The potential for the property tax in the 2004 accession countries of central and eastern Europe

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The potential for the property tax in the 2004 accession countries of central and eastern Europe

William McCluskey and Frances Plimmer

Abstract

The recently-created democracies and EU accession members from central and eastern Europe provide a unique opportunity to research the development and potential role of property taxes in this region. Administrative and fiscal decentralisation has been high on the political agenda for many of the countries. The more traditional and central sources of revenue tend to be under pressure hence the need to introduce new sources of revenue to cope with the re-emergence of local government. This paper examines the development of property taxes in the 2004 accession countries of the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, focusing on the basis of the tax, its administration and potential for the future. The research shows that, even where the necessary conditions are present, several countries are reluctant to introduce ad valorem (value-based) property taxes and continue to rely on area-based taxes notwithstanding their disadvantages.
Acknowledgements
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1 Introduction

The main aim of this research was to investigate the potential role of the property tax within those selected CEE countries\(^1\) that joined the EU in 2005. Following their independence in the late 1980s or early 1990s all of these countries introduced some form of property taxation to fund local government spending.

This research was particularly interested in how the processes of fiscal decentralisation had impacted on the development of the property tax within each country. Subsidiary research objectives included an analysis of revenue, particularly at the local government level; the basis of property taxes; the development of geographical information systems (GIS), computer-assisted mass appraisal techniques (CAMA) techniques and the linkages made between the land registration (cadastre) systems and property taxation; and how the evolution to the anticipated value-based taxes is progressing.

The research methodology applied largely involved in-country visits, individual and group discussions and meetings with relevant personnel and desk-top based searches. Quantitative data was collected over a 2-3 year time horizon (2002-2005). However, there were instances when the only available data on a particular country was less current.

\(^1\) Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

This research has not covered the most recent accession countries of Bulgaria and Romania.
2 Background

Decentralisation is of fundamental importance to the financial well-being of sub-national levels of government and the re-emergence of sub-national local governments is the inevitable consequence of a decentralisation programme (Bahl, 1991).

Fiscal decentralisation and the drive for autonomy by sub-national levels of government within the countries of Central and Eastern Europe (CEE) has created an opportunity for the imposition of property taxes (Almy, 2002a). Enshrined in local government legislation in most CEE countries is the right to have financial autonomy and administrative independence from central control (Bird and Wallich, 1994). The right to have ‘ownership’ of their own tax base has resulted in a debate about and investigation into the most appropriate local taxes. Following on from international best practice the property tax is now viewed as one of the prime candidates for such devolved local government (McCluskey, 1999).

The development of democracy and decentralisation at the local level has increasingly captured global interest, and especially for those transitional countries of Central and Eastern Europe where the main objective of this development is to improve public sector delivery of services and thus contribute to the improving quality of life for citizens (Shah, 1994). Decentralisation has been seen as an integral component of tackling many of the challenges facing those countries in transition (Bird, 1993; Bahl, 1991). These include increasing demands on public services, demographic pressures and growing public expectations regarding the quality of public services (Bird and Wallich, 1994).

In spite of many important differences between individual Central and East European countries before 1989, the starting point for decentralisation reform was very similar (Bird et al, 1995a). The highly centralist doctrine of socialism was leaving little or no space for local self-government (DSS, 1995). Local administration was based upon a hierarchical structure, with high levels of dependence on upper tiers and branch ministries of the central government. This severely limited local discretion to decide upon any financial issues or delivery of local services.

Since the late 1980s, many of the CEE countries have embarked upon the road of delivering aspects of decentralisation (Bird, 2000b). Unfortunately this road has not been particularly smooth (Litvak et al, 1998). Despite the convergence of political and economic forces driving the demand for decentralisation, the reality is often far from the goal that is enshrined in the legislation of most, if not all CEE countries. There is no standard model of decentralisation, instead the processes and procedures vary from country to country, depending upon the original aims and objectives as well as the institutional and implementation arrangements (Bird and Vaillancourt, 1998).

Decentralisation in essence involves the transfer of responsibilities, authority and resources from central government and its agencies to a sub-national level of government (Ebel and Yilmaz, 2001). The rationale for such a process is that, from a democratic perspective, it is perceived as important to move the level of decision-making closer to those most affected by government intervention and actions (Tanzi, 2001; Shah, 1994). The expectation is that there will be better local service delivery because the diverse demands and needs of the local population can be served more effectively by local officials who have better information on what its residents want. There may also be diseconomies of delivering some services at the national or even regional level, which means that local service delivery can be less expensive.

There are several reasons why transitional governments decide to
embark on the path of decentralisation, including the following: the improvement of administrative and economic efficiency in the allocation of scarce resources as there is a better understanding of local needs at local levels; a clear and transparent link between payments made by local taxpayers and the level of services provided at the local level; efficiencies gained by ensuring that those democratically elected officials are accountable to the electorate i.e. subsidiarity; and greater community participation of local citizens within local institutions enhances decision-making and the democratic process (Ebel and Yilmaz, 2001; Bird et al., 1995b).

