DOI: 10.31357/fmscmst.2013.00173

Applicability of Market Value as an Alternative to Annual Value in Rating Valuations with Special Reference to the Colombo Municipal Council

15 JUN 2013
Department of Estate Management & Valuation
University of Sri Jayewardenepura
Nugegoda.

R D M Fernando

Applicability of Market Value as an Alternative to Annual Value in Rating Valuations with Special Reference to the Colombo Municipal Council

Dissertation Submitted to the
University of Sri Jayewardenepura
as a Partial Fulfillment for the
Requirements of the Final Examination of the
M.Sc. in Real Estate Management and Valuation Degree

Full Name	:	Rampati Devalage Milton Fernando
Examination No	:	REMV/38
Registration No	:	REMV/3390/08
Department	:	Estate Management and Valuation
University	:	University of Sri Jayewardenepura
Date of Submission	:	15.05.2013

I hereby declare that the work described in this dissertation was carried out under the supervision of Prof. R G Ariyawansa and any report on this has not been submitted in whole or in part to any university or any other institute for another degree/examination or any other purpose.

Name of the Student: Rampati Devalage Milton Fernando

Examination No: REMV/38

....

Signature of the Student

15.06.2013

Hereby, I certify that Mr. Rampati Devalage Milton Fernando (Reg. No. REMV/3390/08) duly completed the research titled Applicability of Market Value as an Alternative to Annual Value in Rating Valuations with Special Reference to Colombo Municipal Council under my supervision and recommended to submit for the evaluation.

....

Signature of the supervisor

....

Signature of the 2nd examiner

....

Signature and the official stamp of the Head

Abstract

Rating valuation is the process of ascertaining the base value of property tax payable on occupation of a property. This tax is levied by the local authorities and it is the main source of income that finances the relevant expenditure in local authorities. In Sri Lankan context, the tax is levied on annual value basis and the current system is under many arguments due to its inherent disadvantages and there are many debates among researchers. However, there are many alternatives such as market value, site value, unit value that is found in the literature and the market value approach has been highlighted by many researchers as an alternative to the annual value approach.

The inherent weaknesses of the annual value based rating system are taken as the research problem. As a case study, the current system of rating valuations of the Colombo Municipal Council (CMC) is evaluated in order to estimate the accuracy of valuations and the uniformity of assessments.

The general objective of the research is to investigate the possibility of adopting market value as an alternative to annual value approach. To evaluate the existing rating valuation system in the CMC, to estimate the accuracy of their valuations and to analyze the uniformity of assessments, are formed as specific objectives.

The methodology used in this regard is to conduct a descriptive analysis with the help of the case study in the CMC. The research aims to achieve the objective in two ways. First is to review the literature and find alternative tax bases to the annual value. Second is to conduct a statistical analysis to quantify the accuracy and uniformity of assessments to see how they affect the total revenue of the Council.

The study is mainly based on secondary data such as actual market rentals, estimated rentals, floor areas, etc., relating to Milagiriya municipal ward, which are traced from the CMC. This municipal ward is selected as the research sample, since it provides the latest database, which was updated for year 2013 in the general revaluation. This is a fairly developed commercial mixed residential area surrounding Bambalapitiya junction. According to views of the staff of the Assessor's Department, the level of the quality of data and record keeping in the area is relatively high. In addition to the above, a structured questionnaire was administered in order to get valuers opinions. A field survey was also scheduled to ascertain market values of selected properties. The behavior of variables is discussed by using mean, standard deviation, weighted average, hypothesis testing, etc.

According to the findings of review of literature, the market value has more advantages when compared with the annual value. In international context, the tendency is to move towards market value. As per findings of the statistical analysis, it is observed that the valuation ratio in case study area is 26.98%. This has a high variation from property to property and even among property categories. It indicates that the uniformity of assessment is considerably low. The analysis further revealed that the accuracy of valuations is 58%. Therefore, lack of uniformity and inaccuracy of assessments have adversely affected and created a loss of 40% to the revenue.

Finally, it is proposed that the system can shift to market value with the introduction of improvements to enhance the revenue and the quality of the service.

Acknowledgement

My first gratitude goes to Professor R G Ariyawansa, who was my supervisor, for the continuous support, guidance and encouragement extended to me in completing my dissertation in a successful manner. Without his support it would not have been an easy task.

I appreciate the opportunity provided by the University of Sri Jayewardenepura by organizing this Course and enabling the students to enhance their knowledge by developing a Research Report in relation to the subject area in a friendly and a comfortable environment.

A special thank renders to the Coordinators of M.Sc. in Real Estate Management and Valuation Degree, Professor R G Ariyawansa and senior lecturer Mrs. Padma Weerakoon, academic and non-academic staff of the Faculty of Graduate Studies and the Department of Estate Management and Valuation of University of Sri Jayewardenepura for their co-operation.

I offer my gratefulness to Mr. S.H. Wijepala, the Chairman of the Institute of Valuers of Sri Lanka, for sharing his experience and knowledge in rating valuation during the training programme conducted for Assessor's Department of the CMC enabling me to strengthen this study.

