

**International Studies Program  
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Property Taxes reform difficulties in  
transition CE countries**

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# ***Political Challenges to (fully) Using Property Taxes reform difficulties in transition CE countries<sup>1</sup>***

**W. Jan Brzeski**  
*The World Bank*

*It is a widely held belief that the introduction of a real property taxation system will provide the means to improve the revenue flows and stability needed to finance local governments. With this in mind many countries have embarked upon valuation work, mapping projects, computerized regression analysis and like activities . . .*

## **Fundamentals of Property Tax Reforms**

The global march of decentralization in territorial governance has cast sharper focus on the pivotal role of local self-governments and the principle of “subsidiarity”, which is one of the cornerstones of the European Union. Devolution of increasing number of mandates to local self-governments has brought with it accompanying calls for the necessary transfer of broader fiscal competencies allowing local authorities to finance the growing scope of their activities. Of special importance is the power to raise own autonomous revenues allowing local authorities to undertake necessary long-term investments that are less dependent on the vagaries of senior government transfers, which are often captive of national politics. There are various possible

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ways of mobilizing local revenues, among which local property taxation holds prominent place in many countries. The role of property taxation in local finance depends on overall fiscal strategy that local government has. If the current revenue from property tax does not produce desired fiscal outcomes there is a need to adjust, modify and/or reform the existing property tax regime. There is a variety of ways – technical and administrative, that can be used to implement desirable reform outcomes. Property tax reforms, therefore, should be primarily nested within the process of financing local governments. Much of the history of property tax reforms in transition countries, unfortunately, is not consistent with this principle.

### **Local Revenue Choices and Alternatives**

There are numerous choices for mobilizing own revenues by local self-governments, depending on whether they are legally allowed and are not exclusively reserved for senior governments. Often, these revenues may be shared by several government levels including administration - discovery, assessment, billing, collection, and enforcement. Local revenue sources include personal and corporate income taxes, user charges (for locally provided services), business registration and flat-rate taxes, visitor and “climate” taxes, poll taxes (per inhabitant), gross receipt and turnover taxes, transfer taxes (including real property), various registration fees (typically for motor vehicles), betterment fees (often for making infrastructure improvements), hookup charges for utilities, locally imposed excise and sales taxes, local income tax surcharge, dog taxes, and other taxes and fees. Faced with this long list of possible local revenue sources designers of local finance reforms need to make comparisons and selection criteria to finalize institutional architecture that secures local self-governments with a “good” local finance system devoid of unfunded mandates.

## Attributes of a “Good” Local Tax System

Since local self-governments are expected to make numerous long-term capital investments in “infrastructure”, their tax system has to assure sufficient degree of stability and predictability. This requires high compliance among taxpayers, which is dependent on a broad accepting understanding of the system by both taxpayers and administrators. And if the understanding is that the tax is not fairly distributing the necessary burden, acceptance will be eroded and result in poor compliance and ultimately produce insufficient revenue stream. Administration of the system needs to be easy and efficient, so that minimal level of effort and cost is expended to produce the revenues. Taxpayers need to perceive that they can always make an appeal and their complaints will be processed in objective and expedient way. Finally, collection of levied taxes should be effective so that no one can avoid the payment. Property taxation usually scores quite high in comparison with alternative local revenue sources, which explains its almost ubiquitous presence, although there are various property tax models that score differently on the “goodness” scale.

## Property Taxation Choices – Ad Valorem Formula

The basic distinction among property tax regimes is the tax-base formula, which ranges from pure “area-basis” to full “*ad valorem*”. While the area-basis disconnects the tax base from market attributes - and is thus “inferior” in terms of market economic theory, the *ad valorem* formulas are more or less calibrated to market values, whether capital (price) or annual (rent) – and are thus theoretically preferable. Advantages of using market calibrated *ad valorem* formulas are usually referred to revenue buoyancy, which makes revenues (tax payments) grow with local economic development. It is also referred to the fact that this tax burden is carried entirely

locally by those properties (rather than property owners) that benefit from locally provided amenities, services and infrastructure. The *ad valorem* formula is strongly related to taxpayer ability to pay, since wealthier individuals and companies tend to own more expensive (more heavily taxed) properties – this makes this tax formula less regressive than the area-based one. The *ad valorem* formula assures that higher tangible benefits are taxed harder, whether or not they take financial or utilitarian (through use) form. Calibrating the tax to the market stimulates efficient land use, by exerting tax pressure on property owners to develop and use their properties more intensely – in close relation to their highest and best use. The *ad valorem* formula will not provide sufficient revenue if rates are set too low and collection is ineffective. It will also produce suboptimal results if the system has difficult and costly administration. Taxpayers and administrators may be “bothered” by judgmental aspects of tax assessment based on market valuation, which is an estimate and not a measured fact. In addition, like other property tax formulas, it taxes un-realized (imputed) income from “hypothetical” property value or rent, and is a highly visible tax levy that local politicians are not comfortable with extracting from their electorate. It is also difficult to enforce, because of numerous appeal possibilities that need to be available to taxpayers due to the judgmental nature of tax assessment process.

