



2012

Tax Facts

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Recommended Citation

Dunne, T. (2012) Tax Facts. *Surveyors Journal Volume 2 Issue 4 Winter 2012*

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Tax facts

TOM DUNNE clarifies the issues surrounding different forms of property tax.

The debate about property taxes can be intense and often this is due to a lack of clarity about the concepts involved, not to mention the exact meaning of terms used. Such lack of clarity is always a recipe for unhelpful confusion and heat. To assist discussions after the budget, it is worth trying to get some precision about the nature of property, the character of property taxes and the language used.

Charges and taxes

First, let us start by saying something that appears obvious but is worth making clear. A tax is a compulsory payment to the State and there is no legal choice about paying it. Other words can be used and frequently are but, essentially, if it is paid to the State and is compulsory, it is a tax.

There is a useful distinction between a payment made without reference to specific benefits or services, and compulsory payments for particular services received by the taxpayer. The latter are called hypothecated taxes and could be called charges rather than taxes. That distinction can be blurred and often is, but it helps to keep it in mind when discussing property taxes.

Many of the services provided by local government can be identified and costed, and a property owner given a clear indication of what they are being charged for. To the extent that this is done a local property tax can be seen more as a charge than a tax. The major reason for levying local property taxes is precisely because doing so is regarded as the best means of distributing the burden of the provision of many of the services of local government among those who benefit.

If houses are to be taxed to pay for unspecified services, and this includes a subsidy to other households, then it may be more a tax on one specific form of wealth, begging the question: why is a wealth tax only being applied to houses and not to other forms of property?

Property

The word 'property' can simply mean anything that is owned, but is often taken to denote the more specific case of landed property. All property is of course a form of wealth, but there is an important distinction between land and other forms of property.

Land is part of providence and exists regardless of man. Other forms of property were created by man and exist in the form of capital or wealth, and may be physical, but not necessarily so. Using this distinction, a house, for example, can be seen as an amalgam of two factors: capital, i.e., the bricks and mortar etc., and the land on which it sits. In this conceptualisation a house is one property made up of two elements: land and buildings.

Landed property is different

Classical economists saw land as being different to other forms of property, having particular characteristics that made it intensely appealing as a subject of tax. For example, land cannot be hidden, with a consequence that land taxes cannot be avoided, a particularly attractive characteristic. Most important, economic theory holds that taxes on land do not distort

economic activity, unlike labour taxes for example. Because of these most economists find the arguments for taxing landed property compelling and this reasoning is the basis of the appeal of land and site value taxes, which attempt to separate out the land element of landed property. But it is not as simple as that. In many discussions about economics and tax, land is often conflated with capital, and reflecting this, most of us see land and buildings as forming one piece of property.

Importantly, many of the strong arguments for taxing land do not apply as firmly to taxing the whole property. A lot depends on the relativity of the site value to the value of the whole property. In many locations, particularly at times when economic activity is depressed, all the value might be in the buildings and the value of the site might be nominal and little above agricultural value.

It is clear that a tax on property can have a disincentive effect, which does not exist if the land value element only is taxed. This is most clearly seen in the argument that property taxes deter people from improving their homes, which would not be valid if only the site was taxed.

In some jurisdictions this problem is accommodated somewhat by having what is called a split-rate tax, where a separate assessment is made on the land and buildings and the rate of tax applied to each would reflect the distinction. Landed property is indeed different, and while there are compelling arguments for taxing wealth held in this form, isolating the land element can be complex. If it is intended to tax wealth, then landed property should certainly be included, but separate from that there is a strong case for using property taxes as a tool for recouping discretionary spending by local authorities, and clarity about intentions would greatly help the design of the tax and how and who should pay.

Who should pay – owner or occupier?

This depends on what the tax is intended to be. Is the property tax a form of wealth tax or is it a charge for services? If it is a wealth tax the owner should pay, and if it is a charge for services then the occupier should pay.

Adding to the complexity is the extent to which the services of local authorities benefit the property or the occupants. Some services will clearly benefit the property and others the occupants. A lack of clarity around these issues leads to design flaws in the tax, but solutions to this question can be found. For example, in France there are two property taxes, one paid by the occupier and the second by the owner. In simple terms the occupier tax could pay for local services from which occupiers benefit and the owners pay the tax for services provided to the property. In the case of rented property it would seem correct for the landlord to pay if the property tax was intended as a wealth tax, but if it is a payment for services the tenant should pay. There is in addition the thorny question of mortgages. Again it can be said that if the property tax is a payment for services, the mortgage is not relevant as the services are provided to the occupants regardless of their ownership status. To the extent that it is intended as a wealth tax an allowance should be made for this. Clarity in thinking about the purpose of a property tax will help to determine the basis for the tax and the way it is to be paid. A lack of clarity will lead to confusion and design flaws, which make justifying the tax much more difficult and may prove fatal.

Local or central collection

The Government has suggested that a property tax would be collected centrally, but ring-fenced and applied to funding local government, implying that such a tax is a form of local

property tax. Indeed it has been suggested that in future local authorities could have some discretion to vary the rate of tax in their local area. If it is intended to be truly a payment for local services, the logic follows that these should be specifically identified and the tax paid in accordance with the cost of these, as happens in most other countries.

In truth, without local discretion about spending, a national tax on residential property could be seen as a hypothecated wealth tax used to garner central funds to be spent on local government. This is a very long way from a local property tax, but could be justified as a form of wealth tax. But that would beg the question: why is the landed wealth held in houses taxed in this way and not wealth held in the form of, say, agricultural land? Local collection of a local discretionary tax avoids many of these issues, and particularly the problem that property values in some areas are higher than in others. It is the relativities in a local area that should count.

Relative value within a local area is important

Normally with local property taxes the imperative is to distribute the cost of provision equitably among the beneficiaries from the services. This is done by a charge to each property or household specifying the liability for a share based on some aspect of the property occupied. Normally this will be rental or capital value, but it does not have to be. It can be the size in terms of floor area or indeed the site area in towns and cities.

Here the important issue to grasp is that what is at stake is not the actual size or value of each house, but the relativities involved. The objective is to distribute the cost of services as equitably as possible.

Given that it is only the expenditure of the local area that is being recouped, it does not matter much that property values in one part of a country are higher than in another; what matters is the relativities within the local authority area. Conceivably, for a given basket of local authority services, a property tax based on value could be lower per property in a wealthy local authority area than in a less wealthy area, as the cost of provision or uptake of the services might be lower in the wealthy area. For example, if a local authority in a less wealthy area provided a swimming pool and the authority in a wealthy area did not (because all residents had one in their back garden) then, all other things being equal, the property tax in the less well off area would be higher and the householders happy with their amenity and willing to pay for it, while those in the wealthier area each pay much more for their own pool.

Many of the objections to property taxes fall away if they are seen as an equitable tool for paying for local services.

Conclusion

Many of the arguments that are made against property taxes should be seen as being against a particular model of property tax rather than arguments against property taxes as such. There are plenty of examples of property tax systems around the world where acceptable taxes are levied and local government works better than it does in Ireland. The system chosen here will have many deficiencies and maybe they will be fatal. These should be seen as resulting from a lack of clarity about the purpose of the tax other than the crude need to collect money from taxpayers.

It is possible to have a fair and equitable property tax, but clarity of purpose would help in designing it. The debates following the budget will reveal if we have managed to devise an

equitable property tax or whether the model chosen yet again will contain the seeds of its own downfall.