

PROPERTY TAX IN ECONOMIES IN TRANSITION: SELECTED CASE STUDIES

Edited by
Lucie Sedmihradská



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THE NETWORK OF INSTITUTES AND
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The Network of Institutes and Schools of Public Administration
in Central and Eastern Europe

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Selected Case Studies

Edited by

Lucie Sedmíradská, University of Economics, Prague, Czech Republic

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Property Tax in Economies in Transition: Selected Case Studies

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Preface

Property tax, or to be more precise, real estate tax, is a well-suited revenue source for local governments, which may serve as a tool for fiscal autonomy of local governments. However, this is only true in the case where local governments have some real decision-making powers regarding property tax and that the proceeds from this tax are sufficiently significant. The ten presented case studies show that in all seven central and eastern European (CEE) countries, these two conditions are fulfilled either to a very limited extent, or not at all. The expectations of international experts at the beginning of the transformation process, twenty years ago, were not met and local governments in the region still do not have sufficient fiscal autonomy and thus the process of fiscal decentralisation is for now, incomplete.

This volume presents ten country case studies, focused on property taxation from several points of view; first, the role of property tax in the national tax system and as a source of local government revenue is evaluated; second, the property tax incidence is discussed; third, the property tax procedure is described, and finally in some of the chapters, a case study of selected municipalities is presented. This standardised approach allows for a comparison of the situation in the individual countries. Three countries are presented twice; we decided on this format, as the papers complement, rather than overlap each other.

The key step, preceding the preparation of the individual case studies and the entire volume, was the compilation of the research protocol of the NISPAcee Working Group on Public Sector Finance and Accounting carried out by Mihaly Lados from the Centre for Regional Studies of the Hungarian Academy of Sciences, Pécs, Hungary.

The completion of this book would not have been possible without the mutual collaboration of each of the authors, who served as peer reviewers for the other papers and who responded to most of the comments and suggestions in a very limited time. Comments from Phillip J. Bryson, from the Brigham Young University, USA, who served as a reviewer of the entire volume, were very beneficial and we thank him for his precise and rapid work. We appreciate the assistance of the NISPAcee Secretariat with regard to all the technical aspects of the preparation of the book and of Jane Finlay for language editing, which is, for most of our papers, inevitable. We are grateful to the Local Government and Public Service Reform Initiative at the Open Society Institute in Budapest for its generous financial support without which, most of the working group members would not have been able to attend the 16th NISPAcee Annual Conference in Bratislava, Slovakia in May 2008.

1. Property Tax as a Key Tool for Fiscal Decentralisation: Unfulfilled Expectations in Central and Eastern European Countries

Lucie Sedmihradská

1.1 Introduction

After the fall of the central planning system in Central and Eastern Europe (CEE) twenty years ago, many expected that fiscal decentralisation would be amongst the first reform steps, alongside price liberalisation and privatisation. Despite the common belief that decentralisation could improve the performance of the public sector, the transition countries are still, in many aspects, far from having a well-functioning inter-governmental system in which individual local (sub-national) governments enjoy sufficient fiscal autonomy.

Fiscal decentralisation means that local governments make decisions regarding the provision of public services and at the same time, they bear a significant share of the associated costs through their own revenue base (see Oates 1991, 263). Thus, a necessary condition for the efficient functioning of local governments is their ability to influence their revenues. This clearly-stated situation raises a fundamental question: Which tax or taxes should be assigned to local governments? Musgrave (Oates 1991, 266) defined the following tax assignment principles:

- 1) Highly progressive taxes should be centralised,
- 2) Sub-national governments should avoid taxes with a highly mobile tax base,
- 3) Central governments should collect taxes with an unequally distributed tax base and
- 4) Local taxes and fees can be decentralised.

Respecting these criteria leads to the assignment of the largest taxes (i.e. income tax and value added tax, which have already replaced other types of general consumption taxes across the region) to central government, and local governments have to rely on property taxes with only very limited proceeds.

At the same time, many of the CEE countries use a form of tax or revenue sharing among different governmental levels; however, the ability of local governments to influence the revenues from these shared taxes is, for the most part, very limited, so that these revenues almost assume the character of an unconditional grant. A comparison of the tax autonomy in the ten new EU member states, using the OECD system of classification regarding own taxes of sub-national governments (see OECD 2002, 60), shows that out of the ten countries, only in three (Slovakia, Poland and Hungary) can the sub-national governments, to some extent,

influence more than one-third of their tax revenues, and that in three countries (Bulgaria, Lithuania and Latvia), the sub-national governments have no discretion regarding their tax revenue (see OECD 2002, tables 2.3a and 2.3b, 1999 and 2000 data). Despite its limited role, so far the property tax is viewed as a tool which could bring about change in the future, i.e. lead to greater revenue autonomy for local governments.

The purpose of this chapter is to present the main findings from the individual case studies with respect to the framework given by the research protocol of the NISPAcee working group on Public Sector Finance and Accounting.

This chapter is structured as follows: First, the role of property tax in the national tax system and in local government revenues is described and then the main features of tax design, i.e. the tax base and the tax rate, are discussed. In the following part, the extent of local government authority to influence property tax proceeds is evaluated, together with the willingness of local government officials to really use this authority. The final part deals with the administration of property tax.

The term “property tax” is, throughout this chapter and the entire volume, understood to be a real estate tax and therefore not a tax on other types of property.

1.2 The role of property tax in the national tax system and in local government revenues

Property taxes belong to the oldest taxes of all. They were gradually replaced by income taxes and today, they represent only a complementary source of public revenues. These taxes, however, remain important as a revenue source for local governments (see Kubátová and Vitek 1997, 219).

The main advantage of the property tax is its contribution to tax justice, for instance, through the application of the benefit principle. At the same time, property tax can stimulate a more rational or efficient use of property. The main disadvantage of the property tax is double taxation, as the property was purchased from already taxed income. This tax is extremely unpopular among taxpayers and its administration can be costly.

Table 1.1 shows the volume of property tax revenues in nine CEE countries. A comparison of the property tax revenues, expressed as a percentage of GDP, shows very small differences – the only exception is Poland with revenues four times higher than in the other countries. The importance of property tax revenues as a local government’s revenue differs among the countries examined, ranging from 2.7 per cent to 13.9 per cent.

Table 1.1
Property tax revenues in the countries examined

	Property tax		year	Source
	as a % GDP	As a percentage of local government revenues		
Belarus	0,2	9,1	2006	Krivorotko (ch. 2)
Bulgaria	0,2	2,8	2007	Stoilova (ch. 3)
Czech Republic	0,2	3,8	2006	Bryson and Sedmihradská (ch. 5)
Estonia	0,2	2,7	2007	Trasberg (ch. 6)
Hungary	0,3	1,9	2006	Lados (2008)
Kosovo	0,3	4,5	2006	Aslani (ch. 7)
Moldova	0,5	4,0	2007	Busmachiu (ch. 9)
Poland	1,2	13,9	2007	Brzeski (2008)
Ukraine	0,3	5,3	2006	Rudyc and Scherbyna (ch. 12)

The presented figures are, in most of the examined countries, unstable over a long period of time. We observe both a decreasing importance in property tax revenues as a share of local government revenues, such as in the Czech Republic (from 6 % to 3.8 % between 1997 and 2006) or Estonia (from 4.8 % to 2.7 % between 1997 and 2007) and of increasing significance, for example, in Bulgaria (from 0.23 % to 2.8 % between 1997 and 2007) and Belarus (from 7.07 % to 9.12 % between 2001 and 2006).

The figures presented clearly show that property tax revenues are a complementary source of not only general public revenues, but also of local governments' revenues (see also Malme and Youngerman 2001).

1.3 Property tax base and rate

Based on the extent of the property tax base, we witness a general and selective property tax. The general property tax applies to all types of property in a uniform manner, regardless of the nature of the asset, its use or ownership (see Bell and Bowman 1991, 93). The selective property tax is imposed on a well-defined sub-set of property, mostly real estate property. Despite the fact that most of the country studies presented in the volume are entitled "property tax", to be more precise, they deal either with real estate tax or land tax.

Among the countries examined, there are examples of countries which tax both land and buildings (e.g. the Czech Republic, Moldova and Kosovo), and those

which tax only land (e.g. Estonia and Ukraine) and in which land is exempt from real estate tax (e.g. Bulgaria).

The second important characteristic of the tax base is the unit in which it is expressed – either a monetary or physical unit. In the presented case studies, we find both methods – even a combination of both methods in one country. Bulgaria, Estonia and Kosovo use the monetary expression of the tax base. The Czech Republic combines both methods – the tax base for land tax is expressed in monetary terms and the tax base for buildings is expressed in square metres.

The tax base is, after the tax rate, a key factor which influences the total tax proceeds. The volume of the tax base is determined mainly by two factors: the complexity of its evidence and the extent of tax exemptions. The most common way to identify the tax base and the taxpayer is the use of the real estate cadastre. Unfortunately, some of the authors of the case studies report various shortcomings in their real estate cadastres (e.g. in Moldova the process of cadastre computerisation is not yet complete (see Morozov, ch. 8)) and in Ukraine they have a set of several registers (see Slukhai, ch. 10).

The extent and character of property tax exemptions differ across the countries. Generally, some of the owners, such as the state or local governments, are exempt. In some countries, the exemptions are not directed at the owner, but to the use or purpose of the property, such as agricultural land, forests, churches or museums. Next to these exemptions, in many countries there are socially motivated exemptions, e.g. handicapped, poor or retired people are exempt from the tax on their permanent residence. At the same time, we find less usual exemptions, often with unclear reasons for their existence, such as the 15 years' exemption of new buildings in the Czech Republic, which creates the unequal treatment of owners of new and old houses.

Tax exemptions are mostly set by national legislation; however, in some countries, local governments have little discretion over them. For example, Estonian municipalities can approve exemptions for retired people from paying the land tax related to their permanent residence; in the Czech Republic, municipalities can approve exemptions for agricultural land and in Moldova, local governments can approve exemptions in the case of natural disasters.

If the tax base is expressed in monetary units, a crucial part of the tax procedure is the determination of the value. Unlike all other taxes, where the value of the tax base can be measured exactly, in the case of property tax, this value can only be estimated in the majority of cases, as the vast majority of property does not enter into any market transaction within the taxable period (fiscal year). There are several approaches to the estimation of property value: cost approach, income approach and market data approach (see Bell and Bowman 1991, 95–97). Next to these three

traditional approaches, we find, in some of the CEE countries, various administrative ways of valuating property.

Using the cost approach, the property value equals the current cost of reproducing the property, minus depreciation, and which is suitable for new constructions or special-purpose property. The property value, using the income approach, is based on the potential net earnings (income) from the property and is used to value investment properties.

The market data approach values property based on recent sales of comparable properties on the market. This approach can only be used in the case of a well-functioning property market, where many transactions take place and where it is possible to use the information on the transaction realised as a good approximation of the price of another piece of real estate. However, in CEE countries, the real estate markets are only developing and we find well-functioning real estate markets in only a few areas, such as some of the capital cities. In the other regions, only a minimum number of transactions are realised, which do not provide sufficient guidelines for the valuation of other properties. In some cases, such as in Ukraine, there is no market for land at all. Estonia is the closest among all the examined countries to the market data approach; however, due to irregular valuations (the last valuation took place in 2001) it is questionable how accurate their valuation is. A more detailed overview of the different valuation approaches, together with examples, is presented by Asllani (ch. 7).

Among the administrative approaches we can distinguish two types: property categorisation and price maps. The first system uses a complex set of property categorisation and coefficients. These coefficients consider the size, location, purpose and other characteristics of a particular property. This system is used in Bulgaria, where the valuation of a property is provided by a central government agency. The advantages of this system are that it is simple and it can be updated regularly and it does not depend on a well-developed real estate market. The main disadvantage is that regardless of its complexity, it leads to a uniform approach. In Bulgaria, in 2007, the taxable property value was increased uniformly by 20 per cent in the whole country but this does not reflect real price development.

The second system is based on using price maps. In the Czech Republic, there is an annually approved ministerial decree, which determines the price of land across the entire country. However, the price changes between the various years are very small and again, do not really express the value of a particular piece of land.

If the tax base is expressed in real units, a system of various coefficients, similar to the one described above, is used. This system is used for buildings' taxation in the Czech Republic. The main disadvantage is that the tax base basically does not change, thus in case of stable tax rates and a low inflation rate, the real property tax proceeds decrease quite quickly.

The main discussions in many of the case studies do not concern the system of property tax base expression or method of valuation, but the possibility to broaden the tax base. The most obvious case is the interesting discussion by the two Ukrainian authors, when one of them argues in favour of the introduction of a new building tax, whilst the other suggests improving land and taxpayers' records and leave buildings untaxed. In the Bulgarian paper, the possibility of the inclusion of land in the tax base is discussed and in the Estonian paper, on the contrary, buildings are included. In all cases, these discussions attempt to find ways to increase the volume of property tax proceeds.

The construction of the tax rate depends on the way in which the tax base is expressed (physical or monetary units), thus the rate is given either in monetary units per square metre or in a percentage. Next to this categorisation, we can divide the tax rates in the examined countries into two groups: uniform and differentiated. It is not surprising that the tax rates are different in the case where the tax base is expressed in physical units, as it is the only way to capture different values of property.

In many of the countries examined, it is common to see a set of different tax rates for different types of property, so that residential property is taxed less or even much less than property used for entrepreneurial purposes. This outcome is caused by an estimation of the ability to pay by different types of taxpayers. While citizens often own property which does not correspond to their incomes, i.e. people with very low incomes have to pay high property tax and entrepreneurs have income from property and are thus able to pay higher taxes. The social aspects of property taxation are emphasised by authors in several countries (e.g. Estonia, Ukraine, Moldova and Belarus).

1.4 Local government authority regarding property tax

Property tax is well-suited to local governments, not only because of the immobility of the tax base and stable revenues, but especially because it allows for the independent decision-making of local governments regarding the main parameters, such as the tax rate and tax base (or exemption from the tax base). If most of the authors of the case studies conclude that the importance of revenues from property tax is low, then the autonomy or independence of the local governments regarding the parameters of this tax is even lower. Only in Estonia do municipalities have clear discretion regarding the tax rate, i.e. they can choose a tax rate within the range of 0.5 to 2.5 per cent. The Czech municipalities could make some limited adjustments in the so-called correction coefficients, which influence the tax rate for buildings and building plots. Only in 2009 were their competencies increased so that they could exempt arable soil or impose another coefficient up to 5. Similarly, since 2008, in Bulgaria, local governments have received some discretionary power regarding

the tax rate. These recent changes seem promising, even if we do not have sufficient data, so far, to assess their real impact.

Despite the very limited authority that local governments in CEE countries have, regarding property tax, and the limited cases reported in this volume, we can see that local governments focus their efforts on increasing transfer payments instead of using their fiscal autonomy. The case of the Estonian capital, Tallinn, which increased the tax rate from 0.6 to 1.5 per cent, shows that this step caused not only common protests, but raised serious questions regarding the social acceptability of such a step. Recent news from the Czech Republic regarding the approvals of the local coefficient show municipal officials' fear and the discontent of citizens, especially entrepreneurs, due to the differentiated tax rate based on the purpose of the property.

1.5 Property tax administration

Despite the fact that property tax is, in all the countries researched, revenue for the local government's budget, it is quite exceptional for this tax to be administered by the respective local governments. A much more common system is that this tax is collected by deconcentrated financial offices, which are agencies of the central government and are usually subordinated to the Ministry of Finance. The collected property tax is then returned to the local governments to which these revenues belong.

The main arguments for this centralised approach are better qualifications and a higher specialisation of the employees in the financial offices and the low administrative capacity of local government officials and employees, especially in the small or rural local governments. This argument is supported by the Ukrainian case, where many local governments are not yet computerised (see Slukhai, ch. 10)

On the other hand, the centralised collection of property tax leads to several problems. First, it is the classical principal-agent problem, where the local government acts as a principal and the financial office as an agent (see Bryson and Cornia 2004). Local government, in this situation, can only wait to see when and how much the tax proceeds amount to which are transferred, with no chance of influencing, for example, tax arrears.

The experience of the Czech Republic based on field studies elaborated as a bachelor thesis at the University of Economics in Prague (see Aberlová 2008, Pribulová 2009 and Štefek 2009), shows that municipalities are mostly in the position of passive receivers of property tax revenues, knowing only the total amounts received. The three students were only able to obtain detailed information about the structure of the tax base and revenues coming from the partial tax bases after an official request by the mayor. All the mayors saw the information obtained for the first time! This lack of information is extremely alarming when assessed together with the

newly gained autonomy of Czech municipalities regarding the so-called local coefficient – most municipalities probably make a decision without any calculation of how much revenue an increased local coefficient will bring.

