa is generally accompanied by highly visible booms in property development and construction; but unlike the urbanisation that occurred in the 'Global North' this is not necessarily accompanied by industrialisation, and brings questionable benefits to urban dwellers outside of a narrow elite. This SPERI Global Political Economy Brief looks at the relationship between property, land and wealth and the forces that are shaping urbanisation and economic development in some of the world's poorest, but most rapidly urbanising, countries.

Property taxation sits at the middle of these issues and is increasingly emerging on the international development agenda, amid growing recognition that it is an under-utilised source of revenue for state-building and redistribution. The Brief explores the challenges, opportunities and pitfalls of property taxation, and how it relates to land ownership, through analysis of Rwanda and Ethiopia: two rapidly urbanising countries whose recent economic growth and poverty reduction has been more consistent than most others in Africa. It presents new findings from field research in both countries which included interviews with a range of stakeholders including local and national government officials, investors and property developers, and argues that:

- Contemporary rapid urbanisation and the concentration of capital in urban property underscore the need for states to develop effective property taxation and mechanisms to capture rising land and property values.

- Introducing such mechanisms and new property taxes is extremely challenging, as Rwanda and Ethiopia demonstrate. States' ability to do so is determined by multiple factors including: historic property tax and land leasing systems, and how they interact; the concerns of politicians to maintain popular support and prevent resistance to reforms; and the desire to continue to attract investment from investors, both domestic and from diaspora groups, many of which have invested heavily in urban property in recent decades.

- The lessons from Rwanda and Ethiopia should be studied by policymakers in rapidly urbanising countries, and by international development policymakers concerned with securing progress towards poverty reduction and avoiding inequitable economic growth in the developing world.

Part I: Urbanisation, property and economic development

Rwanda, Ethiopia and East Asian 'tigers'

- Despite impressive GDP growth rates and booming capital cities in Kigali and Addis Ababa, Rwanda and Ethiopia continue to have large, poor rural populations as well as growing and relatively unskilled urban populations. Both countries have a strong need to drive investment into sectors that can create jobs and absorb labour, alongside the need to raise government revenues to fund basic infrastructure and poverty reduction measures.

- In countries that have previously experienced periods of rapid urbanisation and economic growth, such as the East Asian 'tiger economies' of Hong Kong, South Korea and Singapore between the 1960s and 1990s, property taxation and mechanisms to capture rising urban land value were implemented relatively early on. This generated significant revenues that helped the state drive sustainable economic development.

- Although not small city-states like Singapore or Hong Kong, Rwanda and Ethiopia are both relatively land-scarce countries with dense populations (especially Rwanda). Elites in these countries have sought to emulate the 'developmental' state-led approach to growth of their East Asian forebears.

- Land value 'uplift' is captured in Hong Kong and Singapore through auctioning land leases and various forms of progressive property-related taxes: annual taxes on real property, 'betterment' levies that capture increases in value due to permitted land use changes, and taxes on capital gains.

- As privately-developed land rises in value, these measures reduce incentives for investors to speculate with land and in so doing encourage private investment into industry. They also generate substantial revenues which the state can redistribute to invest in public services and infrastructure. Urbanisation, industrialisation and sustainable economic growth were therefore inherently linked and reinforced each other.

Drivers of property investment in Rwanda and Ethiopia

- Urbanisation in the contemporary developing world is taking place in the context of a globalised world of increasingly internationally mobile people and capital. In countries where manufacturing does not seem a viable option, urban services and real estate are attracting much more investment.

- Meanwhile, 'global city' discourses of domestic and international investors and the lucrative and quick profits that can be made by investing in urban property combine to outweigh many government incentives to invest in more productive sectors of the economy.

- Rapid proliferation of property development has occurred in Kigali and Addis Ababa over the past two decades. Although there are important differences between the two, the flow of domestic and international investment into property and service sectors has been a key factor behind their recent growth in both cases.

- Rwanda and Ethiopia both have a substantial and powerful class of returnee elites. Often returning after living abroad for decades and bringing significant capital with them, urban land has offered attractive investment opportunities in the absence of a clear route to industrial success.

- In Rwanda, the compound annual growth rate of construction between 2006-2013 was 19.7 per cent, dwarfing all other sectors. Manufacturing's compound annual growth over the same period was just 3.3 per cent. In Ethiopia the property sector grew by an annual average of 14.1 per cent in the second half of the 2000s, significantly above GDP growth.

- The Rwandan government has a number of incentives in place to actively encourage investment in construction and real estate. In Ethiopia, by contrast, it is very hard to get loans for property development. However, for those who have capital to invest, this makes constructing property to sell all the more profitable given the high demand relative to supply. Profits of 100 per cent are commonplace in Addis Ababa for those with the finance to go into property development, and house prices commonly double every five years.

Part II: Property taxation in Rwanda and Ethiopia

In the context of this marked property boom, there have been attempts in the last decade in both Rwanda and Ethiopia to introduce more effective property taxes. The potential of property taxation in Africa is something that governments in the region and their international development partners are increasingly aware of. However, as Part II demonstrates, reforms in Rwanda and Ethiopia have achieved poor results to date and faced significant resistance, partly because of the way they have interacted with land reforms being pursued at the same time.

