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Ad Valorem Property Taxation and Transition Economies

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Ad Valorem Property Taxation and Transition Economies

Anne Paugam

EXECUTIVE SUMMARY

1. Current moves toward introduction of an ad valorem property tax in transition economies respond foremost to fiscal objectives: such a tax is one answer to the growing need for local resources for decentralized authorities. This note examines how this fiscal objective can best be reached, taking account of social impact considerations and administrative and technical constraints. An ad valorem property tax can also help unlock further privatization of publicly owned property, and help increase land use efficiency, a crucial need in transition economies. The paper goes on to examine how this land use goal can be best pursued, while remaining compatible with the core fiscal objective of the tax.
2. The analysis is based on four premises. First that the property tax is above all a fiscal tool, hence that the land use goal should remain compatible with the primary fiscal objective of the tax. Second, that the tax, being a local fiscal instrument, is not adapted to social redistribution, which is better addressed through national taxation tools or expenditures. Third, that the taxation system needs to be kept simple, for taxpayers and for tax administrations. Fourth, that the property tax must be seen and designed as one element within a complex balance of institutional, financial and political relationships between central and local governments, and as such, must gain ownership of both local and central authorities, otherwise a reform could result in significant costs with disappointing results.

I. FISCAL BENEFITS OF AD VALOREM PROPERTY TAX

3. **Two major trends create the need for** additional resources for local authorities in transition economies: the move toward decentralization, and the prospect of EU accession which requires heavy public local infrastructure investments and adequate local counterpart funding for EU funds. **The degree of autonomy in raising local revenues also needs to increase**, because locally raised revenues will ensure an effective decentralization, support the development of local democracy and increase efficiency in the management of local public services.

Despite its potential difficulties, an ad valorem property tax is one answer to this fiscal need:

4. **An ad valorem property tax raises administrative and political difficulties.** First, in some transition economies the excessive centralization of current property tax revenues hides its real potential for local authorities. Second, on the other hand, when decentralized, the property tax, because it is a direct tax, is more visible and politically

painful than other sources of revenues, such as government transfers, and local authorities may be reluctant to assume the corresponding political risk. Third, there are concerns that an ad valorem base would increase the inequalities between richer and poorer cities.

These concerns must be addressed, not through the tax itself, but through national mechanisms of equalization between local authorities. Fourth, the tax raises administrative issues regarding the registration, valuation and updating of the base.

5. Despite these difficulties, strong moves are underway in transition economies toward the introduction of an ad valorem property tax. Estonia, Lithuania, Latvia and Romania are at various stages in implementing such a tax. Poland, the Czech Republic, Hungary and Slovenia are contemplating its introduction. This trend is explained by growing understanding of *the inadequacy of the current property tax*, based on the property area, and often relying on self-declaration, with an incomplete registry of properties. These inherited systems have no relationship with the market value of the real estate being taxed, and generate limited revenues from a narrow and static base. It is thus not surprising that, on average, revenues raised from the property tax remain lower in transition economies than in the EU.

6. By contrast, an ad valorem property tax would provide (i) a consistent measure of municipal creditworthiness and (ii) a larger and much more dynamic base: the market-value base is more likely to grow in line with GDP, and the new tax will necessitate tighter management and a more comprehensive registration system. Simply reaching the EU average of property tax share in GDP would imply a 60% rise in property tax revenues in the eight sample transition countries as a group.

Three main sets of conditions for the new tax to meet its fiscal objectives:

7. The extent of the fiscal benefits will depend on a favorable balance of responsibility between central and local authorities.

8. *The central government must be willing to transfer, and local authorities must be willing to accept, responsibility for a significant part of revenue raising.* On the one hand, local authorities should have sufficient freedom to set the tax rate locally, within certain brackets. On the other hand, they should also have incentives to use their new responsibility. If they feel that they may be able to fund their expenditures by central transfers rather than by raising revenues locally, and if the system allows them to opt for very low effective rates in order to keep the overall tax burden similar to that in the pre-reform period, the purpose of the reform will be self-defeated and its implementation costs will not be justified.

9. The central government must also remain sufficiently involved in key areas of the property tax management to ensure that the tax is actually used to its full potential. *It must organize the necessary information sharing with other tax or administrative agencies and create the appropriate legal and regulatory environment, including tax rate brackets (especially a minimum rate), minimum nationwide regulations on exemptions and rebates, and providing the necessary technical and staff support for the valuation (and regular revaluation) of the fiscal base.*

10. **The tax should not be overburdened with social, economic or administrative objectives, whose effects offset each other, while contradicting the core fiscal goal as well as the concern to keep the system simple.** There are numerous possibilities of specific rules for specific categories of taxpayers or of properties, aiming at a variety of social, economic and political goals, such as progressive tax rates, exemptions of low-income households, preferential treatment of owner-occupants, higher taxation of land versus improvements, higher taxation of vacant lots, exemption of newly constructed buildings, differentiated treatment of business uses (whether higher or lower taxation), and exemption of publicly-owned properties.

11. The review of these options, in the context of transition economies, indicates that a flat rate system, with a large market-value base and very limited exemptions, would best respond to the primary fiscal goal of the tax as well as the need for simplicity. In particular, exemptions for publicly owned properties, a crucial issue in transition economies, should be strictly limited to properties (i) owned by the local taxing authority and (ii) used by this authority for its official administrative duties. Regarding social redistribution issues, and specific problems such as those of low-income households who have been granted ownership of high-value properties, the local property tax is not an adequate tool to address them. They should be addressed through national mechanisms of solidarity.

Three main technical and administrative challenges to overcome in transition economies for the tax to yield its potential:

12. *First, the lack of comprehensive cadastral data, and/or the scattered nature of the existing data* implies that the fiscal cadastre should be limited to the data strictly necessary for valuation and taxation purposes. It should not be required to have the same degree of precision as physical or legal registries, but should have full coverage. In addition, to avoid costly duplication of efforts, the fiscal cadastre should rely on a system of tax-payers' self-declaration, complemented by an organized access, for the tax administration, to complementary and cross-reference information from all other relevant data sources.

13. Second, because real estate markets are not fully developed yet, the *market references for valuation of the fiscal base remain sometimes limited*. This is a real problem in some less advanced countries, and if the market is very thin or non-existent, then the ad valorem tax reform is certainly premature. However the problem will diminish in the medium term, as the market develops. In the short term, when the market exists but is still limited, valuation principles, while based on market value, should remain simple, avoid excessively detailed and heavy data requirements, and allow simple mass-valuation procedures.

14. Third, the reform must be based on a comprehensive and integrated vision of the property taxation system, from the set-up and maintenance of the base to the collection of the tax. Neglecting effective coordination with collection can easily make the investment in a new fiscal base a costly waste of public money.

II. AD VALOREM PROPERTY TAX AND LAND USE OBJECTIVES

15. **There is a strong need to encourage the development of real estate markets and more efficient land use in transition economies.** Former socialist cities have inherited a highly distorted land use pattern: administrative allocative decisions led to a perverse population density gradient, increasing as one moves away from the city center, with a high concentration of industries in prime locations in the center. This structure maximizes the inefficiency in terms of energy use, infrastructure and commuting requirements, diminishes the international competitiveness of the city and has a significant environmental cost. Emerging patterns based on market value are exactly opposite to the inherited pattern.

16. In addition, further privatization of surplus public properties continues to be needed, especially in the countries less advanced on the path to reform where municipalities remain among the largest owners of urban land and properties, and manage these assets, usually at low levels of efficiency, as complementary sources of income for local budgets.

17. In such a context, there is a clear need for encouraging further divestiture of publicly owned property and for supporting the trend toward increased efficiency of urban land use led by market price signals. This would favor the recycling of land, in-fill development and redevelopment of underutilized land. Among the possible tools for encouraging this is the introduction of an ad valorem property tax, based on the market value of real estate, which encompasses the concept of “highest and best use”, and is thus an incentive to recycle properties to more efficient use.

Relationships with other land and real estate market reforms and regulations:

18. *First, introduction of an ad valorem property tax should not be tied up with the reform of legal registries of real estate ownership and transactions.* While the latter is necessary for the development of real estate markets, tying both reforms together is likely to seriously delay the tax reform because of legal issues which are less relevant for tax purposes, such as ownership uncertainties. *Second, excessively heavy taxation of real estate transfers (sales, inheritance) should be avoided because it can impede the development of real estate markets, or at least their transparency, and, as a result, impair the very base of the annual property tax.* *Third, land use regulations should be consistent with the objective of developing the liquidity of real estate markets.* If excessive obstacles are encountered in recycling land to highest and best use, due to contradictory land use regulations, the number of transactions, will be limited and the tax will have little effect on land use efficiency. *Fourth, encouraging the development of adequate funding for real estate transactions is necessary, since the lack of adequate financing for property transactions can also severely limit the number of transactions, and hence the positive effect that an ad valorem property tax can have on the recycling of properties.*

How an ad valorem property tax can positively influence land use patterns:

19. Introducing an ad valorem property tax could help encourage a further privatization of surplus public property. The reluctance to privatize municipal assets results, in part, from fear of losing a locally controlled source of revenue, by transferring assets to the private sector, in exchange for property tax revenues on these privatized assets that are not market based and may sometimes be excessively centralized and outside local control. Introducing a sufficiently decentralized ad valorem property tax could help change this perception, by offering the possibility of substituting a new, permanent and more dynamic tax resource, for current low-return direct management of municipally owned properties.

20. Ad valorem property tax as an incentive on land use patterns. The tax, if based on market value, encompasses the notion of “highest and best use” of the property. As a result, it can act as an incentive to recycle property and relocate activities according to market signals. From a theoretical perspective, the effects of an ad valorem tax on land use patterns depends on assumptions regarding the elasticity of the supply of land and of capital to changes in after-tax rate of return. These assumptions remain debated, but there is a convergence toward the following conclusions: changes in the property tax rate will have allocative effects in the long run, at the national level where capital supply can be considered as elastic, as well as at the local level, where both land and capital are elastic. Allocative effects will also result from national changes affecting only certain categories of properties.

21. The characteristics of the tax will determine its actual impact on land use pattern. Beyond the theoretical assumptions, empirical evidence of the tax impact on land use is not always conclusive, and this seems mainly attributable to: (i) weaknesses in the implementation of the tax (excessively low effective rates); (ii) contradictory effects of other policies and (iii) contradictory rules embedded in the property tax system itself, most of the time because various other economic and/or social purposes are pursued simultaneously through the tax. It is thus necessary to **examine what characteristics of the tax would best serve the land use objective (while remaining compatible with the fiscal objective).**

22. Reviews of potential specific rules for certain categories of land show that higher taxation of land (than of improvements made to it) is theoretically consistent with the objective of encouraging land use efficiency, because it will minimize inefficiencies created by the taxation of improvements and encourage earlier development of land. However, these expected benefits are strongly questionable in the case of a pure site-value system with excessively high rates. Vacant lots should be taxed at least at the same rate as improved land, or even, under certain conditions, at a higher rate, especially in transition economies where the issue of the intensity of land use is crucial. However this tax incentive to earlier development should be used carefully, on a local basis, when and where unsatisfied needs are identified, otherwise it could lead to oversupply of developed real estate. Lower effective rates or exemption of newly constructed buildings would also act as an incentive to earlier and more intense development of supply of new real estate,

but would be contradictory with the fiscal objective of the reform, while likely being socially regressive, and are thus not recommended, especially at a nationwide level.

23. *Specific treatment based on the current use of the property usually has distortionary effects in terms of land use.* Agricultural land is often granted preferential treatment for social and political considerations and/or with a view to the preservation of rural land. However, the tax preference is generally insufficient to prevent conversion to urban use. Furthermore, if the most pressing issue is addressing high and rapidly increasing urban land prices, removing preferential treatment for agricultural plots in the urban periphery will help dampen speculation. This scenario is more likely in EU accession countries over the coming years.

24. *Differential treatment of industrial /commercial properties* has little justification in terms of land use objectives. *Heavier taxation* distorts allocative decisions, favoring residential use over business ones. In transition economies where available space for commercial and service activities is in short supply, taxing these uses more heavily is counter-productive. As for industrial uses, the goal should be to relocate them from the center to the periphery, and this will best be pursued by a taxation of the companies' real estate at market value (an incentive to sell to more efficient users and to relocate to cheaper peripheral areas), not by taxing more heavily all industrial sites compared with residential ones. On the other hand, *lower taxation* of specific areas in order to attract industrial/commercial investments will influence investment decisions only if a limited number of municipalities are using this tool and if the differences in the effective tax rate are significant enough. The main result of such preferential treatments, if left unregulated by minimal national limits, is likely to be a perverse competition among local authorities resulting in a depletion of local revenues and an absence of real impact on allocative decisions.

25. *Specific rules with social or political goals are in general contradictory with land use efficiency and are best addressed through other means.* Preferential treatment of owner-occupants, besides its social regressiveness, creates distortions in allocative decisions. In transition economies, where ownership has often been transferred to sitting tenants, it would delay the possible recycling of properties to highest and best use. Progressive taxation according to the value of the property has negative allocative effects on land use, because it creates a disincentive to improvements and upgrading. However, exemption of low-value properties, which favors income progressivity and lowers collection costs, can have limited disincentive effects on improvements, if the threshold is set low enough. As for progressive taxation according to households' revenues, it would send distorted signals in terms of allocative decisions and protect part of the real estate stock from the incentive to reallocate according to highest and best use -- in return for contributions to social objectives that would best be addressed through other means.

26. *Finally, exemption of publicly owned properties* has strong distortionary effects on land use patterns, because it allows part of the city area to avoid the tax incentive to locate and relocate according to market signals on the highest and best use of the property they are occupying. This is especially crucial in transition economies where the public activities were located according to non-market criteria, and the publicly owned real

estate stock is sometimes still large. Exemptions should thus be strictly limited to properties owned and used by the local taxing authority for its official administrative duties .

III. CONCLUSION

27. The introduction of an ad valorem property tax can serve both fiscal and land use objectives in transition economies, provided that the reform is carefully designed to address the technical, administrative and political challenges, that a consistent articulation is found with other regulations and reform of real estate markets, and that adequate tax characteristics are adopted.

28. The following characteristics would fit both objectives, as well as the overarching need to keep the system simple: (i) a valuation based on capital market value; (ii) a flat rate system (as opposed to a progressive rate structure); (iii) possibly combined with a higher rate on land (moderately graded system) and on vacant lots, these decisions being left to local discretion; (iv) a large base involving very few exemptions (except possibly for very low-value property) and, in particular, very limited exemptions for publicly owned properties; and (v) national regulations limiting the scope of local tax competition.