At the same time, Pribulová (2009) compared the arrears of the property tax (administered centrally) and local fees (administered locally) in the town of Česká Kamenice (5.5 thousand inhabitants) and found that the total cumulated debt, as a share of annual revenues in 2008, was 41.1 per cent for the property and 18.7 per cent for local fees. However, the share of debt for all taxpayers was 3.3 per cent for property tax, 13.8 per cent for the local fee for waste collection and 7.8 per cent for the local fee for the usage of public space. A comparison with other local fees would be, due to other factors, misleading. These results show that there are fairly strong arguments for both the above-mentioned approaches to the collection of the property tax and that a change of the system is not easy.

Bulgaria changed the system of property tax administration in 2005. The two case studies of Blagoevgrad and Silistra show positive experiences: in Blagoevgrad, the volume of the collected taxes increased and in Silistra, tax arrears dropped significantly. In both municipalities, the tax and fees department were strengthened.

1.6 Conclusions

Although property tax is considered to be an almost perfect revenue source for local governments in the examined countries, it plays a minor role, far behind central government transfers or tax sharing. This statement is valid for the last twenty years and there are only a few signs of possible future change.

Surprisingly, none of the presented case studies dealt with the discussion area based on property taxation versus ad valorem property taxation. Regarding possible changes, the most common topic was that of broadening of the tax base, which would lead to increased revenues and possibly more local fiscal autonomy. For the strengthening of local autonomy, it is, for instance, necessary to increase the authority of individual local governments to influence the property tax rate and base, at least to some extent. Recent changes in Bulgaria and the Czech Republic show that we may expect some progress in this respect. However, local governments will probably need some time to accommodate this new authority and local officials will have to learn how to explain to their constituencies their property tax policy.

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2. Property Tax in Belarus

Yuri Krivorotko

2.1 Introduction

This paper is about property taxes in Belarus. During the past years, property taxes had a stable growth both in relation to GDP, and in relation to all local budget revenues. Moreover, property taxes have grown faster than all revenues of the Belarus local budgets. These taxes have now become an appreciable financial source of local budgets in Belarus.

The basic question in this paper deals with the issue of whether the philosophy of property taxes is understood by the Belarus authorities and whether they are ready to realise the advantages of these taxes in the context of decentralisation (For more details about the advantages of property taxes, see Bennet 1980, 290). The focuses are on analysing the ratio of mobile and immobile taxes in Belarus local budgets and the opportunities of how to expand the share of property taxes in Belarus local budgets.

The paper identifies the main barriers of a more effective use of property taxes in light of fiscal decentralisation i.e.: the cadastral estimation of land which is closer to the market estimate, an increase of the population's incomes level, development of the privatisation process and market reforms in Belarus. This paper covers these points.

2.2 The current situation with property taxes in Belarus

In Belarus, property taxes consist of real estate tax and a land tax. These two taxes are simultaneously immobile and do not depend on the industrial conjuncture in the region. The following shows the structure and dynamics of property taxes for the 2001–2006 period (Table 2.1).

As the Table shows, property taxes in Belarus have a tendency to grow, despite a reduction in their share of local budget revenues during the past years. This can be explained by an increase in physical volumes of real estate which has led to an expansion of the tax base and an increase in tax rates which took place in 2003. It is important to note that in the structure of an own revenue base of local budgets, property taxes have grown faster than in all financial sources of local budgets. The mid-year accretion of property taxes' growth for analysing the period in all local budgets' sources have reached 5.6 percentage points and in own local budget revenues 6.1 points.

Table 2.1
Dynamics of property taxes in Belarus for the 2001–2006 period
(bn. BYR and in per cent)

Indicators	Years					
	2001	2002	2003	2004	2005	2006
Property taxes total (in bn. BYR)	237.4	390.5	731	957	1,149.3	1,268.3
including						
• <i>Real estate tax</i>	192.9	316.3	473	657.9	805.2	894.0
• <i>Land tax</i>	44.5	74.2	258	299.1	343.8	374.3
Local budget revenues total (in bn. BYR)	3,356.9	4,767.5	7,293	9,381	12,049	13,904
Share of property taxes in local budget revenues (%)	7.07	8.19	10.02	10.20	9.54	9.12
Own revenues of local budgets (in bn. BYR)	1,400.8	2,166.1	3,405.5	4,643.7	5,277.1	5,777
Growth rates of property taxes in local budget revenues	100.0	115.8	141.7	144.3	134.9	129.0
Share of property taxes in own revenues (%)	16.95	18.03	21.47	20.61	21.78	21.95
Growth rates of property taxes in own revenues of local budgets	100.0	106.4	126.7	121.6	128.5	129.5

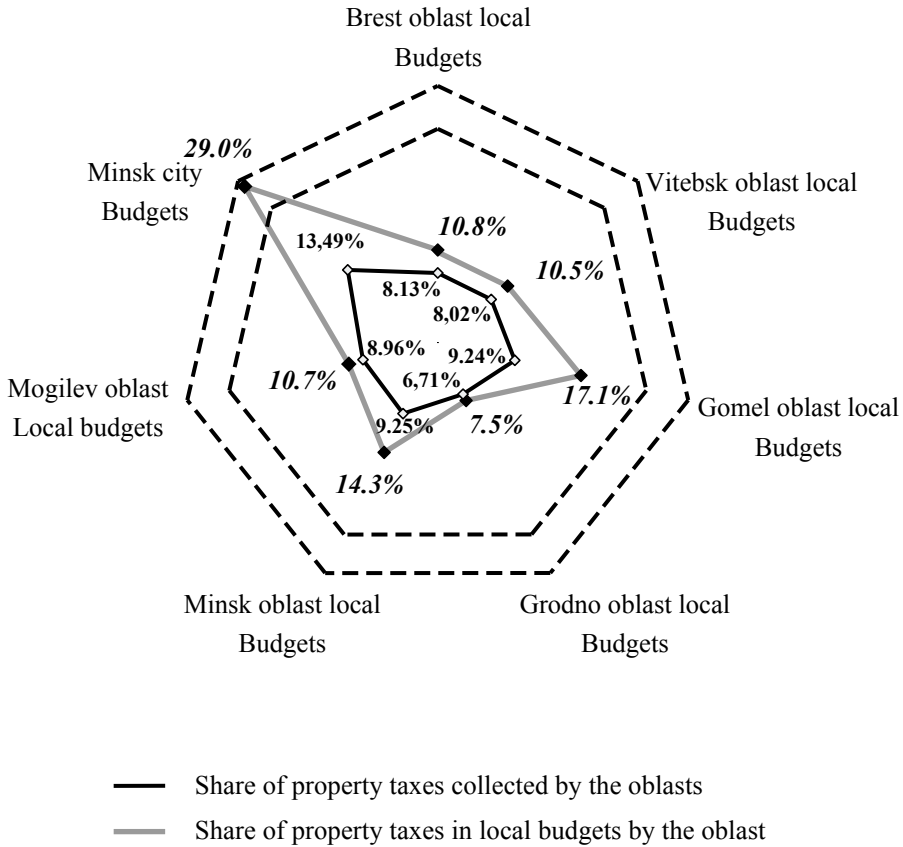
Source: Author's own calculations based on the Ministry of Finance of the Republic of Belarus reports.

This is testimony that for the period analysed, property taxes covered more local budget expenditures than other own financial sources of the local budgets. Further research of property taxes has shown non-uniformity in their collection by the regions. It is characterised by the following data in Figure 2.1.

As Figure 2.1 illustrates, the greatest share of property taxes belongs to the city of Minsk – the capital of Belarus – 29.0 per cent, the Gomelskay oblast – 17.1 per cent and the Minskay oblast – 14.3 per cent. In these regions, more than 60 per cent of all property taxes were collected. The domination of these regions in property tax collection also proves to be a high share of these taxes in local budgets' sources: 13.49 per cent, 9.24 per cent and 9.25 per cent, accordingly. For reasons of property tax development, it is necessary to look at the greatest concentration of available housing funds in these regions, together with the greatest concentration of resort objects and objects of private property, which have affected the size of the taxable base as a whole.

Figure 2.1

Share of property taxes collected by the oblasts and in consolidated oblast local budgets and in Minsk city budget in 2006 year (per cent)



Source: Author's own calculations based on the Ministry of Finance of the Republic of Belarus reports.

In view of the centralisation tendencies which are prevalent in Belarus, property taxes are being centralised to the oblast (regional) local budgets instead of going to local budgets where the property taxation objects are situated. This situation once again shows that Belarus authorities have not yet realised the role and significance of these taxes in local development and management, carrying out its centralisation at regional level. In fact, authorities treat property taxes as a “makeweight” to the basic taxes directed to the local budget.

2.3 Problems of mobile and immobile equilibrium in the revenue base of Belarus local budgets

As noted earlier, in the analysed period, property taxes have grown faster in the revenue base of local budgets than in all financial sources of local budgets. Meanwhile, the growing dynamics of property taxes have been kept and can be characterised by the following data in Table 2.2.

Table 2.2

Share of property taxes in consolidated local budgets and in own revenues in dynamics for the 2001–2006 period (in per cent)

Years	Share of own revenue sources (including real estate taxes and land taxes) in consolidated Belarus local budgets (per cent)						Share of property taxes (real estate taxes and land taxes) in own revenues of consolidated Belarus local budgets (per cent)
	Personal income tax	Local taxes and fees	Real estate tax	Land tax	Ecological tax	Other own taxes and non-tax fees	
2001	15.91	13.84	6.8	1.6	0.6	2.98	16.95
2002	16.22	14.35	6.8	2.9	0.79	4.38	18.03
2003	13.97	9.25	6.45	3.52	0.48	16.26	21.47
2004	14.96	10.2	7	3.2	3.67	8.96	20.61
2005	15.62	9.12	6.68	2.85	3.07	6.46	21.78
2006	17.84	10.35	6.43	2.69	0.83	3.41	21.95

Source:

Author's own calculations based on the Ministry of Finance of the Republic of Belarus reports.

As the table above shows, in Belarus, the share of property taxes in the structure of an own revenue base of local budgets has increased for the 2001–2006 period from 16.95 per cent to 21.95 per cent. This measure can be considered as positive; however it is still insufficient from the position of taxation base expansion.

There are some preconditions to increase property taxes in local budgets' revenue bases. The first, and well-known reason, is connected to the opportunity of filling local budgets by making budgets more "sanguineous". The second reason is connected to making taxes of a property immobile by nature making them soften so-called "budgetary risks". These risks are the most dangerous to municipalities whose budgets are filled mainly by mobile taxes: personal income tax and profit tax (PIT, PT). As a rule, it is the industrially developed municipalities which include donor enterprises.

In Belarus, a significant share of the own revenue base in local budgets is occupied by PIT. During the period analysed this increased from 15.91 per cent to 17.84 per cent. These tax sources create budgetary risks as PIT is extremely sensitive to the parameters of the industrial potential of the enterprises located in the region and depend on the results of their activities. If PIT continues to dominate the structure of own sources of local budgets, this tax will become a “hostage” of the enterprises in the region and will create a certain dependence on them. Any failures in the industrial policy of the donor enterprises or town-forming enterprises will result in a shortage of taxes, both in the central budget and in the local budget. To mitigate or lower these budgetary risks, property taxes are invaluable. However, the developed low share of these taxes in the financial sources of local budgets does not influence risk mitigating. Therefore, the low share of property tax collection is not yet capable of resisting the failures of donor enterprises or town-forming enterprises in the formation of local budgetary policy.

Box 2.1

Case in Gluboksky municipality of Vitebskay oblast

There are three donor enterprises in the Gluboksky municipality: a foodstuff factory and dairy-canning combined with a meat-packing plant. These enterprises and organisations provide almost 40 per cent of local budget taxes. At the end of 2004, due to difficulties of raw material deliveries to these organisations, the production process periodically stopped. This caused serious financial difficulties for local budget formation. There was no output and workers were sent on compulsory holidays. For this reason, mobile tax shortages in the local budget occurred. Shortages in mobile taxes in the local budget were significant due to enterprises being the basic donors to the local budget. Under these conditions, the local authorities addressed a higher authority to receive financial assistance in the form of an extreme horizontal grant. If the share of mobile taxes in the local budget of the municipality had not reached 9 per cent, the local authorities would have had to obtain an extreme horizontal grant from the higher local budget to “amortize” the “shock” of tax shortages. This case is a lesson that it is necessary to keep a balance between mobile and immobile taxes in the local budget.

Source: Own investigations of author

Our municipality research in Minsk oblast has shown that out of 24 municipalities, 11 are industrially advanced and form 77 per cent of the tax and non-tax revenues in the consolidated Minsk oblast budget. This creates dangerous tax shortages when the ratios of mobile taxes are very high. In industrially advanced municipalities, the risks of mobile tax shortages in local budgets appear much higher than the others. This can be seen from the data displayed in Table 2.3.

Table 2.3
Ratio of mobile and immobile taxes in local budgets of Minsk oblast

Municipalities (rayons and cities)	Mobile taxes (PIT, VAT, profit tax) in local budgets (in mln. BYR)	Immobile taxes (property taxes) in local budgets (in mln. BYR)	Ratio of mobile and immobile taxes
Berezenski rayon	4,990.5	1,605.3	3.1:1
Borisovski rayon *	58,462.8	17,696.7	3.3:1
Vileyski rayon	10,166.2	2,903.8	3.5:1
Volozhinski rayon	6,820.4	2,359.9	2.9:1
Dzerzhinski rayon *	19,372.4	6,583.3	2.9:1
Klezki rayon	6,419.9	1,687.5	3.8:1
Kopylski rayon	6,592.2	1,309.8	5.0:1
Krupski rayon	6,141.9	5,738.9	1.1:1
Logoyski rayon	6,596.9	1,870.3	3.5:1
Lubanski rayon	6,400.2	2,125.1	3.0:1
Minski rayon*	15,237.0	32,239.4	0.5:1
Molodechenski rayon*	38,886.6	14,947.0	2.6:1
Miadelski rayon	5,327.0	2,133.8	2.5:1
Nesvizhski rayon *	10,741.5	7,033.0	1.5:1
Pukhovichski rayon *	14,529.7	6,610.2	2.2:1
Slutski rayon *	25,395.8	11,388.3	2.2:1
Smolevichski rayon *	11,240.3	4,236.5	2.7:1
Soligorski rayon *	33,107.7	23,128.9	1.4:1
Starodorozhski rayon	5,017.1	1,340.0	3.7:1
Stolbtsjvski rayon	9,340.0	2,830.5	3.3:1
Uzdenski rayon	4,519.2	1,219.7	3.7:1
Chervenski rayon	5,618.2	1,732.3	3.2:1
Zhodino city *	20,172.5	7,225.4	2.8:1
Zaslavl city *	4,609.4	1,300.5	3.5:1
Total:	335,705.5	161,246.5	2.1:1

Note: * industrially advanced municipalities

Source: Author's own calculations based on the Finance department reports of the Minsk oblast.

The table above shows that fluctuations in the ratio of mobile and immobile taxes at industrially advanced municipalities and all municipalities appeared identical. From this, it is possible to conclude that the risks of mobile tax shortages in local budgets of industrially advanced municipalities appear much higher than others.

This situation once again proves that it is necessary to keep the ratio between mobile and immobile taxes in own revenues as 1:1. Balancing mobile and immobile taxes in the local budgets will also allow a reduction in the sizes of grants from the higher budgets in the process of horizontal equalisation.

2.4 The problems of transition to market methods of the real estate valuation

There are two problems involved in improving property taxes in Belarus. First, there is no advanced real estate market.¹ Therefore, costs are calculated using formulae and non-cost methods of tax burden distribution amongst owners. Second, the problem is the rather low level of monetary income of the population. The low level of income brings no income from property and may cause serious financial difficulties for payers. This can be seen from the data in Table 2.4. The final problem can be solved partly by the establishment of privileges. These two problems however are interconnected. It is impossible to enter market methods of real estate valuation with the low incomes of the population.

Box 2.2

Case of increased land tax rates.

In 2003, according to an addition to the Law of the Republic Belarus “About payments for land” land rates for housing purposes of corporate organisations have been increased by 6–7 times. This decision on an increase in the size of the land tax was administrative. Such a sharp increase of land tax was reflected in production costs and incomes of enterprises and has led to a mass refusal by legal persons regarding superfluous land. Rent payments did not meet the real cost of land areas and have meant that certain kinds of activity became profitable. As a result, the Central government had to refuse a sharp increase in tax rates and return to “reasonable” rates of land tax. Therefore, the increase in taxation due to rates of the land tax has failed. It proves that the decision to increase land tax by raising tax rates creates serious problems.

Source: Own investigations of author.

On the other hand, the presence of sufficient income of the population with no market property valuation will not stimulate new investment or economic growth in the municipalities. However, as a whole, the absence of real estate market methods is difficult to compensate. This problem is widely distributed and requires the

1 Development of a cadastral valuation technology in the Republic of Belarus within the framework of SIDO project “Development of the real estate market in Belarus” has been performed. SIDO project has been performing since 2001 together with Public Association “Land reform” and foreign agency “Swedesurvey” with the participation of the NGO “Lev Sapieha foundation”.

formation of a property taxation system. Even if conditions of a real estate market exist, it is necessary to try to evaluate real estate properly, whenever possible. For this reason, the data on transactions accomplished in other jurisdictions will probably have to be used.