### **Property Taxation Choices – Area-based Formula**

Despite the theoretical superiority of the *ad valorem* formula the area-based formula persists in many transition countries because of its administrative simplicity, easy understanding, lack of judgmental aspects and fewer appeals. The formula sets limits to automatic tax growth (which comes with value growth), but creates unfairness by having people of different real property wealth pay the same tax - if their floor and land areas happen to be the same. The

administrative and political attractiveness of the area-based formula has been a strong force behind the stubborn resistance against *ad valorem* reforms in numerous transition countries. Some other countries – notably several Indian states with long *ad valorem* tradition - have recently switched to the area-based formula, although with assuring sufficient market calibration (using market derived coefficients). Political and technical arguments in favor of such a move hold that market-calibrated unit-value area-based formula is an expedient intermediate stage on the way to the “ultimate *ad valorem*”, which is capital value property tax system. One may expect that this compromise hybrid model of “market calibrated tax simplicity” will gain popularity with the post-communist transition countries. Actually, this debate has been ongoing in Poland for several years now, but has been blocked by political economic obstacles.

## **Specificities of Central European Economies**

The debate about reforming property taxation has been particularly strong and politicized in Central European countries, which I have chosen to focus on in this paper. While the above standard arguments on property taxation have been well understood and debated, the stark resistance to *ad valorem* in Central European transition countries has been puzzling. This can be explained to a large extent by unique specificities of these countries that retard *ad valorem* reforms, even though their tax systems have adopted market calibration in virtually all other tax categories – including property transfer tax and gift/inheritance taxes related to real property. These countries lacked land and real estate markets for long decades, so that knowledge and appreciation of property value has been lost in society at large. Privatizations and restitutions of the initial transition period produced many income-poor and asset-rich property owner-taxpayers. Property taxation, if it existed in the former system, was organized by subjects

(taxpayers) and not by objects (properties), the value of which could not be assessed in a non-market system. And since the former system did not recognize private property, wealth taxation did not exist either formally or mentally. The inception of transition period in those countries saw introduction of income taxation and numerous creative ways to avoid and evade it. Due to weakness of wealth taxation and the lack of market-calibrated taxation of newly acquired real estate assets (quite often using unreported income) a strong constituency against the *ad valorem* reforms was created, backed by tax administrators content with the inherited simple appeal-less area-based property tax system. The situation is easier to change in those transition countries that did not have any property taxation prior to the transition, since there are no vested interests inherited from the former system in this respect. However, the lack of necessary land-use incentives to correct the profound misallocations left by the former system, make the *ad valorem* formula very much needed especially in urban areas suffering from inherited low productivity of urban capital. These non-fiscal benefits of the *ad valorem* reforms are acknowledged by a handful of experts in these countries, who lack “leverage” with politicians at all levels of territorial governance. These potentially strong land-use benefits – together with traditional benefits from higher equity (of tax burden) and economic efficiency - have not been able to outweigh the above-mentioned arguments against.

## **Property Taxation in Central Europe**

In terms of figures for property taxation there is little comparative material, although some collective knowledge on this is gathered at the World Bank, the International Monetary Fund, the Organization for Economic Cooperation and Development (OECD), the Lincoln Institute of Land Policy, the US Agency for International Development (USAID), the

International Property Tax Institute (IPTI), and the Institute of Revenues, Rating and Valuation (IRRV). Property taxes in Central Europe bring some 0.5% of Gross Domestic Product (GDP) on average, but with wide variations among countries. In Poland it is about 1% of GDP while in Hungary it is only at 0.15% of GDP. In relation to the size of public finance, property taxes bring 3.5% of all taxes in Latvia, 2.5% in Poland, while only 0.32% in Hungary. Property taxes constitute one quarter of local government own revenues in Poland and only 5% in Hungary. Given the much bigger size of Poland, this country's property tax revenues constitute somewhere about 80% of such revenues in Central Europe. Consequently, we focus on this country's experience with property tax reforms.