29. Even a well designed property tax with non trivial rates will not, in itself, be sufficient to address all the issues of real estate and land use patterns in transition economies. However, if carefully designed, and applied with rates significant enough, over a sufficient period of time, an ad valorem property tax can be a useful complementary tool that will both respond to its basic fiscal objective (raising revenue for decentralized authorities) and act as an incentive for achieving more efficient land use patterns.

Ad Valorem Property Taxation and Transition Economies

Anne Paugam

1. Despite the administrative and political difficulties involved, there is a strong move toward introducing ad valorem property tax in many transition economies. The main reason for this trend is fiscal: an ad valorem property tax is one answer to the growing need for independent local resources for decentralized authorities. Chapter I examines the conditions under which this fiscal objective can be reached, taking account of social impact considerations and the need to face significant administrative and technical constraints.
2. However, there can be other non-fiscal objectives for introducing such a tax, less often thought of by policy makers, but which respond to crucial needs in transition economies. They are: (i) helping to unlock further privatization of surplus publicly owned real property (i.e., residential, commercial or industrial properties that are not needed for direct public use), and (ii) increasing land use efficiency. The second chapter examines how the introduction of ad valorem taxation can encourage further real estate privatization, to what extent such a tax can act as a positive incentive on land use patterns, and to what extent this land use goal can remain compatible with the core fiscal objective of the tax.
3. The analysis is based on a few premises. First, that property tax is essentially a fiscal tool, well adapted to local budget needs, before being an indirect tool to influence land use patterns. Regarding land use, the property tax is only one instrument among others (such as zoning, planning, infrastructure provision, etc.) that can have an indirect influence on the efficiency of land use. Because the role of the property tax as an incentive on land use is of crucial importance in urban areas in transition economies, the study attempts to discuss it in detail. However, this is done keeping in mind that the two objectives (fiscal and land use) should remain compatible.
4. Similarly, the second premise is that the property tax is essentially a fiscal tool rather than an instrument for social redistribution. As is conventional wisdom in discussions of taxation issues, social redistribution and equity issues are best addressed through other types of taxation (i.e., Personal Income Tax, inheritance taxes, structure and design of consumption taxes, etc.) or through budget expenditures, at national level. Therefore, the attempt here has been mainly to try to identify the social incidence of various options in the key possible features of the property tax and to emphasize those features that efficiently serve the fiscal objective, while remaining socially neutral (or progressive) to the extent possible.
5. The third premise underlying the study is that the property taxation system should be kept sufficiently simple, so that it can be understood by taxpayers and be reasonably

manageable for tax authorities and tax offices. Hence the concern to avoid a complex system involving multiple specific treatments (exemptions, rebates, higher taxation, etc) for various categories of taxpayers or properties. Such rules, besides their often adverse impact on the fiscal and land use benefits of the tax, can make the whole system unintelligible for taxpayers as well as difficult and costly for local authorities and tax administrations to manage.

6. Last but not least, the analysis is based on the premise that property tax is not merely a technical issue for tax specialists, but an element in a more complex financial, institutional and political arrangement governing the relationships between central and local governments, an arrangement that needs to be balanced, in a context of growing decentralization. The property tax reform can be envisaged with reasonable chances of success only if it is seen and designed as an element of the overall balance of the central/local government relationships, and if, as such, it gains the support and ownership of both central and local authorities. Otherwise, there is a risk that a reform could end up with significant costs (investment and operating costs) but disappointing results, both from a fiscal and a land use perspective.

I. AD VALOREM PROPERTY TAX: FISCAL BENEFITS FOR DECENTRALIZED AUTHORITIES IN TRANSITION ECONOMIES

7. In transition economies, both the move toward decentralization and the prospect and challenges of European Union (EU) accession (for Central Europe), create increased needs for locally raised public revenues. The introduction of an ad valorem¹ base for the property tax, in lieu of the existing area-based² property taxes, constitutes one of the ways to address these needs. This explains why, despite the administrative and political difficulties of such a reform, many transition economies are considering introduction of an ad valorem basis for their property tax. However, an ad valorem property tax can in practice take many different forms, depending on the actual characteristics of the taxation system that are selected. Therefore, it is worth examining under what conditions the new tax would best respond to the fiscal objectives of the transition economies, taking into account social impact considerations as well as institutional and administrative constraints in reforming and administering the tax.

1. INCREASED NEED FOR INDEPENDENT LOCAL REVENUES AT THE LOCAL LEVEL IN THE CONTEXT OF DECENTRALIZATION AND EU ACCESSION

1. The trend toward decentralization, as well as the prospect and requirements of EU accession, create increased financial needs at subnational levels as well as a need for more local autonomy in the financial area.

1.1. Growing financial needs at the local level

8. Two major trends create the need for additional resources for local authorities in transition economies, especially in EU accession countries:

- *Decentralization*: the move toward decentralization in many transition economies, especially in Central Europe, leads to increased financial needs at subnational levels (municipal, district—when they exist, county, regional, etc.). Devolution of competencies to the local level needs to be matched by devolution of corresponding resources, to ensure effective local democracy and efficiency gains through greater direct local responsibility.
- *EU Accession*: in transition economies of Central Europe, the prospect and requirements of EU accession increase the need for strengthening the autonomy of local budgets, at two levels:

¹ i.e. based on the capital market value of the property.

² i.e. based on the square meter area of the property.

- First, accession will require heavy public infrastructure investments, making it crucial to increase local authorities' financial capacity, both through increased revenues and through improved borrowing capacity. For the latter, direct revenues are important when it comes to access to capital markets. In spite of private sector participation, it has been estimated, for instance, that the required increase in capital expenditure in Poland in water and wastewater treatment facilities alone, under a low-case scenario, would require a two-thirds increase in the overall public investment (currently 3.6% of GDP, on average, up to 1997), and a doubling in public investment in the environment sector (currently 45% of public investment).³
- Second, local authorities in accession countries need to be able to offer sufficient and strong counterpart funding for EU pre-accession funds and, in the future, structural funds. This means a financial capacity as well as human and technical capacity, which imply budgetary costs (hiring, training of competent local staff), if the local authorities are to be able to come up with efficient and convincing plans and projects to make optimal use of EU funds.

9. In this regard, it is interesting to observe that the share of subnational budgets as a proportion of total public budgets, as well as share of GDP, is currently significantly lower in Central European countries than within the EU: Local budgets in EU member countries account for 25.5% of total public budgets and 12% of European GDP (more than ECU 770 billion or more than ECU 2,000 per capita). By contrast, local spending in a sample of five Central European countries and the three Baltic states accounts for about 20% of total public budgets and 8.4% of GDP, or about two-thirds of the average EU level in terms of share of GDP (non-weighted averages). It is clear that, with decentralization trends and the huge infrastructure needs at the local level, the share of local budgets in public spending as well as in GDP is bound to increase in these countries, and to become closer to EU average.

³ World Bank report, "Poland, Complying With EU Environmental Legislation," July 1998.

Table 1

	Local Revenues a % of General Govt. Revenues	Local Revenues as a % of GDP	General Govt. Revenue as a % of GDP
<i>1/ Central Europe:</i>			
Czech Rep.	20.60%	8.40%	40.70%
Hungary	30%	14%	47.30%
Lithuania	about 17%	about 5.5%	32.70%
Estonia	na	na	39.00%
Latvia	23.00%	9.14%	39.90%
Slovak Rep.	na	na	46.90%
Slovenia	11.35%	5.10%	44.90%
Poland	18.85%	8.50%	45.00%
<i>CE Average (nonweighted)</i>	20.13%	8.44%	42.05%
<i>2/ EU Members:</i>			
Austria	30.00%	14.20%	47.50%
Belgium	13.17%	6.66%	50.60%
Denmark	55.65%	32.36%	58.15%
Finland	34.50%	18.35%	53.20%
France	16.95%	7.86%	46.37%
Germany	12.70%	5.80%	45.96%
Greece	10.70%	3.76%	35.11%
Ireland	26.96%	10.60%	39.30%
Italy	26.93%	11.98%	44.50%
Luxembourg	na	11.7%	na
Netherlands	27.77%	13.96%	50.26%
Portugal	9.70%	3.88%	39.85%
Spain	24.87%	9.84%	39.56%
Sweden	38.47%	22.17%	57.63%
United Kingdom	28.37%	10.59%	37.32%
<i>EU Average (nonweighted)</i>	25.48%	12.25%	46.09%

Source: IMF, OECD, EUROSTAT. Mainly 1996-1997 for central Europe; 1995 for EU members. See the table at Annex I for further elaboration of this data.

1.2. The need for greater local autonomy in local finance

10. Not only are the financial needs of local authorities increasing, but the degree of financial autonomy in raising and managing these revenues also has to increase.

11. Technically, there are several ways of addressing the need for additional local funds, since local budgets are generally comprised of three main elements, in varying proportion: transfers from the central government (block grants and/or specific subsidies), local tax revenues, and other locally raised resources (revenue from

investment and properties, fees for services, etc.). However, in transition economies, there are several converging reasons to favor an increase in locally raised revenues rather than in transfers from the central government:

- Ensuring a real decentralization: The larger the share of locally raised resources, the greater the impact of effective decentralization. Transfers of competencies from the central government should be matched by corresponding transfers of responsibilities in the financing of these competencies. Otherwise, there is a risk of creating a largely fictional decentralization, in which local authorities are theoretically in charge of large areas of public policies and expenditures, but remain excessively dependent on the good will of central government decisions to finance them.
- Supporting the development of local democracy: The responsibility and transparency of local authorities toward their local citizens/taxpayers is best promoted when there is a significant and direct link between taxation (or fees) decisions and the services rendered as a result of the revenues generated by these decisions.
- Encouraging local efficiency in the management of public services: The direct link between the source of revenue and the services and expenditures it helps finance is also an incentive for increased efficiency in the management of public services.

12. Therefore, locally raised revenues are not only an incentive for good local management, but also, from a social and political point of view, an essential element of a democratic decentralized local authority system.

13. There is currently no precise measurement of the degree of effective financial autonomy of local authorities in transition economies, nor comparative measurement with other countries, in particular, with the existing EU members. However the context in transition economies clearly calls for an increase in locally raised revenues rather than in government-controlled transfers. This is because the need to move away from central decision-making, to promote local democracy and real local autonomy in providing local services⁴ and in developing local and regional development policies, has strong political backing in these countries.

14. Within local public budgets, the proportion of resources raised locally, or over which the local authority has a significant decision-making authority, varies greatly (including within the EU). It is also difficult to measure because such measurement requires an assessment not only of the share, but also of the nature of government transfers and their criteria, as well as the actual degree of autonomy of local authorities in

⁴ This is especially true for traditional local services (e.g., water, local roads, heating, solid waste), more than for other services delivered locally and which have been delegated by the national government, usually with strong national directives attached (e.g., education, health, social protection, environment, etc.).

setting the rates or level of locally raised resources (tax and nontax). Detailed studies in this area are still in progress (especially within the OECD), and no precise figures are yet available for Central European countries. However, a broad consensus does exist that the autonomy of local authorities is still weak in these countries with regard to setting the rate and level of their resources, compared with EU practices. This autonomy needs to be increased to keep up with the decentralization movement.

15. One clear fact, in this regard, and beyond the general observation on the lower share of local budgets within total public spending (as discussed above), is the lower level of resources raised through the property tax, which is typically a local tax on which subnational authorities do have (albeit to varying degrees) a significant level of autonomy.

2. THE INTRODUCTION OF AN AD VALOREM PROPERTY TAX IS ONE ANSWER TO INCREASED LOCAL REVENUE NEEDS

16. Introduction of a sufficiently decentralized ad valorem property tax is one answer to the growing need for increased independent revenues for local budgets in transition economies. This is why, despite its well known administrative and political difficulties, many transition economies are considering moving toward such a tax.

2.1. The administrative and political challenges of property tax reform

17. Introducing an ad valorem property tax raises several administrative and political difficulties.

2.1.1. The current excessive centralization of the tax in many transition economies hides its real potential for local authorities

18. The interest of local governments in transitional countries in introducing ad valorem property taxation is partially lessened by the current excessive centralization of property taxation in many of these countries, which is masking the true potential of such a tax. In the current property taxation systems of the less reformed of these countries, all or most key elements of the tax are typically under the control of the central government: definition of the tax base, setting of the tax rates, determination of the shares allocated to central and local governments (if the property tax is a shared one), and administration of the tax through local tax agencies of the central government.

19. As a result, in Russia, for instance, local governments do not have any real influence on the property tax and do not consider it a stable source of local revenues. Therefore, one cannot expect local governments to be among the active supporters of a property tax reform, unless the reform includes, as a key element, sufficient decentralization of the property tax system.

20. Sufficient decentralization, in that sense, means that the tax revenues should accrue entirely to local budgets (in contrast to the central state budget), and that local

authorities must have some freedom (even if limited by brackets, as discussed below) to set their own tax rate. It does not necessarily rule out the possibility of sharing the tax between two (or even three) layers of local government, for instance, municipalities, counties and even regions, provided that no level of government has the arbitrary power to impose modification of the shares of other levels, and provided that, on the contrary, each level of government is free, within a bracket set by a national law, to adopt its own rate, and that the tax bill clearly spells the amounts and rates for each level of government (for accountability purposes).

2.1.2. The characteristics of ad valorem property tax makes it politically sensitive

21. First, the very existence of a tax on wealth can be subject to debate. However, first, from a theoretical point of view, the respective levels of distortionary effects of such a tax compared with others continue to be discussed, but arguments in favor of a real estate tax are strong (mainly because of the limited elasticity of land supply, which limits the effects of the tax). Second, from a practical point of view, in the absence of a property tax, there are not many other potential sources of autonomous resources for decentralized authorities. The availability of autonomous local resources does provide, in itself, benefits that cannot be easily disregarded (as outlined above) and must be weighted against the disadvantages of such a tax. These elements explain why such a tax is in fact widely used across the world, despite this polemical debate.

22. Second, although the tax is widely used in developed and developing countries, it is often considered a painful process by local authorities because it is a direct tax, not a hidden one. It is therefore more visible, and more politically sensitive, than other potential ways to raise resources, such as government transfers funded through national taxes. Indirect taxes, such as VAT or excise taxes, or even direct taxes, such as a Personal Income tax, when it is deducted directly from the paycheck, are much less visible for taxpayers. In addition, local authorities take less responsibility for their spending policy, vis-à-vis their local voters, when funds are coming from such transfers than from direct taxes raised locally.