Decentralisation thus forms an important component in the development of democracy, as reflected in the European Charter of Local Self-Government adopted by the Council of Europe in 1985. This provides the theoretical basis for decentralising public tasks and financing, of which the following are of major importance:

- **Local self-government denotes** the rights and the abilities of local authorities, within the limits of law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interest of the local population (art. 3.1.)

- **Public responsibilities shall generally be exercised, in preference, by the authorities, which are closest to the citizens.** Allocation of responsibility to another authority should weigh up the extent and nature of the task and the requirements of efficiency and economy (art. 4.3.)

- **Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers (art. 9.1)**

- **At least a part of their own resources should be derived from local taxes and charges of which, within the limits of the statute, the local authorities shall have the power to determine the rate.**

Decentralisation to sub-national levels of government is an extremely complex phenomenon (OECD, 2002). It involves issues of finance, administration, control, regulation, reporting and accountability – all comprising part of the interrelationship between different tiers/levels of government (Bird, 1993). Recent amendments to the Treaty of the European Union state that the Union is one ‘in which decisions are taken as closely as possible to the citizens’ i.e. the so-called principle of ‘subsidiarity’.

This principle has also been one of the main driving strategies for many transitional countries.

Substantial and significant differences exist among the various countries of CEE in implementing decentralization. It is not a panacea, because there are limits to what can be achieved given the mosaic of cultural, historic, economic, legal and financial constraints facing many countries. Often, a more pragmatic approach is to consider a balance between centralisation and decentralisation (Bird et al, 1995a). In this context there is a challenge to identify what should be devolved as ‘localist’ responsibilities and what should remain as ‘centralist’. Many countries have tended to move away from pursuing a programme of full decentralisation by adopting a mixture of deconcentration and devolution of powers and responsibilities.
Local governance in CEE countries

Local governments existed in many of the transitional countries under the previous socialist regime (Bird et al, 1995a). However, the typical fiscal system adopted was highly centralised, with the function of local government taking the form of administrative units of the centre with no or very limited fiscal independence or legislative authority.

With political and fiscal decentralisation from the centre to the local level, the whole role of intergovernmental finance has become extremely important. Central governments generally view fiscal decentralisation as an opportunity to reduce central expenditures in two ways: firstly, by relocating expenditures to the local level and secondly, by reducing the level of grants.

In order to reform local governance in CEE countries, the emerging democracies must re-establish the concept of local self-government; build up the necessary technical capacity, expertise, personnel, and political capabilities and skills to develop autonomy at a local level; stimulate the political and popular support for and an understanding of what it means to run an active local government; and overcome the legacy left by the former command structures.

Following the demise of socialist rule, all transitional countries moved at various speeds to establish or re-establish their systems of sub-national government. Under specific national legislation, local self-government has been constituted in municipalities, which are territorial and legal entities. Generally within certain limits prescribed by the law, local governments have their own budgets and financial assets. In Central and Eastern Europe, a large number of smaller local authorities have been established in connection with the transition, which has created problems of administrative fragmentation.

The pattern of local government development has seen the mushrooming of hundreds of small local governments (particularly in the Czech Republic, Slovakia, Poland and Hungary). There is a real challenge to ensure competent administration of such small administrative units, given their available resources. Reforms at the local level are to a large extent being constrained by a national trend for the re-emergence of small local government units i.e. towns and villages with a population of less than 1,000 (see Table 1). It can be argued that towns with a population of less than 5,000 also have problems in terms of managing their own tax and revenue affairs (Jaber, 1994).

This has inevitably led to three major problems: firstly, towns and villages with small populations tend to lack the necessary financial resources to employ essential and experienced personnel; secondly, small local government units have made it difficult to further decentralise real responsibility for a number of services; and thirdly, the small size of the towns has required the existence of a regional government structure or the maintenance of administrative power at the central level.
The scope of services allocated to local governments within CEE countries has been gradually widening throughout the last decade, whilst each transitional country has developed its own mix and share of responsibilities between the various levels of government. The problem of the small size of many of the towns and villages makes it difficult to generate a significant amount of local tax revenue to meet the cost of services. This has inevitably led to local government being highly dependent upon grants from the centre. Thus, many of the small towns tend to be merely political units, rather than true service providers.

As a result of the small towns’ inability to provide the necessary services for their populations, many larger cities are taking on the additional role of assisting smaller jurisdictions. In some respects, larger municipalities and cities are maintaining a similar administrative role as they had during the communist period. As a result, urban administrations are playing a strong and fundamental role not only in their own jurisdictions but also, by acting as providers and coordinators of services, in the smaller rural areas.