## **Political Problems with Property Tax Reforms**

Experience with property tax reforms in Poland indicates that political problems overshadow technical issues in moving towards the recommended (by all international development institutions) market based *ad valorem* formula from the current simple area-based one. Tax administrators are content with the current system due to its simplicity and little (if any) problems with handling appeals. Local politicians are generally not enthused by the prospects of greater direct accountability associated with the *ad valorem* formula (value assessments). There is also a perception that *ad valorem* is an expensive system to run and will thus require higher tax burden to finance net increase in operating costs. Residential properties are taxed at very low rates as compared to non-residential ones (35 times difference) reflecting the continuing populist attitudes that "people are poor" and "businesses are rich". Since residential property taxes are very low, the standard literature arguments about the advantages of equity in *ad valorem* system do not resonate with politicians, since taxpayers treat this tax as a nominal fee that does not enter

into decision criteria when buying and managing housing. The low residential tax rates have already been capitalized into higher property values, making the owners of the higher value properties a strong and vocal constituency against *ad valorem* reforms. The main proponents of the *ad valorem* reforms have been tax reform experts and professionals standing to gain from doing more business in this area, but various camps having been fighting to gain control of this process. Politicians have been worrying about equalization challenges between “rich cities” where property values and incomes are higher, and “poor cities” with low incomes and low property values. The opponents of the *ad valorem* formula have been emphasizing the legacy of the socialist period, which has left many cases of residential owners who are income poor and asset rich, and therefore cannot afford to confront the *ad valorem* changes. They remain unimpressed by the reformers’ arguments that there is a rich array of mitigating instruments that can be used in such cases. To make the reform debate even more difficult the experience of Western European countries with market-based property taxation is mixed and lacks a coherent story, especially that Poland likes to compare to the other large European countries - Germany, France, UK, Italy and Spain. Another argument sometimes invoked against locally administered *ad valorem* systems is that popular perception of local self-governments is often not favorable as evidenced by the very low participation in local elections. Finally, on technical grounds, some critics argue that value differentiation is too small in little towns and villages to warrant introduction of expensive *ad valorem* formula there, and since the tax regime should be uniform across the country, one may consider additional property-based tax in larger cities and towns. The political problems of *ad valorem* property tax reforms have been highly publicized to the degree that even most of the media seem to be against them. And the reformers have spent too much effort on extolling the virtues of the *ad valorem* system instead of analyzing and criticizing

weaknesses and inefficiencies of the existing area-based system. Well meaning foreign advisors and consultants added fuel to this political mistake by encouraging the reformers to move into proposing radical full-fledged one-step *ad valorem* reforms rather than strategizing a gradual process.

## **Features of the Current Area-based Property Tax**

The tax base is floor area of buildings and land area with different treatment of non-building business facilities, which are taxed at 2% of book value. Rates are different for residential and non-residential (business) uses with the latter rate 35 times greater than the former. Consequently, an average home with floor area of 120 m<sup>2</sup> on a land plot of 400 m<sup>2</sup> carries an annual property tax of 21 USD payable in four installments – and this in a middle-income country with gross national income per capita of 7,110 USD (Atlas method for 2005). Much of the significant amount Poland raises from property taxes is carried by business properties. A USAID study of the system done in 2000 showed that business-use buildings yielded about 50% of property tax revenues, while storing only about 5% of market value of the property tax base in the country. Residential buildings stored about 70% of the tax base value, but contributed only some 10% of the property tax revenues. The area-based system translated into the *ad valorem* equivalent produced further highly stunning results. Business-use buildings were effectively taxed at 7.8% of their average capital value, business-use land was taxed at 1.4%, residential buildings were taxed at 0.062% and residential land was taxed at 0.046%. And not much has changed over the past 5 years, since tax rates (per floor and land area) are adjusted every year to inflation. Such shocking results indicate that property taxation in Poland amounts to a “disguised” business asset taxation, much in the tradition of the former system – especially

penalizing to industrial companies using large floor space and land areas. And it helps to appreciate the strong vested interests entrenched with residential property owners – i.e. electorate – against the contemplated movement toward *ad valorem* formula. Consequently, repeated attempts to move towards *ad valorem*, which began in mid 1990s have been rejected by governments regardless of their political persuasion.

Needless to say that such area-based tax rate regime perpetrates land-use inefficiencies and encourages land speculation, given that land rates are 8 times lower than building rates – both in residential and business-use property categories. In addition to the residential taxpayers, also tax administrators are far from supporting the change towards the *ad valorem* formula. Business taxpayers do self-assessment by pulling all the floor and land area they own in a given jurisdiction, which results in incomplete coverage with too sporadic efforts to control and verify this information. The system is riddled with numerous exemption and abatements mandated centrally through other non-tax laws, internally within the tax legislation, and through additional exemptions granted by local governments themselves. The area-based system does not require the administrators to engage in PR and taxpayer education campaigns and appeals are not a problem, since floor and land areas are rarely challenged and can be easily verified (contrary to market value in *ad valorem* systems). Tax bills provide simple and easily understood information with threatening information about what happens if the bill is not paid. Both taxpayers and tax administrators seem to have reached the level of comfort dissuading them from any serious consideration of changing the formula of the current property tax system. The paradox of Poland's property tax system is that it produces enviable fiscal outcome, but at the high cost of non-fiscal distortions and inefficiencies that are difficult to estimate.

