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Based Property Taxes: The Baltic
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Lessons in Introducing Value-Based Property Taxes: The Baltic Experience¹

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Abstract

This article surveys property taxation issues in the Baltic countries². The property tax is defined as a recurrent levy on land and buildings (industrial, commercial and residential property). The author observes the pace of property taxation reform in the Baltic states, similarities and differences of property taxation systems, goals and challenges of property tax reform in these countries. Most attention is, however, devoted to the analysis of obstacles that contributed to the delayed ad valorem property tax reform in the Baltic countries. Legislative initiatives to modernize property taxation are explored in the light of some other reforms, i.e. local governance reform, privatization, reestablishment of property rights.

1. General trends of property tax reform

Taxes are one of the most important criteria to evaluate production costs as well as competitiveness of country in the international arena. They often play a crucial role to decide on making investments in the particular jurisdiction. In the last decades many European Union (hereafter: EU) Member States from Western Europe took initiatives to reduce rates of income as well as corporate taxes, so that to attract more investments or at least to retain companies from shifting business to the cheaper Central and Eastern European countries (cf. also *Brown P., Hepworth M.* 2003). However, the rates of income and corporate taxes have been reduced in the Baltic States as well. For instance, in 1995-1999 in Lithuania flat corporate tax rate amounted to 29 pct., in 2000 it was reduced to 24 pct., starting from 2002 –

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² The author is grateful to the Ministries of Finance of Estonia, Latvia and Lithuania for rendering information on taxation of property in these countries.

to 15 pct., respectively. Estonia does not levy corporate profits at all, if they are later reinvested. Until 1 July 2006 income tax rates in Lithuania amounted to 15 and 33 pct. (different rates are still applicable in respect to different income sources). From 1 July 2006 until 31 December 2007 income tax rates in Lithuania were also reduced to 15 and 27 pct. They will be even more reduced to 15 and 24 pct. starting from 1 January 2008. Similar tendencies of reduction flat personal income tax rates are apparent in Latvia as well. The global reduction of some centrally administered taxes is very relevant to the property tax. In this context, property taxes can be seen as means to compensate lost tax revenues if the rates of some other taxes are reduced. From fiscal point of view, property taxes can ensure relative stable and visible tax revenues. Real estate cannot be hidden. Therefore, tax debt can be easily recovered. Moreover, property taxes can be a reliable revenue source during economic fluctuations, whilst revenues from some other sources might shrink. Non-fiscally, property tax can serve as a financial tool to decentralize public governance. Taxation of real estate should motivate a taxpayer to use their property more effectively. Despite these advantages, experience of many countries proves to be true that property tax reform takes sometimes longer than of the other taxes.

2. Similarities and differences of property taxation in the Baltic States

All three Baltic states have a common historical legacy that affected their tax systems. After Reestablishment of their Independencies in 1990 these countries inherited Soviet property taxation systems that could not be directly applicable under free market conditions. In general, property taxes were centrally administered under plan economy before the 1990s. Property taxes were employed only to a limited extent. For instance, there was a Building Tax as well as Land Rent Tax in the former Baltic USSR Republics. The Soviet Building Tax was applicable in respect to all buildings except general state buildings, defense buildings and some other structures. Land which was used by state organizations, land for military purposes, railways, and other land for specific purposes was exempted from Land Tax (cf. Ott, 1999, at 41). These taxes achieved neither fiscal nor territorial planning goals.

After switching to the free market economy all these three countries had to decentralize their local governance systems, privatized governmental property or conveyed some governmental property to the local municipalities. However, property taxation systems could not be changed in a very short time because of the inherited undeveloped real estate market. The absence of free market contributed that real value of levied real estate was not

really known at the beginning of the 1990s. The taxation of land, as a rule, was based on site value (area). Almost until the end of the 20th Century buildings were appraised with a nationally approved value or balance sheet value (book value). Moreover, all the countries lacked a developed cadastre as well as real estate registry systems.