23. There is also a concern in transition economies that are debating adopting an ad valorem base about increased inequity between richer and poorer cities. Since the value base of the tax will be different in different localities (in contrast to the area-based system of today), people fear that services will also differ, unless higher tax rates are charged in places where real estate market values are lower. By a mechanism that has been observed in other countries, higher rates would actually exacerbate the inequalities as more affluent residents leave these areas.

24. In this respect, it must first be noted that even with an area-based system, there is inevitably some degree of inequality, for instance between a small rural town and a large urban center benefiting from the tax paid not only by owners of residential units, but also by numerous owners of industrial and commercial premises. A small rural town cannot provide the same diversity and degree of services as a large city, whatever the property tax system. However, it is true that an ad valorem base can reinforce these disparities. The answer to this concern lies not with the tax itself but with the existence of

mechanisms of equalization across local authorities, at the national level and financed by national resources. Such mechanisms can be, for instance, block-grant transfers from the central government to local budgets, based on indicators of local fiscal revenue potential (i.e., tax potential, tax effort, etc.).⁵ Giving local authorities control and responsibility over a larger (and more dynamic) part of their resources, through a modernized property tax, does not mean that all mechanisms of solidarity between cities, at the national level, should disappear. A significant part of local budgets will still come from central funds, and some of them can be distributed according to equalization criteria.

25. In addition to these political difficulties, the tax also raises administrative issues: The registration of the base (fiscal cadastre), its valuation, maintenance and update are not easy tasks, especially in countries where the cadastral information and the technical competencies required are still at least partially deficient (see Section 3 below, for a discussion of these conditions in transition economies). Therefore, the tax is often seen as administratively complex and potentially costly to implement. In addition to start-up costs and issues, although intensive and judicious use of information technology (IT) solutions should make the processing of data easier than in the past, if the taxation system is not carefully designed, it can also become costly to operate in the long run.

26. Illustrating the reluctance that these difficulties can raise among elected officials, as a result of these fears, there are many examples throughout both developed and developing countries of ad valorem property tax systems that remain largely underused, compared with the potential revenues they could raise. This happens most often for one or a combination of the following reasons: undervaluation of the base, lack of revaluation and/or of proper indexation of the value of the base (to inflation), excessively low rates, multiple exemptions and rebates of various sorts and with various motives, and poor or discriminatory enforcement (on the collection side). All these elements lead to lower than expected revenues and a lack of buoyancy of the tax.

2.2. The trend toward introduction of an ad valorem property tax in transition economies

27. Despite these well-known difficulties, there is a growing trend, in transition economies, toward the introduction of an ad valorem property tax. Estonia has been in the process of implementing such a tax since 1993: It has implemented a land tax based on market valuation and is planning to extend it to buildings and premises beginning in 2002. Lithuania is engaged in a reform process regarding both market valuation methodology for the existing land tax and the perspective of an extension of the tax to buildings and premises. Latvia is also engaged in such a reform, with ad valorem taxing of land in 1998 to 1999 and planned inclusion of buildings in the tax base in 2000 to 2001. Romania adopted formally a market value-based tax in 1997, but fiscal values have

⁵ These indicators must be carefully designed so that they do not encourage cities who choose not to exercise their tax responsibility. For example: A town that would very lightly tax its residents on the property tax, hence have little revenues, should not automatically receive fundings that compensate for the forgone revenues. The criteria should be based on the potential fiscal revenues that could be raised, if an average rate was levied on the local value base.

little relation to market value in practice, and more reforms are planned in order to proceed to effective market valuation (establishing a national office in charge of collecting data on land and building transactions). Poland and the Czech Republic, where the property tax is still based on the area of the property, as well as Hungary and Slovenia, are also contemplating moving to an ad valorem tax based on market value in the short term.

28. This movement is explained by a growing understanding of the inadequacy of the land and real estate tax system inherited from the socialist era and the fact that a sufficiently decentralized ad valorem property tax (as defined above) could respond to the pressure to mobilize additional funds at the local level and to increase local financial autonomy.

29. It is interesting to note that in Western European countries, a move toward the suppression of local business taxes can simultaneously be observed (France, Germany). This trend will give more importance to the land and real estate property tax, which will become the main local tax resource for subnational authorities. In Germany, for instance, the stated intention is to compensate for the loss of revenues from the business tax by increasing the resources raised from the property tax.

2.3. Inadequacy of the current property tax system in transition economies

30. The current system of taxation in most transition economies in Central Europe and the Baltic States is inadequate and does not respond to the need for increased local resources. Former socialist economies have inherited situations in which, in the absence of a land market, the property tax was based on a measure of the area of the property (or some sort of valuation related to area and production for agricultural land). In addition, the effective rate of taxation has often been linked to the social, economic or legal status of the taxpayer. For example, individual retail shops could be taxed more heavily than cooperative or social entities, or the tax imposed on a property was different for individuals than it was for legal entities (usually with preferential treatment given to individuals). These examples illustrate a nonmarket appreciation of current use or users (as opposed to a market valuation of highest and best potential use of a property). In addition, the system is often based on self-declaration and assessment; hence the registering of properties is often incomplete, especially for improvements, thereby limiting the tax base.

31. These inherited systems have no relation to the market value of the real estate being taxed. They generate limited revenues from a narrow base that is neither elastic to economic growth nor ensuring any vertical or horizontal equity. In addition, from a political point of view, raising the level of revenues levied this way is a difficult task politically, since, as the base is relatively rigid (area), the main way to increase revenues significantly is to increase the amount due per square meter.

32. As shown in Table 2 below, comparison with the situation of local authorities of EU member countries illustrates the limitations of the current property tax system in transition economies: Figures show that revenues raised from this tax remain lower in the

Baltic and Central European states than in the 15 EU countries as a whole. The property tax provides a comparable share of local revenues in both groups of countries (7.5 to 8%). However, as mentioned above, these local budgets constitute a smaller part of public spending and of GDP in Baltic and Central European states than they do in the EU, on average. Thus, logically, the property tax revenues represent a smaller share of the GDP in Baltic and Central European countries (about 0.55% of GDP) than in the EU (average of about 0.92%). These averages cover large ranges, both in the EU and in Baltic and Central European countries, which illustrates the fact that even within the EU, and more generally among Western countries, the actual degree of decentralization of both competencies and resources, and the effective use of property taxes, remain variable from one country to another. But on the whole, and despite these variances, the weight of the property tax in GDP in the sample transition economies remains below the average weight for the 15 EU member countries.

Table 2

CENTRAL EUROPE	PT as a % of Local Revenues	Property Tax As a % of GDP	EU MEMBERS	PT as a % of Local Revenues	Property Tax as a % of GDP
Czech Rep.	2.66%	0.20%	Austria	1.80%	0.27%
Hungary	1.07%	0.15%	Belgium	17.22%	1.15%
Lithuania	About 10-11%	0.57%	Denmark	3.24%	1.07%
Estonia	na	0.40%	Finland	2.62%	0.48%
Latvia	12-13%	1.10%	France	20.73%	1.63%
Slovak Rep.	na	< 0.8%	Germany	6.82%	0.40%
Slovenia	8.70%	0.44%	Greece	na	na
Poland	13.9%	1.15%	Ireland	7.91%	0.87%
<i>CE Average (1)</i>	<i>8%</i>	<i>0.57%</i>	Italy	6.80%	0.81%
			Luxembourg	2%	0.14%
			Netherlands	5.34%	0.75%
			Portugal	8.63%	0.41%
			Spain	6.91%	0.68%
			Sweden	0.00%	0.93%
			United Kingdom	12.56%	3.26%
			<i>EU Average (1)</i>	<i>7.33%</i>	<i>0.92%</i>

(1) Nonweighted. Source: IMF, OECD, EUROSTAT. Mainly 1996-1997 for Central Europe; 1995 for EU members. See detailed table at Annex I for further elaboration of this data.

33. Because the resources that can be raised through non-ad valorem property tax are limited, and because in some transition economies local authorities have very limited, if any, influence on the property tax, local authorities often use other recurrent property-related fees as a source of truly local revenues (i.e. revenues locally determined and administered). Simultaneously, local authorities in countries where municipally owned property is still large, rely heavily on the rental revenues of leased municipally owned

properties⁶. Recent studies in Russia and Bulgaria indicate that local public revenues raised through rental of public property can range from about one half of the amount currently raised through the property tax, to several times this amount. Furthermore, there are direct indications that local authorities also use local service charges as a substitute for a property tax⁷.

2.4. An ad valorem property tax can be a powerful reform instrument with multiple benefits

34. There are numerous arguments in favor of developing a sufficiently decentralized ad valorem property tax as a major resource for local authorities and also as an important step in deepening reforms in transition economies. The potential benefits can be split into two groups: fiscal and non-fiscal.

2.4.1. Non-fiscal benefits of decentralized ad valorem property taxation in countries in transition

35. An ad valorem property tax, if it encompasses the concept of “highest and best use” of the properties being taxed, may positively influence land use efficiency and the development of real estate markets. Beside these tax incentives per se, which are of a permanent nature, an ad valorem tax, by providing a new, dynamic and stable local revenue, may also have a more “transitional” effect by encouraging further divestiture of public land and real estate to the private sector. These elements are crucial in transition economies and are discussed in more detail in Chapter II below.

36. An ad valorem property tax provides one answer to the needs for autonomy in raising local revenues, in line with the needs for effective decentralization, promotion of local democracy and of more efficient management of local services. A decentralized property tax creates a direct link, at the municipal level, among the source of revenues (local) and the services and expenditures it helps finance. To a certain extent, it even creates a direct link between the use of local services by local residents (owners or renters) and the funding for the provision of such services, because there is a link, even if not directly proportional, between the size and value of a property—and the number of residents or workers it can accommodate—and the extent to which it makes use of local services and infrastructures. More generally, it is one of the few taxes that clearly offer an

⁶ O. Kaganova, (ed.), *Monitoring Indicators of Land and Real Estate Reform in Russian Cities. Project Report*, The Urban Institute, Washington, D.C., January 1999, and O. Kaganova, *Improving the Municipal Asset Management System in Dobrich. Project Reports*, The Urban Institute, Washington, D.C., May – July, 1998.

⁷ For example, as soon as local governments in Bulgaria were allowed to set up service charges for garbage removal (a special law of 1997), the Plovdiv government set up the service fees, based on *assessed property value*, with expected total revenues six times higher than before. Other cities have been following this example, and there are direct indications that, at least in some cities, this remarkable increase in the fees has no relation to the cost of the service. For example, the Dobrich government expected an eight-fold increase from the garbage collection fee in 1998, compared with 1997, though the municipal enterprise responsible for garbage removal was already profitable in 1997, before the fees were increased. In fact, local governments in Bulgaria use this service fee as a substitute for a decentralized property tax.

easily identifiable local base, and it can provide autonomous local tax resources (even if the degree of autonomy in the taxation policy varies greatly from one country to the other).

2.4.2. Fiscal benefits of decentralized ad valorem property taxation in countries in transition

37. Despite the difficulties outlined above, an ad valorem property tax also offers several significant advantages from a fiscal point of view, especially in the context of transition economies:

- It is a stable and autonomous source of revenue, relatively easy to identify because it is immovable.
- When based on market value, or an approximation of it (“fiscal value”), it is considered as ensuring a good degree of vertical and horizontal equity (i.e. properties with the same characteristics in different locations are taxed similarly, and properties with different characteristics are taxed according to these characteristics).
- In most cases, ad valorem property tax is also supposed to be a close approximation of the taxpayer’s ability to pay, even if it is clearly not a perfect measure of this ability (and although there is a specific issue of “income poor-asset rich households” in transition economies, which is discussed later).
- For the local jurisdiction, this stable and autonomous resource provides a consistent measure of municipal creditworthiness, a prerequisite to accessing the capital market. Access to capital markets, in turn, is a critical development for transition economies where local authorities face huge infrastructure investment needs.
- Last, but not least, the base of an ad valorem property tax is more dynamic and more likely to grow in line with the GDP growth, because it is linked to market value, than the inherited area-based taxation systems of most transition economies. Also, the switch to an ad valorem property tax would necessitate the implementation of tighter management and of a more comprehensive registration system. Thus, an ad valorem property tax will provide a larger as well as a much more dynamic base.

38. Comparison between the eight sample Baltic and Central European countries and the 15 EU members (see tables 1 and 2 and detailed table in attachment) indicate that there is a margin to increase the amount of the resources levied through the property tax in transition economies: on average, simply to reach the EU average, the property tax share in GDP in the eight sample countries would rise by more than 60. Among the eight sample countries, the scope for increase is the highest in Hungary (currently 0.15% of

GDP) and the Czech Republic (0.2%), and is significant for Estonia, Lithuania, Slovenia and the Slovak Republic.

39. In Poland and Latvia, by contrast, the share of the tax in GDP is currently comparable to (and even slightly above) EU average. From a fiscal perspective, one could thus hesitate in the face of the start-up costs of an ad valorem reform of the property tax. However, this in no way implies that reform is unnecessary, for two reasons:

- First, a reform toward market value property tax will in any case increase local revenues, even when the resources now raised through the old tax are already significant. This increase will occur thanks to the expanded and more elastic base it will provide (i.e. a more comprehensive base, better linked to economic growth). Given the scope of the local spending needs in accession countries, going somewhat beyond the EU average is probably justified.
- Second, and more crucially, beyond the static comparison of the current situation in terms of GDP, there is also a strong rationale to reform when one thinks in terms of the future dynamic, over the medium and long term. Because the current tax in former socialist countries, including Poland and Latvia, is based on the area, it is not likely to rise in line with the GDP growth (whether in real or in nominal terms) over the coming years. Therefore, even when the revenues raised with the tax today are comparable with those in the EU, in terms of proportion of the GDP, this will not remain true in the future, and the revenues of the tax will be progressively marginalized, until they may not even justify the administrative and collection costs anymore.

40. In the case of Poland, for instance, property tax revenues have simply been maintained in real terms (i.e., have increased at the inflation rate) over the past few years. However, local governments have taken over additional responsibilities from the state. As a result, the share of property taxes in local revenues has dropped from 17% in 1995 to 13.4% in 1997 and 1998.

41. In terms of macroeconomic impact, it should be observed that the fact that there is scope, as well as a strong rationale, to increase the weight of the property tax in transition countries, does not imply in any way that the overall share of public revenues in the GDP should rise in the same proportion, at the national macro-level. The choices on the overall level of public revenues as a proportion of GDP naturally have to take many other elements into consideration. The conclusion here is that within the chosen level of total public revenues, there is scope for an increase in the share of local property tax revenues. If total revenues are to remain unaffected, this implies a decrease in another item in the public budget. And, to remain consistent with the need to globally increase local revenues, the increase in property tax revenues should be matched by a decrease in another public revenue at the central level, not at the local level. This shift of resources would be consistent with the transfer of competencies from the central to the local level with the decentralization process.