Table 2.4
Monetary income of the population in 2006 (per capita, thousands BYR)

Oblasts (regions)	Monetary income of the population (thousands BYR)	Monetary income of the population (in US\$ – estimation)
Brestskay	4,240.6	1,981.5
Vitebskay	4,383.0	2,048.1
Gomelskay	4,294.4	2,006.7
Grodnenskay	4,865.8	2,273.7
Minskay	4,248.9	1,985.5
Mogilevskay	4,398.3	2,055.3
Minsk – city	7,738.1	3,615.9

Source:

Author's own calculations based on Ministry of Statistics of the Republic of Belarus reports

In Belarus, currently the technique and methods of cadastral valuation are calculated and allow the construction of a taxation system on a market basis. The basic purpose of a cadastral valuation is the formation of a “fair” base for taxation. The system of land resources’ taxation, on the basis of their market or cadastral valuation, has a number of advantages. First of all, it is fair in comparison with the administrative methods of property tax valuation. A person who owns the best property and has the advantage of additional revenues should pay more. The second system of a cadastral valuation prompts inefficient proprietors (users) to transfer their land areas to those who can use it more productively. Moreover, it can result in situations whereby proprietors of expensive sites with low incomes will be happy to rent to those who pay the corresponding tax.

As a result of the cadastral costs definition of the estimated zones, for each of the cadastral zones’ calculations on the basis of land cost of the estimated zone and average cost in 1 sq.m. estimations of the land are made. A cadastral valuation of the land areas is carried out using an application of the indexes adjusting the cost of the

land area using the base cost of the land of the estimated zone. The cadastral cost for land areas registered in the State land cadastre is determined.²

The approbation of the cadastral estimation in a number of municipalities in Belarus has shown that this influences the amount of property tax. For example, with the results of the cadastral estimation of lands in the Gomel city in 2002, calculations of recommended rates for land tax (in percentage of cadastral cost) were carried out, depending on the functional use of the land. For zones of industrial building and municipal zones the land tax rate is 1 per cent of the cadastral cost. As a result, the amount of land tax, in comparison with existing estimations, should increase by 1.77.

It should be noted that the developed cadastral valuation in Belarus approaching market valuation, is not applied because of the unwillingness of the Central government to follow market mechanisms. The low level of income of the population can cause negative social consequences due to the introduction of a market approach to the estimation of land and real estate. However, a similar market approach to land estimation has been used in Russia since 2007.

2 The cadastral cost of land is the cost of a land area unit reflecting the value (benefits) of land under use by the existing special-purpose designation. The cadastral estimation of the land is estimated uniformly on an estimation model which takes into account the influence of a limited amount of factors. The cadastral cost is close to the market price with the following conditions: sufficient market information and when the current land use coincides with the variant of its most effective utilisation.

The method of cadastral estimation is a method for estimating the land and includes, (1) the land area which is applied if the conditions are insufficient or if there is an absence of market information. It assumes the use of data contained in the state land and town-planning cadastres and using the estimation model; (2) model of a cadastral estimation – the estimated digital surface reflecting the interrelation of the cadastral cost of the land and factors of estimation; (3) factors of estimation are the economic, physical and other factors essentially influencing the cost of land.

Box 2.3

Case: An example of cadastral valuation in the city of Orsha

The cadastral estimation of land costs in Orsha shows there was a balance between the areas of the estimated zones of the city with the various kinds of functional use: the vein of a zone, zone buildings, zones of public centres, industrial zones and landscape zones. Public centre zones occupy a rather small part of the territory of the city. However, within them, there is expensive land. The cadastral values range from 2.33 USD/m² to 9.98 USD/m². In comparison with zones in the public centres, the share of industrial territories is more apparent. This ranges from 0.89 USD/m² to 6.4 USD/m². It is obvious that for the city it would be preferable to increase the share of public territories occupied by commercial organisations (trade, services) due to the reduction of inefficiently used territories, especially in the central part of city. The tendency towards employment reduction was outlined in Belarus and increases in employment in the branches of infrastructure are confirmed by this. As a consequence, it results in a reduction of industrial territories in cities and an increase in territories occupied by commercial functions. An analysis of zones occupied by a housing estate shows that in Orsha there is a situation whereby the greatest area is occupied by territories with the lowest cost of the land. These are territories with manor buildings which range between 0.16 USD/m² and 1.15 USD/m². At the same time, the share of the land occupied by multi-form buildings is three times more than that of manor buildings. Here, the range of values changes from 1.47 USD/m² to 8.04 USD/m². It proves that in Orsha city territories a trend for building an economically inefficient system of land tenure has developed. For a more effective utilisation of building land it would be necessary to reduce the areas of manor territories and increase the areas of multi-form building territories. The cost of land with manor buildings could be increased if there was an improvement in the quality and accomplishment of existing buildings. The basic purpose of cadastral lands' estimation of the settlements is to form a basis for taxation.

Source:

Tehnologia kadaastrovovoy otsenki zemel naseleennyh punktov Pespubliki Belarus (2004), 80–82

2.5 Reserves of the property taxes in Belarus

In Belarus, opportunities to increase property taxes are linked to the development of foreign investments in many respects. At present, the rates of investment growth are insignificant and investments in fixed capital are basically carried out using internal financial sources (central budget financial resources and long-term banking credits) and this is obviously insufficient. As far as the development of foreign investments is concerned, a “recoil” has been seen and the share of foreign investments has steadily reduced. This is illustrated in Table 2.5.

Table 2.5

Investments to fixed capital for the 2000–2006 period (bn. BYR and per cent)

Indicators	2000	2001	2002	2003	2004	2005	2006
Total fixed capital investments by financial sources	1,809	3,049.3	4,484.6	7,131.2	10,783.4	15,095.8	20,374.1
Including:							
Internal financial resources	1,731.4	2,968.1	4,251.2	6,737.3	10,491.6	14,855.4	20,192.9
Share of internal financial resources in total fixed capital investments (per cent)	95.7	97.3	94.8	94.5	97.3	98.4	99.1
Foreign financial recourse (excluding foreign credits and loans) (per cent)	77.6	81.2	233.4	393.9	291.8	240.4	181.2
Share of foreign financial resources in total fixed capital investments (per cent)	4.3	2.6	5.2	5.5	2.7	1.6	0.9

Source: The table was produced by the author on the basis of data from the Statistical Yearbook of the Republic of Belarus 2007, 437–438

As displayed in the Table, in Belarus the share of foreign investments has decreased from 4.3 per cent in 2000 to 0.9 per cent in 2006, or by almost 5 times. This position is explained by the insufficient investment climate in the country and does not attract foreign investors to invest in the Belarus economy. Under conditions of foreign investments' expansion in the country, it would be necessary to pursue a policy to uniformly distribute investment in the regions and municipalities, with the purpose of maintaining an equal tax base for property taxes.

In Belarus a serious reserve to activating property taxes could be the development of the privatisation process with the participation of the foreign capital, which is now suspended. It should be noted that Belarus has made little progress in advancing structural and institutional reforms. Meanwhile, State ownership continues to dominate in the economic environment through budget and off-budget funding, support to enterprises through state-owned banks and various targets imposed on enterprises. The privatisation process, however, remains stalled and the State has regained its stakes in some formerly privatised enterprises. The results of these processes are briefly summarised in Table 2.6.

Table 2.6
Privatisation of Belarus organisations

Indicators	Since the beginning of privatisation (1991–2006)	2006
Organisations (projects) reformed and alienated	8,909	546
Total organisations (projects) reformed by privatisation:	4,116	16
<i>transformation of stated owned organisations into joint-stock companies</i>	<i>1,990</i>	<i>12</i>
<i>redemption of leased property by lease holding organisations</i>	<i>724</i>	<i>–</i>
<i>sales at auctions</i>	<i>1,402</i>	<i>4</i>

Source: Statistical Yearbook of the Republic of Belarus 2007, 559.

As we see from the Table above, in 2006 only twelve organisations transformed from State ownership into joint-stock companies. However, we should mention “quasi privatisation”. Many state organisations turn into joint-stock companies with dominating State ownership. So, the share of State ownership in such joint-stock companies totals 70–90 per cent, which allows them to keep a control function.

Private enterprises experience excessive regulation and a high tax burden. The earlier existing law on “golden shares” remains a factor of serious mistrust for investors, even though this law was cancelled in March 2008. The cancellation of “the golden share” is a progressive step, but insufficient to begin speaking about a substantial improvement in the investment climate in the country. Certainly, externally “the golden share” which gave an opportunity for the state to actually manage, was like a “scarecrow” for investors. But, in making a decision about investments, any serious investor studies the investment climate. Unfortunately, the Belarus legislation is still not favourable to attract foreign investments.

In the country an administrative regulation of pricing is maintained. An administrative normalisation of expenses and artificial restrictions on salaries has also taken place. Currently, the Belarus tax system has many problems. It is not so much because of the size of rates, but because of discrepancies and complexities. For example, many taxes and fees actually have an identical base and theoretically they could be united in one tax or fee. Tax calculations are confusing, and very often a mistake in one tax calculation leads to a chain of other mistakes which results in punishment. In the country, the right to a private property is insufficiently protected: Fiscal and control bodies can, without a court decision, write off the financial resources of bank accounts of private organisations and enterprises. There is also a practice of imposing official penalties without a court decision. Therefore, we can-

not speak about any serious improvement in the business climate without solving these problems.

Over the last months, many acts on economic relations, directed to liberalisation, were adopted. For example, decrees about the simplification of the registration of organisations and enterprises, a decree about granting privileges to businessmen in small cities and the countryside, a decree about the status of diligent participation of foreign trade activities and a decree on guarantees for the activity of free economic zones' investors were enacted. Although these acts also respond to important questions, it is obviously not sufficient given the measures taken. Unfortunately, the Belarus authority, similarly, cannot be solved through a fast and general economic liberalisation. Therefore, business is limited to half measures.

2.6 Conclusions

The growth of property is represented as a good positive trend in Belarus. However, the increase of taxes in local budgets is not realised through the conception of fiscal decentralisation. An area of concern is that property taxes go to the local budgets of the high governmental tiers. For example, property taxes do not go to the lowest local budgets (budgets of rural and city settlements), and are centralised in the higher local budgets – rayon and oblast. This is due to the wave of financial centralisation in Belarus. The Belarus authorities regard property taxes as “makeweight” to higher local budget revenues instead of being an instrument of local government development at the lowest level.

This has meant that the Belarus authorities realise property taxes in their own manner and have carried out a number of measures to increase them. These measures, however, remain insufficient and vague. First, there is no advanced market of real estate. Therefore, the calculations of real estate and lands by means of cadastral valuations, formulas, and approximate market prices are used. This is why non-costing methods of tax burden distribution among proprietors are taking place. Second, there is the obstacle of the low level of incomes of the population and this may cause serious financial difficulties for those who pay. Nevertheless, the developed cadastral valuation in Belarus is not applied because: central government does not follow market mechanisms; because of the low level of incomes of the population, and also the fear of negative social consequences through the introduction of market approaches to estimating land and real estate.

Property tax evolution is rooted in the development of Belarus's economic potential, its ability to attract foreign investments, the creation of an investment climate and development of the privatisation process. Unfortunately, these processes are very slow. Their development and activation would allow them to considerably increase their role in local financial management and their share in local budgets.

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3. Property Tax in Bulgaria: A Case Study of Blagoevgrad

Desislava Stoilova

3.1 Introduction

The purpose of this paper is to provide a critical analysis of property taxation within the general framework of fiscal decentralisation in Bulgaria. First of all, the changes in government structure and inter-governmental financial relations are presented on the base of the legislation in force. Analysis is focused on the role of different governmental tiers within the public sector of the country. The rate of fiscal decentralisation is assessed through the relative importance of the inter-governmental transfers, both in central government expenditure and local budgets. Special emphasis is placed upon the evolution of local budgets revenue structure over the transition period. The relatively small share of property tax revenues, both in the national tax system and local government revenues, is analysed as a basis for further assessment of the property tax system's effectiveness. A short case study on property taxation in a particular local government is included, in order to illustrate the basic principles of the property taxation system in the country. Finally, some recommendations are outlined, intended to improve property taxation in Bulgaria and fully utilise its revenue raising potential.

3.2 Government structure and inter-governmental relations

3.2.1 Government structure

Bulgaria is a unitary state with a 7.9 million population and a territory of 111,000 km². The process of gradual political, administrative, and financial decentralisation in the country began in 1991, parallel to the transition from the centrally planned, socialist-type economy to a market-based economy. The process was inspired by the adoption of the new Constitution of the Republic of Bulgaria, which provided protection for the basic principles of local self-government. In addition, a package of laws has been adopted, shaping the legal grounds for decentralisation. For example, the organisation and functions of local governments are prescribed by the Local Self-Government and Local Administration Act (1991), which concretises the guidelines provided by the Constitution in conformity with the formulations of the European Charter on Local Self-Government, ratified by the Republic of Bulgaria in 1995. Another important component of the legislation, in the scope of local self-government, is the Act on Administrative and Territorial Structure of the Republic of Bulgaria (1995), which determines the legal criteria and procedures for establishing, merging, splitting and liquidating administrative units. Some of the most

important principles, which form the fundamentals of this law, are the principle of territorial neighbourhood and compliance between the size of the administrative units and their competencies and resources; subsidiarity principle; principle of succession and territorial stability of the administrative structure, as well as the principle of democratic choice in all decisions, causing administrative and territorial changes. Although the five administrative reforms, which have been conducted during the second half of the last century, brought about consequential transformations in the administrative-territorial units and changes of functions at the different government levels, the modern decentralised system in the public sector was initiated with the new Constitution and the first democratic elections. Since 1991, local self-government in Bulgaria has become constitutionally and legally regulated.

Table 3.1
Main Characteristics of Government Structure

Administrative Territorial Units Year	Planning Regions		Districts		Municipalities	
	Number	Average Popula- tion	Number	Average Popula- tion	Number	Average Popula- tion
1950	–	–	14	516,300	2,178	3,300
1961	–	–	28	261,000	979	8,000
1979	–	–	28	315,900	291	30,400
1987	–	–	9	997,400	273	32,900
1999	–	–	28	284,800	262	30,300
2008	6	1,280,000	28	280,000	264	30,000

Source: National Statistical Institute

Now, classified according to European standards, the territorial structure of the country includes 6 planning regions, defined as level NUTS II, 28 administrative districts corresponding to level NUTS III, and 264 municipalities, which represent the level LAU 1 (NUTS II and NUTS III are the abbreviations respectively of the level II and III of the Nomenclature of Territorial Statistical Units within the meaning of Regulation (EC) No. 1059/2003 of the European Parliament and of the Council of 26 May 2003. LAU 1 is the denotation for a local administrative unit).

Created according to the Regional Development Act (2008), and in compliance with the requirements of the European Union for the allocation of regional development funds, the planning regions in Bulgaria are merely statistical units and do not perform administrative or financial functions. The districts are deconcentrated administrative units of the central government, which coordinate national and local interests. They neither enjoy financial autonomy, nor provide public services to the population. Basically, districts are intended to manage the state property on its

territory, to monitor the compliance of local decisions with the law, to implement the state policy at local level, to foster local development and unite municipalities to work together on large-scale projects. According to the Constitution, municipalities represent the only tier of really autonomous sub-national government in the country. They are legal entities, which have the right of ownership and adopt independent municipal budgets, used according to the interests of the local population. The bodies of local government – the Municipal Council and the Mayor – are elected directly by the local population for a 4-year mandate with the purpose of making and carrying out governmental decisions. The democratic election procedure is determined by the Local Elections Act (1995).

The municipal council comprises municipal councillors, elected on the basis of proportionate representation. It is the representative body of the local government that determines the policies for the development of the municipality, adopts the budget, and conducts the management of municipal property. The mayor performs executive functions, directly manages the municipal administration, and ensures the performance of the municipal budget and the implementation of the municipal council's decisions. The elections for mayor take place in two rounds, based on the majority system. The candidate who gains the absolute majority of votes in the first round becomes mayor. A second round is organised a week after the first round if none of the candidates has been elected. Only the first two candidates may participate and the candidate who gains the most votes becomes mayor. The last local elections held at the end of 2007, elected respectively 264 mayors and 264 municipal councils with 5,234 municipal councillors. Men prevailed in the municipal councillor seat takers (75.1 %). There is a two-year lag between the central and local elections in Bulgaria.