All the Baltic states considered property tax reform as means to increase fiscal revenue in their countries. It was sought to increase financing of local authorities that might later enable to reduce flows of financial subsidies from the central governments. The property tax rates in the Baltic states remains, however, not really high comparing some other countries. For instance, the rate of the Real Estate Tax lies at 1.5 pct of the assessed value in Latvia. The Land Tax rate is fixed at 1.5 pct. of the assessed value, while Property Tax in respect to commercial buildings might vary from 0.3 to 1 pct in Lithuania. The rate of the Land Tax fluctuates between 0.1–2.5 pct in Estonia. Some lower rates - from 0.1 to 2.0 pct. - are applicable for areas under cultivation, natural grasslands as well as forest land in Estonia. Within these limits local governments decide on the exact tax rates. In general, the property tax reform in the Baltic states followed the recommendations of international bodies (the IMF, the World Bank) to implement *ad valorem* property tax. This goal was not, however, achieved in a short time. Sometimes the established value is still based on some non-market coefficients rather than actual market value thereof. Moreover, the Baltic states still appear to be in different stages of modernization of the property taxes. They all have adopted different legal regulation in this area as well. For instance, there is a Land Tax (1993) in Estonia, Real Estate Tax (1997) in Latvia, while Lithuania has two separate taxes on the property taxation – Land Tax (1992) and Property Tax (2005).

Despite divergent legislation as well as different pace of performing property tax reforms the Baltic countries were praised by international experts. The Baltic countries of Estonia, Latvia and Lithuania have been in the forefront of implementing value based taxes on land (Malme, 2004, at 5). The experience of Estonia was highly reputed, as it was the first Baltic country to introduce *ad valorem* property tax already in 1993. The land appraisal has been done by the Land Board on the basis of comparable sales price approach. Estonian officials expected that *ad valorem* property taxation system will allow increasing tax revenue from this tax. Furthermore, application of *ad valorem* property taxation system enables to receive more information about real estate market (cf. Malme J., Youngman J., 2001, at 3). However, Estonia does not levy residential or commercial buildings by recurrent property taxes. This exemption was based on the idea that the investments in the real estate market should increase in case buildings are not levied.

The other Baltic countries – Latvia as well as Lithuania – have implemented *ad valorem* property taxation elements more gradually. Lithuania and Latvia levy both land and buildings used for commercial purposes. It should be noted that Latvia will not levy constructions starting from the beginning of 2007. Furthermore, residential property used for personal needs of inhabitants (*e.g.* dwellings, apartments) is still exempted in all the Baltic countries.

After adoption of the new Law on Immovable Property in Latvia in 1997 so-called “cadastral value” of real estate is determined by the formula that includes different criteria, such as – area, land use, basic value of 1m² land, servitudes, utilisation purpose of agricultural land. Since 2000 the results of cadastral (or mass) valuation were employed for taxation of developed land for the first time. Cadastral value was based mainly on the market value of real estate that was calculated by combining cost estimate, income value as well as price market methods. The value of agricultural land has been determined mostly considering fertility thereof. Starting from 2007 the results of mass appraisal will be applied for taxation of commercial buildings. The prepared zoning maps now embrace different types of property (*e.g.* residential property, commercial as well as agricultural property) in the whole territory of the Republic of Latvia.

Lithuanian Land Tax was first cardinally reformed in 1992. Though development of land maps has been completed in 2003, these results are not applicable to calculate Land Tax thus far. Lithuanian officials still appraise land for taxation purposes on the basis of a “normative value” as well as on some coefficients (fertility of land, location, sort, *etc.*). In 1995-2006 buildings used by legal persons were taxed pursuant to the Law on Real Estate Tax paid by Enterprisers and Organizations in Lithuania. Commercial buildings were appraised with the replacement value. The Law on Real Estate Tax paid by Enterprisers and Organizations was later abolished by adopting a new Law on Property Tax on 5 July 2005. The new Lithuanian Law on Property Tax has fully implemented *ad valorem* property tax based on market prices. There are used cost, comparable sales as well as income approaches to determine value of different types of buildings used for commercial purposes. Furthermore, Lithuanian strength was that it was one the best prepared countries in integrating and unifying real property cadastral, registration and valuation systems (Malme, 2004, at 5). Finally, Lithuania carried out a mass appraisal of buildings for taxation purposes at the end of 2005. The valuation carried through by the State Enterprise Centre of Registers was based on the transactions of real estate that took place in 2005. Currently Property Tax, which levies commercial buildings, is calculated on the values established by this mass valuation.