## Issues in Other Transition Countries

Property tax reforms have been facing political challenges in other transition countries as well. Generally, the level of revenues is rather low except in Latvia, so the role of property tax in financing of local governments is rather marginal. In the post-conflict countries of South-Eastern Europe tax compliance and collection is a real problem. In the post-Soviet Baltic countries, which are arguably the most convinced about *ad valorem* reforms (together with Slovenia), the movement towards market calibration has been relatively easy given the absence of property taxation predating the transition. However, the significance of property tax revenues in Estonia and Lithuania is rather low reflecting those countries' size and related little interest in genuine decentralization. Some countries, like Bulgaria and Romania, operate nominal *ad valorem* systems, but with taxable values having little relation to actual market prices. Taxation of real property in general is politically disregarded in Czech Republic where the parliament has repeatedly been close to eliminating this tax altogether. In Hungary, local governments have had an option to choose property taxation formula - between area basis and *ad valorem*, but decided almost universally to retain area basis and keep property tax rates very low while focusing on local business taxation. In some countries, such as Macedonia (Former Yugoslav Republic of), property tax reforms have been driven mostly by valuation issues, which - given the low tax rates and poor discovery and collection - may turn out to be an "overkill". In Russia, which has boldly moved to adopt the *ad valorem* philosophy, there is an ongoing technical dispute over the choice of valuation methodology for property tax assessment. Compared to the great progress in market based taxation reforms in the transition countries, the meager progress of property tax reforms is perplexing.

## Lessons Learned for Property Tax Reforms in CE Countries

The area-based property tax formula has its strong appeal with taxpayers and administrators, and the politically feasible way to move towards *ad valorem* may often be to begin with market calibration of the area-based unit values – not the radical shift to a new *ad valorem* tax. The triggering signal should be to modify the existing system, rather than to introduce a “new tax”. Good examples to study are in India – for example in the State of Gujarat. This requires also a fundamental shift from subject-based tax rolls to additional object-based (cadastral) tax rolls. Market calibration can use additional “coefficients” that can be added gradually to make the area-based unit values increasingly closer to market value levels. In Poland, the proposal is to start with land unit values by establishing land-value zones in larger cities, and then begin adding other infrastructure coefficients. The call for property tax modification should be nested within the need for decentralization and reforms of local government finance, rather than as a stand-alone legislative project. The tax modification should strongly refer to analyses of inefficiencies and inequities of the current property tax system rather than to extolling the virtues of the *ad valorem* formula. Implementation should begin in large cities, where value differentiation is greater and thus makes the effort most worth it. The scope of “modification” should be comprehensive covering all facets of property tax regulation and administration including all stakeholder groups – government, legislation, assessment, valuation, adjudication, billing, collection, enforcement, appeals etc. There is a need to realign tax burdens between residential and non-residential properties and put equal emphasis on assessment and valuation (market calibration) methodologies of both categories of properties. So far most of the emphasis has been set on residential properties (likely for political reasons), which contribute much less revenue.

## **Conclusion**

Most of all, however, the political economy of property tax reforms towards the *ad valorem* model should be the underlying consideration recognizing the simple political truth that reforms unsettle the “current balance” of vested interests – political, administrative, economic, financial, institutional, and personal. The change of this balance is not a matter of political will (courage) and technical skills, but requires vision, strategy and documented process with subsequent stages, contingencies, and transition periods. Management of change is more than simply legislating it, as was eagerly practiced during the initial “heroic” years of the transition process. Reforms often fail due to mismanaged transition through lack of big-picture vision of the current and the desired state, and through the lack of communication and taxpayer education, causing widespread disruptions that create personal risks and fears. Management of such a change in property taxation requires full support of local governments willing to set higher rates, full discovery (of taxable properties), reduction of exemptions, and full collection / compliance. This calls for broad and bold local leadership in transition countries with understanding that proceeds from asset privatization and reliance on central government transfers are soon to dry out leaving them to seek other ways of mobilizing own revenues. Prospectively, property taxes are bound to offer one of the few ways open to pursue, and within this market calibration of the existing area-based systems will need to be seriously considered as the way forward.