3.2.2 Inter-governmental fiscal relations

During the period 1990–2007 Bulgaria has made remarkable progress in reforming its system of inter-governmental fiscal relations. In addition to the new Constitution and the Local Self-Government and Local Administration Act, which provide the basic regulation of the local self-government, a package of laws has been adopted in order to promote a decentralised organisation of inter-governmental fiscal relations. Some of the basic laws are the Referendum Act (1996), which regulates citizens' participation in the political process at local level, the Municipal Property Act (1996), which solves the issues of acquiring and managing municipal property, the Municipal Budgets Act (1998), intended to specify the procedure and organisation of the municipal budgeting process, the Local Taxes and Fees Act (1997), which defines the type, base, and rate of local taxes and fees, and the Municipal Debt Act (2005), which determines the procedure, conditions and limits of local debt service. The administrative reform carried out in the country and the necessity for qualitative perfection of the services, provided by the central and local government administrations, provoked the adoption of the Administration Act (1998) and

Table 3.2
Public Sector Expenditures in Bulgaria

a) 1990–1999

Indicators		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP in current prices	(mio BGN)	45.4	135.7	200.8	298.9	525.6	880.3	1,761.2	17,432.6	22,421.1	23,790.4
Consolidated Public Sector Expenditures	(mio BGN)	30.6	69.4	107.7	167.7	286.0	432.1	768.8	5,976.8	8,620.3	9,638.7
	(% of GDP)	67.48	51.11	53.66	56.09	54.41	49.09	43.65	34.29	38.45	40.52
Expenditure of Central Government	(mio BGN)	18.0	31.9	46.0	81.9	150.0	235.0	514.0	3,124.9	3,072.7	4,130.4
	(% of GDP)	39.65	23.58	22.91	27.43	28.54	26.81	29.18	17.93	21.15	21.46
Expenditure of Local Government	(mio BGN)	5.6	14.9	26.2	33.8	48.6	67.9	111.7	990.2	1,658.7	1,864.1
	(% of GDP)	12.34	10.95	13.04	11.30	9.24	7.71	6.34	5.68	7.40	7.84
	(% of CPS)	18.30	21.47	24.33	20.16	16.99	15.71	14.53	16.57	19.24	19.34

b) 2000–2007

Indicators		2000	2001	2002	2003	2004	2005	2006	2007
GDP in current price	(mio BGN)	26,752.8	29,709.2	32,401.6	34,627.5	38,822.6	42,797.4	49,090.6	54,864.0
Consolidated Public Sector Expenditures	(mio BGN)	11,233.8	12,017.3	12,732.5	14,068.8	15,198.9	16,657.3	18,275.6	21,356.4
	(% of GDP)	41.99	40.45	39.30	40.63	39.15	38.92	37.23	38.93
Expenditure of Central Government	(mio BGN)	4,721.7	5,214.9	5,192.0	6,073.9	6,404.0	6,869.6	6,998.8	9,206.3
	(% of GDP)	21.75	20.62	19.02	20.75	19.93	19.49	17.54	15.70
Expenditure of Local Government	(mio BGN)	2,005.3	1,990.1	2,391.6	2,243.8	2,382.5	2,738.7	3,332.9	4,070.6
	(% of GDP)	7.50	6.69	7.38	6.48	6.14	6.40	6.79	7.42
	(% of CPS)	17.85	16.56	18.78	15.95	15.68	16.44	18.24	19.06

Source: Ministry of Finance of the Republic of Bulgaria, National Statistical Institute and own calculations

Note: BGN is the abbreviation for Bulgarian currency. According to the Currency Board provisions, the exchange rate is fixed in proportion to 1.95583 BGN per EURO. Transfers to local governments are not included.

State Officers' Act (1999). These laws are directly related to the improvement in the functioning and organisation of local self-government, particularly the part concerning the development of the municipal officers' statute.

In response to the fast-changing legal and financial environment during the transition period, public sector expenditures have been very dynamic. Due to economic stagnation, financial instability, and vertical imbalance in the last decade of the 20th century, the relative importance of local governments within the governmental system decreased. Moreover, regardless of the financial stabilisation and economic growth, achieved during the first years of the new century, this downward tendency persisted. Although providing up to 30 per cent of public sector services in the country, local budgets' relative share in GDP has been reduced to 7.5 per cent in 2000 and 6.1 per cent in 2004 in comparison with 12.3 per cent in 1990. At the same time, expenditures of the local governments, which formed 21.5 per cent of the total expenditures in the consolidated state budget in 1991, reached respectively 17.9 per cent in 2000 and 15.7 per cent in 2004. The downward tendency was reversed in 2005, due to the ongoing process of fiscal decentralisation during the period 2003–2007, which has considerably influenced inter-governmental fiscal relations. As a result, financial autonomy of the municipal level of government increased. Now, local governments are an important part of the public sector in the country, accounting for about 19 per cent of total government spending. In 2007, the consolidated public sector expenditure represented 38.9 per cent of GDP, while the local government share was 7.4 per cent of GDP.

The fiscal decentralisation process in Bulgaria comprises several distinct periods. As a whole, the inter-governmental fiscal relations in the period 1991–2002 can be characterised by a lack of stability, fairness and transparency. At the very beginning of transition (1991–1993), the highly centralised system was preserved. Moreover, the public sector suffered from the absence of a sensible dialogue between local and central authorities. In 1993, the independence of municipal budgets, within the consolidated state budget, was acknowledged, meaning, in essence, that the State abandoned the automatic centralisation of local budget surplus and financing of the local deficit. In addition, the financial relations between central and local governments developed, with the introduction of a formula for the distribution of state subsidies for municipal budgets. However, the reform of the local budgetary process and municipal financial management was inevitable, as a reflection of broader social and economic changes implemented throughout the country.

Typical for the period 1994–2002 was the process of gradually building the capacities of local authorities. The National Association of Municipalities in the Republic of Bulgaria (NAMRB) and regional associations of municipalities appeared as champions of financial decentralisation. By means of instructive training, seminars, roundtables, discussion forums, publications, and in co-operation with foreign consultants, the efficacy of the existing legislation was estimated and the financial

situation of municipalities was analysed as a base for further reforms. This resulted in several changes in inter-governmental relations, gradually eliminating mandatory priorities in the allocation of municipal budgetary expenditures. Since 2000, central government's efforts have been focused on implementing structural reforms in functional systems, which affect some of the main expenditure responsibilities of municipalities (education, social and health care). As a result, primary health-care and integrated regional hospitals were excluded from municipal financing and half of all welfare benefits were financed by a subsidy from the central government. However, to the end of this period, the financial system remained centralised and municipalities did not have the possibility of planning even own-source revenues. As regards the transfer system, the large amounts of additional subsidies allocated on a regular basis throughout the financial year established a model of almost complete control over the municipal budgets.

Reflecting the entire organisation of inter-governmental fiscal relations, the transfer system in the period 1991–2002 has had several basic shortcomings. First, the overall amount of the transfers has not been stable. The share of subsidies for the period varies widely between 5.2 per cent and 11.0 per cent of the gross domestic product and represents from 10.6 per cent to 29.4 per cent of central government expenditures in the different years. Second, the formula for the allocation of state subsidies among the municipalities was exceptionally complicated and difficult to predict. Since its introduction in 1993, it has been changed every year, becoming more and more complex with each change. Moreover, the original legislative rationale for the general state subsidy, namely to meet different expenditure needs based on so-called objective criteria, has been converted into a redistributive scheme based largely on the ad hoc decisions of the Ministry of Finance. The rationale of capital investment subsidy allocation was completely unclear and seemed to have no relation to any quantitative or qualitative criteria. Whereas the general subsidy became a safety net for municipalities with low revenues per capita, analyses of its actual allocations indicated numerous instances of unexplained variations across municipalities (see Thcavdarova, Ivanov and Savov 2000, 36). Finally, the continual redistribution of subsidies in the course of the fiscal year, as well as the end-of-year special subsidy allocations, ignored the objective criteria adopted with the annual State Budget Acts. Because the relative share of additionally allocated funds during the period represented from 20.2 per cent to 47.0 per cent of the total governmental subsidy (about 35 % on an average), this approach caused unfairness, unpredictability, and instability of local finance and undermined the effective budgetary process at the local level, fostering a political orientation to the inter-governmental transfers' allocation.

The end of 2001 set the starting point for inter-governmental co-operation aimed at implementing fiscal decentralisation principles by improving the regulatory framework of inter-governmental financial relations. The Council of Ministers

Table 3.3
Role of the Inter-governmental Transfer System

	1991	1992	1993	1994	1995	1996	1997	1998	1999
a) 1991–1999									
1. Expenditure of CG, (mio BGN)	53.4	79.4	130.6	229.8	347.0	818.6	3,124.9	4,741.6	5,106.0
2. CG transfers to LGs (shared taxes + grants), (mio BGN)	14.8	21.5	32.8	37.7	53.1	86.9	906.1	1,392.9	1,496.5
2.1 From this: CG grants to LGs	3.6	9.3	16.7	21.7	28.8	37.1	349.1	617.7	737.7
3. Share of total CG transfers in CG expenditure (%) (2/1)	27.7	27.1	25.1	16.4	15.3	10.6	29.0	29.4	29.3
3.1 Share of CG grants in CG expenditure (%) (2.1/1)	6.7	11.7	12.8	9.4	8.3	4.5	11.2	13.0	14.5
4. Share of total CG transfers in GDP (%)	10.9	10.7	11.0	7.2	6.0	4.9	5.2	6.2	6.3
b) 2000–2007									
1. Expenditure of CG, (mio BGN)	5,819.0	6,125.9	6,164.2	7,186.2	7,736.6	8,339.1	8,611.7	10,524.2	10,524.2
2. CG transfers to LGs (shared taxes + grants), (mio BGN)	1,602.3	1,556.3	1,786.1	1,479.8	1,590.1	1,663.6	2,185.5	2,106.0	2,106.0
2.1 From this: CG grants to LGs	832.6	640.9	870.7	755.7	790.0	883.2	1,343.3	1,317.9	1,317.9
3. Share of total CG transfers in CG expenditure (%) (2/1)	27.5	25.4	29.0	20.6	20.6	19.9	25.4	20.0	20.0
3.1 Share of CG grants in CG expenditure (%) (2.1/1)	14.3	10.5	14.1	10.5	10.2	10.6	15.6	12.5	12.5
4. Share of total CG transfers in GDP (%)	6.0	5.2	5.5	4.3	4.1	3.9	4.5	3.8	3.8

Source: Ministry of Finance of the Republic of Bulgaria, National Statistical Institute and own calculations

Note: The expenditures are presented in nominal terms only due to the following reasons: 1) Because of the two periods of great, even hyperinflation, namely 1991–1992 and 1996–1997, on 5 July 1999 the Bulgarian currency was denominated and 1000 old BGN were replaced by 1 new BGN; 2) The methodology of the CPI calculation has been changed several times, so it cannot be used as a reliable measure.

and the National Association of Municipalities signed a co-operation agreement, whereby both parties agreed to decentralise local government and increase the financial independence of municipalities. Both the Fiscal Decentralisation Concept and the programme for its implementation were adopted in 2002. As a result, the reform of local finances allowed for one of the main achievements in the scope of inter-governmental fiscal relations, namely the clear distinction between the local and central responsibilities for the public services. Provided, for the first time, by the annual State Budget Act for 2003 it was continued and improved during the following years. Basically, public services in Bulgaria are organised into nine major functions, each of them containing a number of activities. The central and the local governments provide services in each of these functions, but the ratio of their shares in the consolidated public expenditures varies for the different functions. Prevailing state functions are defence, public order and security, social insurance and social care, healthcare, and economic activities and prevailing municipal functions include housing and public utilities, while functions such as administration, education, and culture are mixed.

Consequently, municipalities provide services connected to state delegated activities and local activities. State delegated activities are entirely financed through the inter-governmental transfer system, mainly by the proceeds from personal income tax and a supplemental subsidy to the amount of expenditures calculated according to standards, which take into account quantitative indicators, such as the personnel number, the necessary salaries and insurance payments and the number of users, etc. Local activities are connected to the provision of local services, with type, amount, quantity, and quality independently determined by the municipalities. Expenditures for local services provision are only financed by own revenues and the equalisation subsidy. Additionally, the State Budget Act 2003 provided a framework for regulating a new, simple and transparent model of assigning government subsidies.

The inter-governmental transfers in Bulgaria are not competitive and comprise shared taxes and state subsidies. The most important shared tax is the personal income tax. It was divided among the central and local governments in 50:50 ratios, but since the beginning of 2003, personal income tax has been defined as an entirely municipal revenue, intended to cover delegated state activities at the local level. However, significant inter-municipal disparities were inescapable, because personal income tax was a progressive tax, collected by withholding at source, and the tax base was unevenly distributed, favouring the richest local governments. For this reason, the normative expenditure standards for the delegated state activities have been developed and the shared tax proceeds for any particular municipality have been limited to the amount of these standards. Since the beginning of 2008, personal income tax has been entirely removed from the inter-governmental transfer system.

According to the legislation in force, Bulgarian municipalities can count on three types of state subsidies: general, targeted, and extraordinary. The general subsidy is provided to municipalities without restrictions. It is unconditional, so no strings are attached to the use of the money. Target subsidy is conditional. It is provided for a preliminary set of purposes, usually for social assistance, healthcare, ecological recovery, and capital investment projects. The extraordinary subsidy is an unplanned financial flow, granted to municipalities in the course of the fiscal year, based on vague criteria and is generally aimed at supporting those municipalities in a difficult financial situation.

Total inter-governmental subsidies are allocated based on a formula, which is stated in the State Budget Act. Basically, the formula takes into account the expenditure needs and revenue capacity of the local governments. In 2007 it comprised three components. The first element is the general supplemental subsidy, which is calculated by a “gap-filling” method, as a comparison between the full cost of all state mandates imposed on the municipal budget, and the amount of shared tax revenues. Actually, the general supplemental subsidy plays an equalisation role as well, and compensates for the uneven distribution of the personal income tax base. The second element is the general equalisation subsidy, which consists of two ingredients. The rights to receive the first component are only given to the municipalities whose proceeds from local taxes in the fiscal year before have been under the average local tax proceeds at the national level. Actually, this governmental transfer brings the revenue capacity of those below-average municipalities up to the national average level. Those eligible to receive the second component of the equalisation subsidy are those municipalities with per capita expenditures for local activities lower than 110 per cent of the country’s average. In addition, the annual equalisation transfer pool must be equal to at least 10 per cent of the total municipal own-source revenues in the fiscal year before. The last element of the allocation formula is the capital investment subsidy. It is a very important targeted financial flow, because a wide range of infrastructure capital investments and ecological recovery projects is assigned to local governments. For the present, this grant is allocated on an ad hoc basis and seems to have no relationship to the general subsidy criteria.

In fact, despite the positive intentions, a small part of the necessary measures to increase fiscal decentralisation was included in the legislation for 2003. Overall, the local governments remained highly dependent on transfers from the state budget. Indeed, state-delegated public services were defined, valued, and entirely financed through the transfer system, but municipalities remained in total ignorance of the timing and amount of possible additional transfers. The significant amount of arrears existing at local levels, which exceeded 74.3 mio BGN at the end of 2003 (3.3 per cent of total LGs expenditures), constituted yet another problem. These liabilities have been accumulated as a result of the fiscal policy in the period 1991–2002, namely delegating responsibilities to the local level without providing

the necessary financial resources. Because of the insignificant fiscal autonomy of local governments and the burden of the unfunded state-delegated expenditures, the central government should bear at least partial responsibility for the local arrears. However, it was not until 2006 that the Ministry of Finance, together with the National Association of Municipalities, developed a mechanism for supporting the municipalities in difficult financial situations. As a result, subsidies of a total annual amount of 10 mio BGN, intended to assist in liquidating the arrears, were targeted towards 14 municipalities in 2006 and 24 municipalities in 2007. Although considerably reduced to 1.3 per cent of total local governments expenditures; the arrears still impede the financial independence of the municipalities with low fiscal capacity.

3.2.3 Composition of LG revenues

Basically, a key issue in the design of fiscal federalism is the financing of sub-national governments. Because of the advantages of taxation at the central level and spending at the local level during the transition period, Bulgaria has often ended up with a vertical and horizontal fiscal imbalance. The decentralisation of expenditure was not accompanied by equivalent revenue-raising responsibilities and the taxable base was unevenly distributed within the country's territory. Municipal financial resources in the country are regulated by the Local Taxes and Fees Act and the annual State Budget Acts. They comprise own source revenues (namely local taxes, fees and revenues from municipal property management) and governmental transfers. Before the Constitutional amendments at the beginning of 2007, Bulgarian municipalities were prohibited from setting either rates or bases of local taxes. Property tax, motor vehicle tax, inheritance tax, donation tax, and tax on real estate and movable property purchases, recognised as local taxes, were entirely regulated by the central governmental level. In terms of modern public finance, if local governments do not have any influence on the local tax design, it cannot be considered a local tax, but as a special transfer, based on the location of taxable property. Moreover, this regulation conflicted with article 9.3 of the European Chart of Local Self-Government, ratified by the Republic of Bulgaria in 1995. It was not until the beginning of 2008 that municipalities were given the authority to set local tax rates within certain legal limits. However, they are still not allowed to define the local tax base and provide additional (or remove existing) legal alleviations for certain taxpayers. Consequently, a legislative amendment is still necessary because local governments' financial autonomy can only be gained through full control over the local tax levy.