Unlike the towns and cities in the countryside, capital cities throughout the region have been successful in raising necessary taxes and funds to support economic development programmes. Because of the crucial financial and political significance of the capital cities, these have been a focus of both sustained investment and infrastructure and service development; with financing coming from the central and city governments. This emphasis has, however, been to the detriment of the smaller rural areas in many of the CEE countries.

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**Table 1 Number and size of local government units**

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of local government units</th>
<th>Average population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>3,070</td>
<td>2,834</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>6,233</td>
<td>1,652</td>
</tr>
<tr>
<td>Lithuania</td>
<td>60</td>
<td>66,000</td>
</tr>
<tr>
<td>Poland</td>
<td>2,500</td>
<td>15,440</td>
</tr>
<tr>
<td>Slovakia</td>
<td>2,871</td>
<td>1,846</td>
</tr>
<tr>
<td>Slovenia</td>
<td>194</td>
<td>9,974</td>
</tr>
<tr>
<td>Latvia</td>
<td>558</td>
<td>4,130</td>
</tr>
<tr>
<td>Estonia</td>
<td>254</td>
<td>5,511</td>
</tr>
</tbody>
</table>

Source: OECD, 2002
Careful consideration of the composition of revenues is crucially important. Typically, the following main types of local government revenues can be identified: revenue from the sale of services - non-tax revenues and user charges/fees; tax revenues - local taxes (property tax) or shared national taxes; different types of grants (e.g. general and specific) made available to local governments from the central government; and borrowing, e.g. for investment expenditure.

Freedom of movement is limited by power of the central government to intervene and set the base or the rate of a local tax or both. In addition, various tax-sharing arrangements may range from those controlled by local governments to those completely controlled by the central government.

There are two broad critical issues in respect of local government taxation. The first deals with how far local government should rely on local taxes for its own revenue and the second is deciding on which local taxes are the most appropriate for the expenditures devolved to local government. In dealing with the first issue it is important, when considering the appropriate level of local taxation, to decide the purposes and functions of local government. Essentially, a choice has to be made that will directly impact on those purposes and functions, between the ‘localist’ position i.e. whether to give local government the main responsibility for raising the money they need and for deciding how that money is spent; or the ‘centralist’ position i.e. whether to give central government the main responsibility for raising the money to be spent by local government and control over how the money is spent (Davey and Peteri, 1998).

Some direction on the most appropriate choice was given by the Layfield Committee\(^2\) (1976) when it commented, ‘whoever is responsible for spending the money should also be responsible for raising it so that the amount of expenditure is subject to democratic control’. Thus, the Committee favoured the localist approach, where the emphasis is on the raising of the revenue locally. There are a number of reasons as to why local authority revenue should come from local taxes: firstly, local taxes are necessary to enable local government to vary the quantity and the main responsibility for raising the money.

Own revenue sources are becoming more important to local government as fiscal constraints from the centre begin to harden (Bird, 1993). Therefore, there is a real desire, as well as a need, for sub-national governments to have access to their own revenue sources i.e. those where local governments have an influence on the revenue level, and are able to spend the revenues without undue constraint. These are often connected with local taxes and different kinds of user charges (Bird and Slack, 1991).

According to the OECD (1998) classification, the extent of local government autonomy over revenues should be judged against two criteria. Firstly, freedom to determine the tax base and secondly, setting of the tax rate. Such autonomy extends from a situation where the local government can determine both the rate and the base of a tax i.e. complete local independence, to one where the freedom of movement is limited by power of the central government to intervene and set the base or the rate of a local tax or both. In addition, various tax-sharing arrangements may range from those controlled by local governments to those completely controlled by the central government.

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\(^2\) Report of a committee of inquiry into local government finance in Great Britain. This report provided an extensive and thorough review into the finances of local government. The commission concluded that to increase local accountability local government should be able to raise revenue through taxes levied at the local level.
quality of their services in the light of local preferences; secondly, if local government relies on central grants, there is a danger that a loss of direct democratic accountability will result in financial inefficiency i.e. that local politicians might spend the money inefficiently; thirdly, there tends to be greater accountability for money raised locally than with fiscal transfers from the centre; and fourthly, central government grants often come with strings attached and constrain the way the grant is spent.

If the localist approach is adopted, it is important that local government should have access to those local taxes where it can set the tax rates, albeit within broad limits.

The second issue deals with the most appropriate local taxes for local government (Davey and Peteri, 1998). There is an extensive literature on the criteria for ‘good’ local taxes, and it is possible to evaluate each alternative tax against these criteria to see how well they perform. Whilst an exercise like this is useful, it is to some extent limited because there is no perfect local tax. However, there is a high degree of consensus internationally about which local taxes are most satisfactory (Bird, 2000b; Balas and Kovacs, 1999). The most common local taxes among Council of Europe member states are property, income and sales taxes. Few countries, either in Europe or elsewhere, have implemented large revenue-raising local taxes other than these three.

