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Mobilizing Local Own Source Revenues

Reform discussion note

Introduction

- The revenue assignment framework in Malawi is largely consistent with theory and international practice. While central government grants and ceded revenues play the dominant role in funding local governments in Malawi (see policy note on intergovernmental fiscal transfers), locally generated revenues (own source revenues: OSR) are essential to expand LGA fiscal space and promote local
- Urban LGAs finance about 50-60% of their budget expenditures through their OSR while most district LGAs fund less than 10% due to differences in fiscal capacity. Urban LGs largely receive their OSR from property rates (54%), market fees (24%) and licenses (12%) while rural LGs rely on market fees (47%) and fees and service charges (23%).
- While OSR have grown in nominal terms over the last decade, their growth has not kept up with economic growth and has stagnated in per capita real terms. The OSR buoyancy has been inelastic. For example, the revenue buoyancy from 2010-2019 was 0.56 while the OSR buoyancy over the period from 2010-2015 was only 0.37. Property rates buoyancy was only 0.13 while the buoyancy for market fees and charges was 0.27.
- Property rates overall are significantly underperforming as a percent of GDP. Property rates averaged 0.077%. as a percentage of GDP from 2010/11 – 2019/20. This property rates performance has declined over the last 5-year period. Malawi should be able to double or triple its property rates revenues based on international experience in low – middle income countries which can range from 0.2% to 0.5% of GDP.
- The low performance for property rates, as well as market fees and charges, can be attributed to a combination of policy and administrative variables. On the policy side, narrow tax base definitions and lagging adjustments in tax rates can lead to stagnant revenue yield, while revenue performance can be affected on the administrative side by by incomplete and outdated market / business registries and property rates rolls, outdated and inconsistent valuations for property rating, weak collection and ineffective enforcement as well as poor rate payer and civic education/service.
- This suggests the need to broaden the tax base, rationalize exemptions, and improve the rate structure on the policy side and to strengthen revenue administration with regards to the tax base coverage, property valuations, tax liability assessment and collection / enforcement, along with improved taxpayer/civic education and service, as appropriate.
- Through a mixture of policy and administration reforms, local OSRs should be able to be increased in an efficient and equitable manner while simultaneously strengthening the accountability "fiscal contract" between LGAs and their residents. This will require LGAs to be empowered through simplifying the legal framework and regulations, overcoming capacity and institutional constraints while mobilizing stakeholder willingness (politicians, administrators, taxpayers, residents) to improve revenue mobilization.

Options for Improving LGA Own Source Revenues

Priority should be on enhancing the property rates, especially in the urbanized areas, and on improving the market fees, licenses and permits in both the urbanized and the rural LGAs. International benchmarks for low to middle income countries suggests that the property rates should be able to double from the current 0.075% of GDP to 0.15% of GDP, largely with changes in administration. Market fees / business licence revenues should also be able to be made more buoyant with adjustments in policy and improved administration.

Improving any of these revenues will require a combination of policy and administrative remedial actions. Any such reforms need to be designed to optimize local revenue collection while minimizing possible efficiency distortions affecting economic growth and/or inequity implications disproportionally affecting the poor. It is critical not to undertake reforms which will increase administrative and compliance costs more than the revenue collected by the LGA, essentially turning that local revenue source into a "nuisance" tax. All OSR reforms must focus on enhancing net revenue yield while minimizing compliance costs, possible distortionary costs to the economy and administrative costs for long term sustainability.

General Options & Considerations:

1. **Strengthen / Broaden the Local Revenue Enhancement Strategic Plans (LRESPs):** The CG should review the LGA LRESPs experience in Malawi, assessing the quality of the LGRESPs being generated and their implementation experience in order to strengthen their quality and effectiveness. All LGAs should continue to prepare and/or review their LRESPs, turning the LRESPs from a onetime report to an ongoing strategic management tool and used as input into their projected revenues used in the budget process. A well-designed LRESP should provide an opportunity for LGAs to review current revenue performance, identify challenges and constraints including a review of their council by-laws/fee schedules/, identify appropriate remedial policy and/or administration interventions, and then allow for the prioritization and sequencing of those interventions into a strategic implementation strategy. The LRESP should feed directly into the OSR revenue forecasts used in the medium term and annual budgets. Annually the actual revenue performance against budgeted amounts should feedback into the LRESP and into the revenue projections for the following annual budget.