It should be noted that at the beginning of the 1990s it was really complicated to calculate market price of land parcels and other real estate as well as to systematize information about owners of real estate. The real estate market was not sufficiently developed in the Baltic countries at this time, as free market has not existed previously under the economy of the Soviet Union. The countries haven't got sufficient qualified personnel as well as enough financial resources. For instance, a computerized register with the land sales prices started functioning in Estonia in 1997. Lithuania still appraises separately land and building for taxation purposes. Separate taxation of land and buildings is problematic, as it is quite complicated to determine separately value of land and construction that are on it. (cf. Almy, 2001, at 69). This is especially relevant to the urbanized territories, as land value is highly dependant on the buildings and other constructions on the land. However, until now many commercial buildings stand on publicly owned land in the Baltic countries. State land is not levied by property or land tax. Therefore, it is still easier to tax land and buildings separately. Estonia does not levy buildings at all. The buildings as well as other improvements have a certain influence to the land value, though this affect is indirect.

3. Criticism of property taxation reform

The share of property taxes in public revenue is not very significant in many countries. For instance, the share of taxable revenue from property taxes remains at little more than 1 pct. GDP or about 4 pct. of all tax revenues in many OECD countries (cf. Bird, Slack, 2002, at 33). Therefore, it seems that this tax should be not very disputed. In 2004 the share of these taxes amounted to 0.34 pct of GDP in Estonia, 0.4 pct. of GDP in Lithuania, 0.8 pct. of GDP in Latvia, respectively. On the other hand, it is generally accepted that transitional economies apply relief measures that are too generous and should additionally improve bill delivery procedures (Almy, 2002, at 42). The property tax revenues, however, amount to about 12 pct. of local tax revenues in Lithuania. Sometimes they are really important to those municipalities, where the biggest cities are situated. Even though there are many undisputed advantages of property taxation (see Chapter: "General trends of property tax reform"), they are sometimes more unpopular among taxpayers than some other direct taxes. This tendency appears in the Baltic states as well.

The reform of property taxation has been often criticized in the Baltic states. However, resistance against taxation of residential property was the strongest. It might be admitted that an exemption in respect to residential property was reasonable at the beginning of the 1990s.

Such taxation was hardly possible due to relative poor situation of inhabitants of the Baltic countries just after the breakdown of the Soviet Union. During the shift to the free market economy many inhabitants have lost their savings as well as experienced a rapid decrease of their living standards. Moreover, it was alleged that the tax will infringe the rights of the poorest people, encumber business climate in the Baltic countries, *etc.* For instance, R. Vainienė, who represented position of the Lithuanian Free Market Institute, has denoted that taxation of residential property would be unforgivable mistake that lessens the feeling of social security amongst population, initiatives to run business, *etc.* (Vainienė, 2000). Some other skeptics (*e.g.* from the Lithuanian Labor and Social Researches Institute) have warned the introduction of the new taxes should be made after profound examination of interests of the poorest people. All these contemplations contributed that taxation of residential property has been postponed in Lithuania. Moreover, many Baltic people (to some calculations about 20 pct. of population) have taken credits to acquire real estate. Some of them acquired real estate in order to avoid inflation as well as depreciation of their savings. There were also those who wanted to receive a permanent income source by renting their property. As a rule, taxation of residential property reduces the value thereof. Furthermore, if the price of rent falls down, this can diminish inhabitants' capacities to give back loans taken. There are also many inhabitants who acquired real estate considering the boosting prices thereof in the last years before as well as after the Baltic states joined the EU. Therefore, those people who acquired real estate for speculative purposes will resist to any attempts to expand property tax base or otherwise increase property tax burden. Just like in some other countries politicians are still afraid to propose essential amendments concerning property taxation, so that not to loose political support.