The ideal for many CEE countries is to adopt a localist approach. However, the reality is that in many countries the centralist approach is still dominant.

Own local taxes are limited and there is still a significant reliance on transfers from the centre (see Figure 1). Notwithstanding this reliance on transfers, there is a clear presumption that local government should be raising significantly more revenue from local sources to reduce the reliance on central grants. Average tax revenue for local authorities amounts to some 38% of total revenue, while grants tend to average 46%.

**Figure 1 Tax and Grant Revenue as a % of Total Local Government Revenue – 2003**

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax</th>
<th>Grants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td></td>
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<tr>
<td>Estonia</td>
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<td></td>
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<tr>
<td>Hungary</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Poland</td>
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<td>Slovakia</td>
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<td>Slovenia</td>
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</tbody>
</table>

Source: Government Finance Annual Statistics, IMF, 2005

Figure 1 illustrates that for the majority of the countries, grant-based revenue is a significant source. Only in Estonia and Latvia does tax revenue exceed grant income. In many respects this is an allocated income-based revenue which is broadly similar to an unhypothecated grant from the centre.
Figure 2 illustrates the relative importance of property tax revenue when compared to other taxes available to local government. Whilst the property tax has some distance to go before competing with income tax in terms of revenue yield, it nonetheless is considered by sub-national governments to be a tax with potential. In comparison to the selected EU original member states, where average revenue raised by the property tax is 31%, the equivalent figure is 18% within the CEE countries. The opposite trend is apparent when income tax is considered, with the CEE average at 66% in comparison to 57% in the EU countries.

Figure 3 illustrates the distribution of local government revenue between the three main categories of tax, grants and non-tax sources.
The property tax as a percentage of GDP for the CEE countries averages around 0.60% (see Figure 4). For the original European Union countries the same measure is 1.13%. The difference indicates that there should be a significant potential for increasing levels of property tax revenue in CEE countries.

Source: Government Finance Annual Statistics, IMF, 2005
Figure 4  Property Tax as a percentage of GDP

Source: Government Finance Annual Statistics, IMF, 2005
4.1 A sustainable local tax

A ‘good’ tax for a local government in a transitional country should comprise a number of characteristics, particularly if the tax is to be considered as “sustainable” i.e. a tax which is stable, transparent, affordable, raises sufficient revenue for the needs of the spending authority on a year-by-year basis, which allows for growth in yield over time to reflect the growth in demand, which has a wide tax base (so that tax rates can be low), and which is socially acceptable to the taxpaying public (Davey and Peteri, 1998).

There are also recognised advantages to achieving fiscal independence from other tiers of government (particularly from central government) and to ensuring democratic accountability within the process i.e. that taxpayers have a clear and demonstrable link between their tax raising and spending authorities and the electoral process which appoints the decision-makers (Brzeski and Frensen, 1999).

The choice of a ‘good’ tax for local governments is even more limited than that for provincial governments, because the latter are usually larger, more populous and have a more developed capacity for tax administration (Kelly, 1994). Local governments need to plan their budgets with some certainty about the continuation of their revenue source and the yield it produces. Too often in transition countries, central government may abolish or suspend local taxes, impose expenditure mandates, or assign new expenditure responsibilities to the local governments (Dillinger, 1994).

Under the command economy, sub-national governments had few, if any, autonomous spending responsibilities (Bird and Wallich, 1992). Although this is changed under Article 9, No. 1 of the European Charter of Local Self-Governments, the revenue sources of local governments could be divided as follows: own income (taxes, fees and revenue from municipal assets); appropriations from state taxes (shared taxes); state budgetary appropriations and loans. The implementation of these revenue sources, however, varies greatly as, in some countries, the intent has been supplanted by the reality of central pre-emption of proposed sub-national authority, or by the lack of institutional readiness of sub-national governments (Bird, 1993).

The unstable and usually inadequate availability of financial resources has made finance one of the most important issues on the agenda for both national and sub-national levels of government in the countries of the CEE. As the central governments’ need for revenue increases, with them withholding larger and larger amounts, and as the limits on other main taxes approaches, there has to be greater reliance on alternative tax sources such as the property tax and income tax (Balas and Kovacs, 1999; Bahl, 1998; Bird and Slack, 1991).

To provide the necessary credibility as autonomous sub-national tiers of government with major responsibilities, local government must have strong and stable sources of discretionary revenues. This represents one of the foundation ideals of local government, as prescribed within most, if not all, countries’ constitutional legislation. However, the reality is that sub-national governments only have access to one or two major taxes and even then their control of these taxes can be constrained by the centre (Bird and Slack, 1991).