42. In conclusion, given the growing need for financial resources at the local level, in the context of decentralization and of EU accession, it is not surprising that despite its inherent difficulties, the ad valorem property tax is considered a serious option by many transition economies, because such a tax would provide one answer (albeit partial and not sufficient in itself to address all the financial needs) to these growing needs.

3. THREE MAIN SETS OF CONDITIONS FOR THE REFORMED TAX TO MEET ITS FISCAL OBJECTIVES

43. An ad valorem property tax can, in practice, take many different forms, depending on the actual characteristics of the taxation system selected. Therefore, it is worth examining under what conditions the new tax would best answer the fiscal objectives of the transition economies, taking into account social impact considerations as well as administrative constraints in reforming and administering the tax.

3.1. The fiscal efficiency of the new tax will depend on a favorable balance of responsibilities between central and local authorities

44. The extent of the fiscal benefits of the new tax will depend on the overall balance of responsibility between central and local authorities. To yield its potential benefits, and justify the costs, the reform must rely on effective decentralization, and also on a significant central government involvement as well as incentives for local authorities to use the tax to its true potential.

3.1.1. Local governments should have sufficient freedom to influence the tax amount anticipated in their jurisdictions

45. This is achieved by allowing local authorities to set the tax rate locally, sometimes within tax brackets determined by the state. To ensure some stability and credibility to this decentralization of tax responsibility, a strong and stable legal background for this aspect of local governments authority is required. This would involve defining the local authority in property taxation in legislation at a sufficiently high level.

3.1.2. Central government must be willing to transfer to local authorities, and local authorities must be willing to accept, responsibility for a significant part of both expenditure and of revenue raising

46. Experience in developed as well as in developing countries shows that the proportion of local revenues obtained through the property tax is higher when (i) a larger share of public expenditure is devolved to local authorities and (ii) the proportion of direct transfers from the central budget is lower. If local officials have the feeling that they may be able to fund their expenditures by central funding, rather than by assuming the political responsibility for raising revenues locally, they will not have sufficient incentive to make full use of the tax potential, and, given the tax's political difficulties described above, they will let the tax stagnate through all available means (non-indexation or non-revaluation of the base, low rates, weak enforcement effort, etc.).

47. The issue is of particular importance in transition economies, where the switch to an ad valorem system will necessarily, over time, imply a significant rise in revenues collected. Indeed, as discussed above, this is the very objective and justification of the reform. This increase should occur due to: (i) the extension of the base that will stem from a more comprehensive registration of properties, (ii) an assessment based on market value that will increase the value of the base and its buoyancy, (iii) property appreciation due to increased land use efficiency generated by the new tax itself, including possible further divestiture of public property to the private sector and (iv) better tax administration.

48. In this context, if local authorities adopt and maintain very low rates to offset the effects of a larger and higher valued base (i.e., to keep the overall tax burden similar to that of the pre-reform period), then the purpose of the reform will be self-defeated, from a fiscal point of view (as well as from a land efficiency point of view, as will be discussed in Section 2), and its implementation costs will not be justified.

49. The political acceptance of the reform rests on the adoption of transition periods and staged phases, allowing for a progressive implementation of the increase in the property tax burden. It should nevertheless be clear from the start that in the medium term, the ad valorem tax will indeed increase the share of revenues raised locally. As discussed above, this does not mean that the overall national tax burden should increase, and this local increase can be offset by a corresponding reduction of national tax burden. Therefore, and this is especially true for former centrally planned economies, the central government must be willing to transfer to local authorities, and local authorities must be willing to accept, responsibility for a significant part of both expenditure and of revenue raising.

50. One key application of this principle is that the central government must not offer, directly or indirectly, and even unwillingly, automatic compensation, through transfers or grants, to local authorities, for loss of local tax revenues resulting from local decisions to grant special exemptions, rebates or excessively low rates. For example, central grants must be based on some measure of the local tax potential, not on the actual local tax revenues raised as a result of local choices on effective tax rates.

3.1.3. Central government must remain involved in key areas of the tax system

51. At the same time, and for the same reasons, the central government must remain sufficiently involved in key areas of the property tax system to ensure that it is actually used to its full potential.

52. The central government must create the proper legal and regulatory environment and organize the necessary information-sharing with other tax or administrative units and entities. The legal and regulatory environment essentially involves adopting tax rate brackets, and in particular a minimum rate (this is important because governments often think of imposing a maximum tax rate but do not always think of a minimum one), enforcing minimum nationwide regulations regarding the rules for exemptions or rebates

that may be granted by local authorities⁸, making sure that updates of the base and its revaluation are done properly at regular intervals and providing the necessary technical and staffing support for the valuation process. This supervisory role is necessary not only for fiscal purposes but also for horizontal equity reasons.

3.2. The new tax system should not be overburdened by characteristics that aim at social, economic or administrative objectives and that contradict the core fiscal objective

53. The ad valorem property tax, in practice, can take many different characteristics, regarding its base, valuation principles, rate structure, exemption and collection policy. Most of the time, these features of the tax system have social, economic or administrative objectives, which will produce various, sometimes conflicting or offsetting effects, and which can be contradictory with the core fiscal objective of the tax. Therefore, it is worth examining some of the most frequent options that can be selected with an ad valorem tax system, and attempting to assess which characteristics would be best suited to the fiscal goal, without neglecting the social impact considerations.

54. This examination will show that, in the majority of cases, features added to serve specific social, economic or administrative objectives, contradict the fiscal purpose and should be addressed by other means or have no sound basis. The property tax is often overburdened with too many of these objectives, whose effects offset each other, or cannot be reasonably measured, or are clearly negative, while on the whole resulting in lower revenues than could reasonably be expected. If and when this happens, the cost of reforming the property tax appears to be high compared with the results.

3.2.1. Land use objectives

55. The ad valorem property tax can have an impact on land use, and this central issue in transition economies is discussed in Chapter II. However, it should be emphasized that what is true for all possible nonfiscal objectives of the tax also holds for this particular one: features of the tax system introduced for land use purposes should remain compatible with the core fiscal objective of the tax.

56. Without getting into details discussed further in Chapter II, it can already be said that to remain consistent with both objectives (fiscal and land use) the property tax system should respect the following conditions: (i) it should avoid large exemption systems, or excessively low effective rates; and (ii) it should avoid excessive differences in local effective tax rates, from one jurisdiction to the other. In both cases, this would

⁸ National regulations on minimum tax rates and limitations to rebates and exemptions must be done strictly with the aim of (i) ensuring that the tax does not fall into disuse in some municipalities excessively sensitive to local political pressure, and (ii) avoiding excessive (economic) distortions or unfairness (inequities) across or within local jurisdictions (or even possibilities of local corruption). Such regulations seen as “minima” to be respected by all local authorities should thus be limited to what is strictly necessary and will in that case remain compatible with the objective of increasing local autonomy by leaving a substantial margin of maneuver to local decisions in setting the tax rates and policy.

reduce the effectiveness of the tax from both the fiscal and the land use efficiency points of view.

3.2.2. Social and economic objectives

(i) The social impact of a flat rate structure

57. In terms of income redistribution, the impact of a flat tax rate is often perceived as socially regressive, or at least non-progressive, and authorities are often tempted to insert rules that are supposed to make the tax more progressive, and/or that have specific social purposes (such as encouraging owner-occupancy).

58. However, on the whole, as discussed in Box 1 below, it appears more likely that a flat-rate tax is either neutral, or even slightly progressive, depending on assumptions regarding (i) the elasticity of the supply of land and capital to modifications in the tax rate and (ii) the income distribution pattern among owners, renters and consumers of goods and services in which land and improvements inputs are embedded.

59. Regarding transition economies, it is worth emphasizing that the income distribution of a flat-rate ad valorem tax burden would certainly not be less equitable than that of the current area-based system, where property-ownership characteristics have little to do with income level: property ownership was generated successively by the administrative allocation process of the socialist era and the privatization process, which was largely made to the benefit of these administratively allocated existing tenants.

Box 1:

The **incidence on income distribution of a simple, flat rate** is difficult to measure in practice. From a theoretical point of view, the effect depends mainly on assumptions regarding (i) the elasticity of the supply of land and capital to changes in the tax rate and (ii) the income distribution pattern among owners, renters and consumers of goods and services in which land and improvements inputs are embedded. Although assumptions about the elasticity of supply are still debated, there is some convergence to assume that (i) in the short term, both land and capital are fixed, at the local and national levels. As a result the tax burden is borne by owners. It can be assumed that the distribution of real estate property is generally correlated with income, so, in the short term, the effect of the flat rate tax is progressive. (ii) In the longer term, capital is usually considered elastic at the national level (although this is debated) and at the local level (i.e. capital supply is reacting to significant differences or changes in tax burden from one area to another, or from one category of land to another). Land supply can also be considered elastic at the local level (if conversion of rural land at the urban periphery is possible), while it is fixed at the national level. Thus the tax on improvements will be passed on to renters and consumers, and the tax on land at the local level will also be passed on. In the case of the tax on residential improvement and land, if the income elasticity of housing expenditures is 1, or at least 1, then even if the entire tax is passed on to occupants, a flat rate would not be regressive, on the whole. The case is more complex for the tax on non-residential properties and its shift to consumers of goods and services: If entirely shifted, then it is likely to be regressive because the income elasticity of total consumption is below unity. However, if the tax is not applied to agricultural land, the effect is more neutral (income elasticity of nonfood goods and services is closer to 1). All in all, the overall effect of a flat rate, with these offsetting impacts, is likely to be neutral. If the assumption of fixed supply of both land and capital is retained (which is defended by some analysts for the analysis at national level at least) then the effect is more likely progressive.

(ii) The specific issue of low-income households in high-value properties in transition economies and the temptation to exempt low-income households

60. Even if it can be demonstrated that a flat rate, in general, is probably roughly neutral in terms of income distribution, there remains a particular concern in transition economies regarding the social impact of the tax. Authorities in transition economies are concerned because they feel that there is a significant (although not quantified so far) number of low or modest-income households which have been granted ownership of high- (or increasing) value properties through the process of privatization in favor of sitting tenants.

61. To address this issue, it would first be necessary to have documented and quantified information on the problem on a country-by-country basis. Second, whatever the conclusions of such surveys, the temptation to exempt low-income households from the ad valorem tax should be resisted. Although it would clearly address the social concern, it would both impair the fiscal goal and very seriously impair the land use efficiency objective (see Chapter II). This peculiar situation must be addressed in another way, through national solidarity mechanisms, for instance through a means-tested housing allowance to low-income households whose housing charges (for owners: utilities and property tax) exceed a certain proportion of revenues. Another solution could be to defer part of the tax until the next transaction (sale or inheritance), making the tax a liability on the property, but this may delay the development of much needed transactions.

(iii) Other possible features of the tax system with social or economic purposes and their interaction with the fiscal goal

62. Besides the exemption of low-income households, many other specific rules can be introduced in the tax system to pursue social or economic objectives. However, while the social effect is not always clear, the effect on the fiscal objective is often detrimental.

63. One frequent feature introduced in the taxation system, which aims at social progressiveness is differentiation according to property value, through progressive assessment ratios, progressive rate structure, or exemption policies. Since ownership of property and land use consumption tend to vary directly with income, this will indeed result in a more progressive tax incidence than a flat rate, whether the tax is borne by owners or passed on to renters and consumers. From a fiscal point of view, the progressive structure does not necessarily imply a loss of revenues, compared with a flat rate structure. The result depends on the tax rate levels adopted, which can yield an amount comparable to a flat rate system. The contradiction in objectives here is therefore more with land use efficiency goals (see Chapter II) than with fiscal necessities. It should be added that a basic exemption of very low-value property can be compatible with all objectives (fiscal, social, land use). It would, in fact, improve the fiscal objective, due to better recovery costs⁹, while being roughly “progressive” in terms of income, and, if the

⁹ A break-even point, beneath which the cost of administering and collecting the tax is higher than the tax bill to be collected, can be estimated.

exemption threshold is set low enough, it would have a very limited disincentive effect on improvements.

64. *Site value system (taxation of land only) or graded system (higher tax rate on land compared with improvements):* these tax features have social and land use objectives (the latter themselves debatable in the case of the pure site value system), but they are less easily compatible with the fiscal goal than a comprehensive taxation of the properties (land and improvements) with a single rate. From a social point of view, the site value and the graded systems are theoretically more progressive than a flat rate system, since in the long run and if applied nationwide, the tax on land will be borne by owners rather than being passed on to renters and consumers.

65. From a fiscal point of view, however, a graded system, and furthermore, a site value system, are more difficult to manage and are thus more risky in terms of ease in raising the needed revenues. Because the tax base is narrower than in a system taxing land and improvements without distinction, such systems require higher rates to produce comparable revenues. They can thus be much more difficult to introduce, and, if implemented, run a higher risk of becoming politically unmanageable. Just as the experience with income tax demonstrates (where taxpayers show extreme sensitivity to the marginal tax rate, even if the average tax rate they face is in fact quite low), the acceptability of a tax with high rates on a narrow base (land only) is likely to be more difficult to obtain than that of taxing the whole property (i.e., land + improvements) at a lower rate. Therefore, a site value system would add to the political sensitivity of the property tax, which is already significant, as outlined above, and it would add to the risk of the tax being underused, from a fiscal perspective, because of this taxpayer sensitivity.

66. *Lower effective rates, or exemption of newly constructed buildings.* This specific rule aims at stimulating construction. However, it will have a clearly negative fiscal impact while it will likely have a regressive social impact (lower-income groups tend to live in older rather than new buildings, and the tax they pay would likely only be partially offset by the reduction in rent level due to a larger offer of housing stock).

67. *Higher taxes on vacant lots in urban areas:* this particular feature is likely to be socially progressive (because the higher tax burden would by definition be borne by owners), while fitting the fiscal objective, and possibly also fitting the land use objective under certain conditions (see Chapter II).

68. *Preferential treatment of agricultural land:* this favorable treatment, which is quite frequent, has clear adverse fiscal consequences, which impact essentially small rural towns rather than the bigger cities, although they can affect larger cities whose perimeter include rural fringes. Its implications for land use patterns are discussed in Chapter II.