   To the extent possible, the LRESP formulation should be prepared in a consultative, open manner where various stakeholders (government and the private sector/citizen stakeholders) can be engaged, consulted, and mobilized. This participatory preparation process can lead to a better understanding on the role of LGA revenues in development, to their links to local expenditures and improved services, and to a "buy-in" by the LGA and their residents. Ultimately this stakeholder "buy in" can encourage voluntarily compliance with local taxes, fees and charges.

   It is suggested that a 2-day workshop be held on LRESPs where the CG and LGAs can review the LGA experience, identify a way forward for further strengthening the LRESPs and improve actual local OSR mobilization, with a set of agreed to milestones for monitoring their implementation.

2. **Strengthening the Fiscal Contract / Mobilizing Citizen Engagement**: LGAs must improve their "fiscal contract" with their residents / taxpayers. Through improved, effective citizen engagement, residents need to understand the OSR revenue objectives and their links to local services. This will encourage

greater participation and voluntary compliance with their civic obligation, responsibilities and rights related to the payment of taxes and fees and to the ultimate link to improved local governance and service delivery. At the same time, the LGA must recognize the need to provide efficient and equitable revenue system and improved local level public service.

Ultimately revenue systems must depend on voluntary compliance, with sanctions and penalties reserved only for those few who fail to meet their civic obligations. Effectively using sanctions and penalties can enhance revenue mobilization while also enhance equity and efficiency, which in turn can encourage greater voluntary compliance.

Civic engagement training and information materials should be developed, field tested and disseminated to all LGAs, along with training workshops on how to effectively mobilize residents/taxpayers. Information materials could be developed for each major OSR revenue source as appropriate.

3. **Synchronize OSR policy/administration reforms with Intergovernmental Transfer System:** Local government OSR revenue performance is intrinsically linked to and affected by the overall structure of the intergovernmental transfer system. Theory and experience suggest that there may be a "substitution" affect where the grant system can "crowd out" the mobilization of local OSRs. To avoid this disincentive, the grant system allocation formula should to the extent possible include a variable based on OSR fiscal capacity (potential local OSR which could be collected) rather than OSR fiscal performance (actual local OSR collected). The key is to create the right incentives to encourage LGAs to mobilize their OSR while reducing any disincentives which may discourage LGAs mobilizing their OSR.

4. **Automate OSR revenue administration:** Automating revenue administration can improve efficiency, equity and accountability. However, any automation improvements must be cost-effective, thus should be only undertaken with caution limited to only those revenues and revenue functions justifying the investment. Typically, this means that those systems focus on the treasury functions of billing and revenue collection management and enforcement, for such revenue sources with high revenue potential such as the property rates in the urban areas.

   Any automation must begin with a thorough analysis of the business processes. Streamlining / rationalizing the business processes is critical before introducing major automation reforms. While the system design should be comprehensive, the priority should be focused on improving the billing / collection treasury functions with the potential to expand as justified for the management of the underlying registries and tax rolls. Effective revenue administration automation will require building up LGA capacity in automation management and data security, among others.

Specific Options:

1. Property Rates Specific Actions

a. A review of the property rates policy suggests that the tax base and tax rates are largely logical—thus do not seem to be the binding constraint to enhancing property rates revenues. Revenue underperformance is largely administrative leading to incomplete tax base coverage, low and inconsistent property valuations and low collection and enforcement, further impacted by poor taxpayer engagement and service. The key to higher revenue performance therefore must focus on improving the coverage, valuation and collection administration ratios (see below).

b. **Policy Reform Options:** Although the reform focus should be on administration, the government could consider several policy changes such as the following:

- Clarify criteria to be used by Minister for defining "rateable areas" (Local Government Act Article 61). The definition and the process to ensure that LGA areas can be classified as "rateable" should be clear, transparent and automated to the extent possible based on objective criteria so as not to require a proactive, intentional administrative decision.
- Allow private hospitals and educational to pay a reduced property rate on their land and improvements. Currently Art 83 provides a blanket exemption for education and health properties. While perhaps fully justified for government and non-profit facilities, there may be equity and efficiency justification for levying a partial property tax on those properties which are private, profit-making facilities. Similar to the Government being required to pay 50% of the rates on their assessable property (Article 85) perhaps it may be reasonable and appropriate to allow private, for-profit health and educational properties to also pay 50% of the rates.
- Allow for an automatic property tax roll indexation in cases where valuation rolls are not being periodically updated. The LGA Act provides that valuation rolls should be produced not less than once in every five years. In the event that the tax roll is delayed for some reason, the law could be changed to provide that any such valuation roll will be automatically indexed to an official price index such as the CPI, until such time a new valuation roll is completed. While a general indexation would not account for changes in relative property values across properties, it would allow for a general value increase to maintain the "real" value of the property tax paid. This indexation would alleviate the need for LGA to increase their property rates only due to the lack of an updated valuation roll.
- Require private and public agencies handling property-related information to report relevant property information to the LGA for rates administration purposes. This would include agencies such as banks, notaries, developers, deeds office, land department, utilities. The type of information required would be stipulated in the law / regulations but would typically include information on occupant/owner of the property, physical property characteristics and value-related information.
- Allow differentiated "fixed sum" rates under LG Act Article 64 to incorporate size, use and location of buildings and/or land. These adjustments, if properly made, would allow the fixed sum amounts to be more equitable. Currently Article 64 (a) only allows for the fixed sum on buildings to be differentiated by purpose (and not location or size) while Article 64 (b) only allows for the fixed sum on land to be differentiated by size (and not by location or purpose).
- Provide for the explicit use of simplified mass valuation for property rating purposes. While the law doesn't necessarily prevent the introduction of mass valuation techniques, it may be prudent to introduce a specific legal provision to allow / encourage the development and implementation of mass valuation for property rating purposes. (see section on improving the valuation ratio below).

2. Administration Reform Options:

a) Options for improving the Coverage Ratios:

- **Separate the data collection function from the valuation function.** To improve efficiency and reduce costs of preparing a valuation roll, it is recommended to split the coverage function from the valuation function. Registered valuers, as required in the LG Act Article 67, would then be able to use the property data, along with any appropriate valuation models, to value the property for rating purposes. Registered valuers, as discussed below, will be encouraged to develop and use simplified mass valuation models.
- **Reduce the required property information collected and maintained to the minimum required for property rating purposes.** Any property declaration form should be simple, user friendly and strictly limited to the minimum information required (eg, taxpayer information, property physical characteristics and available value-related information).
- **Strengthen property-related information sharing.** Taxpayers should be required to submit (declare) their property ownership and physical characteristics on a periodic basis to the LGA, not only during a revaluation event (LG Act Art 74). Third party stakeholders should also be required to submit defined property-related information to help improve the coverage ratio (and the valuation ratio).
- **Targeted field data collection:** In addition to receiving property-rates related information from taxpayers and third parties, LGAs should proactively undertake targeted field data collection to identify missing properties, properties with inaccurate information, etc. This coverage rate activity could be done separately from the valuation function if a mass valuation approach is adopted or jointly with the valuation functions if a single parcel valuation approach is continued.
- **Field work could be improved through using appropriate technology.** For example, existing maps could be used, possibly assisted by updated maps using arial photography [drones (eg, Zanzibar) or satellite mapping (eg, Rwanda)]. Field data collection can also be facilitated by using using tablets. Note all technology options should be carefully costed and tested to ensure that they are cost effective for the task.

b) Options for Improving the Valuation Ratio:

- **Shift from individual parcel-based valuation to simplified mass valuation.**[1] To reduce costs and delays in updating valuation rolls, Malawi should shift from a single parcel valuation approach to a simplified mass valuation approach. As shown in a recent pilot project in Mzuzu which used a "point-based" simplified mass valuation system,[2] such a simplified mass valuation system could dramatically reduce the costs and time required to value properties for rating purposes. The recent Mzuzu experience should be reviewed, adjusted as necessary and then used for rating purposes in Mzuzu, and subsequently rolled out to other urban LGAs.
- As discussed under the coverage ratio above, the role of the valuer should focus on developing appropriate valuation models and tables to move toward a simplified mass valuation approach. Registered valuers can focus the individual-based valuations on unique high value commercial / industrial properties (e.g., using an income approach for commercial properties). The basic collection and maintenance of property information could be delegated to non valuers reducing the costs of improving the coverage and the valuation ratios.
- Enhance the transparency of property valuation appeals to ensure legitimacy, acceptability, consistency, equity and accountability from the taxpayers, the registered valuers, tax administrators, and politicians. Publishing the valuation rolls and

1 Shifting to a simplified mass valuation system for rating purposes should not require any legal changes, as mass property valuation is an internationally recognized valuation technique. However, changing the law explicitly to mention mass valuation as an alternative may provide the political-legal support needed to encourage adoption and implementation of such more cost-effective valuation approach for rating.