The other issues of property tax reform were less disputed. For instance, Estonian population has supported government's decision to appraise land according to its market value already at the beginning of the 1990s. No significant resistance faced Lithuanian government introducing market value based property taxation in respect to buildings in 2005. Most criticism received the decision to tax residential property used for commercial purposes. It was argued that some people rented a part of their flats or houses to improve poor life standards, but not really to generate profits of this activity (for instance, a retired person rents a room for students). Though only a part of such real estate is rented, the tax shall be calculated from the whole complex (*e.g.* flat, house). Thus, it might be admitted that taxation of residential property used for commercial purposes makes it unprofitable to use a part of the real estate for personal needs and the rest one for commercial purposes.

4. Influence of economic reforms to property taxation

All these countries have privatized governmental property. However, privatization has not been always carried out according to the best offers (cf. Rural property tax systems in Eastern and Central Europe, 2002, at 17). The privatization was an objective factor that does not allowed rearranging property tax systems in the Baltic countries in a short time. The governments did not possess the exact and classified information about proprietors of real estate. Many objects of real estate were not really profitable in the transitional period. A big property tax burden could have slowed down privatization as well as negatively contributed to the flow of investments in the country. Therefore, during the transitional period in the middle of the 1990s the Baltic states applied many temporary tax relieves (duration up to 5 years) with respect to some taxes (e.g. corporate tax). For instance, in 1994 Estonia adopted a temporary exemption for private farms for five-year-term. Successful privatization required not only transferring property to the private proprietors, but also establishment of new register systems, respective tax administration procedures. The lack of sufficient information on the owners and their property impeded fast reforming of these taxes. For instance, due to the uncompleted land reform, only approximately 70-80 pct. ownership rights are recorded in Estonia and Latvia.

Furthermore, all three Baltic countries adopted special laws regarding reestablishment of the property rights that were expropriated by the USSR authorities after the occupation of the Baltic countries in 1940. However, because of the lost documents previous owners or their heirs were not able to prove their property rights in a short time. For instance, a special Law on Restitution of Real Estate was adopted in Lithuania in 1991. The term to submit documents for reestablishment of property rights has been, however, postponed for several times, as not all the applicants were able to prove their property rights in a short time. Thus, in 1999 only 37 pct. of all farmland land, 13 pct. of urban land, and 9 pct. of forest land were private property in Lithuania (Mikuta, 1999). Delayed restitution processes encumbered identifying owners of real estate. Furthermore, privatization of land did not contribute the farm land was used effectively by the new owners. There were many people who reestablished property rights though many of the new owners had no plans on effective utilization of the land (cf. Trasberg, 2003). Moreover, the property rights were sometimes reestablished in some other regions than the persons were settled down. Due to the big distances they were not able to cultivate land effectively. Implementation of *ad valorem* property tax would be a proper tool to motivate landowners to utilize land more effectively or sell/lease it to the persons who are able to do this. Moreover, *ad valorem* property taxation

system should discourage inhabitants from acquiring real estate only for speculative purposes without any plans to use it effectively.