Local taxes normally represent the major source of income, and are one of the most important features of local authority fiscal autonomy (Bird, 1993). The possibility of influencing
either the tax base, the tax rate or the collected revenues is a very important opportunity for the local authorities, enabling them to adapt the service level to the financial possibilities.

The arguments for the introduction of own local taxes are both persuasive and essential to ensure real fiscal decentralisation. However, a number of conditions should be met for a tax to be a good ‘own’ local tax; firstly, the revenue of a good local tax should increase over time in order to match the natural growth in costs and to fulfil the growing need for local public services; secondly, local taxes should not be too sensitive to cyclical fluctuations, as the local services normally are not suitable as instruments for demand management; thirdly, a good local tax should be distributed relatively equally among local authorities; fourthly, the size of the potential revenue is important; fifthly, there should be a close relationship between the citizens who pay and the citizens who benefit; and finally, the tax administration should be without major problems, i.e. the tax yield should be much higher than the administrative costs.

From a local tax perspective the two main candidates that can realise potentially significant revenues are the income tax and the property tax (Malme and Robinson, 1999; McCluskey et al, 1998). The local income tax has the advantage of complying with the criteria of perceived fairness and ability to pay. The tax cannot be a true local tax unless the tax rates are set locally, however. In the CEE states, the income tax is normally a shared tax where revenue is channelled through central government, with a portion going to local authorities. In many local budgets of transitional countries, the income tax is a significant contributor (Czech Republic, Hungary and Estonia) (Tiits, 2006; Szalai and Tassonyi, 2000; Ott, 1999).

Income tax is therefore used in some CEE states as a shared tax, funding both central and sub-national governments, with the centre responsible for administering and collecting the taxes. This system has the advantage of administrative simplicity, economy and feasibility, important considerations in most countries in which municipalities have yet to develop their own administrative capabilities. There are, however, some important disadvantages. Firstly, it maintains the previous regime's local fiscal dependency and thus undermines central as well as local fiscal accountability; and secondly, it is incompatible with the efficient provision of local public services, which require a system of intergovernmental transfers firm enough to serve as a basis for budget certainty, and flexible enough to be compatible with structural reform. Thus, it undermines local authority financial, administrative and, by implication, functional independence from the centre.

The property tax is generally less attractive for central government because its actual and potential yields are usually much less than alternative sources of revenue, such as income tax, sales taxes and corporate taxes. It is not considered suitable as an instrument for social or economic policies which tend to be the domain of central government. The local nature of a real property tax lends itself to economies in terms of taxpayer identification and collection, because real property is physically located in the territory of a local government, which tends to make the tax base relatively simple for a local administration to identify (Dhimitri, 2003; Brzeski, 2001).

When national governments decentralize or devolve responsibilities, they often retain important policy and supervisory roles over sub-national tiers of government. It is essential, however, that they create or maintain the 'enabling conditions' that allow sub-national governments to take on more responsibilities. Central ministries have crucial roles in promoting and sustaining decentralization by developing appropriate and effective national policies and regulations for strengthening local institutional capacity to assume responsibility for new functions. The success of decentralization frequently depends heavily on training for both national and local officials in decentralized administration (Davey, 1999). From an ad valorem (value-based) property tax perspective, local governments are likely to have devolved responsibilities in terms of administering and managing a property tax system.

In comparison with other revenue sources, the local property tax has many advantages (Maurer and Paugam, 2000; McCluskey, 1999). Bahl (1998) reports that real property taxes account for less than 1 percent of GDP in over 60 developing and transitional economies.

Despite its relatively modest yield, the property tax is significant from both tax policy and political perspectives. Fisher (1996) suggests that, in the absence of a property tax, local
governments would want to ‘invent’ such a revenue source. There are many reasons for this view. Above all, the property tax provides a high degree of fiscal autonomy for local governments because the amount of tax or revenue collected as a percentage of income can be controlled by local government. If a local government requires more revenue to meet its fiscal objectives, it can increase rates, encourage compliance, or increase the assessed value of the property. Without autonomy, fiscal revenue sources can easily be withdrawn by the centre. It is often easier for local government to exert greater control over a property tax base and tax rates than over any of the other main revenue sources, given that property value is affected to some degree by the services provided by local authorities and their wider effects – either positively or negatively.

Another advantage of the property tax is that it imposes political accountability on local officials. If they decide to increase the property tax, they face direct criticism from voters. It is also a tax that is extremely difficult to avoid. A tax on land and improvements to the land is applied to a tax base that cannot relocate. In simple terms, the property tax does not allow economic distortions and behavioural disincentives for taxpayers. It is often argued that among the tax bases a local government could select, the one causing the least distortion is a tax imposed on immobile property and improvements to property.
5 Basis of the property tax

Each of the CEE countries, subsequent to their ‘independence’ from Soviet control, introduced a programme of land and property taxation (Brown and Hepworth, 2000). Given that land and property ownership was previously vested in the state, property markets largely did not exist, so there was little possibility of developing property tax bases using market values (Deveikis and Bagdonavicius, 2006; McCluskey et al, 1998).