69. *Higher rates on business uses (industrial, commercial, offices, etc.) versus residential housing* is a common feature in many developed countries' property tax systems, as well as in the current systems of transition economies. It is mainly based on the "ability to pay" argument. From a fiscal point of view, in the short term, it does not automatically imply surpluses or losses in tax revenues compared with a single rate

system for all types of use: the amount raised will depend on the rates applied to the each tax base, which may or may not generate the same amount as a single rate applied to a single base. However, in the long term, overtaxation of business uses may indirectly have negative fiscal consequences, if it impedes the growth of business activities (either locally and/or at the national level).

70. Finally, another rule frequently inserted into ad valorem property taxation systems is a *preferential treatment for owner-occupants*. However, this will negatively impact the fiscal objective, while being likely socially regressive, because in the long run the tax is passed on to renters and consumers, and rental is likely to be more frequent among low-income groups. While obviously limiting fiscal revenues, this frequently used preferential treatment is in fact socially regressive and is thus not recommendable. Encouragement of owner-occupancy, if it is considered a desirable political, social or economic goal (which is in itself debatable), should be sought through other means.

71. In sum, specific features introduced into the property tax system with income distribution or other economic goals often have effects that are not easy either to demonstrate or to measure in practice. Moreover, their combined effects are often unclear or offset each other, from a social point of view (for instance, the overall social impact of a progressive rate structure combined with preferential treatment of owner-occupants is contradictory and unclear), while impairing the core fiscal objective.

72. Fiscally, the only cases in which it is clear that a variation from the basic comprehensive flat rate system can be positive, while being progressive from an income distribution point of view are:

- (i) the case of a higher tax rate on vacant lots (under certain conditions regarding the real estate market); and
- (ii) possibly, a graded system, provided that (and this is a big if) the effective rate level is high enough to provide sufficient resources to local authorities.

73. Thus the main conclusion is that an ad valorem property tax is not the best suited tool for income redistribution. This legitimate concern should be assigned to other mechanisms, generally at the national level, which are more efficient and better adapted to this goal, whether through other taxes more directly linked to income (such as Personal Income Tax), or through direct budget expenditures. Burdening the property tax system with features aimed at specific social or economic goals will most of the time not ensure that these goals are properly obtained, while they will clearly impair the fiscal revenues raised from the tax and thus undermine the whole justification of the reform toward a modern ad valorem property tax.

3.2.3. Administrative objective: exemption of publicly-owned properties

74. Exemption of publicly-owned properties is very frequent in property tax systems. However, it should be used with the greatest restriction. The concept of exempted public property should be very strictly defined, especially in transition economies where governmental and quasi-governmental entities sometimes still own a large amount of land and buildings, in particular commercial properties, because most of the time such exemptions have no sound budgetary basis and, on the contrary, have clear negative effects on local revenues.

75. From a fiscal point of view, exemptions of properties owned or used by public or quasi-public entities other than the municipality itself deprive the local authority of fiscal revenues that can be very significant, without sound reason: these public entities are actually using local services and do generate local costs for the municipal budget (roads, infrastructures, services for workers, etc.), for which they should be taxed just as any other employer located in the city. The potential negative fiscal impact of such exemptions is especially high in transition economies where the real estate stock owned by public or quasi-public entities (such as utility providers or railways) is sometimes still a significant part of the city area.

76. Therefore, exemptions should be strictly limited to buildings meeting two conditions: (i) being owned by the local taxing authority and (ii) being used by this authority for its official administrative duties; i.e. the exemption should be limited to the cases in which taxation would mean that the municipality would, strictly speaking, be taxing itself for its administrative functions. Exemptions should not be granted in other cases. In practice, this means that exemptions should not be granted to properties owned by other government authorities (central, or other local and regional levels), nor to properties owned by quasi-public entities (such as utility or railways companies), nor even to properties owned by the local authority itself but used by the local authority or by another public entity (whatever its legal status) for purposes other than strictly official administration (such as for residential or business rental, or for the provision of municipal public services or utilities). In the latter case, a specific provision should mention that the tax is due by the property user (for instance a municipal agency), not by the property owner (i.e., the municipality itself).

77. At first glance, such a taxation may look like an unnecessary and cumbersome administrative process, since it implies tax transfers from public budget to public budget. However, this view would be misleading: actual taxation is the only clear and straightforward way to ensure that other public authorities and entities will actually pay the local government for the cost of local services they use and for the local expenses they generate, in a stable and equitable manner compared with other non-public entities (other means of compensations between public budgets, such as grants and compensation transfers, are less transparent, less stable and more subject to variations due to external political or budgetary factors).

78. Taxation is also the best way to make public entities internalize, in their budget, the real cost of operating in the municipality. This latter argument also applies to municipally owned properties used for non-administrative purposes (such as residential or business renting of municipally owned housing): although such taxation may appear to be a case of the local government taxing itself, this is not, or should not be so. These activities should have a separate budget and separate balance sheets (separate from the municipal budget), and the property tax should be paid out of this separate budget to the municipal budget. Indeed, instituting the property tax on these activities should be an incentive to separate the municipal budget from the budgets of municipally owned entities and activities that are not strictly administrative, when this separation has not been implemented already, and this would contribute to greater clarity and transparency of local budgets.

3.3. The taxation system must overcome technical and administrative challenges in transition economies to yield its potential

79. The new property tax system must be designed to overcome the several technical and administrative issues found in transition economies, to make sure that the reform is worth the investment and future operating costs, and actually leads to an expanded and more dynamic tax.

80. The main technical and administrative issues are: the lack of comprehensive cadastral data, and/or the scattered nature of the existing data; the still narrow market references for valuation; and the necessity of an integrated vision of the reform, which needs to include all aspects of the taxation system, from the tax base to the tax collection. All this leads to the necessity of simple, cost-efficient solutions that can be upgraded and refined further in the future, as conditions improve.

3.3.1. Lack of comprehensive cadastral data, and/or scattered nature of the existing data

81. This technical constraint implies that the fiscal cadastre should be strictly limited to the data absolutely necessary for valuation and taxation purposes, without interference from other types of cadastral requirements (i.e., the fiscal cadastre should not be required to have the same degree of precision as physical or legal registries, but should have full coverage, which is often not the case with physical and legal registries in transition economies).

82. In addition, to avoid costly duplication of efforts in the gathering of data and the future maintenance of the base, the fiscal cadastre for an ad valorem property tax should rely on two main sources of information: (i) a system of self-declaration from tax-payers and (ii) an organized access to all elements of information existing in the public and private domains, allowing the tax administration to complete and cross-check tax payers' declarations. This means that the fiscal cadastre should be fed from all relevant existing data sources from the various other registers or sources of information (such as the legal registries, the physical cadastre, transaction data from notary offices, real estate agents,

etc.). This implies overcoming institutional issues relating to cooperation between various government (and local) agencies and ministerial departments.

83. The increased use of information technology will make the data collection easier and less expensive. However, the difficulty of setting up, maintaining and regularly updating a fiscal cadastre in a cost-efficient and cooperative manner must not be underestimated. Yet, it is a prerequisite to ensuring that the reform toward an ad valorem property tax is cost-efficient.

3.3.2. Limitations of real estate markets information and price references

84. Because real estate markets are not fully developed yet, the market references for valuation of the fiscal base remain sometimes limited. This is a real problem in some less advanced countries: if land markets are extremely thin or nonexistent, then by definition market-based valuation for property tax purposes is very difficult, or even impossible, except maybe for some limited segments of the real estate sector. In such a case, the introduction of an ad valorem property tax is certainly premature. However, this constraint has already diminished considerably, compared with the situation in the early 1990s; in the most advanced transition economies, and in the medium term, it will continue to diminish, as the real estate markets develop and the number of transactions increases.

85. In the short term, in the case of existing but still limited markets, this constraint essentially means that the valuation principles, while based on market value, should remain simple, avoid excessively detailed and heavy data requirements and allow simple mass-valuation procedures. This initial simplicity of valuation formula will also ensure that the future regular updates (revaluations) can be done in an easy and cost-effective manner (note that in between the regular update, the system should also naturally include a simple indexation mechanism, to avoid a progressive narrowing of the base by inflation). Over time, as market references increase in number and variety, the methodology for valuation can be refined, but initially it should aim at robustness and simplicity.

3.3.3. Lack of an integrated vision of the taxation reform

86. To produce the expected revenues, the reform must be based on a comprehensive and integrated vision of the property taxation system. This integrated vision should be clearly described in legislation and governmental regulations.

87. To avoid duplication of costs and lower-than-expected revenues from the new tax, an integrated vision of the tax has to address all elements of the taxation system, from the set-up and maintenance of the base to the collection of the tax. This integrated vision is defined in terms of administrative process and organization, of relationships between the various actors (assessors, fiscal cadastre offices, tax collection offices, if the latter are separate from the former) as well as in terms of compatibility of software applications.

88. It also implies the necessity to adopt collection rules, at the national level, which will help increase compliance, such as the principle of taxation applied to the property rather than to the owner (or the provision, in the law, that when the owner cannot be identified or located, the tenant or user is liable); the enforcement of effectively deterrent penalties for late payment, set sufficiently above inflation and interest rates; and the adoption of dissuasive enforcement tools (such as automatic enforced debit on the debtor's bank account or salary, and the possibility of forced auction sale of the property). Investing in a new ad valorem tax base while neglecting effective coordination with collection priorities can easily make the investment in the new fiscal base a costly waste of public money.

89. Addressing these technical and administrative issues clearly calls for (i) simple, flexible, cost-efficient solutions, that can be upgraded and refined further in the future, as conditions improve; and (ii) strong central government involvement at least in the start-up phase of the reform, to provide support and directions for the set-up of the fiscal cadastre, the valuation principles and methodology (thus ensuring consistency and avoiding costly duplication of efforts), and providing the basic national rules and principles regarding tax collection and enforcement.

4. CONCLUSION

90. The move toward decentralization in transition economies, as well as the prospect and requirements of EU accession, create a growing need for local autonomous financial resources. The introduction of a modernized and reasonably decentralized ad valorem property tax constitutes one of the ways to address these needs. This is why, despite the administrative and political difficulties of such a reform, many transition economies are considering the introduction of an ad valorem property tax, and this should be encouraged. To ensure that such a reform yields its true potential and justifies the costs, however, the reform should meet certain conditions and address certain issues:

91. First, the extent of the fiscal benefits of the new tax will depend on the overall balance of responsibility between central and local authorities. On one hand, the reform must rely on significant central government involvement, especially for providing the proper legal and regulatory environment, organizing a rational information and administrative structure for property taxation, and providing the incentives for local authorities to use the tax to its true fiscal potential. On the other hand, local governments should obtain strong and stable legal guarantees of sufficient decentralization of the property taxation system. These guarantees are a prerequisite for local authorities' willingness to support such a reform.

92. Second, the property tax should remain a simple tool targeted on its core fiscal goal, integrating other goals (social, economic or administrative) only when the effect is well-demonstrated and is not contradictory with the fiscal goal. This implies an ad valorem property tax:

- based on a simple, large base, without many exemptions (except possibly for very low-value property), and in particular with very strictly limited exemptions for publicly-owned properties;
- with either a flat rate on the property (land and improvements) or a graded system with a higher rate on land;
- possibly combined with a higher rate on vacant lots in urban areas; and
- with limitations imposed on local differences in tax rates (hence the need for national regulations on tax brackets and exemption rules).

93. Third, the new taxation system should be carefully designed to take into account the specific administrative and technical challenges of transition economies. This implies the selection of simple, cost-efficient technical solutions, that can be upgraded and refined further in the future, and, although the overall objective of the reform is to strengthen the decentralization, a strong central government involvement is required at least in the start-up phase of the reform.

II. AD VALOREM PROPERTY TAX AND LAND USE EFFICIENCY OBJECTIVES IN TRANSITION ECONOMIES

94. Studies of land use patterns of former socialist economies have demonstrated that there is a clear need to encourage real estate market development and increased land use efficiency in transition economies. This also implies, in some of the less reformed countries, further divestiture of still significant publicly owned land and premises. Under what conditions and to what extent can an ad valorem property tax help meet these objectives? This section examines how the introduction of a sufficiently decentralized ad valorem property tax can help unlock further divestiture of public properties owned by local authorities, and under which conditions such a tax can be an incentive for increased urban land use efficiency, while remaining compatible with the core fiscal objective of the tax discussed in the previous section.

1. THE NEED TO ENCOURAGE THE DEVELOPMENT OF A REAL ESTATE MARKET AND MORE EFFICIENT LAND USE IN TRANSITION ECONOMIES

1.1. A history of highly distorted land use patterns

95. Studies of the land use patterns in former socialist cities¹⁰ have shown that these “cities without land markets” have created a highly distorted spatial pattern. Administrative decisions allocating land use were made under greatly distorted price signals (no site value for land; no interest on capital; far below world market energy prices), and there were no incentives to the recycling of land use over time (because of the lack of price signals). This resulted in a perverse population density gradient, increasing as one moves away from the city center, in total contrast with market cities. The typical former socialist city has a high density of population far away from the center, in distant suburbs, but a high concentration of industries (often rusting factories) in prime locations in the center, with the share of land allocated to industrial use often two to three times higher than in market cities of comparable size and economic function. This structure maximizes inefficiency in terms of energy use, infrastructure and commuting requirements, diminishes the international competitiveness of the city and has a significant environmental cost.

1.2. Emerging patterns based on market value are exactly opposite to the inherited pattern

96. Compared with market-based land use patterns, the inherited socialist pattern means that with price liberalization, relative prices tend to shift rapidly, as a recent study on Cracow¹¹ demonstrates, leading to a situation in which a part of the residential stock of high-rise suburban mass housing has a very low and decreasing value and may even

¹⁰ Alain Bertaud and Bertrand Renaud, *Cities without land markets, lessons of the failed socialist experiment*, World Bank Discussion papers, Washington DC 1994.

¹¹ *Cracow in the 21st century: Princes or merchants?*, Alain Bertaud, with support from Robert Buckley, Margret Thalwitz and the Cracow Real Estate Institute, November 1997.

end up with a negative asset value for a significant period of time, as rents compared with housing costs are out of balance. By contrast, opportunities for capital gains in the center are at least potentially large. In particular, there is a need for more land and building space dedicated to services and commercial activities in the center, where the shortage of such space leads to very high prices for new office or service space in capital cities. Regarding housing, the market trends lead to higher prices and density in the most accessible areas around the city center and along the transport corridors.

97. Over time, the development of real estate markets and the price liberalization produce, as the Cracow study illustrates, a move toward a population density profile opposite to the inherited socialist profile. The new profile, comparable with trends observed in market economies, is negatively sloped from the high population center to the periphery, and a corresponding land price gradient pattern, where the price decreases as one moves away from the center. In other words, the emerging price patterns based on market value are exactly opposite to the initial urban population density profile and land use patterns.