Rwanda

- Booming development in Kigali led one expert to suggest in 2009 that property taxation could, hypothetically, generate revenues equivalent to 5 per cent of Rwanda's GDP. Yet in 2013 the property tax collected nationally (the vast majority from Kigali) was just 0.018 per cent of GDP. This is extraordinarily low. The average in developing countries is 0.6 per cent, and in African countries it is 0.5 per cent.

- Rwanda's attempt to introduce a new property taxation system involved updating a decades-old system whereby freehold property owners paid an annual levy of 0.2 per cent of the property's registered value, based on square metres usage and not market value. This generated little revenue because only some older properties were on government registers (often with valuations from the 1960s), and because whilst owners of new properties were required to have them valued for taxation purposes in practice many did not.

- A new 2011 law introduced a property tax based on market value rather than floor area. However, effective processes of valuation were never developed, and in some cases market values were opaquely determined on the basis of self-reported value. In a country where in the words of one observer, '*nobody has any clue about market values*', this has proved highly problematic.

- The new law set the levy at 0.1 per cent of the assessed value for all properties, whether commercial, residential or industrial, lower than the previous 0.2 per cent rate and extremely low by international standards. In the year after the new law came into force property tax revenues declined, though they have subsequently started to increase again.

- To further understand this failure it is also important to consider how property taxation in Rwanda relates to land ownership and earlier reforms to the land leasing system.

- Land reforms in 2004-5 introduced a new system whereby investors in urban land who met certain development criteria were entitled to freehold rights for the land, while all other land holders – the vast majority – were granted a lease of 20-99 years (depending on land use) in exchange for paying a lease fee based on plot size and location.

- Crucially, property leaseholders pay land lease fees (based on simple square metre calculations), whilst only owners of freehold titles – which constitute just 3 per cent of land plots – pay property tax.

- Under this system, existing landholders can pay to convert their leases into freehold titles, provided they develop the land in accordance with approved plans. This dual system of leasing and property tax was intended to spur development and provide a steady flow of lease fee revenues. It was hoped that over time the number of freeholders paying property tax (based on market value) instead of lease fees would increase.

- However, since the reforms were introduced, landholders have tended not to exercise their right to acquire freehold titles, primarily because by doing so they would have to pay property tax. The concepts of freehold and leasehold (and their benefits) are also not commonly understood, posing a further obstacle to the functioning of the system. As such, it is estimated that many property owners with leaseholds only pay around a fifth of what a freeholder would pay in property tax on an identical plot.

Ethiopia

- Addis Ababa, like all Ethiopian cities, has a municipal tax known as 'roof tax'– the equivalent of property tax. It is levied on buildings with no reference to land, which is ultimately still owned by the state. After the Ethiopian People's Revolutionary Democratic Front (EPRDF), the ruling political coalition, took power in 1991, it realised that property valuation rolls used for taxation purposes were out of date and only captured a fraction of Addis' fast-growing housing stock, and moved to address this.

- A census was undertaken in 1996 which captured all properties and a new annual value was calculated for each property. The newly calculated tax bills presented to all property owners indicated they were currently paying around a quarter of what they should be. There was such an outcry that the city government slashed the values to a quarter of the new calculations, rendering the valuation exercise essentially pointless.

- Since the 1990s there has been no revaluation of properties or audit to identify new properties. Meanwhile, the population of Addis Ababa almost doubled from 1.8 million in 1990 to 3.2 million in 2014. For houses that the city authority does have on its register, severe undervaluation is normal. A 2006 study in Lideta, one of the 10 sub-cities of Addis Ababa, found that on average bank valuations were 300 per cent higher than property values on government rolls. For some properties, bank valuations were thousands of per cent higher. This disparity is likely to be even higher today.

- When new structures are built, property owners can, in the words of an expert, get the property valued '*if they want to pay the tax*'; unsurprisingly, few do. Most private homeowners '*pay nothing, because the government does not know them*'. As such, the roof tax contributes just 0.1 per cent to total city revenue.

- In short, despite reform attempts in the 1990s, property tax in Addis Ababa has been rendered almost non-existent by interventions to deliberately undervalue properties, the lack of revaluation over time, and the failure to capture virtually all properties constructed in the past two decades.

- As in Rwanda, the Ethiopian regime has undertaken major land reforms. Land is nationally owned, but a Chinese-style leasing system was introduced in the 1990s to allow commercial development and generate revenues. While the need to purchase leases initially only applied to public land made available by the government, in 2011 a law was passed incorporating all land into the leasehold system, so anyone acquiring a land plot from another individual would have to also purchase a lease from the government. This drastically increased the cost of land and generated significant resistance.

- Leases for commercial developments are generally auctioned by the state, which has increased revenues but also led prices to rapidly escalate. In 2014 one plot in Addis Ketema sub-city was auctioned for 307,000 Birr per square metre. This is higher than the average price in Geneva, the fifth most expensive city in the world for property.