Another important legislative change concerning municipal revenue sources was the reassignment of the patent tax as an own revenue source at the beginning of 2008. The patent tax is a net annual income tax, which is collected from craftsmen and owners of small enterprises, who offer hand-made products, transport, trade activities, and tourist services such as accommodation and restaurants. It is due by legal entities and individuals, who have up to 50,000 BGN annual turno-

vers for the previous fiscal year, are not registered under the VAT Act, and perform so-called “patent activities”, strictly specified by the Local Taxes and Fees Act. The tax size for different types of products and services is based on the quantitative characteristics, such as the square metres trading surface for shops, the number of rooms in hotels, consumption seats in restaurants, number of seats in Internet clubs and number of installations or workplaces for craftsmen, etc. The patent tax replaces the payment of personal income tax or corporate income tax. Actually it does not consider the income, realised by the owners, but the capacity for potential income. The patent tax came into force in 1998 to ease the central tax officer’s duties and to decrease the expenditures for tax collection, due to its high effectiveness. The tax-obliged persons should declare at the beginning of the fiscal year that they will carry out certain activities. From this moment on, they become liable persons and are obliged to pay the full tax even if they do not work due to illness, absence or death. The patent tax schedule (base and rate limits) is fixed in the legislation. Now, municipalities are free to select annual rates within the legally defined set of ranges. In addition, while the patent tax schedule contains a provision for applying rate differentials, not only in different municipalities, but in different zones within municipal jurisdiction, it can adjust to the different economic conditions found across the local governments. In order to strengthen fiscal decentralisation in our country, municipalities should be gradually given full tax autonomy over the patent tax, in terms of taxable activities, tax bases, and rates. Undoubtedly, the patent tax has the potential to become an important part of local revenues and a powerful instrument in the municipal tax policy.

In addition to the lack of real tax autonomy outlined above, several problems had a decisive influence over the own-source local revenues during transition, causing a significant decline of their relative share, especially in the period 1991–1997. First of all, there is the difficult inter-relation between local governments and the tax administration, which in 1991 became subordinated to the Ministry of Finance. As a result, the interests and corresponding efforts of the centrally dependent officers were aimed at collecting taxes from the larger taxpayers, resulting in the delayed collection of local taxes and fees and even in a waste of local revenues. In a dynamic inflationary environment, any postponement led to additional losses for the municipal budgets. Another serious problem was the outdated tax base for the property tax, which was also used for the calculation of inheritance tax, donation tax, and tax on property purchase. Moreover, it was beyond the municipal competence to solve the problem. For this reason, in the first seven years of the transition period, local taxes accounted for less than 3 per cent of local revenues. Especially low was the local tax revenue share in 1997 (0.45 %), due to the hyperinflation, which additionally devaluated the property tax base. In addition, the inability of local governments to impose local fees and to set their rates freely, particularly in the inflationary situation, resulted in a growing gap between the revenue potential and the actual costs of the local service provision. The Local Taxes and Fees Act, in force since the be-

Table 3.4
Local Governments Revenue Structure (%)

a) 1991 – 1999

	1991	1992	1993	1994	1995	1996	1997	1998	1999
1. Own revenues	3.90	10.65	4.91	19.63	20.44	20.61	8.30	15.19	17.64
2. From this:									
2.1 tax revenues	0.65	0.93	1.16	2.25	2.48	2.85	0.45	5.00	4.79
2.2 property tax	0.63	0.91	1.13	1.84	1.61	1.87	0.23	1.56	1.58
3. Total Transfers	96.11	89.35	95.09	77.10	77.66	77.52	91.38	83.98	80.29
4. Shared taxes	72.73	56.48	46.82	32.72	35.47	44.42	56.17	46.74	40.71
5. From this: PIT	n/a	n/a	n/a	n/a	n/a	28.01	34.28	30.66	27.22
6. Net grants	23.38	32.87	48.27	44.38	42.19	33.10	35.21	37.24	39.58
7. Specific grant for capital expenditure	n/a	n/a	n/a	n/a	n/a	2.85	4.37	7.61	4.39
8. Borrowing: Loans/bonds	n/a	n/a	n/a	3.27	1.90	1.87	0.32	0.83	2.07
Total (1+3+8)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total revenues (mio BGN)	15.4	21.6	34.6	48.9	68.5	112.1	991.6	1,658.6	1,863.8

Table 3.4 (continuation)
Local Governments Revenue Structure (%)

b) 2000–2007

	2000	2001	2002	2003	2004	2005	2006	2007
1. Own revenues	18.03	22.03	23.88	31.69	33.80	35.58	35.67	43.54
2. From this:								
2.1 tax revenues	4.85	5.23	7.02	9.61	9.31	9.45	10.68	13.42
2.2 property tax	1.59	1.66	1.93	2.37	2.39	2.41	2.41	2.80
3. Total Transfers	81.96	77.59	75.67	67.95	65.88	64.02	64.02	55.10
4. Shared taxes	39.37	45.64	38.78	33.25	33.15	30.03	24.67	20.62
5. From this: PIT	26.81	26.03	22.05	33.25	33.15	30.03	24.67	20.62
6. Net grants	42.59	31.95	36.89	34.70	32.73	33.99	39.35	34.48
7. Specific grant for capital expenditure	3.74	3.63	5.91	5.33	2.45	3.27	4.25	4.08
8. Borrowing: Loans/bonds	0.02	0.37	0.44	0.36	0.31	0.40	0.31	1.36
Total (1+3+8)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total revenues (mio BGN)	1,955.0	2,005.7	2,360.2	2,177.8	2,413.6	2,598.7	3,414.1	3,821.8

Source: Own calculations based on the Ministry of Finance of the Republic of Bulgaria Database

ginning of 1998, updated local tax bases and allowed local governments to set the rates of the local fees within certain legal limits. Consequently, in 1998, local taxes reached 5 per cent of the total revenues and retained and expanded this share in the following years. Especially high is the share of local taxes in 2006 (10.7%) and 2007 (13.4%) due to the considerable revaluation of the property tax base.

During the period 1997–2007 local own-source revenues tended to increase gradually, from 8.3 per cent of total municipal revenues in 1997 towards 18.0 per cent in 2000 and up to 43.5 per cent in 2007. Obviously, this is an important step forward in fiscal decentralisation. However, this tendency is mainly due to the increase of local fees and non-tax revenues. Since 2003, local governments have been given full discretion over local fees and service prices, which have tripled their importance in real and relative terms. Municipalities can charge the local population and businesses for domestic waste; for the use of marketplaces, fairs, sidewalks, and roadbeds; for the use of nursery homes, kindergartens, social care homes, camps, hostels, and other municipal social services; for the extraction of quarried materials; for technical and administrative services; for the purchase of grave plots; tourist charges; and other local charges as regulated by law. Presently, the system of local fees is based on several main principles. First, municipalities have the authority to determine the services on which they charge fees. Second, the calculation of any particular fee is based on the full cost recovery principle and third, the revenues are mainly dedicated to fund the service for which the fee is imposed. Municipalities should be given full authority to determine the types of fees to be levied (in addition to the mandatory fees defined above), as they determine the rates, base, exemptions, and regulate the collection process.

The inter-governmental transfer system plays the dominant role in financing local governments in Bulgaria, since governmental transfers form the prevalent part of municipal revenues. Due to the gradual decrease of its relative share in the total local revenues, from 96.1 per cent in 1991, 91.4 per cent in 1997, and 81.9 per cent in 2000 towards 55.1 per cent in 2007, the Bulgarian inter-governmental transfer system is approaching European standards. There is not an absolute rule, but it is accepted that local fiscal autonomy is properly secured, when local own-source revenues are comparable to governmental transfers. According to the economic and financial point of view, the dominant role of the transfers allows local governments to be entirely compensated for the vertical and horizontal imbalances, but according to the political point of view, such a proportion gives the central government more political and financial control over the local level, than is acceptable for a modern revenue assignment system. Bearing in mind the great difference between the fiscal capacity in several of the richest municipalities and the remainder of local governments in the country, for the present, the strong inter-governmental transfer system has no effective alternative.

3.3 Historical background

In Bulgaria, the taxation on immobile property is not a completely new phenomenon. It has some tradition, dating from before and during the Communist period. After liberation from Turkish slavery (1878), Bulgaria, as a young sovereign state, inherited the tax system of the Turkish Empire, where property taxes were the main sources of budget revenues. The Land Tax Act (1894) abrogated the levy on agricultural production and imposed a land tax on agricultural land, based on a unit of area. The property tax was only levied on house properties, but the local government administrative buildings and churches were exempt. In the first years of the Communist period (1945–1950) there was no evidence of property taxation. In 1951, the Local Taxes and Fees Act was adopted, continuing the tradition to tax house properties. This law has been amended several times until 1997, when the new Local Taxes and Fees Act replaced the old one. It was intended to base the taxation on the market prices of the taxable properties. Actually, the regulation of property taxation in Bulgaria during the transition period was not very dynamic. Although there were several insignificant amendments, the current legal framework is, to a large extent, similar to the previous one regarding the basic principles in determining tax objects, taxpayers, tax rate, exemptions, tax collection, and incentives of tax administration.

3.4 Property tax as a revenue

3.4.1 Property tax in the national tax system and in LG revenues

Property tax has exceptionally little importance, both in the national tax system and in local government revenues. As a whole, the Bulgarian tax system is extremely based on consumption taxes, namely VAT, excise and custom duties, which form the prevalent part of the consolidated state revenues. The indirect taxes on consumption yield three times more than direct taxes on income, and this tendency is becoming stronger, especially after the adoption of the proportional personal income tax in 2008. Traditionally, the taxes on movable and immovable property form an insignificant part of the consolidated revenues and have never exceeded 1 per cent of the gross domestic product.

The property tax yield is extremely low, representing 0.2 per cent of the GDP, 0.6 per cent of the total consolidated tax revenues, and 2.8 per cent of the total local revenues. This is due to the various problems outlined above. First, the central subordination of the tax administration, resulting in delayed collection of local taxes and even in a waste of local revenues. Second is the outdated tax base for property tax, which remained stable in a highly inflationary environment. Third, there are the extremely large exemptions, including all properties used as basic residences of their owners, which pay only 50 per cent of the property tax.

Table 3.5
Bulgarian Tax System (the main tax revenues as a percentage of GDP)

	1991	1994	1997	2000	2003	2006	2007
Social Security Contribution	8.7	8.1	7.6	11.0	10.6	8.8	8.9
Indirect Taxes	8.6	8.3	10.2	13.9	14.2	17.9	18.4
• Value Added Tax	–	–	6.0	8.8	8.9	11.9	12.0
• Turnover Tax	7.4	6.3	–	–	–	–	–
• Excise duties	n/a	n/a	2.1	4.2	4.5	5.1	6.0
• Custom duties	1.2	2.0	2.1	0.8	0.7	0.9	0.4
Direct Taxes on Income	21.2	9.7	8.8	6.9	6.4	5.6	6.6
• Personal Income Tax	3.8	4.5	3.9	4.1	3.3	2.9	3.3
• Profit Tax	17.4	5.2	4.9	2.8	3.1	2.7	3.3
Local Taxes	0.3	0.6	0.03	0.4	0.6	0.7	0.9
• Property Tax	0.08	0.2	0.01	0.1	0.2	0.2	0.2

Source: Own calculations based on the Ministry of Finance of the Republic of Bulgaria Database

Note: Data for turnover tax and excise duties were presented together from 1991 to 1993. VAT was introduced in Bulgaria in 1994.

Table 3.6
Property Tax in the National and Local Revenue System

	1991	1994	1997	2000	2003	2006	2007
1. Own local tax revenues (mio BGN)	0.1	1.1	4.5	94.8	209.3	364.6	512.7
1.1 as a percentage of total consolidated tax revenues	0.32	1.05	0.09	1.09	1.88	2.23	2.65
1.2 as a percentage of total local revenues	0.65	2.25	0.45	4.85	9.61	10.68	13.42
2. Distribution of local taxes							
2.1 Property tax as a percentage of total consolidated tax revenues	0.32	0.86	0.05	0.36	0.46	0.50	0.55
2.2 Property tax as a percentage of total local tax revenues	95.50	81.82	51.11	32.81	24.65	22.55	20.89
2.3 Property tax as a percentage of total local revenues	0.65	1.84	0.23	1.59	2.37	2.41	2.80

Source: Own calculations based on the Ministry of Finance of the Republic of Bulgaria Database

Note: The only taxes that can be called local are the taxes on movable and immovable property. Income taxes have never been local revenues. During the transition period, corporate income tax and personal income tax have been shared in different proportions between the central and local governments. VAT has never been part of the local revenue system.

3.4.2 Tax incidence analysis

A simplified analysis of tax incidence, through the term of “formal” and “effective” incidence, evaluates taxes in four steps (Musgrave and Musgrave 1989). First of all, the formal incidence is the immediate answer to the question “Who pays the tax?”; second, the effective incidence includes the taxpayers’ reactions to the tax and its consequences; third, the problem of tax evasion and avoidance measures the potential distortion of tax capacity, and fourth, changes in price level show significant effects on tax when progressive taxes are being levied in times of rapidly changing prices and monetary income. In order to put into practice this analytical framework, this list has been extended and has built up an economic and financial tax analysis framework. The following Table 3.7 goes through this analysis step by step, comparing property tax with personal income tax in Bulgaria. For the purpose of comparison, some helpful categories are used characterising the relevance of each of the factors of the analysis, namely H (high), M (medium/moderate), and L (low).

3.5 Property tax as a procedure

In order to implement property taxation, the administration has sequences of tasks, namely identification, classification, valuation, assessment, rating, collection, enforcement, and appeals procedures. The description of property taxation in Bulgaria reflects each step of the property tax procedure.

3.5.1 Identification

The basis of the property tax system is an accurate cadastre of immovable property within tax jurisdictions. The new Law on Cadastre and Property Register came into force in 2000 with the purpose of arranging for the organisation, funding, creation, administration and use of the cadastre and the property register. Currently, the cadastre is a computerised aggregate of basic data about the location, boundaries and extent of immovable property within the territory of the Republic of Bulgaria, which are collected, represented, maintained up-to-date and stored according to routines, established by the law. The cadastre also encompasses data about the main quality and quantity characteristics of the real estate, the right of ownership, and the other legal rights or restrictive measures on the immovable properties. The state borders, boundaries of administrative-territorial units, boundaries of territories belonging to settlements, and boundaries of territories of identical durable land use are also outlined.

Local administrations use this database to identify the tax objects as a potential tax base. The Local Taxes and Fees Act, which regulates property taxation provides a list of exemptions. Some of the exempt properties include properties owned by the central and local governments, agricultural and forestry land, churches, community centres, museums, libraries, galleries, cultural monuments, public parks and sport facilities, Red Cross buildings, university and academic buildings, temporary build-

Table 3.7
A simplified analysis of tax incidence

Criteria	Description of the criteria/indicators	Property Tax	Personal Income Tax
Formal incidence: Who pays the tax?	owners/tenants, local residents/foreigners households/businesses	Local residents and foreigners owners of property within the municipal jurisdiction	Physical persons
Effective incidence:			
A) Economic analysis			
- Efficiency		M	H
by scale (yields)	the yields of tax revenue and share of collected tax in total local revenues	L	H
by distortion of local economy	people/businesses move from the jurisdiction	H	H
- Equity/Fairness	measured by exemptions	H	H
by horizontal	exemption applies to all taxpayers	M	H
by vertical	exemptions apply to the same group of taxpayers or progressive rating	H	H
B) Financial analysis			
- Limitation	A self limit is the number of tax units/taxpayers or the size of the tax object Limit by law e.g. regarding rating (maximum rate, minimum rate)	H	H
- Flexibility	The right to change the rate setting, to install exemption by LG	L	L
- Avoidance, tax evasion	Taxpayers avoid and evade paying tax measured by rate of collection (levied tax/collected tax)	L	M
- Reliability	Difference of budgeted and realised tax yields. If the difference is large, it is hard to estimate the tax revenue for the next years/periods (unstable budgeting)	H	H
- Volatility	The change of tax yield from one year to another. If there are high waves year to year, it is hard to estimate the tax revenue for the next years/periods (unstable budgeting)	L	M
- Elasticity	How do tax yields reflect the change in income of taxpayers or the number of tax payers? (income elasticity, population elasticity)	L	H
- Cost of administration	What is the share of tax administration costs in the tax revenue?	M	L

Source: author, 2007

ings, and properties with a tax valuation up to 1,680 BGN. Local governments have no authority to declare exempt properties within their jurisdiction. Although the current list of property tax exemptions is not too long, municipalities should have the right to implement independent property tax policy.

3.5.2 Classification

Based on the objective of the local tax policy, immovable property has different features, market position and tax-paying ability of the owner. That is why tax administration classifies the identified immovable properties. The main categories in Bulgaria are residential and non-residential property. In addition, residential property is classified as apartments and houses, and non-residential property is divided into sub-categories, namely industrial properties, agricultural properties, commercial properties, garages, etc.