I sincerely thank Mr. K A C D Kumbalatara for the advice and support given in statistical analysis and evaluating the results.

I kindly remind with gratitude the Municipal Assessor and the staff of the Assessor's Department of the Colombo Municipal Council for their excellent support and interest showed in many ways. I also appreciate the opinions provided by the Valuers of the Colombo Municipal Council by ways of questionnaire and interviews.

Last but not least, I remind my beloved wife Nilusha Mendis, who is always supporting me with liveliness and encouragement. Her immense enthusiasm is behind the success of this study.

Table of Contents

Contents	Page No.

List of Tables

List of Figures

List of Annexes

CHAPTER ONE

Introduction

1.1 Background of the Study

Rating valuation is the process in ascertaining the base value of a property for the purpose of computing the tax payable on occupation of the property. Rating income is considered as a major source of income for local authorities to meet their expense to provide services. However, it is argued whether they perform a sound and adequate role to meet the local authorities' financial needs with the rapid changes in the property market. The methodology used in this valuation process is well established along several decades and the theories are described in many texts.

As per the Annual Budget of the Colombo Municipal Council (CMC) for 2012, the budgeted rating income is accounted for 38.5% of the total revenue. There is a fluctuation in the contribution of rating income as a percentage of the total income since 1997 and reported a declining trend during last few years. However, as figured out by the researchers, the international trend is fairly different. As an example, McCluskey *et al* (2002), reveal that in New Zealand, the contribution of rating income for the total income in local authorities is around 55%. Further, the current system of assessment is also under many criticisms and arguments. This indicates a gap between the appropriateness of the methods used by local authorities in Sri Lanka and other countries for rating assessments. Therefore, the reasons and solutions for this gap should be properly studied in order to enhance the revenue of the local authorities.

"The Report of the Commission of Inquiry on Local Government Reforms Sri Lanka" (1999), also has pointed out some inherent disadvantages of existing annual value rating system based on several factors and suggested the 'market value method' as an alternative to increase the rating income of local authorities.

According to a study paper on "Local Taxation" (1974), College of Estate management University of Whitknights, the rating system was originated in Great

Britain as a fund raising instrument to help the poor and now it is applied to provide services such as education, police, sewerage disposal and many other. This indicates the need of improvements to the process since now it has moved from its original objective to a range of financial needs. Smith (1990), discusses that the rating valuations was subjected to modernization in 1920's and re-valuation, the valuation list and some other concepts were introduced to the system. Butler and Richmond (1990), point out that 1990's was a transitional period and there were many debates for seeking alternative methods of raising funds to local government authorities. But the changes introduced did not effect to the principles of valuation.

Property tax must perform a dual purpose. It should provide money for public purpose and influence economic behavior. Therefore, it is essential to make property taxation an effective instrument in the economy. Therefore, the public sector should design this tax instrument, which can stimulate both income and economic behavior.

According to William *et al* (1980), the general principle is to assume that the property is vacant and to let to a hypothetical tenant. The property is valued on its present physical condition by comparable rental evidences. Basically there are four methods to be used in ascertaining the base value, namely rental method, the contractors test, the profits test and by formula but whichever the method be used, the end product must be the tax amount mentioned in statutory definition. The rental comparison method is considered as the best method the valuer is free to go for other methods where rental evidences are not available. According to the Annual Budget Report of the CMC for 2012, the annual value is taken as the base value and 35% of annual value for commercial properties and 25% for residential properties are levied as annual rates.

Ariyathilake (1994), argues that the property tax is a burden on the tax payer. The annual value based property tax is a tax on development making and in some cases the property tax amounts to four months' rent of the premises. He further explains that the tax burden of annual value based system as follows.

Tax Burden on the Tax Payer	=	Annual Value	X	Percentage of Rate

This indicates that there should be proper mechanism to estimate this value in order to achieve the good qualities of a tax.

1.1.1 Property tax base – alternatives

"The basic value, which is used to determine the tax amount payable is the tax base", (Harvey and Jowsey, 2004). They further discus that the base of the tax chosen may be net annual value, capital value or site value.

According to them, the net annual value is the yearly rent that the property might reasonably be expected after deductions of repairs maintenances and insurance. Here a hypothetical tenant is expected to pay all the taxes while the landlord to bear the cost of repairs and up keeping.

"Capital value is the value of a property if sold freehold in an open market between willing buyer and willing seller at an arm's length deal" (Harvey and Jowsey, 2004). This value is equal to the capitalized net annual value at the relevant rate of interest.

According to Harvey and Jowsey (2004), site value rating means the tax falls only on the land element of the real property. That is the open market value of the site on the assumption that it is currently available for its most profitable use. When comparing this base with above two bases, the buildings are not taxed but the potential value is taxed.

As elaborated by Kitchen (2003), under the unit value or area assessment, the tax base is a combination of building area and lot area. According to him, assessed value is the sum of lot area times an assessment rate per square meter of building area.

Kitchen (2003), has given these bases under four headings, namely, market value, rental value, site value and unit value. Further, the tax base should be relatively