1.3. Further divestiture of publicly-owned properties is needed in the less-reformed transition economies

98. Despite several years of privatization and restitution, municipal governments in many transition countries, in particular the less advanced on the path to reform, continue to be the largest owners of urban land and nonresidential real property or administrators of properties owned by central governments. Exact data regarding the size of public property holdings do not exist in most countries because either the process of registration of public property has not been established yet or has not been completed. However, available fragmental or sample data indicate that in some countries, for instance in Russia, public holdings clearly still dominate the private sector holdings.

99. The magnitude of land and/or non-residential property owned or controlled by local governments often goes far beyond what is needed for public use. Surplus property is used for business purposes by municipal or public-private enterprises or directly as income-generating property by municipal governments themselves. Vacant urban land is often not used at all. In most instances, the efficiency in the use of surplus property for generating revenue for municipal budgets is very low, by any standard.

100. The arguments for property privatization are well known: the private sector is better able than public authorities to develop, use and recycle real estate properties according to market signals and, hence, is most likely to pursue the land's "highest and best use." In addition, in some transition countries, the economic benefits of a new wave of divestiture of real property to the private sector could be significant because current public holdings of urban real property are so large (and monopolistic in some subsectors of the real estate markets) that they effectively block market transition in many sectors of the urban economy.

101. Further property divestiture would lead to a reduction of municipal involvement in real estate management and business activities. Currently, in some countries such as Russia or Bulgaria, local governments are heavily involved both in direct real estate property management and in various industrial or commercial activities through municipally-owned companies (in which case the municipality owns the company, which itself holds the real property in its balance sheets). Available data indicate that in both cases, incomes generated by these assets under municipal management are, as a rule, much lower than the incomes that could be expected if the properties were managed by the private sector.

102. In such a context, there is a clear need for encouraging a further privatization of publicly-owned properties, and for supporting the trend toward increased urban land use efficiency led by market price signals, which favors the recycling of land, in-fill development and redevelopment of underutilized land. Among the possible incentives for encouraging such a move, is the introduction of an ad valorem property tax, based on the market value of real estate, which encompasses the concept of “highest and best use”, and is thus an incentive to recycle properties to their most efficient possible use.

2. THE RELATIONSHIPS OF AN AD VALOREM PROPERTY TAX WITH OTHER TAXATION AND REFORMS OF REAL ESTATE MARKETS

103. Before discussing what could be the best suited characteristics of the property tax itself with regard to land use objectives, an examination of the interactions between an ad valorem property tax and other reforms and regulations of the real estate market is necessary. In light of the objective of developing real estate markets, should the property tax reform be linked to reform of the legal registries, the latter being another crucial element of policies encouraging real estate markets? What relationship should there be between the ad valorem property tax reform and the introduction of other land and real estate market regulations and reforms?

2.1. The introduction of an ad valorem property tax should not be tied with the development of proper registries of ownership titles and transactions

104. A frequent but misplaced expectation is that the implementation of a comprehensive ad valorem property tax, based on a renovated or newly built fiscal cadastre, will at the same time allow the development of proper registries of real estate ownership titles and transactions, and that the two reforms should be conducted together. It is largely agreed that the development of proper and comprehensive legal registries of real estate ownership and transactions is a necessary element for the development of real estate markets.

105. However, this does not mean that the two reforms should be tied together, because such a link is likely seriously to delay the establishment of the fiscal cadastre, which has different needs than those of a legal registry. For instance, the fiscal cadastre is not particularly interested in precise boundary quarrels. More generally, the fiscal cadastre is less concerned with ownership uncertainties. A basic tax principle is the

principle of “economic reality”, as opposed to the legal description of reality and, for this reason, the tax law often provides that if the owner of the property is not identified, then its user is liable for the bill. Another way to address the issue of legal uncertainties is to have the law provide that the tax is applied to the property itself, and again, if the owner is not identified, the user is liable. Therefore, tying together the building of both legal and fiscal cadastres carries a real risk of over-burdening the tax reform and delaying it for years because of legal issues that are less relevant for tax purposes.

106. The implementation of a renovated property tax *may indirectly support* the development of real estate markets and clarification of property rights, by giving a sense of increased security to taxpayers claiming ownership rights (even if payment of the tax is by no means a sufficient proof of property ownership), and also by revealing potential legal issues that claimants to user and ownership rights will then be encouraged to settle. However, these effects will remain indirect and should not be overestimated.

2.2. Real estate transactions should not be overly taxed

107. Taxation of real estate transfers (sales, inheritance) is a specific form of real estate taxation that is quite widely used across developed and developing countries but should be applied cautiously because of its potential to impede the development of real estate markets, or at least their transparency, and, as a result, impair the very base of the “regular” property tax levied annually. If the effective rate of the transaction tax is too high, it can impede the declaration and registration of transactions at their true price, thus impairing both the transparency of the real estate market, and the development of a useful source of data for the base of the annual property tax based on market value of properties.

108. The taxation of property transactions, if needed to complement fiscal resources, should therefore be set at a reasonable rate. Also, whenever possible, it should be a tax resource and responsibility of local authorities, so that there is a comprehensive view of the entire tax burden of real estate properties by a single taxing authority, and an awareness of the sensitivity of the links between the two types of property taxation.

2.3. Land use regulations should be consistent with the objective of developing real estate markets and a market-based ad valorem property tax

109. An ad valorem property tax will have a positive effect on land use, provided there is enough liquidity in the real estate market. If excessive difficulties and obstacles in recycling land to highest and best use, due to contradicting land use regulations, limit the number of transactions, then the tax will have little effect on land use efficiency. It should be noted that this would, in turn, generate a lower tax yield, from a fiscal point of view.

110. Poorly conceived land use regulations, such as excessively low floor to occupancy ratios, or inadequate zoning, can limit the number of transactions or greatly reduce land and property values per square meter. This would be the case in Cracow, for instance, according to the recent study on this city cited above. Therefore, it is necessary, when considering the introduction of an ad valorem property tax, to conduct an audit of the

impact of land use regulations on the prospects for real estate market development and, therefore, on the property tax, and such consistency audits should be conducted regularly.

2.4. The development of adequate funding for real estate transactions is necessary

111. Similarly, the lack of adequate financing for property transactions can also severely limit the number of transactions, hence the positive effect that an ad valorem property tax can have on the recycling of land (and buildings) use, and also, in the end, on the fiscal benefits of the new tax. A reform of the property tax toward a market value-based taxation will therefore produce its best results if an active policy of developing financial markets for real estate transactions is also implemented.

3. AD VALOREM PROPERTY TAX AS A POSITIVE INCENTIVE ON LAND USE PATTERNS

112. Introducing a sufficiently decentralized property tax could encourage further divestiture of municipally owned land and premises. Beyond this one-time or transitional effect, an ad valorem property tax is generally viewed as affecting land use patterns, under certain conditions and assumptions (tax incentives). In this context, the tax can present various characteristics (regarding its base, the valuation principles, the rate structures, the exemption policy, etc.) that will have different, sometimes opposite, effects on land use patterns. Therefore, in the context of the trend toward the introduction of an ad valorem property tax in Central European countries, it is necessary to examine what could be, in practical terms, the best-suited characteristics of the new property tax, with regard to the objective of increasing land use efficiency and speeding up the process of moving away from the inherited socialist pattern, while remaining compatible with the core –and essential—fiscal objective discussed in Chapter I.

3.1. The introduction of a decentralized ad valorem property tax could help unlock further divestiture of public land and real estate to the private sector.

113. Privatization of municipal assets, and especially real estate property, quite commonly faces a strong opposition at the local level, in the less advanced transition economies. This reluctance is based on the consideration that municipally owned properties are assets that have income-producing capacities, which are under local control. Therefore, local authorities tend to consider that privatization of these assets would result in a decrease in the basis for locally raised and locally controlled revenues, and in an increased dependence on central state subsidies, which are often considered unreliable and unpredictable. In the current context, privatization of these assets means that they become private assets, yet they cannot be taxed at market-based values. This way, in terms of local budgets, privatization leads to a substitution of rents, more or less market-based (depending on the countries and cities), with non-market taxes (i.e. area-based tax).

114. The reluctance to part with surplus public property, not directly needed for local administrative functions, through property privatization, is based on the absence of a reliable and controllable link between local private real property, on the one hand, and the

raising of local public resources, on the other. A decentralized ad valorem property tax would provide such a link. If local governments knew that privatization of surplus property is not a loss of wealth, but rather the creation of a permanent, economically dynamic and controllable base for raising local revenues through a modernized, ad valorem property tax, they would be less reluctant to envisage further privatization of surplus property. This change of perception among local authorities can realistically be expected only if the modernized property tax is sufficiently and credibly decentralized, as defined above.

115. The introduction of a sufficiently decentralized ad valorem property tax, by offering the possibility of substituting a new, stable, adequate and more dynamic source of revenue for the current low-productive direct management of municipally owned properties, may help unlock further privatization of publicly owned land and premises, especially in the less-reformed countries where public real estate is still prevalent.

3.2. The ad valorem property tax influence on land use patterns

116. Beyond this one-time effect, an ad valorem property tax acts as a tax incentive on allocative decisions and is generally considered as having effects on land use patterns, under the following conditions and assumptions:

- The degree of influence of the tax on land use patterns will depend on the effective tax rate, which needs to be significant enough to generate substantial response in the allocation of land and capital.
- The effect of the tax depends on the elasticity of the supply of land and capital to changes in the after-tax rate of return. Assumptions in this regard remain debated, but, as outlined in the first chapter (see Box 1), there is a convergence toward the following conclusions: changes in the property tax rate will have allocative effects:
 - in the long run,
 - at the national level where capital supply is generally considered elastic (but land is fixed), and
 - at the local level, as well as in the case of national changes affecting only certain categories of properties, where both land and capital supply are elastic (see Box 2 for more details).

Based on these assumptions, property tax is thus considered a tool to influence land use patterns, generally with the aim of encouraging a more rapid and intensive pace of development by discouraging speculation, inducing earlier development and higher density.

117. In the context of transition economies, it is interesting to note that speculation, i.e., the holding of land or properties that are not put on the market, can be voluntary (individuals and mostly professional speculators acting rationally, given the prevailing market incentives, and holding the property until they think they can get the best price for

it), but also involuntary (i.e., properties that have been forgotten by the owner or whose title is so fuzzy that nobody can sell them). The latter case, which is the worst because involuntary speculators (including governments) often end up never selling their assets, is likely to be more frequent in transition economies, given the inheritance from the socialist era, and in these cases, an ad valorem property tax should be particularly useful as an incentive to put these properties on the market, hence encouraging a recycling to highest and best use.

Box 2:

Theoretical effects of changes in the property tax burden. Assumptions in this regard are still debated, but there is a convergence toward the following conclusions: in the short term, both land and capital are fixed, whether at the local or national level, hence changes in the tax have no allocative effects. In the longer term, capital is elastic at the local level (i.e., reacting to significant differences in tax burden from one area to another), and is most often also considered elastic at the national level (although this is discussed). As for land supply, it is fixed at the national level but can be considered elastic at the local level if conversion of rural land at the urban periphery is possible. From this it can be inferred that, in the long run, a nationwide change in the effective property tax rate (uniform across the country) will have either: (i) no significant allocative effect, if the supply of capital is deemed fixed (the land itself being fixed at the national level). The only effect of an increase in property tax is to lower the price of properties, because their present-value is decreased by the higher tax; or (ii) on the contrary, the nationwide tax change will affect the supply of capital, if the latter is considered elastic, by reducing the supply until the after-tax rate of return returns to the pretax level. As for a change at the local level (still in the long run), or a national change affecting only some categories of land and structures, it will lead to changes in the allocative pattern, favoring reallocation of investment from taxed to non taxed (or less taxed) areas or categories, because supply of both land and capital are flexible at this level.

3.3. The characteristics of the tax will determine its actual impact on land use efficiency

118. The actual extent of the tax influence on land use patterns, and the direction of this impact (positive or negative from a land use point of view), depends to a large extent on the main characteristics of the tax itself. Beyond the theoretical assumptions, empirical evidence of the tax impact on land use patterns that can be drawn from available country examples is not always conclusive. However, it seems that this lack of clear empirical evidence is mainly attributable not to the tax in itself, but rather to:

- (i) weaknesses in the implementation of the tax itself, such as an excessively low effective tax rate, making its impact trivial compared to other factors influencing allocative decisions;
- (ii) contradictory rules embedded in the property tax system itself (such as certain exemptions, preferential treatments of certain categories of properties or taxpayers, etc.); and
- (iii) contradictory or offsetting effects of factors and policies other than the property tax, influencing allocative decisions in opposite directions.

In many cases, these contradictions happen because various other economic and/or social purposes are pursued simultaneously through the property tax.

119. It is thus necessary to examine the main possible characteristics of the property tax that could be considered by governments pursuing tax reform in transition economies, in order to understand which features would best serve the land use efficiency goal, while remaining compatible with the core—and essential—fiscal objective discussed in the first chapter.

3.3.1. Higher taxation of land

120. *From a theoretical point of view*, higher taxation of land, compared with improvements, is a tax feature that is consistent with the objective of encouraging land use efficiency and discouraging speculation. It can take the form of a “site value” system (taxation of land only) or a milder form, the “graded system” (higher rate applied to land versus improvements). In both cases, the rationale is that the site value or graded system will minimize or suppress inefficiencies created by taxation of improvements (i.e., by decreasing or suppressing the disincentive to invest in improvements which is created by a tax on buildings), lower the acquisition value of land (by decreasing the capitalized expected returns), encourage earlier development of land and stimulate use to its highest potential (by increasing the cost of holding unused or underused land, compared with developed land).

121. However, these expected benefits (compared with a tax on both land and improvements) are strongly questionable in the case of a pure site value system with excessively high rates, or with a 100% rate on land rent (i.e., a system taxing away the entire return on land investment), as is advocated by proponents of the “George” land tax. In fact, as discussed in details in Box 3 below, the expected benefits of such taxation, i.e., the possibility of taxing 100% of monopoly land rents from owners with an absence of economic distortions, are based on a contested assumption of fixed land supply (at least locally, or for particular uses, land supply in fact is not fixed). In addition, such a system raises difficult questions of valuation, and given the nature of the tax (taking away 100% of the land rent), errors in valuation would have powerful distortionary (and inequity) effects. Moreover, the acceptability of the tax would be very problematic, because of the higher tax rates implied (compared with taxation of a larger base including both land and improvements) and because of the horizontal inequities among different types of investments that would be generated by its implementation ex post. Finally, and perhaps decisively, such a tax would create a serious problem of incentive to hold the land (in the end it logically leads to a system of public ownership with land leases approximating the tax) and to allocate it efficiently (see Box 3 below). Therefore, despite its attractiveness at first glance, such a tax would have strong adverse effects and should not be seriously considered when contemplating the introduction of an ad valorem property tax.

