

Property Taxation as Incentive for Cost Control: A South African Case Study

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Abstract

In recent years, the incentive effects for public officials has formed an important part of debate discussions about implementing tax structures within decentralized governance structures. Emanating from these discussions is the hypothesis that by raising fiscal awareness, property taxation may work as a disciplining device that could assist in monitoring costs across local governments. The institutional setting in South Africa is setup in such a way that such a hypothesis can be tested empirically, since we can categorize municipalities within the local government sphere into those with and without a property tax regime. Hence, this presents a unique opportunity to assess whether or not the case of South Africa conforms countries with similar decentralized structures where, empirical evidence suggests that local governments with property taxation achieve significantly lower unit costs in the delivery of assigned functions. In this study we will employ propensity score matching to examine whether property taxes can contribute to controlling service costs across South Africa's municipalities

Keywords: Local government, Property tax, Public sector costs, Propensity score matching

JEL Classification: H71, H72, H77

1 Introduction

The impact of property taxation has been shown to influence the incentives for government actions ([Borge and Rattsø, 2008](#); [Fiva and Rønning, 2008](#); [Paler, 2013](#)). This premise features under the broader idea developed by [Brennan and Buchanan \(1978\)](#), which argues that different tax bases, or tax bases that change with respect to regional or local structures, can help contain the size of the public sector in decentralized governments.

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The link between the tax structure and the costs of a government entity is not an obvious one. It draws from the unobservable nature of efforts or lack thereof of public officials. This presents an ideal scenarios for moral hazard. It is impossible for the voters to observe whether or not public officials have the best interests of community members as priority, and as such an individual can attain public position with no intention to provide requisite public services, given the current public budget. The situation becomes even more complex, given the counter-intuitive approach to budget construction employed by government officials. They seek policies and endeavors that expand their budget, instead of those that reduce it. It is therefore necessary to incentivize public officials to seek policies that tighten the budget constraint, and effectively control costs.

The underlying moral hazard still presents a dilemma, since, the lack of information on the type of public official in power, prevents the effective use of any form tax incentives to encourage cost reduction. [Glaeser \(1996\)](#) attends to this issue, by arguing that property taxation is a form of accountability measure, whereby increased attractiveness in the locality is an immediate aftereffect of higher property values. In a similar manner, [Hoxby \(1999\)](#) argues that the traditional social planners approach—which links property taxes to the type officials in power—in solving the moral hazard problem, can be extended to a decentralized government system as well. It is from this same premise that this study approaches the analysis of incentive effects of property taxation.

Empirical analysis of the impact of property taxes on the costs saving behavior of public officials requires a decentralized government system, which allows for different property taxes between localities. In this regard, [Borge and Rattsø \(2008\)](#) performed an empirical analysis of the effect of property taxation on cost control in Norway, by making use of the decentralized structure of the Norwegian government. Similarly, South Africa has a decentralized government, and the freedom of property taxation is allowed at the municipal level. This makes South Africa an ideal case study for an empirical analysis of the incentive effects of property taxes on municipalities. The setup of the polity in South Africa is similar in many ways to that of Norway, for which [Borge and Rattsø \(2008\)](#) tested incentive tax effects empirically. The data we have allows us to test the incentive effects hypothesis empirically because municipalities by law are allowed revenue raising powers, which include the levying of property taxes. Municipalities that exploit this power to a certain extent are then deemed as those which employ property taxation. Further, given the unique apartheid feature of South Africa's history, we will examine for any long-standing impact of such a system on municipalities and hence cost control within these municipalities.

This study adds to the local government cost control literature, by exploring the effectiveness of property taxes on budget constraints, and in essence the provision of services in these municipalities. The services we focus on are water coverage, electricity coverage, sanitation coverage and refuse disposal coverage. All these services fall under individual municipality's responsibilities. In similar studies such as [Glaeser \(1996\)](#), income tax effects on local governments have also been examined in addition to property tax effects, however, no such data exists for South African municipalities. More importantly, [Glaeser \(1996\)](#) shows that property tax is a more important incentive for cost control and local government performance than income taxes. Therefore

following the broad argument put forward by [Brennan and Buchanan \(1978\)](#), which hypothesizes that property taxes increases the level of accountability and hence fiscal responsibility by local governments. This in turn motivates for tighter budget constraints, thus working as a device which disciplines local government officials. This study extends on and tests the this theoretical argument, using South Africa as out case study.

The rest of the paper is proceeds as follows: Section 2 discusses the link between costs and property tax, as well as the nature of property tax in South Africa. Section 3 presents the data and empirical strategy, while section 4 discusses the results. In section 5, we conclude.

2 Property taxes in South African municipalities

3 Empirical strategy

4 Results

5 Conclusion

References

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