The beginnings of the property tax in each country therefore tended to adopt a simple area approach, based around the size of the property (often with land and improvements being treated separately). As the size or area of the property was relatively easy to determine and as there was normally an occupier on the property, the basis of the new property tax was rapidly established (Szalai and Tassonyi, 2000).

Thus, the so called ‘value’ of each parcel was based on established rates for specified property types in that locality, determined either by central or local government i.e. value per square metre of land or improvements. This official or normative value had little to do with the real value of the property, but as property markets largely did not exist, particularly outside major capital cities, there was no opportunity to make comparison with actual transactions, nor to use market evidence to produce an ad valorem tax base.

Table 2 illustrates the predominance of area-based property tax systems and the date of their introduction. Estonia was the only country to develop a market value-based system for land only, improvements not being included within the tax base (Tiits, 2006). The control of the valuation or assessment function tends to be centralized, particularly in those countries where the levying of the property tax is mandatory (Czech Republic, Estonia, Latvia and Slovenia). In Hungary and Poland, for example, municipalities can choose whether to levy the area-based property tax and therefore, both collection and assessment tend to be locally based (Szalai and Tassonyi, 2000; Brzeski, 1999).
In many of the countries, there is limited capacity at local government level to administer own taxes (McCluskey and Bevc, 2007; Bevc, 2000). This is particularly relevant for small and often rural jurisdictions which have a limited human resource capacity. However, in relation to a property tax, the administration can be shared with higher tiers of government. Central or regional governments have an important role in setting up a standard legal tax framework and in undertaking the highly technical tasks of valuing property and training staff. On the other hand, administrative functions such as the collection and enforcement of property taxes should ideally be allocated to the local level. Table 2 shows that central government tends to control valuation whilst local government deals with collection.

Since the introduction of the property tax, most countries have been exploring the possibility of the introduction of a fully fledged ad valorem system (Aleksiene and Bagdonavicius, 2006; Almy, 2002b; Szalai and Tassonyi, 2000). However, for various reasons such a transition has been delayed in several of the countries. This move can in part be explained by the inadequacy of the current property tax, which tends to be based on the property area of land (ignoring improvements) and often relying on self-declaration.
5.1 Problems with area-based systems

The use of area-based formulae is commonly used as a means of determining an assessed ‘value’ for property particularly where the property market is not functioning properly or where it has not reached a sufficient state of maturity to support an ad valorem tax base.

These systems only have a very indirect relationship with market values and generally suffer from having a narrow tax base that is neither elastic to economic growth, nor ensuring any vertical or horizontal equity. It is thus not surprising that revenues raised from the property tax remain lower in the CEE economies than in the rest of the EU. Area-based systems tend to use the size of land (and in certain countries buildings) as the underlying basis. This area is often adjusted to, for example, reflect the number of floors in a building and the net usable area as opposed to gross area (Brzeski, 1999; McCluskey et al., 1998).

Whilst area-based systems are often regarded as ‘simple’ solutions for jurisdictions with limited resources, they do suffer from several significant and serious drawbacks. A principle drawback is that they tend not to reflect the value of location and other spatial benefits which location offers to property. In an area-based system, well located buildings and land will pay the same as less well located property of a similar size (Brzeski, 2001; Malme and Youngman, 2001). Compliance with the concepts of vertical and horizontal equity therefore becomes difficult, if not impossible. Buoyancy of the tax revenue under an area system is primarily afforded by altering the tax rates. This is because the assessed value comprises the area of property which tends to remain relatively fixed over time (Rao, 2006).

Because it does not account for the differences in value due to property location, the area-based property tax also distorts land markets (Brzeski, 2001). In effect, it does not put a “scarcity” value on the individual parcel. By applying the same rate to all types of land and not taking into account any value in that land such as services, amenities, or location, the government treats all land the same, thereby discouraging within the tax system the most productive and efficient use of land. As a result, land that typically commands high market value due to its prime location (e.g., in the centre of a city), will not be recognized as such and may be encouraged to retain an inefficient use (such as industrial).

The main advantages of the area-based approach, as currently operated in many countries, generally relate to lower administrative costs, for example, in that self assessment and/or self declaration of property areas is provided by the taxpayer (e.g. Czech Republic) which obviates the need for technical skills in assessing liability. Data requirements are much less than with a typical ad valorem system; trained valuers are not required; and area-based techniques can easily be modified to reflect additional attributes, such as location and quality of structures (Zorn, et al., 1999). The methodology can, therefore, be viewed as a preliminary step in the process towards a value-based system.
Table 3 shows that both Latvia and Lithuania have introduced market value assessments of both land and buildings, whilst the majority of the other countries have delayed such an introduction. However, it must be recognised that considerable efforts have been made in Czech Republic, Hungary and Slovenia in terms of the development of assessment systems that could deliver market value estimates.