Box 3:

The case against the “George” tax. Even today, some people seem tempted by a “Georgist” type of land tax, i.e., a taxation of land only (excluding all improvements and infrastructure) at 100% of land rents, as advocated by Henry George, a 19th century social reformer whose best known work is *Progress and Poverty*. However, assuming such a system were feasible, this (as well as a site value system with very high rates, even below 100%) is likely to have much more negative than positive effects, from a land use efficiency point of view. Henry George, along with Ricardo and Marx (among others), held the classical view that land is in fixed supply, and therefore a land tax will not generate the deadweight loss that a tax on other factors of production (labor, infrastructure, etc.) generate, and thus will not distort economic decisions. Land rent, which is socially concentrated in the hands of landowners benefiting from a monopoly rent, can thus be taxed at a 100% rate, generating the means for needed public spending without creating economic distortions. Despite its attractiveness, this view is unfortunately strongly questionable, for a series of (cumulative) reasons, both theoretical and practical:

- The assumption of fixed land supply has been questioned by the neoclassical view. As seen earlier (see Box 1), it does not hold when land is considered for a particular use, or locally: The supply of land in a particular urban area has some positive price elasticity, because of possible expansion in the surrounding countryside. Therefore Henry George’s claims (on the absence of distortion) will only be met if all substitutable land is taxed the same, i.e., if the 100% land tax is imposed nationwide. If not, distortions are reintroduced, and the rationale for limiting the base to land is lost.
- Practically speaking, not much land devoid of all improvements can be found, especially in urban areas, where even vacant lots are serviced with infrastructure. As a result, reasonably accurate valuation is difficult and distortions will be reintroduced. Since the tax is supposed to take away 100% of the rent that can be expected from the land, an accurate valuation would lead to a zero return, overvaluation would lead to an inevitable loss for the owner and under valuation would create undue windfall benefits for owners.
- The acceptability of such a tax would be very problematic. First, because of the high rate implied (compared with a taxation of a larger base including land and improvements); second because in every country where all or part of the land has already been appropriated by private owners (and this now applies to several transition economies), it would create significant horizontal inequities due to the ex post (unanticipated) nature of the tax. Someone who has invested his/her savings in land would see his/her savings wiped out by taxation, while another who has invested in equities would be untouched.
- Such a taxation would create a problem of incentive to hold the land and to allocate it efficiently: a 100% tax on rent in fact logically implies public ownership of land, with land leases to users at approximately (ideally) the tax. If all the return is taxed away, where would the incentive be to hold land and to allocate more valuable land to more efficient use? Here two situations can be distinguished: (i) In some of the less transformed transition economies, it can be doubted that the technical capacity or the political will exists, or would prevail, to institute transparent public systems of land allocation to auction the leases to those with the most productive plans for the land. A continued government allocation of land (rather than market allocation) does seem risky in this context. (ii) In capitalist or closer to capitalist economies, it could be argued that if the tax is levied as if the land were efficiently used (whatever the actual, current use being made), then there would be an incentive to adopt efficient use to avoid losses. However, who would want to hold an asset that can only at best provide a zero return if all efforts are made to keep losses at zero, or at worst generate financial losses if the choice of use reveals itself as inefficient (or if the land rent that can be expected from the property is overvalued by the tax administration, which brings us back to valuation problems). It could be further argued in defense of the “Georgist” tax that investors would accept a zero return simply because they have no choice and need the land to make a profit on other factors of production (labor, infrastructure), but this brings us back to the question of the inelasticity of land supply, which, as seen above, is not held true in the neoclassical view. Therefore, taxing the land only will affect the capital/land and labor/land ratio. In addition, even if the question of elasticity of land supply from a local (i.e., sub-national) or particular use were solved by a uniform nationwide land tax, distortions would remain with other competitor countries, exactly along the same principles as for distortions among local jurisdictions: with the increased ease of investment flows from one country to another, the scale of the country itself can be seen as “local” on the international scene.

122. *From an empirical point of view*, there are in fact few examples of pure or graded systems that have been analyzed. One well-known example of modification of land tax rates to influence land patterns is the increase in land tax introduced in Japan in the early 1990s to dampen the land speculation and rocketing prices that were occurring at the time. Although it can be argued that other factors have contributed to the rapid reversal of the land market situation in Japan since then, this policy is considered today by some analysts as among the main reasons for the ensuing depression of the real estate market. Koichi Mera from the Tokyo University Urban Development Institute, for instance, strongly suspects the new Japanese property tax of being largely responsible for the collapse of the economy. Changing the rules too fast, with not enough supply elasticity, could lead to such adverse effects, even if the intentions were good (the initial intentions were moderating land price increase and encouraging a more intensive use of urbanized areas).

123. Examples of site value systems can be found in a limited number of countries such as New Zealand or some parts of Australia, or some developing countries such as Jamaica or South Africa. Empirical results on the effects of the tax in these countries are mixed, mainly for the reasons cited above, i.e., reasons not by nature linked to the tax itself but more to the way it is implemented or its environment. For instance, in Australia, a study presented in 1991 involving a sample of 56 local authorities in the Melbourne area concluded that the empirical results were mixed and rather inconclusive. In New Zealand, another study considers that various overriding elements, in particular contradictory public incentives, have played against the theoretical effects to be expected of a site value tax, leading to a general pattern of low density of urban land use, and encouraging profitable speculation on vacant land (see Box 4).

124. *In terms of administrative feasibility*, the site value system can seem more simple than the capital value one, because the registering and valuation of improvements is omitted, a strong argument for some transition countries where data on improvement is scattered and incomplete.

125. However, site or graded systems may also raise difficult valuation issues because they require the ability to make separate valuation of land and improvements, which is not always easy in urban areas where samples of comparable vacant lots are rare. The site value system also presumes a clear definition of undeveloped/ unimproved land, which is not always clear cut in practice, as the New Zealand example shows (this country had to switch, in 1970, from the concept of unimproved land to a concept of land value which excludes structural improvements but does include some man-made nonstructural improvements). The higher the tax rate on land, the wider the distortionary consequences of such valuation uncertainties, the extreme case being a “Georgist” tax at 100% of land rent (see Box 3 above).

126. *Finally, in terms of compatibility with the fiscal objective* of the property tax, a site value or graded system can be politically more difficult to manage because with a narrower base (since improvements are excluded), higher effective tax rates will be needed to achieve the same amount of revenues (see Chapter I).

Box 4:

(i) ***Study of site value effects on a sample of 50 cities in Australia.*** This study, conducted by Kenneth M. Lusht in 56 local authorities in the Melbourne area, and funded by the Lincoln Institute of Land Policy, reached mixed conclusions. The hypothesis of an absence of association between the stock of residential improvements and the site value tax could not be ruled out, and the same conclusion applied to the flow of alterations and additions to the residential stock. The association between the site tax and the stock of all improvements was negative. On the other hand, a positive association was found for the flow of new industrial developments. In addition, there was evidence supporting the analysis that under certain circumstances, the site value tax, rather than lowering land prices (as the theory leads to expect), may instead stimulate higher land prices, the argument for this trend being that the incentive effect of reducing the tax on improvements will tend to dominate the liquidity effect of increasing the tax on land, resulting in greater demand for land and higher, not lower, land prices.

(ii) ***Study of the New Zealand case.*** This study, presented by Robert Hargreaves, from Massey University, at the Lincoln Institute of Land Policy Conference of 1991 on Property Taxation and Land Policy, considers that overriding elements, external to the property tax itself, such as lifestyle preferences, but also contradictory public incentives such as the quasi absence of capital gains tax, the subsidization of loans for first home-owners coupled with the provision of infrastructures and services to turn more farm land into housing suburbs, have played against the theoretical effects to be expected of a site value tax and have led to a general pattern of low density of urban land use, and encouraged profitable speculation on vacant land.

127. In conclusion, while the theory tends to conclude that a graded system, or a site value system with reasonable rates, could have higher positive effects on land use patterns than a system taxing both land and improvements at a single rate, there is little empirical evidence to corroborate this, mainly, it seems, for reasons due to external contradictory factors. Simultaneously, there are strong theoretical and practical reasons why a pure “Georgist” site value taxation at 100% of land rents would in fact have more negative than positive effects and should not be considered as an option when reforming the property tax toward an ad valorem model.

3.3.2. Lower taxation of urban land

128. Conversely, there is no good reason to take the opposite stand and to tax more lightly developed land in urban areas, compared with buildings (the specific question of vacant lots is discussed below). Under-taxation of land, compared with buildings, can be observed, for instance, in the area-based tax in Poland, where the rate on residential buildings is 5.5 times higher than the rate on land area, and the rate on nonresidential buildings is 30 times higher. Such differentiation essentially acts as a disincentive for improvements (the higher the added value of improvements on a given piece of land, the heavier the increase in the taxation burden). There is no reason to tax land value, which is largely attributable to actions of local authorities (through zoning, the provision of infrastructure, etc.), under its market value, or at lower rates than the improvements (premises) added on it.

3.3.3. Specific treatment of vacant lots

129. There are good arguments for taxing vacant land at least at the same rate as improved land, and even, under certain conditions, at a higher rate, especially in transition economies where the issue of the intensity of land use and the need for the recycling of low-efficiency uses are so crucial.

130. Higher taxation of certain categories of land, and, in particular, of vacant lots—more rarely of vacant residential structures (as recently in France)—is based on the same reasoning as above (graded system), and is intended to discourage speculation and encourage earlier, more rapid and dense development of urban areas. It can therefore be very useful in a context of high unsatisfied demand for residential and/or commercial premises and of a strong need for the recycling of current uses, as is the case in most large cities in transition economies. This tax incentive should, however, be used carefully and selectively (as opposed to a uniform nationwide measure), and left to local decision. It is justified only in areas where unsatisfied needs are observed, only as long as such needs are observed, and should be used in conjunction with an urban development plan designed to yield the most rational pattern of urban growth. Otherwise, this measure, which by definition is intended to act as a tax incentive, i.e., a voluntary distortion of market signal, could lead to an oversupply of developed real estate.

131. In any case, there is certainly no reason to tax vacant land at lower rates than developed ones, or even to exempt them, as governments are sometimes tempted to do, on the ground that the tax should reflect a charge for urban services used by serviced/improved lots, based on actual use. In fact, even on these grounds, lower tax or non-taxation is not obvious because vacant lots also impose costs on the provision of infrastructure and services (size of the networks, distances, potential excess capacity for future developments, etc.). In addition, from a land use point of view, the absence of taxation on vacant lots does not discourage speculation or encourage advancement of development, on the contrary.

3.3.4. Lower effective rates or exemption for newly constructed buildings

132. This preferential treatment would act as an incentive to earlier/more intense development of the supply of new real estate, and its coupling with higher taxation of vacant lots would therefore be consistent (see above) in an attempt to respond to the needs of transition economies in which the lack of adequate housing and business property is felt strongly in big cities. However, it would be contradictory with the fiscal objective of the reform, while likely being socially regressive (see Chapter I), and is thus not recommended.

3.3.5. Preferential treatment of agricultural land

133. Preferential treatment of agricultural land mainly raises issues about the treatment of areas at the urban periphery, and the possible effects on land price increase in urban areas and land speculation. Very often, agricultural land is granted *preferential treatment*

through a system of assessment based on *some kind of measure of the revenue generation provided by the current usage (current use value)*, rather than on market value (highest and best use). This special treatment is mainly based on two sets of reasons. One is linked to social and political considerations. The other (not excluding the first) is more preoccupied with preservation of rural land, and is thus aiming at influencing land use patterns. However, there are two limitations to the effectiveness of this tax feature:

- (i) *The objective of preserving rural land cannot be obtained simply through the tax preference.* The lower property tax rate applied is intended to prevent the conversion to urban use that would otherwise be encouraged by the standard tax rate based on value at highest and best use. Examples of such preferential taxation can be found, for instance, in Japan before the reversal of policy in the early 1990s (see above), in France or in Canada. However, the experience in Canada, according to a study on the subject (presented by Julian K. Greenwood and Jennifer A. Whybrow, Government of British Columbia, to the Lincoln Institute Conference on Property Tax and Land Policy in 1991), shows that the lower tax does not suffice, by itself, to prevent conversion of land to urban use. The main reason is that the tax differential is not high enough, weighed against the possibility of selling at several times the price a potential farmer buyer would pay. The preferential tax treatment in itself is therefore not sufficient and must be coupled with other regulations, in particular a strict zoning (in which case the lower tax on land with restricted development rights reflects the limitations imposed on the “highest and best use” possible under the regulations).
- (ii) *The preferential treatment of rural land can fuel land speculation at the urban periphery, and preservation of these rural fringes may not constitute the highest priority to address.* The main issue, and objective of land policy, may not be preserving agricultural land in the urban periphery but, on the contrary, addressing high and rapidly increasing land prices in urban areas. In this case, as the Japanese case illustrates (see above), removing preferential treatment for agricultural plots in urban fringes can, in fact, be a way to try to reduce land price increase and speculation, by increasing the land supply. This scenario is more likely in EU accession countries where the progressive reduction of the still large agricultural population (compared to EU ratios) is likely to lead to an increase in the urban population over the coming years and after EU accession (comparable to the shift that occurred in Western Europe during the 1950s and 1960s).

134. Therefore, transition countries that are considering moving to a market value-based taxation system, while retaining a specific (preferential) system based on current use for agricultural land, should be careful about the way agricultural land at the urban periphery will be treated, and should insert this in a comprehensive vision of the growth of the urban area based on a well designed land use plan.

3.3.6. Differential treatment of industrial/commercial properties

135. Differential treatment of industrial and commercial properties, whether higher or lower, has little justification in terms of land use objectives and, in the case of lower taxation, can generate serious adverse consequences in terms of fiscal revenues, while not having any real impact in terms of land use.