Part III: Why reforms are needed, and what is obstructing them

In both Rwanda and Ethiopia, state revenues from urban land are increasing, albeit from low starting points. However, as suggested above, this is due much more to land leasing arrangements than property tax. This is problematic in both countries, particularly in the long term. While they may generate very substantial resources in the short term, land leasing systems are less sustainable and progressive than property tax for the following reasons:

- Land lease fees do not recapture any of the value of structures built on the land and do not capture increments to value over time.

- Lease fees are fixed sums of money, determined at a specific point in time, that do not provide continuous payments like taxes.

- Lease fees are an unpredictable and limited revenue source: property sales can vary hugely year-to-year, and urban land is ultimately finite.

- The purchasing of leases through auctions drives up land prices (which the state cannot continue to recurrently capture without property tax), provides no disincentive to speculative property development, and may encourage it.

- Land leasing auctions are also increasingly associated with the displacement of low-income communities, driving the poor further and further afield as cities expand to get more funds.

It is significant that in China, which has the world's largest and most well-known public land leasing system, policymakers have become acutely aware of these issues and are moving to introduce property taxes.

To achieve the significant revenues needed for states to be able to invest in infrastructure, as well as to make such revenue streams sustainable, help promote private investment in industry and address widening social inequalities, robust and progressive property taxation is required. However, such taxes are notoriously difficult to implement due to political resistance and concerns about maintaining stability:

- In Rwanda, introducing a progressive property tax would substantially increase the tax burden on wealthy elites relative to the poor. Given the fragility of the country's governing coalition, this may be seen as a very risky move politically. As the country's new elite since 1994 has been allowed to accumulate property wealth virtually untaxed for over two decades, the desire not to 'rock the boat' is substantial.

- In any case, because there is a major overlap between political elites and large property-owners, parliamentarians have obstructed and watered down prior efforts to improve the tax system. The draft version of the 2011 law set the property tax rate at 0.5 per cent, which reflects international norms, and had addressed the freehold/leasehold issue by making leasehold properties subject to property taxation. However, both of these clauses were revised by politicians in parliament before the law was passed; indeed, rather than being increased to 0.5%, in the final law the tax rate was slashed from 0.2 to 0.1 per cent.

- Similarly in Addis Ababa public opinion and maintaining political support have been significant factors behind the limited attempts to effect property tax reform since the 1990s. However, in this case placating the growing urban middle classes has been an important priority. People in the middle-income category are mostly used to paying miniscule amounts of 'roof tax', and would be substantially impacted by the imposition of a comprehensive property tax.

- Having introduced a leasing system which means property owners in Addis Ababa were forced to pay lease fees substantially higher than any nominal land rent they had paid previously, policymakers were faced with a situation where people were 'already feeling taxed' when it comes to property. This makes introducing an effective property tax highly politically challenging.

- Making this all the more problematic is the fact that when the lease fee system was introduced, explicit public announcements were made that people would not be taxed on their property once they had paid for the lease.

- In Ethiopia the government has recently introduced a pilot property tax project in three cities; however, Addis Ababa was not included despite its massive accrual of property wealth. It was felt that in the capital there would be too much resistance, both because of the extent of interests in property and a general concern not to inflame the significant political opposition to the regime that exists in the city. Given this, whether the new system being piloted will ever make it to the capital is an open question.

- Rwanda similarly is taking steps towards designing a new tax system with a clear priority being to expand the property tax base beyond freeholders, who are likely to remain a small minority. The Rwandan Revenue Authority has brought in the IMF and other experts to help address this. However, even if sound technical solutions are proposed, the key question is whether political constraints and resistance from powerful vested interests will again prevent them from being implemented.

Conclusion

The option of transforming into industrial powerhouses is largely closed to today's rapidly urbanising countries in the developing world, due to intense and ongoing competition from established low-wage manufacturing hubs in Asia. Governing elites in many such countries, including Rwanda and Ethiopia, have therefore chosen to encourage investment into service sectors as a core part of state-led efforts to transform their economies and achieve high growth rates, which has promoted substantial real estate development. Moreover, even when the government is actually quite hostile towards private real estate developers (as in Ethiopia), the potential for returns is still viewed as being much greater (and the overall risk lower) in real estate than in virtually any other sector. The relatively much easier and more lucrative profits in property have been bolstered by the lack of effective property taxes. By the time concerted efforts to reform property taxation started to materialise in both Rwanda and Ethiopia, a powerful class of wealthy elites concerned with protecting profits and asset values held disproportionate influence and have been able to obstruct and water down reforms.

Furthermore, in many developing countries political elites are under pressure to maintain the support of a new urban middle class that is growing in size and influence, and to hold together often fractious governing coalitions of competing political parties and powerbases. These pressures have conspired against the introduction of progressive property taxation regimes. In countries like Ethiopia and Rwanda where the government still has substantial powers over land, public land leasing systems have been able to generate quite substantial amounts of revenue for local authorities – but these have significant shortcomings. This situation risks driving unsustainable and inequitable economic growth and harming progress toward state-building and poverty reduction measures. As more cities in Africa and throughout the developing world urbanise, the experience of efforts to introduce property taxation in Rwanda and Ethiopia should be heeded.

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