3.5.3 Valuation and assessment

The basis of the property tax is established by the Local Taxes and Fees Act, which provides a comparatively clear, transparent and effective methodology for the assessment of so-called tax valuations of immovable property, which is applicable for the entire country. The assessment scheme is intended to reflect the real market value of the property, hence to promote fairness and equity within the property tax system. The tax valuation process is based on this unified scheme and depends on so-called basic tax value, determined in Bulgarian currency (BGN) per square metre of the usable surface of the property, according to its usage (residential or non-residential) and construction (massive, panel, frame house, etc.).

In addition, there are so-called “location coefficients”. All the settlements are grouped into eight functional types, according to the National Classification of the Settlements in the Republic of Bulgaria (1999). However, Sofia – the capital city – and each of the biggest cities such as Plovdiv, Varna, Burgas, and Stara Zagora are placed in a single group. The first functional type includes the next economically most developed and attractive settlements with strong fiscal capacity. As the functional type number increases, the attractiveness of the included settlements decreases, and logically, the location coefficient decreases as well. Additionally, city zones are identified within the capital city and the bigger cities at the discretion of the Municipal Councils, intended to further bind the tax valuation of the property with the economic attractiveness of its location. Other important coefficients, uniform for all the settlements in the country, increase or decrease the tax valuation of any particular property, taking into account its height, amortisation, improvements, and infrastructure (availability of water and sewage system, electricity, heating installation, telephone, and road network).

The National Revenue Agency bears the responsibility for the assessment functions, so local governments have little influence on the property tax base. At

the beginning of 2007, the tax valuation was raised by 20 per cent in order to reflect the increased market price of immovable property in our country. However, the property is still underestimated for taxation purposes, representing no more than 30 per cent of its real market value, which is one of the main reasons (along with tax exemptions for the taxpayer's basic residential property) for the low yield of the property taxation in the country.

3.5.4 Rating

The property tax rate is prescribed by the Local Taxes and Fees Act. The annual tax rate has always been proportional and uniform for the country, representing a fixed percentage (1.5%) of the assessed tax valuation. Since the beginning of 2008, each municipality can independently determine the property tax rate valid for its jurisdiction within the legally defined limits (1.5–3%). In relation to local autonomy, there is a general acceptance that each local government should have discretion in terms of determining their own rates and providing local tax policy. Presently, there is no legal possibility to apply differential tax rates to property according to the use, location, and improvements. These specific characteristics of the properties are reflected in the process of the tax base assessment. One of the main reasons for the low tax revenues lies in the significant tax alleviations. The taxpayers pay only 50 per cent of the property tax for their permanent, basic residence. Bearing in mind that 95 per cent of the Bulgarian population lives in its own property, this exemption causes significant losses for the municipal budget. If the taxpayer is a disabled person, the tax is due with a 75 per cent reduction, which is a socially acceptable exemption.

3.5.5 Collection

In 1991, contrary to expectations and logic, the tax collection offices passed from local to central subordination. The Tax Administration Division was established under the Ministry of Finance, which was responsible for collecting all municipal revenues. However, in early 1998, the Local Budgets Act gave the municipalities the right to collect the revenues from local charges. Since 2006, municipalities have been empowered to create local tax administrations, intended to ensure full municipal control over local tax collection. The Local Taxes and Fees Act allows quarterly payment of the annual property tax, respectively before 31 March, 30 June, 30 September and 30 November in any particular financial year.

3.5.6 Enforcement

The range of enforcement procedures tend to be fairly standard across most countries. Unpaid taxes in Bulgaria normally become a first lien against the property. Where the property tax payments are in arrears, the debt outstanding accrues a penalty, based on a fixed annual/daily rate, so the taxpayer's liability is relative to the

length of time the tax remained unpaid. The penalty rate is so-called “legal interest”, determined by the legislation as the basic annual interest rate announced by the Bulgarian National Bank plus 10 per cent. The daily rate is calculated as 1/360 of the legal interest per every delayed day. Legislation in our country permits the seizure and sale of goods and chattels belonging to taxpayers. In addition, the immovable property can be seized and sold at public auction, although, this action is normally the last resort. The most usual mechanism to recoup delinquent taxes involves the attachment of wages or property rents payable to the defaulter.

3.5.7 Appeals procedures

The appeal system in our country comprises two distinct elements. First, appeals can be made against a new property valuation list prior to its coming into effect and secondly, appeals against revised assessment can be made during the currency of the property valuation list. However, no tradition in appeal procedures exists in Bulgaria.

3.5.8 Computerisation

Property tax administration, i.e. the cadastre system, collection and assessment, lends itself to highly automated computerised systems. In fact, it is almost essential to have such systems if property tax is to be administered efficiently, as the large number of properties and taxpayers create problems of scale which can more readily be handled by the processing capacity of computers. Property tax administration in Bulgaria is fully computerised in response to modern fast-developing conditions.

3.6 Case study: Property taxation system in the municipality of Blagoevgrad

3.6.1 Characteristics of the selected municipality

The property taxation system in Bulgaria can be illustrated by a short case study on the property taxation system in a particular local government, namely the municipality of Blagoevgrad. Situated in south-western Bulgaria with an area of 621 km², this municipality comprises the city of Blagoevgrad and the neighbouring 25 villages. The administrative centre of the municipality – the city of Blagoevgrad – is situated on the main route E-79, 100 km to the south of the capital city of Sofia, 20 km from the border with the Republic of Macedonia, and 100 km from the border with the Republic of Greece. With a total population of 80,000 the municipality of Blagoevgrad is a medium-large size local government by Bulgarian standards. The size of municipality is a precondition for development of a complex system of local services, financial system and significant local administration capacity.

The municipal economy is relatively varied and well-balanced without dominating industrial branches. The biggest contribution to the total volume of pro-

duction is made by the industrial sector, followed by trade and transport. Despite the economic diversity, the following industrial sectors appear as leaders: mechanical engineering and electronics, textile and confection, food, wine and tobacco industry, and construction. Motor and railway transport are well-developed within the municipal territory. The level of unemployment (4.6 %) is below the average national level. The concentration of anthropogenic and natural resources is a favourable precondition for tourism development. The most prospective tourist products are in the scope of the cultural tourism, balneology, skiing, and ecotourism. The demographic situation in the municipality is characterised by a favourable age structure. The city of Blagoevgrad has strong traditions in education. There are a total of 16 elementary, primary and secondary schools, besides the profiled secondary schools of mathematics and natural science, humanity and foreign languages, and vocational schools of construction, economy, mechanical engineering, electrical engineering, and textiles. In addition, the Medical College, the Southwest University and the American University in Bulgaria are situated in the city of Blagoevgrad. The availability of many cultural institutions, such as Drama Theatre, Puppet Theatre, Opera di Camera, Museum of History, Universal Scientific Library, Art Centre, and Ensemble for folk songs and dances “Pirin”, provide the city with considerable advantage.

The expenditure responsibilities of the Municipality of Blagoevgrad reflect the national principles for the distribution of functions in the public sector. Local responsibilities prevail in the functions of housing and public utilities (87.1 %), education (54.4 %), and culture (36.8 %). The central authorities are responsible for the prevailing part of the expenditures in the sectors of national defence and security (98.4 %), social care (96.6 %), healthcare (95.6 %), economic activities (87.6 %), and administration (74.1 %). Some of the most important expenditures, financed through the local budgets are in the scope of education, housing and public utilities, which also form the prevalent part of expenditures in the Municipality of Blagoevgrad. The relatively higher share of expenditures in the scope of culture (10.3 %) is due to the availability of many cultural institutions in Blagoevgrad. The municipal administration is cost effective with a modest share (7.5 %) in total expenditures compared with the country's average. The Municipality of Blagoevgrad is lagging behind the country's average regarding capital expenditures and economic activities.

The revenue distribution in the Municipality of Blagoevgrad is similar to the national average. The rate of fiscal autonomy of this particular local government is slightly above the national average, measured by the weight and composition of own revenue sources. Although significantly increasing, own revenues share (47.1 %) still remains below half of the total municipal revenues. Regarding local taxes and particularly the property tax, the relative weight of these revenues is not

very different from the national average figures, mainly due to the lack of possibility for independent local tax policy.

Table 3.8
Expenditure Responsibilities of the Municipality of Blagoevgrad (%)

Expenditures	1991	1994	1997	2000	2003	2006	2007	LGs in Bulgaria 2007
1. Education	40.1	39.9	36.0	37.7	46.0	38.9	35.2	30.9
2. Healthcare	40.6	41.4	39.4	31.4	10.7	12.2	12.4	4.7
3. Social services	9.6	8.3	6.7	9.8	3.7	5.5	4.8	7.2
4. Housing and public utilities	-	-	7.6	7.8	15.9	13.7	22.6	24.7
5. Culture	7.4	8.1	5.0	5.9	9.8	10.3	9.7	5.5
6. Economic activities	-	-	1.7	2.5	6.0	7.1	6.7	14.2
7. Administration	2.3	2.3	3.4	4.4	6.9	8.4	7.5	10.7
8. Defence and security	-	-	0.2	0.5	1.0	2.9	1.1	2.1
9. Capital expenditures	-	-	-	2.0	9.8	10.0	14.5	27.1
Total (1-8)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total expenditures (mio BGN)	0.7	1.2	11.9	20.4	21.5	31.1	37.2	4,077.1

Source: Own calculations based on the Municipality of Blagoevgrad Database

The administration of local taxation is the responsibility of a specialised department within the municipal administration, namely the Local Taxes and Fees Department. Particularly in the Municipality of Blagoevgrad, this department consists of 16 officers, who represent 10.7 per cent of the total municipal administration. The duties of local tax officers include the identification of tax objects and tax base, calculation of tax liabilities, printing and sending announcements to the taxpayers containing information about their tax liabilities, and tax collection. The Municipality regulates the incentives of local tax administration by annual bonuses in cases of more than 100 per cent tax collection. According to the last administrative report, local tax collection reached 140.3 per cent in 2007.

Table 3.9
Local Revenue Structure (%)

Revenues	1991	1994	1997	2000	2003	2006	2007	LGs in Bulgaria 2007
1. Own revenues	3.9	18.6	10.4	24.0	37.0	25.9	47.1	43.5
2. From this:								
2.1 tax revenues	0.7	2.3	1.2	5.9	8.8	7.8	9.2	13.4
2.2 property tax	0.6	1.8	0.5	1.8	2.3	2.4	2.5	2.8
3. Total transfers	96.1	81.4	89.6	76.0	63.0	64.8	52.9	55.1
4. Shared taxes	72.7	54.7	71.4	71.1	49.5	48.8	39.4	20.6
5. From this: PIT	–	–	34.3	35.8	49.5	48.8	39.4	20.6
6. Net grants	23.4	26.7	18.2	4.9	13.4	15.9	13.5	34.5
7. Specific grant for capital expenditure	–	–	1.4	1.7	0.9	2.1	0.3	4.1
8. Borrowing	0.1	–	–	–	–	9.3	–	1.4
Total (1+3+8)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total revenues (mio BGN)	0.7	1.3	12.3	20.6	21.6	33.2	39.3	3,821.8

Source: Own calculations based on the Municipality of Blagoevgrad Database

3.6.2 Identification of local tax policy

Similarly to the rest of the municipalities in the country, the Municipality of Blagoevgrad has not had the opportunity to provide its own local tax policy until the beginning of 2008. Currently, the Municipality is not allowed to influence the type of levied taxes, taxable base, subjects, and exemptions. The only instrument available is the possibility to set tax rates within the legal limits. However, the Municipal Council restrained from changing the existing rates, because of the lack of experience. According to the current budgetary process, it is possible to identify a general relation between local tax revenues and the expenditures for local activities. However, there is no possibility for taxpayers to earmark the spending of the tax, which they have paid, because the total local own-source revenues are directed towards financing total local activities, while state-delegated activities are financed through the transfer system. As with all the other own local revenues, property tax is used as a general revenue source and goes towards financing local expenditures. For now, it is not possible to assess the incidence of “tax exporting” or “tax competition” among the jurisdictions, because most of the local governments in the country have still not used their new tax authority.

3.7 Summary and policy recommendations

Due to the role of the property tax as an entirely local source of revenues, property taxation is an important part of the framework of the fiscal decentralisation process in Bulgaria. During the transition period, local governments have suffered more than central government from the decreased financial capacity of the public sector in the country. Since 1991, the legislation in the scope of local finance has been subject to continuous changes, but the real decentralisation of local revenues is proving to be a very long and difficult process. Local governments have had limited possibilities to influence the size of local revenues and therefore to project local budgets. The small importance of own-source revenues in the local budgets, including the insignificant share of the property tax, and the prevailing share of the state transfers, resulted in the dependence of local governments on the consolidated state budget. Subordinated to the Ministry of Finance, the tax administration had no incentive to perform in a timely manner and fully, the collection of local revenues. In general, the above mentioned factors resulted in local governments, which continue to focus their efforts on approaches for the increase of transfer payments, than to the possibilities of strengthening local tax capacity.

It is expected that the positive amendments in the tax legislation for 2008, namely the new tax competences of Bulgarian local governments to set local tax rates within legal limits, and the reassignment of the patent tax as a local tax, should promote a gradually increasing local tax independence and concentrate their efforts on strengthening local tax capacity. Bearing in mind the conservative Bulgarian state budgets, especially for the fiscal years 2004–2007, the transfer of additional funds from the central budget to the municipalities, beyond the amounts intended to finance state-delegated activities, is considered undesirable from the macroeconomic stability aspect. Notwithstanding the considerable improvement of government finances in recent years, the consolidated state budget is still overburdened with non-discretionary expenditures for welfare benefits, healthcare, interests, which are extremely difficult to reduce. Consequently, reallocation of resources from the state budget to the municipalities in the form of further reassigned taxes is considered as a generator of instability to the state budget in a short-term perspective, hence as a trigger of general macroeconomic destabilisation.

In this context, if the property tax is intended to be a significant source of revenues for local governments, the most crucial element of the tax reform should be directed towards strengthening its revenue raising ability. In order to utilise this revenue source more effectively, the following basic recommendations can be summarised. First, the municipalities should be given more flexibility to influence the property tax base through adjustments within the existing system of functional types and development zones. Second, local governments should be authorised to define property tax exemptions. Due to the expanded range, the current legally defined exemptions decrease the yield of the property tax by more than 40 per cent.

Third, municipalities should be given the right to decide how often they revalue property for taxation purposes. As a result, property tax would become more responsive to the local economic conditions – i.e. more buoyant in rising markets, but also more sensitive to contracting markets. In other words, local governments would have a legal means to react more quickly (preferably annually) to the changes in the economic environment, such as general economic trends, demographic growth, residents' income levels, and to determine the tax burden accordingly. At the same time, drastic changes in the existing tax base valuation mechanism are not recommendable because it is relatively robust, fair, and transparent. Moreover, local administrations still do not have the necessary experience in developing and implementing independent local tax policy. Consequently, their new tax authority should be gradually introduced, allowing local governments to keep pace with legislative changes.

3.8 Conclusion

Due to various reasons, the effectiveness of the property taxation system in Bulgaria during the transition period has been extremely low. Presently, property tax has exceptionally little importance, both in the national tax system and in local government revenues. Because of the significant role of the property tax as an entirely local revenue source, central and local governments should jointly focus their efforts on utilising more effectively its revenue raising potential. Although there have been significant achievements in the scope of fiscal decentralisation in our country, the possibility for real tax autonomy and independent tax policy of the local governments still lie in the future.

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4. Property Tax in Bulgaria: A Case Study of Silistra

Nadezhda Bobcheva

4.1 Introduction

The latest data available as of October 2007 confirms that there are 264 municipalities and 1,445 mayoralties in Bulgaria. According to the Constitution of the Republic of Bulgaria and other laws, the municipality is “*the basic administrative and territorial unit in which local self-governance is performed*”. Indeed, the municipal councils and mayors hold the local self-governing power. However, at present, the local government has limited, especially in terms of financial opportunities, autonomy in managing revenues and expenditures.

In 2006, own revenues of the municipalities totalled 1.23 billion BGN. The national government transfers to municipalities an additional 2.18 billion BGN. The total amount covers 3.17 billion BGN municipal annual expenditures. From an expenditure point of view, municipalities spend less than 18 per cent of all expenditures from the consolidated state budget, so the local government part of the consolidated budget is very low. But this is not all as far as the few resources which can be managed by the municipality are concerned. A large part of state transfers is allocated to meet the expenditures of delegated state activities such as kindergartens, schools, libraries, asylums, etc. These allocations are earmarked and cannot be used for other purposes.

This paper will attempt to answer the question – what is the importance of property tax to the municipal budget? It will shed light on municipal practices regarding property tax raising and co-ordination: the revenues levied and collected and/or administered.