136. *Heavier taxation:* Industrial and commercial properties are often taxed more heavily than residential properties, including in the current area-based systems of accession countries, for reasons based on “ability to pay” and “equity” arguments. This is the case, for instance, in the current, area-based Polish system, where nonresidential land and buildings are taxed much more heavily than residential properties. However, this may be justifiable only from a fiscal revenue point of view. From an equity point of view, in the long run, the result is far from obvious (see Chapter I: most of the tax is passed on to consumers). From a land use efficiency point of view, this higher taxation does not have any sound basis. It essentially distorts allocative decisions, favoring residential use over industrial/commercial use, while, in an ad valorem system, a flat (similar) rate on both uses would normally suffice to ensure that the choice of uses is based on the highest and best use, which may be one or the other type of use, depending on local and national circumstances and needs.

137. In transition economies, where space available for commercial and services activities is in short supply in the cities, taxing these uses more heavily is counter-productive. Regarding the industrial sites, the goal should be to relocate them from the center to the periphery, and this will be achieved by (among other means) a taxation of the enterprises’ real estate properties at market value (an incentive to sell to more efficient users and to relocate in cheaper, more peripheral areas), not by taxing more heavily all industrial sites compared with residential ones.

138. *Lower taxation:* An opposite but also frequent case is the lower taxation (or even exemption, sometime temporary) of particular areas that seek to attract industrial/commercial investments. However, this will influence investment decisions only if:

- one or a limited number of areas/municipalities are using this tool (in other words, a lower uniform taxation nationwide will have no effect), and
- if the difference in the effective taxation rate is significant enough to have an impact on investment decisions. This latter condition is not easily met because private investment decisions factor in many other elements, such as the availability of labor with the type of skills needed, access to services, inputs, distribution facilities and infrastructures, which can easily outweigh the comparative property tax incentive (or disincentive) of a particular municipality.

139. The main result of such preferential treatments, if left unregulated by minimal national limits, is thus likely to be a perverse competition, among local authorities, for ever lower rates, with two adverse results: (i) a depletion of local authorities' badly needed revenues raised from the property tax and (ii) an absence of real impact on allocative decisions, the pervasive breaks throughout the country not being able to really make a difference at local level and only resulting nationwide in adding a bias in favor of capital-intensive development.

3.3.7. Preferential treatment of owner-occupants

140. Such preferential treatment has as a stated goal the encouragement of ownership, which, aside from likely being regressive from an income distribution point of view, is a political or social goal but not a land use efficiency goal. From a land use perspective, there is no reason to tax more lightly certain properties because they are owner-occupied than similar ones having the same market value, which are rented out or used for nonresidential purposes. This only creates distortions in allocative decisions.

141. In particular, in transition economies, where ownership of housing has often been transferred to sitting tenants, such a preferential treatment would not encourage households to become fully aware of the real market value of the assets they have acquired, hence delaying their possible recycling to highest and best use. It would also create unearned windfall gains for households that benefit the most from the preferential system, thanks to the growing new trends in market value, as illustrated in the Cracow study for instance (the extreme example being the tax benefit for a household that has acquired a property with growing market value compared with a household that benefits very little or not at all from the tax break because its property is of very low, even decreasing value, and is close to or under the threshold for taxation).

3.3.8. Progressive taxation system

142. *Progressive rate structure* according to the property value has income distribution goals, which are well served by this structure (see Chapter I), but from a land use efficiency point of view, it has negative allocative effects. It will create a disincentive to improvements and upgrades, and to engaging in a more intensive use of the land (improvements will push the property into a higher tax bracket), if the tax "pain" of moving up to the next bracket is high enough to outweigh other considerations in favor of improving the property (such as capital gains, comfort for owner-occupant, etc.).

143. *Exemption of low value properties*, which is one particular form of progressive taxation, as discussed in Chapter I, favors both income progressivity (social goal), and lower collection costs (fiscal goal), but, from a land use point of view, it raises the same kind of issue as a progressive rate structure, i.e., it may have disincentive effects on upgrading and improvements. However, if the threshold is set low enough, given that there are many other factors motivating improvements, the disincentive effect can be limited.

144. *Progressive rates according to household revenues* would have distortionary effects on allocative decisions and would prevent the strongly needed recycling of land and properties in transition economies: the exempted properties would escape the tax incentive to recycle and relocate according to highest and best use criteria, to help serve social purposes that would be best addressed through other means.

3.3.9. Exemptions of publicly owned properties

145. This very frequent exemption has clear distortionary effects, from a land use point of view, because it allows part of the city area to avoid the tax incentive to locate and relocate according to market signals on the highest and best use of the area they occupy (in addition, as mentioned in Chapter I, such exemptions have negative fiscal effects). This issue of distorted incentives in land use patterns is especially crucial in transition economies where (i) the administrative offices, as well as all government and quasi-government companies, such as railways or utilities, like all other activities, were located according to non-market criteria, and (ii) real estate stock owned by such public or quasi-public entities (land and/or buildings) is sometime still a significant part of the city area.

146. Therefore, land use considerations lead to the same conclusions as fiscal ones: As argued in Chapter I, exemptions should be strictly limited to land and buildings owned and used by the local taxing authority for official administrative purposes, and should not be granted in other cases (when the public entity owning or using the land is not the municipal authority acting for municipal administrative purposes. See Chapter I for more details). This will ensure that incentives to relocate according to best use criteria apply, to the greatest extent possible, to all public operators.

3.3.10. Annual rental value tax

147. In addition to the debate about easiness of administration (for which the conclusions are not clear), this particular method of valuation and taxation, which is quite widely used, is often criticized from the land efficiency point of view, because it taxes the present-use value, while capital-based taxation allows taxing property on “the highest and best use” basis. The critique is quite strong, and persuasive, in the case of vacant lots, which in some extreme forms are not taxed at all (because of the absence of rent revenue), in which case the terms of the debate in fact come back to the ones about the non-taxation of vacant lots, which is not recommendable (see above).

148. In practice, rental value taxation systems are often completed, whenever no rent can be assessed, by some derivation of capital valuation (converted to annual revenue). Capital value systems also sometimes use derivatives of rent value assessments. Thus the contrast between the two systems should not be overstated. From a land use efficiency point of view, however, a valuation based on capital market value of properties, which encompasses the capitalized revenues expected from the highest and best use, remains more pure and adapted to the goal of promoting land use efficiency than a valuation system based on revenues raised by the current use of the property.

4. CONCLUSION

149. The discussion of the effects of the various characteristics that can be given to an ad valorem property tax demonstrates that, if such a tax is to have positive effects on land use patterns, it is essential to select key features that will avoid major contradictions in objectives, and that are likely to have combined effects consistent with the desired direction in terms of land use.

150. *This means in particular that the following should be avoided:*

- The new ad valorem taxation system which is selected must avoid features that have social more than land use efficiency objectives and which, in addition, are likely to have contradictory effects. This applies, in particular, to inadequate treatment of agricultural land at the periphery of urban areas (excessively rigid preferential treatment not coupled with a comprehensive land use plan), preferential treatment of owner occupants and progressive rate structure.
- The ad valorem taxation system should also avoid taxation rules that are pursuing economic or land use goals, but which, in fact, will negatively affect the efficiency of land use patterns. This applies in particular to the under-taxation or non-taxation of vacant lots, lower taxation for properties located at the urban periphery, specific treatment of industrial and commercial uses (either through excessively high taxation or on the contrary through preferential treatment or exemption of such activities), and excessive differences in effective tax rates from one jurisdiction to another.

151. *By contrast, a property tax system that would encourage land use efficiency would have the following characteristics:*

- a valuation based on capital market value (rather than annual/rental value), and encompassing “the highest and best use” of property (rather than its current use),
- a simple, flat rate system (in contrast to a progressive rate structure),
- possibly combined with a higher rate on land (moderately graded system) and, under certain conditions, on vacant lots (in any event this should be left to local decision),
- a large base involving very few exemptions (and in particular very limited exemptions for publicly owned properties) and
- national regulations limiting the scope of local tax competition.

152. These features have the advantage of being compatible with the primary fiscal objective of the tax (see Chapter I above), as well as with the overarching need to keep the system simple.

153. Finally, it must be emphasized that even a well-designed property tax will not, in itself, be sufficient to address all the issues of real estate market development and land use patterns in transition economies, whatever the effective rates charged. It needs to be coupled and coordinated with other regulations and tools, in particular moderate transfer and capital gains taxes, a land use planning and control system responsive to market signals, as well as the development of proper registries of ownership titles and transactions, and of adequate financing systems for real estate transactions. An ad valorem property tax will have an effect on land use provided there is enough liquidity in the real estate market. If transactions remain few, because of excessive capital gains taxes, or difficulties in changing land use to highest and best use due to contradicting regulations or lack of secured title or of adequate financing, then the tax will have little effect on land use efficiency, and will also generate a lower fiscal yield. However, if carefully designed, and applied with rates significant enough to be an incentive for economic agents, over a sufficient period of time, an ad valorem property tax can be a useful complementary tool that will both respond to its basic fiscal objective (raising revenue for decentralized authorities) and act as an incentive for more efficient land use patterns.

Property Tax In Transition Economies

<i>I/ Central Europe:</i>	Property Tax as a % of local tax revenues	Property Tax as as a % of local revenues	Property Tax as a % of GDP	Property Tax as a % of general tax revenues (1)	Local revenues as % of general govt. revenues (2)	Local revenues as a % of GDP	General Govt. Revenue (2) as a % of GDP	Main Source & Year (except when otherwise stipulated in the table)
Czech Rep.	5.22%	2.66%	0.20%	0.50%	20.60%	8.40%	40.70%	IMF. 1997 Prel. Est.
Hungary	8.50%	1.07%	0.15%	0.32%	30.00%	14.00%	47.30%	IMF & OECD, 1996
Lithuania	na	about 10-11% (3)	0.57%	1.77%	about 17.00% (4)	about 5.50% (5)	32.70%	IMF - 1997
<i>Lithuania (FDI-95-96)</i>	8.90%	6.00%	0.70%	na	24% (Est. 1996)	9.5% (Est. 96)	38.9% (Est. 96)	<i>FDI Conf. - 1995</i>
Estonia	na	na	0.40%	1.09%	na	na	39.00%	IMF - 1996
Latvia	22.15%	12.13%	1.10%	3.50%	23.00%	9.14%	39.90%	IMF - 1997
Slovak Rep.	na	na	< 0.8% (6)	< 2.10% (6)	na	na	46.90%	IMF- 1996
Slovenia	na	8.7% (7)	0.44% (8)	na	11.35%	5.10%	44.90%	IMF- 1996
Poland	31.80%	13.90%	1.15%	3.00%	18.85%	8.50%	45.00%	IMF & Bank (CEM) 1996
<i>Average (non weighted)</i>	15.31%	8.08%	0.57% (9)	1.68%	20.13%	8.44%	42.05%	

<i>2/ EU Members:</i>	Property Tax as a % of local tax revenues	Property Tax as as a % of local revenues	Property Tax as a % of GDP	Property Tax as a % of general tax revenues (1)	Local revenues as % of general govt. revenues (2)	Local revenues as a % of GDP	General Govt. Revenue (2) as a % of GDP	Main Source & Year (except when otherwise stipulated in the table)
Austria	2.80%	1.80%	0.27%	0.64%	30.00%	14.20%	47.50%	OECD - 1995
Belgium	45.65%	17.22%	1.15%	2.53%	13.17%	6.66%	50.60%	Eurostat & OECD - 1994
Denmark	6.50%	3.24%	1.07%	2.03%	55.65%	32.36%	58.15%	OECD - 1995
Finland	4.70%	2.62%	0.48%	1.03%	34.50%	18.35%	53.20%	OECD - 1995
France	36.37%	20.73%	1.63%	3.51%	16.95%	7.86%	46.37%	Eurostat & OECD - 1994
Germany (10)	13.87%	6.82%	0.40%	0.87%	12.70%	5.80%	45.96%	OECD - 1995
Greece	na	na	na	na	10.70%	3.76%	35.11%	OECD - 1994
Ireland	100.00%	7.91%	0.87%	2.30%	26.96%	10.60%	39.30%	Eurostat & OECD - 1994
Italy	40.82%	6.80%	0.81%	1.97%	26.93%	11.98%	44.50%	OECD - 1995
Luxembourg	4.87%	2.00% (11)	0.14%	0.31%	na	11.70% (11)	na	OECD - 1995
Netherlands	66.10%	5.34%	0.75%	1.70%	27.77%	13.96%	50.26%	OECD - 1995
Portugal	21.14% (1995)	8.63%	0.41% (1995)	1.18% (1995)	9.70%	3.88%	39.85%	OECD - 1993
Spain	14.87% (1995)	6.91% (12)	0.68%	1.94%	24.87%	9.84%	39.56%	OECD - 1994
Sweden	0.00% (13)	0.00%	0.93%	1.87% (14)	38.47%	22.17%	57.63%	OECD - 1995
United Kingdom (15)	97.44% (1995)	12.56%	3.26%	9.30%	28.37%	10.59%	37.32%	OECD - 1994
<i>Average (non weighted)</i>	32.51%	7.33%	0.92%	2.23%	25.48%	12.25%	46.09%	

Property Tax In Transition Economies

na = not available

- (1) Total tax revenues of the General government, as defined in (2) below (i.e. including social insurance contributions)
- (2) General government revenues = Central govt. + local govts. + social security + extrabudgetary funds (Note: Local govt. includes all subnational levels)
- (3) 1997 data, Source: Copenhagen Seminar (FDI, October 1998) - information provided by the Lithuanian delegation
- (4) Extrapolated from Column 2 (Copenhagen data) and IMF data - 1997.
- (5) Extrapolated from Columns 2 (Copenhagen data) and 3 (IMF data)
- (6) Data for property tax alone not available. However there is data for a category "other taxes", of which property tax is part.
Weight of the property tax can thus be assumed to be "less than" the weight for the whole "other taxes" category.
- (7) Source: Copenhagen Seminar. The ratio for 1997 is up to 10.7%.
- (8) Extrapolated from Column 2 (Copenhagen data) and 6 (IMF data).
- (9) Assumption for the Slovak Republic: 0.6%.
- (10) Landers not included in the Local Govt. data. Share of PT in GDP not affected by reunification: ratio of 0.36% in 1988.
- (11) Source: "Local Finance in the 15 countries of the EU", Dexia. Data for 1994.
- (12) About 16% of revenues of municipalities (excluding provinces and autonomous communities). Source : Dexia.
- (13) The property tax is entirely devoted to central government revenues in Sweden since 1987.
- (14) Reached 2.74% in 1996.
- (15) More than half of the property tax revenue accrues to central government revenues in 1994 (and 1995). Columns 1 and 2 reflect only the local part of the property tax revenues. Columns 3 and 4 reflect the whole property tax revenue (local and central)

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