**Table 3 Tax base and reforms**

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax base</th>
<th>Land</th>
<th>Buildings</th>
<th>Reforms planned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>Area</td>
<td>✓</td>
<td>✓</td>
<td>Delayed introduction of market value</td>
</tr>
<tr>
<td>Estonia</td>
<td>Market value</td>
<td>✓</td>
<td>✓</td>
<td>Move to include buildings</td>
</tr>
<tr>
<td>Hungary</td>
<td>Area</td>
<td>✓</td>
<td>✓</td>
<td>Delayed introduction of market value</td>
</tr>
<tr>
<td>Latvia</td>
<td>Market value</td>
<td>✓</td>
<td>✓</td>
<td>Introduced market value</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Market value</td>
<td>✓</td>
<td>✓</td>
<td>Introduced market value</td>
</tr>
<tr>
<td>Poland</td>
<td>Area</td>
<td>✓</td>
<td>✓</td>
<td>Delayed introduction of market value</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Area</td>
<td>✓</td>
<td>✓</td>
<td>Delayed introduction of market value</td>
</tr>
<tr>
<td>Slovakia</td>
<td>Area</td>
<td>✓</td>
<td>✓</td>
<td>Delayed introduction of market value</td>
</tr>
</tbody>
</table>
The property tax, like user fees, can often be a good benefit tax, but only if local incentives to impose taxes on some captive industries are limited. Minimum rates may also be useful to limit the degree of tax competition that can arise between local or regional governments. Few transitional countries currently give local governments sufficient discretion or responsibility with respect to property taxes.

An analysis of different CEE countries illustrates the general pattern and trend in relation to a number of legislative and administrative functions. Table 4 shows that central governments generally control the legislative power to levy the property tax. Often, however, there is a delegation of power to local government in terms of whether to raise tax revenue on property. In addition, the local government often has the power to adjust tax rates, albeit within prescribed limits. Of some interest is the fact that in all of the countries, the revenue raised by the property tax is allocated directly to local government budgets. The fact that in all of the countries, sub-national government is the beneficiary of property tax revenue is significant.

<table>
<thead>
<tr>
<th>Country</th>
<th>Power to levy tax</th>
<th>Revenue ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>Central</td>
<td>Local</td>
</tr>
<tr>
<td>Estonia</td>
<td>Central</td>
<td>Local</td>
</tr>
<tr>
<td>Hungary</td>
<td>Local</td>
<td>Local</td>
</tr>
<tr>
<td>Latvia</td>
<td>Central</td>
<td>Local</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Central</td>
<td>Local</td>
</tr>
<tr>
<td>Poland</td>
<td>Central</td>
<td>Local</td>
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<tr>
<td>Slovakia</td>
<td>Central</td>
<td>Local</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Central</td>
<td>Local</td>
</tr>
</tbody>
</table>

Table 4: Central versus local government ownership of property tax revenue
On independence, for many of the CEE countries issues of restitution and privatization tended to take precedence over sub-national revenue and budgets. As part of these processes, the countries had to embark on processes of land registration and titling. This in turn has provided the ideal foundations upon which the ad valorem tax can be grounded. Developments in mapping and GIS are evident in several countries and have clearly provided the framework for the identification of both real estate owners and taxpayers (e.g. Lithuania). However, these developments have not always been linked into the potential for the introduction of the ad valorem property tax. Significant progress has been made in Estonia, Latvia and Lithuania in terms of system (GIS and CAMA) developments which have been utilized within the property tax administration (see Table 5); whereas in Czech Republic, Hungary and Slovenia, developments in GIS and CAMA have yet to be applied to the property tax regimes.

**Table 5 Development of GIS and CAMA systems**

<table>
<thead>
<tr>
<th>Country</th>
<th>GIS</th>
<th>CAMA systems</th>
<th>Used in property tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Estonia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Hungary</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Latvia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Poland</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Slovakia</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
It is clear that all of the countries studied have ambitions to develop a property tax based on the market value (ad valorem) of real estate. It is widely recognised (e.g. Balas & Kovacs, 1999; IAAO, 1997) that taxing property according to its market value has major advantages, which include the ability to reflect changes in local economies and the distribution of property-related wealth.

Market value-based tax ensures a degree of buoyancy within the tax base (provided it is subject to regular and frequent revaluations) as well as a high degree of vertical and horizontal equity, based on the relative values of different sectors of real estate in different locations.