5. Accession to the European Union

Many tax initiatives in the Baltic states have been implemented to fulfill *Acquis Communautaire* requirements and successfully join the EU. The European Commission took, however, more of an interest in indirect taxes (VAT, excises) rather than property taxes. Art. 93 of the Amsterdam Treaty required the Member States to harmonize indirect taxes in the EU, while direct taxes have been harmonized basically according to the general principles (prohibition to discriminate, subsidiary principle, *etc.*). Harmonization of taxes in the EU is based on the idea that general freedoms of the European Community might be realized only if similar business conditions are created in the whole domestic market. Property taxation issues were left to the competences of the Member States. As a consequence, the Baltic countries have paid less attention to the property taxes than some other direct taxes. Furthermore, it is doubtful, if the EU presents some concrete directives or some other instruments to harmonize property taxation in the EU. The EU does not require a full harmonization of tax systems. Property taxes have always been evaluated as national taxes, whereas real estate does not move across borders (cf. also Youngman, Malme, 2004). Indeed, the European Community has paid little interest to the decentralization of public governance. The EU does not *expressis verbis* require fiscal decentralization of public governance from the new Member States. The necessity to strengthen the role of municipalities can be, however, considered as a condition for stability of institutions, which guarantee democracy, human rights, functioning market economy, *etc* (cf. Bryson, Cornia, 2000).

6. Local governance reform and property taxes

Introduction of the new *ad valorem* property taxes is also linked with decentralization of public governance. Support of local authorities is very important for the Baltic countries, as under the Soviet administrative system local authorities were expected to implement the planned decisions of the central government concerning what types of public services were to be rendered. Decentralization of local governance should make procedure of local decisions more transparent as well as comprehensive for local inhabitants. Modernization of property taxes should strengthen the role of municipalities, as property taxes can serve as additional

autonomous revenues for local governments. In general, most of revenues of local governments were limited to shares and other subsidies from central governments in the Baltic countries even after the 1990s. Though all the observed Baltic countries have recognized the need to strengthen local governance, municipalities did not gain many authorities in respect to administration of property taxes. Currently property taxes are at least partly administered by municipalities in the Baltic states. Art. 9 § 3 of European Charter of Local Self-Government sets forth that “at least part of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate”. Thus, property tax revenues are transferred to the local funds in all three Baltic countries. Moreover, municipalities were allowed to employ limited property tax relieves on expense of their own budgets. For instance, Latvia has a special rule that municipalities may grant a relief up to 90 pct. for certain categories of taxpayers. Some municipalities (e.g. in Estonia) are *inter alia* allowed determining property tax rates considering the minimal and maximal boundaries established in the law. The respective right to establish particular tax rates Lithuanian municipalities gained only in 2006. However, this right is applicable only in respect to the buildings used for commercial purposes. Latvia still uses a flat real estate tax rate set forth in the Law on Immovable Property. However, property tax collection is organized on a municipal level in Latvia. Furthermore, Latvian municipalities classify property for taxation purposes as well as deal with information about taxpayers of levied real property.

It should be noted that many municipalities of these countries are too small to carry out all property tax administration functions. They might lack financial, institutional as well as technical capacity to administer property taxes. Moreover, some tax administration issues (e.g. mass appraisal of real estate, tax collection, and enforcement of tax debts) can be sometimes centrally better organized than on the local level. Furthermore, there is a general mistrust in population in respect to municipalities. Many Baltic people still believe that municipalities can be easier influenced by big companies to relieve them from property tax levy or grant at least a partial exemption. Therefore, some property tax administration functions are retained by central governments thus far.

7. Conclusions

All the Baltic states have inherited similar property tax systems that should have been gradually reformed and adapted to the newly emerged free market environment after the 1990s. A substantial modernization of property taxation has, however, delayed, as it could

have been implemented only finalizing privatization, reestablishing of property rights as well as some other economic and legal reforms. Moreover, some time took implementation of technical procedures to create *ad valorem* real estate appraisal system. Poor economic situation of the Baltic people after breakdown of the Soviet Union has also hampered national governments to put through cardinal reforms and increase property tax burden. However, the experience of the Baltic countries shows that property tax reform indeed motivated taxpayers to use their land and buildings in a more efficient way. In addition, property taxes were used as a tool for decentralization of local governance in the observed countries.

National governments should overcome political resistance and carry on property taxation reforms. The property tax base should be as wide as possible, including land, buildings, and residential property. Moreover, there should be as few tax exemptions as possible. However, there is not doubt that inhabitants - especially those who acquired real estate for pure speculative purposes – will utmost resist to any attempts to increase tax burden.

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