4.2 Government structure and inter-governmental relations

At present, Bulgaria has a three-tier system of government as follows: central government, regional government(s) and local government(s). The territory of the country is divided into districts (*oblasti*) and municipalities (*obshtini*). Municipalities can be further sub-divided into mayoralties (*kmetstva*) and/or regions (*rayoni*).

The municipality is a legal entity, has its own property and sovereign budget. It is an independent sub-national government which is assigned the responsibility to deliver a set of public services, along with the authority to impose taxes and fees to finance those services. The district has purely administrative functions and it does not consist of locally-elected officials. *The oblast* is a typical example of a deconcentrated unit of the state, i.e. a regional branch of the central government with some authority to take decisions. The regional governor is appointed by the Council of

Ministries. *The oblast* does not collect own revenues and its budget is part of the state budget.

4.2.1 Government structure

Local government reforms in Bulgaria were initiated at the beginning of the transition period, in 1991, when the Local Self-government and Local Administration Act was enacted. The law provides the basis for administrative decentralisation of the state by establishing various sub-national governmental units – *obshtini*, *oblasti* and *okolii*. While the first two did survive the transition period, *okolii* were not institutionalised during a period of 4 years. In 1995, with the adoption of the Administrative and Territorial Structure Act, which re-identified the new sub-national units in the country, *okolii* were abrogated. In 1999, the Regional Development Act brought about a new administrative division, increasing the number of districts (*oblasti*) from 9 to 28. The law vested districts with the power to conduct regional policies, to implement state policy at the regional level, and to harmonise national and local interests.

An important step was the division of state and municipal property. In 1996, both the State Property Act and the Municipal Property Act were enacted with the aim of fully, exhaustively, and consistently regulating the basic relationships of specific ownership forms —both state and municipal. The Municipal Property Act has sped up the process of forming municipal property portfolios regardless of its 5-year delay (the Bulgarian Constitution granted ownership rights to municipalities in 1991).

In 1998, the Municipal Budgets Act was passed. The law arranges the composition, endorsement, implementation, and reporting of the municipal budget, as well as fiscal relationships between municipalities and the state budget, and administration of off-budget municipal funds. The Municipal Budgets Act allows Bulgarian municipalities to budget for deficits up to 10 per cent from the projected own municipal revenues. This deficit can be financed through: 1) emission of securities, 2) municipal bonds, 3) loans from financial institutions and 4) other sources and off-budgetary funds.

The 2003 State Budget Act stipulated the “official start” of fiscal decentralisation in the country – 1 January 2003. Its main objectives are the efficient allocation of resources, equitable provision of services to the citizens in different jurisdictions, preservation of macroeconomic stability and promoting economic growth. The implementation of the Fiscal Decentralisation Programme includes the division of activities financed by municipal budgets to state and municipal ones, and setting of standards for a number of personnel and state activities funding.

In 2003, with the beginning of fiscal decentralisation in Bulgaria, local governments were vested with the power to set up the rate of local fees. Local governments

are free to decide on types of local fees to levy, as well as the amount to charge, corresponding to local needs and preferences.

Bulgarian local governments have been entitled to collect local taxes since 1 January 2005. A special tax department has been established within all Bulgarian municipalities. Prior to that, local taxes had been collected by the Regional Tax Agencies, directly subordinated to the Ministry of Finance.

In the same year, the Municipal Debt Act was endorsed. The law arranges the conditions and regulations for assuming municipal debt and the issuance of municipal guarantees, as well as the types of municipal debt. Municipal debt refers to two types of loans: interest-free loans from the state budget for covering temporary budget shortages, and those for funding municipal projects under the EU Structural and Cohesion Fund, necessary for project implementation.

However, several constraints can be identified. The majority of them seem to be a shortage of staff. Another serious constraint is that Bulgarian local governments do not have any law enforcement powers. To this extent, tax payments are practically voluntary, i.e. compliance with taxes levied is left to local taxpayers to meet their obligations. Legally, sanctions and penalties penalising non-compliance exist but these mechanisms are at the disposal of the Regional Tax Agencies. Finally, it is not clear whether collection and checking techniques will be uniform or each municipality has to develop its own.

Finally, the latest amendments in the Local Taxes and Local Fees Act empowered municipalities to set up the local tax rate. The amendment entered into force in 2008 and provided local governments with a powerful tool to be used for development.

4.2.2 Inter-governmental fiscal relations

For the better and independent performance of any government, each governmental tier should have financial resources at its disposal, preferably “own” sources of revenue, in order to match its service cost. Table 4.1 presents Government revenues and expenditures.

Regardless of all attempts for furthering fiscal decentralisation, expenditure of Local Government as a percentage of GDP tends to be stable and is in the margin of 6.4 per cent to 6.8 per cent. However, the expenditure of local government is almost 4 times lower than that of the national government.

Inter-governmental transfers are specific financial flows from central to local government. Transfers proved to take two major forms: revenue sharing and grants. The ultimate goal of any transfer system is to “soften” any vertical and horizontal fiscal imbalance, and compensate local governments for financial disparities caused by spillover effects. Table 4.2 illustrates CG grants to local government.

Table 4.1
Government revenues and expenditure

	1991	2002	2003	2004	2005	2006
GDP in current price (in mio BGN)	135.7	32,335.1	34,546.6	38,275.3	41,948.1	56,519.8
Expenditure of National Government as percentage of GDP (%)	n./a.	25.2%	28.2%	26.9%	27.3%	26.5%
Expenditure of Local Government as percentage of GDP (%)	12.3%	7.6%	6.4%	6.8%	6.6%	6.8%

Source: EUROSTAT

Table 4.2
Central government grants (current prices)

	2002	2003	2004	2005	2006
1. Expenditure of CG (in mio BGN)	8,155.0	9,775.0	10,443.0	11,668.0	13,014.0
2. CG grants to LGs (in mio BGN)	629.8	629.8	1,430.1	1,663.0	1,970.0
3. CPI (previous year = 100)	102.3	106.1	105.0	107.3	108.4

Source: EUROSTAT

Inter-governmental transfers provide the major share of local government finance. State transfers are a prevailing part of municipal revenues – about 60 per cent in the last few years. However, a positive shift is observed – their relative share has gradually decreased from 90 per cent in 1999, to 76.3 per cent in 2002, and 59 per cent in 2004.

4.2.3 Composition of LG revenues

In Bulgaria, a local authority has its own structure of taxation. The revenue side of the municipal budget consists of revenues from municipal sources, transfers from the state (subsidies and shared taxes), and borrowed funds. Municipal sources may be further sub-divided into the following categories:

- local taxes and other taxes imposed on behalf of the local government
- local fees charged for services
- proceeds from concession and sales of municipal property
- rents paid for use of municipal property
- fines and pecuniary penalties imposed by a local administrative body
- other municipal revenues.

All *local taxes* are determined in the Local Taxes and Local Fees Act. As of 2008 they were: real estate tax, inheritance tax, tax on donations, tax on vehicles,

tax on non-freely acquired property, patent tax and other local taxes levied by law. Municipalities have no discretion over the local tax base.

Table 4.3
Structure of municipal revenues (in %, total revenues = 100 %)

Revenue items	1996	1997	1998	1999	2000	2006
Own-source revenues	19.27	9.36	15.86	18.19	17.47	33
• Local taxes	5.36	2.04	4.95	4.43	4.40	
• Local fees	4.85	3.16	6.21	6.13	6.69	
• Other local revenues	9.06	4.16	4.70	7.63	6.38	
Inter-governmental transfers	78.80	90.32	82.83	76.79	79.03	64
• Subsidies	32.75	34.79	36.61	35.92	40.66	
• Shared taxes	46.05	55.52	46.22	40.87	38.37	
Borrowings	1.93	0.32	1.31	5.02	3.5	3

Source: Club "Economika 2000", "Needs Assessment of Sub-national Governments Draft Report" 2002, 11

At the same time the flow of state transfers has decreased and in 2006 reach 64 per cent – an almost 20 per cent reduction on average. As a result, Bulgarian municipalities continue to be fiscally weak – their revenues from sources are less than those from central government.

4.2.4 Property tax as revenue

Property taxes are compulsory charges/levies which relate specifically to ownership, occupation or development of land and buildings. They are mostly levied on capital value or annual rental value (real or imputed) and are collected for use by local authorities. Their effects are both fiscal (revenue generation) and regulatory (encouraging property development and/or discouraging land speculation). Property taxation is sometimes used interchangeably with a rating and the rating has been defined as a method by which residents of a particular area contribute money to share the burden of the cost of providing services to them within their area year by year. Table 4.4 presents the property tax system in Bulgaria.

Table 4.4
Property tax system in Bulgaria

	Land	Buildings	Movables	Other property-related taxes	Property tax exemptions
Taxable item	No	Property tax	No	Transfers, gifts and inheritance	Yes

Source: Local Taxes and Local Fees Act

Bulgarian municipalities cannot freely decide on how to spend revenues raised. Out of 1.23 billion BGN local revenues, the share of tax revenues is below 18 per cent and the remainder is non-tax revenues. Hence, the only budget revenues that municipalities can manage in the way they wish are tax revenues. Beginning in January 2008, local governments can decide on the tax rate for the first time since the beginning of the transition period. For more details, see Table 4.5

Table 4.5
Municipal powers regarding own revenues

Own revenues	Type	Tax base	Tax rate	Exemptions	Plan-ning	Admin-istration
Local Taxes	CG	CG	LG	SG	LG	LG
Local fees	CG	LG	LG	LG	LG	LG
Other non-tax revenues	LG	LG	LG	LG	LG	LG

Note: CG – central government, LG – local government

4.2.5 Property tax

This part describes the main features of the property tax and is based on Brown and Hepworth (2002).

The main provisions for this tax are articles 10–28 of the Local Taxes and Local Fees Act. The tax is one of a number of locally raised taxes that provide a substantial part of funding of local government. It is an annual tax on the ownership of property.

The tax applies to all property, regardless of whether used or unused, but excludes land and buildings used for agricultural purposes. Taxpayers are required to make a return to the tax authorities in the location of the property, indicating what property they own by 1 February each year. The tax is based on rates provided by the legislation and updated annually. The rates for the valuation are fixed by legislation and updated annually.

A range of exemptions are available under article 24, including:

- Public municipal property;
- Public state property, except in cases where state-owned property is used by persons who are not exempt from the tax;
- Public reading-halls;
- Buildings owned by other countries and occupied by consular or diplomatic missions under conditions of reciprocity;
- The buildings of the Bulgarian Red Cross;

- Buildings used by graduate schools and by academies for education and research activity;
- Places of worship of legally registered religious beliefs in the country;
- Parks, sports grounds, playgrounds and similar properties for public use;
- Museums, galleries, libraries;
- Buildings, excluding residential buildings, used directly for the purposes of operating public transport;
- Agricultural buildings of agricultural producers which are used for agricultural activity;
- Temporary structures used for assisting the construction of a new building or equipment until the latter is completed and occupation is taken;
- Buildings which have been duly condemned as endangered from collapse or in a hazardous sanitary state, for a period of 5 years from the date of issue of the initial certificate.
- Real estate properties, the title of which has been restored by law and which are not fit for use, for a period of 5 years. The tax on the above real estate properties, which are used by the state, municipalities, public organisations or companies of which they are a part, inclusive of those privatised, shall be due by the users.

The following relief is available under article 25:

- For property used as a main residence, the tax shall be due with a 50 per cent reduction.
- For property used as a main residence of an impaired person, in the first or second category of disability, the tax shall be due with a 75 per cent reduction.

Challenges to the notice of assessment can be made under the Tax Procedures Act.

The taxpayer is the owner of the land, buildings or rights (article 11). Where a property is owned by more than one person, then each person is liable proportionately to the extent of his ownership. Where buildings are built on land owned by the state or municipality, the owner of the building is liable for the tax.

The tax rate varies amongst municipalities. As a rule, the rate is reduced by 50 per cent if the property is the taxpayers' residence or by 75 per cent for a disabled person. The tax is payable in quarterly instalments on 31 March, 30 June, 30 September and 30 November and with a 5 per cent discount payable if the total amount is paid by 31 March.

The tax is collected by the Municipal Tax Office responsible for the municipal budget.

4.2.6 Revenues raised from property tax

In general, the property tax is aimed at ensuring revenues which are supposed to cover the cost of building a new infrastructure or proper maintenance of the existing one. The municipal councils approve the investment plans of Bulgarian municipalities, including infrastructure. At the same time, the central authorities determine the property tax base. There is a breakdown in the linkage between revenues raised from property tax and expenditures necessary for the delivery of property-related services such as water supply, sewage, roads, etc. In order to overcome this, local authorities are required to hold discretionary powers, both for revenue assignment and expenditure assignment, to be able to fulfil their duties to the local community. Table 4.6 shows property tax revenues of Bulgarian municipalities.

Table 4.6
Property tax revenues of Bulgarian municipalities

	2003	2004	2005	2006
Revenues from property tax (current price in BGN)	51,579	57,788	62,655	82,206
Revenues from property tax (per cent of total revenues from municipal taxes)	31.85%	30.07%	26.16%	22.81%
Total revenues from municipal taxes	161,962	192,194	239,537	360,404

Source: Ministry of Finance

During the period 2003–2006, the revenues raised from property tax have gradually decreased their share from 31.85 per cent to 22.81 per cent as a percentage of total municipal revenues from taxes. This leads to the problem that property tax does not provide significant revenues to the municipal budget. In the period under review, both the tax base and the tax rates were determined by central government. At that time, no consideration was given to the specific municipal characteristics with regard to their geographical location, number of permanent or temporary citizens, density of building, etc. The calculation of the property tax due was carried out by using a uniform formula with indexes, including one for all locations. The index for location was not adopted on the basis of objective criteria.

4.3 Case study



Located on the bank of the Danube river, bordering Romania to the North, the municipality of Silistra covers a territory of 516 sq. km. It comprises the city of Silistra and 18 villages. The city is determined as medium-sized for Bulgaria and is the major city of a district. Since 1990, every year there has been a reported reduction in the overall number of the municipality's population – in 1992 the inhabitants amounted to 71,889, in 1997 – 68,797, in 2000 – 66,538, in 2002 – 61,294, and in 2007 – 58,194. The reasons for this are negative natural growth

and migration. Furthermore, there is a trend of ageing of population, and the increase of the share of the elderly is due to the decrease in the share of children.

Silistra has always been, and continues to be, an isolated community in the North-eastern part of Bulgaria. Historically, the city has relied on the food processing industry and, to a lesser extent, to the wood industry to provide the basis for its economy, besides being a major agricultural area.

4.3.1 Financial analysis for the period 2005–2007

The years 2005, 2006 and 2007 are an important period in the process of fiscal decentralisation, an on-going process that follows the state fiscal policy and the concept of separation of public services to municipal and state. The budgets of the municipality of Silistra are prepared in compliance with the Municipal Budgets Act, the State Budget Act for the respective year, the municipal plan for development and the strategic goals and priorities of the municipality of Silistra. The studied period covered an important stage towards Bulgaria's membership of the EU. Table 4.7 presents the composition of revenues of the municipality of Silistra.

Shared taxes have maintained a stable share in municipal revenues over the period observed. At the same time, there is an increase in central government grants whose share doubled during the 2005–2007 period. The specific grant for capital expenditures has significantly increased in 2007 with almost 70 per cent compared to 2006.

Table 4.7
Revenues of the municipality of Silistra (in BGN)

	2005	2006	2007
1. Own revenues	5,756,418	6,059,508	10,138,590
• From this: property tax	306,054	344,410	449,335
2. Shared taxes	6,691,291	5,973,458	6,031,827
• From this: PIT	6,691,291	5,973,458	6,031,827
3. CG grants	6,523,313	9,358,654	14,276,274
• From this: Block grants	2,967,786	4,818,393	5,432,683
• Specific grant for capital expenditure	1,196,380	1,391,527	5,125,321
4. Other revenues	859,729	1,381,914	624,967
• From this: Loans/bonds	n/a	n/a	165,912
Total = 1+2+3+4	19,830,751	22,773,534	31,071,658

Source: Financial Department at the municipality of Silistra

The share of property tax in own revenues has slightly dropped from 5.32 per cent (2005) to 4.43 per cent (2007). At the same time, property tax revenues have maintained a steady share in total revenues of about 1.5 per cent, a bit lower than the national average rate of 2 per cent.

The highest percentage of expenditure is devoted to education, followed by housing and public works, executive and legislative bodies and social security, social assistance, and social care. Table 4.8 presents the expenditure of the municipality of Silistra.

4.3.2 Municipal tax administration

Bulgarian local governments have been entitled to collect local taxes since 1 January 2005. A special tax department, staffed with 6 employees, has been established in the municipality of Silistra. Prior to that, local taxes had been collected by the Regional Tax Agencies, directly subordinated to the Ministry of Finance.

Still, it is early to assess what the workload for the new tax department is or what the cost will be of administering local taxes. However, the financial department at the municipality of Silistra reports that local tax arrears have significantly dropped since the establishment of the department. One of the reasons is that taxpayers are citizens within the municipality and its relatively small size allows social control to be introduced. At the same time, collecting local taxes allows the municipality to better track tax payments.