2 A similar point-based Mass valuation system is now being successfully implement in Free Town, Sierra Leone.

allowing property valuation appeals will improve the accuracy of property valuations and encourage voluntary compliance and system sustainability.

c) Options for Improving Collection Ratio[3]:

- **Reduce compliance costs to encouraging voluntary compliance** for the property rates, as well as for all LGA revenues. This can be done through (a) using effective community and social outreach and taxpayer education to ensure taxpayers (and all local residents) understand the rationale and responsibilities for property rates payment and (b) structuring the payment system to ease compliance costs by providing various convenient payment points, including the use of Airtel money. Other possible payment points could include government office subunits, banks, ATM machines, utility payment points, among others.
- **Use reminder notices** (individual or collective) to remind taxpayers of their responsibilities and obligations. This has been shown to encourage taxpayers that may be forgetful of their obligation and deadline to pay.
- **Use effective sanctions** — i.e., withholding of LGA services for those taxpayers in non-compliance. Use of tax clearance letters have been shown to be effective. If possible, tax clearance letters should also be required by central government and other non-government institutions dealing with properties such as banks, lending agencies, utility companies, others).
- **Use appropriate penalties** such as a lump-sum late payment penalty, along with the levying of a percentage based fine per month. The fine should be set equivalent to the same levels being imposed for late payment of the VAT, income tax and others CG-level revenue obligations. Typically, these are set at equal to the prime interest rate plus 1 or 2 percentage points. Currently LGA Act Article 86(3) provides for a surcharge rate of 4% per month.
- **Use other compliance measures** for accounts in arrears (longer-term non-payment situations). Based on an analysis of the stock of arrears, develop a strategic arrears compliance enforcement plan. Similar to enforcement measures for the CG level taxes, collection options should allow for such actions as garnishing rents, banks accounts, salaries, and the seizure and auctioning of immovable and movable property. Strategic use of tax liens imposed on the titles of non-compliant properties should also be used.
- **Avoid use of "Tax Amnesties" which are not linked to changes in improvements in collection** and enforcement. One time tax amnesties followed by strict enforcement again non-compliance can be quite effective, but tax amnesties followed by business as usual typically will have only a short-term effect as taxpayers wait for the next expected amnesty period.

3 Note these actions to promote property rates payments can also be adjusted to encourage payments for other LGA OSR revenue instruments such as license/permits, market fees, among others. These actions should be encouraged and incorporated into the LGAs LRESP:

3. Market Fees and Charges/Licenses and Permits/ Other OSRs

As per Article 11 of the Local Government Act, a LGA Assembly can set the market fees and charges "as the Assembly may decide" while Article 13 grants power to the Assembly to "levy any charge it may think fit ..." Thus, LGAs seem to have complete autonomy to set the structure and level the various fees and charges levied by the LGA. As per Article 13, these fees and charges are levied "notwithstanding that the costs of such service shall ordinarily be a charge upon the general fund." Improving these non-tax revenues can be enhanced through the following:

- **The LGA fee structures should be periodically collected, collated and analysed to identify potential inefficient and inequitable fees and charges** which may potentially distort location, investment and production decisions.
- **Based on this analysis, LGAs should be provided guidance and capacity development to assist LGAs to levy and implement effective these non-tax revenue fees, charges, licenses, etc.** This can be done through providing policy guidance and consultative workshops
- **Support should be given to facilitate communication and coordination between the LGA, market committees and traders.** Transparent and participatory election of effective market committees is critical to encourage ownership, effective market management and voluntary compliance with market fee collections.
- **As with property rates, ensuring a transparent, equitable, efficient and accountable feel structure and payment system is important for promoting voluntary compliance.** Thus, use of simplified fee structures, revenue accounting systems, Airtel payments, and a dispute resolution system are all critical.

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