Property values benefit significantly from many of the services normally provided and decisions made by local authorities. Similarly, their absence or poor delivery can reduce the value of real estate. Basing tax on property values allows taxing authorities to recoup at least some of the increases in value which the community creates. Social concerns about the failure to link property values to ability to pay can be resolved by a system of appropriate and selective exemptions. Thus, there are strong economic, social and policy arguments in support of an ad valorem property tax.

However, a prerequisite of such a system is an open, active, and healthy property market for the full range of property types to be taxed and therefore valued. It is clear from the research that none of the CEE countries has yet achieved such a property market, at least not across the entire country (although in some capital cities, such a market seems to operate). Thus, as the markets develop, it is likely that existing area-based property tax systems will be transformed into ad valorem systems, which should allow local authority revenues to increase, thereby enabling such authorities to increase both the range and the quality of services they provide their citizens.
8 Conclusions

With independence from Soviet control, all of the selected countries have introduced property taxes based on the size or area of the taxable property. These initial area-based taxes had the principal fiscal objective to raise revenue whilst at the same time to expand the local tax base beyond income taxes and to attempt to capture wealth being diverted into real estate thereby providing a measure of financial autonomy to municipalities.

The transition to market-based economies, coupled with the establishment of private property rights, has made broad-based taxes on the market value of real estate both politically attractive and technically feasible. One of the early impediments to a value-based property tax was that of land and property ownership rights. In all of the countries, land and property restitution is well advanced. The majority of previous ownership claims on property have largely been resolved which is creating the necessary confidence, transparency and stability in the real estate markets. Linked to this have been developments within the privatization of state and local government-owned assets, again providing an impetus for private ownership.

This research has found that property tax revenues tend to be relatively low in many of the transitional economies, in part, because of the way in which the tax is administered. The administration of the tax, in particular, coverage and assessment needs to be handled strategically. Local government fragmentation is creating difficulties in devolving the administration to the local level which results in highly centralized administrative systems.

The initially introduced area-based property taxes have had the advantage of being relatively simple to administer. However, as property markets continue to mature, the profound inequities and inconsistencies inherent in this approach are compounded. A development which most countries have introduced is that of adjusting areas to reflect, in some way, the locational value of property. Whilst this is an improvement, it is a rather blunt technique to reflect the value of location. Although area-based systems have been functioning relatively well, an additional problem is that they do not capture growth in the tax base resulting from a developing market economy and appreciating capital values, nor do they raise a level of yield comparable to that found in other EU states where ad valorem taxes are used.
This research has found that the migration to a property tax based on market value is ultimately the goal of many of the selected countries. However, difficulties with the capacity to create the necessary tax base, and administer such a tax along with the lack of political will is ‘slowing’ the transition from area-based approaches. Ad valorem-based property taxes are often considered to be ‘expensive’ taxes to administer. In this regard, it is imperative that costs are controlled whilst revenue potential is maximized through efficient procedures and practices. Linkages between agencies such as mapping, titling, land registration, soil quality, land and property ownership need to be co-ordinated to ensure that economies can be made with regard to administration.

Given the plethora of sub-national governments, the division of administrative responsibilities needs to reflect the capacity and capability of lower tiers of government. This work has found that a centralist approach to valuation and assessment has the benefit of economies of scale in terms of providing the necessary professional and technical skills. In addition, the assessments can be determined in a manner which will ensure uniformity of process across an entire country. Whilst collection and enforcement can be organized at a central level, there are greater advantages if these functions are allocated to the local level, either through devolved responsibilities or deconcentrated agencies of central government. Where the property tax is a local government tax, there is an increased incentive to ensure that levels of compliance are high.

In addition, maintenance of the tax base through the updating of fiscal cadastral information and, where available, market transactional data is ideally suited to the local level, given the quality of local knowledge.

The research has indicated that several of the countries have well-developed computerized land registration and titling systems which give confidence in terms of ownership of real property. In addition, the non-fiscal benefits of such systems include a stimulus to real estate markets and mortgage/finance organizations as well as a tool for the more efficient use of land. Linked to this is the evidence that GIS and CAMA approaches are being aggressively used for property tax assessments, albeit only in a few of the countries. Other countries, whilst having developed such approaches, have not yet utilized them for their property tax systems.

In the majority of transitional countries, citizens have been unaccustomed to paying taxes, especially property taxes. Popular acceptance of such taxes will largely depend upon the support provided by politicians and government and the anticipated benefits received by taxpayers. It is clearly evident from this work that the process of introducing ad valorem systems has slowed down significantly in several of the countries, due primarily to political resistance to the ‘new’ basis of the property tax. In addition, there are major administrative hurdles to be overcome in many of the countries in terms of responsibilities and professional training for assessment, valuation and collection. Notwithstanding these difficulties the potential of the property tax for several countries remains just that, a potential, but one which is capable of transforming the sources of local authority revenue and, thereby, the level and range of municipal services.
The potential for the property tax the 2004 accession countries of central and eastern Europe
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