Table 4.8
Expenditure of the municipality of Silistra (in %, total expenditure = 100%)

Functions	Total			State delegated activities			Municipal activities			Co-funding		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
The executive and legislative bodies	15.00	14.48	13.22	8.00	8.55	9.40	24.00	22.04	15.48	30.00	33.30	48.78
Defence and security		1.37	0.56	-	2.30	0.89	-	0.13	0.30	-	-	-
Education	40.00	36.90	33.55	62.00	58.11	56.72	14.00	8.12	14.00	40.00	39.24	34.15
Healthcare	4.00	4.05	3.70	5.00	4.99	5.10	4.00	2.89	2.61			
Social security, assistance, and care	13.00	13.51	12.03	20.00	20.69	21.25	4.00	3.95	4.47	16.00	7.33	4.50
Housing and public works	21.00	20.12	28.27	-	-	-	47.00	47.85	52.84	-	-	-
Holiday activities, culture, and religious activities	5.00	6.26	5.92	5.00	4.92	6.23	5.00	7.75	5.49	14.00	20.13	12.57
Economic activities and services	1.00	2.76	2.60	-	-	0.41	1.00	5.98	4.52	-	-	-
Expenditure non-classified in other functions	1.00	0.55	0.15	-	0.44	-	1.00	1.29	0.29	-	-	-
Total expenditure	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: Financial Department at the municipality of Silistra

4.4 Conclusions

Bulgarian municipalities are fiscally weak – their revenues from own sources are less than those from central government. Still, Bulgarian municipalities are not allowed to impose local taxes or levy surcharges on national taxes. The central government decides the type of local taxes and defines the tax bases. A positive fact is that beginning in 2008, municipalities set the tax rates within the margins stipulated in the law. Municipalities continue to rely on grants from central government.

However, municipal revenues from own source tend to increase gradually, from approximately 10 per cent of total municipal revenues in 1997 towards up to 33 per cent in 2006. It is an important step forward for fiscal decentralisation and real local financial autonomy. At the same time, local tax revenues tend to decrease. In order to foster local financial autonomy, it is necessary to expand the local tax base. Possible solutions could be a recommended property tax base updating and/or allocating new local tax revenue sources.

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Legislation

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Local Elections Act, promulgated in issue #66/25.07.1995 of the State Gazette, last amendment – issue #63/3 August 2007 of the State Gazette.

Local Taxes and Local Fees Act, promulgated in issue #117/10 December 1997 of the State Gazette, last amendment – issue #36/2 May 2006 of the State Gazette.

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5. Property Tax in the Czech Republic¹

Lucie Sedmihradská and Phillip J. Bryson

5.1 Introduction

Property tax, as a main source of local government revenues, is not a particularly European institution, although it is used in Britain and maintains a nominal presence on the continent. It nevertheless comes into discussions of fiscal matters quite regularly, since it is used in many countries in the world with fair success. It offers the potential not only of strong revenue flows, but also the possibility of a reliable source of own revenues for local governments (LGs). For the Czech Republic, it is also potentially important, since the Czech municipalities rely mostly on tax sharing and grants for their revenues and lack own-revenue resources. A symbolic real estate tax is in place in the Republic and the municipalities would benefit in terms of fiscal autonomy if it were to become a more significant source of revenue.

The second section of the paper will review the property tax setting in the Czech Republic, showing why it takes its current form. The small, but important role, of property tax will be reviewed and discussed in this section. The structure of inter-governmental relations is addressed as an explanation for the parallel phenomena of self-government and state administration. These things help explain the nature of government budgets and the financial situation of the sub-national governments of the Czech Republic.

The third section looks at the scope and characteristics of the tax, reviewing its revenue flows, the role of the central government in its design and incidence, the exemptions that are possible and the latitude the municipalities have in its implementation. As observed above, the tax is an area-based one and the valuation process and methodology are reviewed. It concludes with a discussion of some of the implications of the Czech property tax institutions, addressing, for example, the fact that the central government (rather than the municipalities themselves) collects the actual revenues without any strong incentives to perform the task well.

A brief fourth section provides a case study of the fiscal story of the town of Beroun in the Czech Republic. It is appropriate that the reader gain a sense that the institutions discussed in this paper apply to real municipalities with real Czech citizens whose lives are affected by the governance implicit in Czech inter-governmental fiscal relationships.

¹ This project was supported by the Czech Science Agency, No. 402/07/0823.

5.2 Government structure and inter-governmental relations

5.2.1 Government structure

The Velvet Revolution ended the central planning regime of communism in late 1989 and the division of the Czech and Slovak Republics followed in 1993. A more western-style tax system was introduced in 1993 and, apart from some minor changes that system remains in effect today. The pursuit of reforms that could provide a more meaningful devolution of central power continued in the period that followed.

State Administration, which meant the retention by the centre of many of the functions normally carried out by sub-national governments, existed in the previous era and has continued in the Czech Republic. It was a part of the foundation institutions of the new republic because the central government believed that many of the municipalities were too small and were lacking in manpower and other resources necessary to manage their own affairs independently. Fiscal decentralisation was designed to increase the scope of local autonomy, but not to provide complete autonomy, which was perceived to be beyond the capacity of many of the small municipalities. Out of 6,249 municipalities, 78 per cent have less than 1,000 inhabitants (Czech Statistical Office 2007).

Fiscal decentralisation delegated some functions to “self-governing” municipalities, but district offices (not local government units but local branches of the central government) retained many functions of state administration until the end of 2002. Despite the constitution, there were no regional governments at the time of the founding of the republic. The 14 regions, *kraje*, representing a second tier of sub-national government, were introduced as part of the reform of public administration in 1997. They did not really begin to function until 2001. Their creation was an additional effort to apply the principle of subsidiarity in the Czech Republic, or to bring government closer to the people.

Some of the larger municipalities were granted “delegated powers”, i.e. additional functions of state administration performed by the districts until they were eliminated in 2002. The municipalities were divided into five categories according to the scope of the delegated powers they received. There is no definitive structure for the less significant delegated powers and no strict hierarchy of powers. Some municipalities, for example, provide building permits, but do not register inhabitants. The geographic boundaries of the networks of the smaller services do not necessarily line up with those of the municipalities of second and third types, designated respectively as “authorised municipal offices” and “municipalities of extended scope” (see Hemmings 2006, 13 and Ministry of Interior 2004, 33–35 for more detail). Table 5.1 provides information on the structure of local governance in the Czech Republic.

Table 5.1
Levels of delegated powers in municipalities

Type of Municipality	Number of Municipalities
Total	6,243
Basic delegated powers (e.g. emergency management)	6,243
Municipalities registering inhabitants	1,226
Municipalities providing building permits	617
Municipalities of the second type or "authorised municipal offices" (<i>pověřené obecní úřady</i>). These manage, for example, water allocation and all types of elections.	388
Municipalities of the third type or "municipalities of extended scope" (<i>obecní úřady s rozšířenou působností</i> or <i>malé okresy</i>). They issue, for example, driving licences and identity cards and ensure the legal protection of children	205

Source: Hemmings 2006, 13 and Ministry of Interior 2004, 34–35

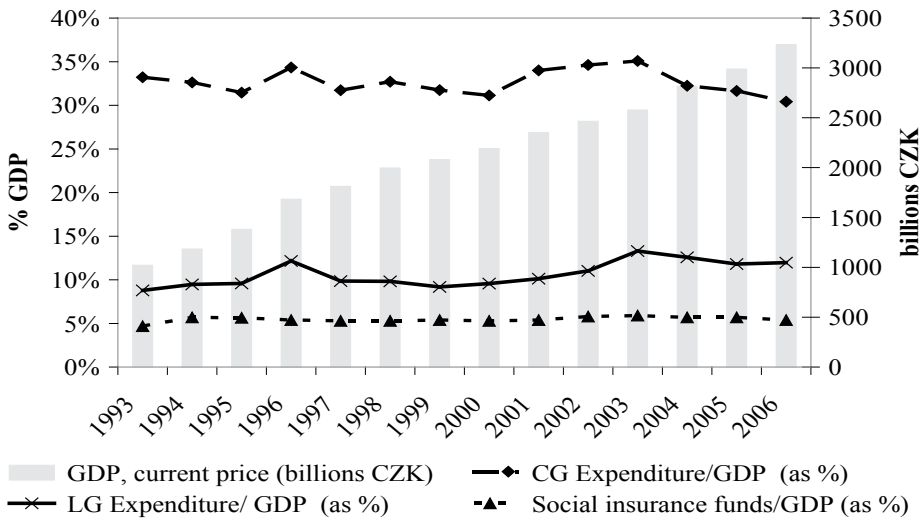
As a part of the initial devolution of power in the Czech Republic, properties were transferred from the centre to municipalities, including public housing and many previously state-owned businesses. Many of these have already been privatised. This property transfer included shares in utility companies, which were sold mostly in 1999–2001.

5.2.2 Inter-governmental fiscal relations

Let us now turn to the fiscal relationships between the central and local governments, which are best summarised in the relevant budgets. Figure 5.1 displays both national and aggregated local expenditures as a share of the Czech Gross Domestic Product from 1993–2006. Throughout the entire period, national expenditures (including health care insurance funds) have been around forty per cent of GDP and local expenditures increased throughout this period from just over eight per cent to twelve per cent. One can therefore see that the level of taxation and social expenditure is considerable.

The increase between 2002 and 2003 was caused by the reform of public administration (eliminating districts and establishing regions). The one-time growth experienced in 1996 was caused by unexpectedly high (greater than originally estimated) revenues in those sources transferred as shared taxes to local governments. Revenue assignments were redone the following year (Sedmíhradská 2007).

Figure 5.1
Public budgets, national and local of the Czech Republic, 1993–2006



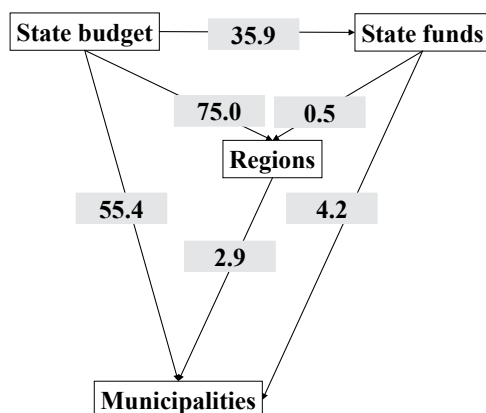
Notes: (1) Central government (CG) expenditures include the state budget and the state funds. The social insurance funds (i.e. health care insurance) are reported separately. (2) Until 2000, local government (LG) included municipalities and districts; after 2001, municipalities and regions. (3) 1993–1995 data on public expenditures use the GFS methodology; data since 1996 on the ESA 95 methodology; data for GDP since 1996 are revised.

Source: Table 5.9 in the appendix

The grant system is quite complex and includes transfers between different public budgets. Figure 5.2 shows a summary of the amounts transferred from the state or central budget to regions and municipalities in 2006.

Table 5.2 presents consolidated data about central government transfers to local governments – the data on the central government grants were taken from the revenue side of consolidated municipal and regional budgets. It should be noted that any discrepancies in the numbers in the different tables are the result of differing methodologies; sometimes the old districts are included and sometimes not.

Figure 5.2
Grant flows among different public budgets (billions CZK)



Source: State final account 2009, part F, own figure

Table 5.2
Central government grants to local governments (billions CZK)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Current price (in national currency)									
Expenditure of CG	652.9	660.5	681.5	799.8	853.1	904.3	907.7	945.4	983.0
CG grants to LGs	40.4	31.5	51.9	72.6	94.0	146.7	142.9	127.2	144.3
Revenues of LG	161.8	194.8	190.3	195	239.6	301.9	308.9	334.7	359.5
CPI (2000 = 100*)	94.4	96.4	100.0	104.7	106.7	106.8	109.7	111.9	114.7
Real term (in national currency)									
• Expenditure of CG	691.6	685.0	681.5	763.9	799.4	846.5	827.2	845.2	857.4
• CG grants to LGs	42.8	32.7	51.9	69.4	88.1	137.4	130.2	113.7	125.9
Share of CG grants in CG expenditure (%)	6.2%	4.8%	7.6%	9.1%	11.0%	16.2%	15.7%	13.5%	14.7%
Share of CG grants in LG revenues (%)	26.5%	16.8%	27.3%	35.6%	36.8%	45.5%	42.2%	34.0%	35.0%

Note: LG = municipalities, regions and voluntary municipal associations (no districts)

Source: CG expenditures – Fiscal outlook, October 2007, 48–49, CPI – Czech statistical office, CG grants – ARIS

The change in the central government grants' shares and volumes are closely linked to the public administration reform mentioned earlier. In 2001, the new revenue sharing began and the regions began their operations; in 2003, the regions really began to function and in 2005 the share of regions receiving shared taxes grew from 3.1 per cent to 8.92 per cent and thus grants were replaced by shared taxes.

The character of the grants provided is an indication of the degree of fiscal autonomy of the sub-national governments, since where they are provided unconditionally, i.e. with no strings attached, the independence of local finance is enhanced. In the Czech Republic, the significant majority of grants are conditional grants (these are grants provided through ministries, state funds and all investment or capital transfers); the only exception are grants to municipalities for state administration, senior care homes and specified social institutions (in 2006 26.3 billion CZK). All of these funds are formally classified as conditional, pretty well tying all central grants and transfers to specific projects and activities. In fairness, it should be noted that these particular funds are referred to as contributions to the "current costs" of the municipalities and nobody checks to see how they are really used. Therefore, municipalities have some budget flexibility and fiscal autonomy beyond that which one might expect through formal classifications.

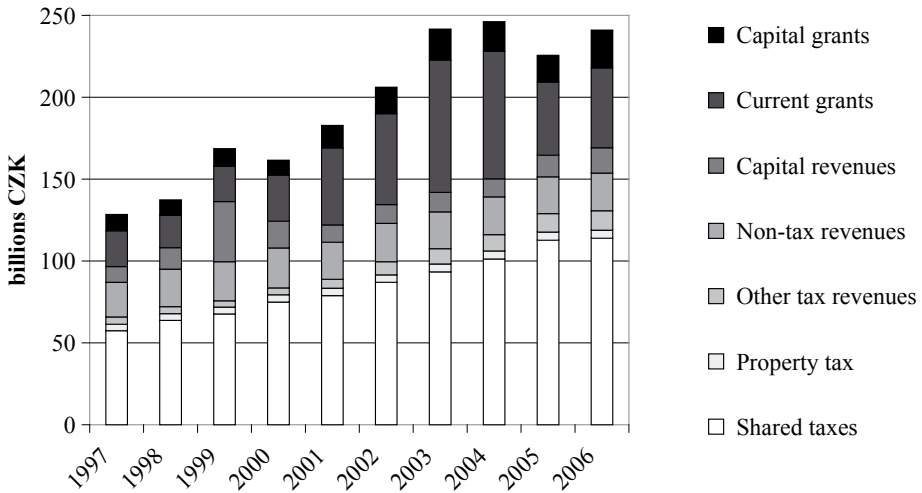
5.2.3 Composition of local government revenues in the Czech Republic

Municipal revenues are specified in two laws: the Act on Budgetary Rules for Territorial Entities (Act # 250/2000 Coll.), which lists all municipal revenues, and the Law on Tax Assignment (Act # 243/2000 Coll.), which specifies the revenue-sharing formula. Figure 5.3 shows the development of the main revenue sources since 1997. We observe stable nominal growth in the total municipal revenues with two exceptions. First, there was a one-time increase in 1999 when the 1998–2000 sales of shares held by municipalities in utility companies peaked. Second, there was a decline in revenues in 2005 when transfers from the Ministry of Education to individual schools began to pass through regional, rather than municipal budgets.

The years covered by this figure mark the decline of the property tax from 3 per cent of the total revenues of Czech municipalities to 2 per cent. This tax, viewed generally by economists and advocates of fiscal decentralisation as an important source of potential revenues, and thus of fiscal autonomy for municipal governments, is of purely symbolic significance in the Czech Republic. This is of course due to the nature of the tax and the fact that its rates have not been adjusted since 1993. The adequacy of revenues, which sub-national governments can regard as "own revenues", presents the case for fiscal autonomy. The Czech Republic defines own revenues as tax revenues, non-tax revenues and capital revenues. Tax revenues, however, also include shared taxes, which are distributed among the municipalities based on a formula.

Capital revenues, derived as was observed above from the sales of state-owned properties, represented roughly a quarter of municipal own revenues over the period. The only exception was the year 1999 when that revenue source surged to 50 per cent of municipal own revenues. As a share of municipal total revenues, own revenues increased dramatically up to 1999; as municipalities sold their shares in utility companies. At that point, own revenues represented nearly 44 per cent of the total. After 2000, however, they settled to a level of 25 per cent of municipal revenues.

Figure 5.3
Municipal revenue sources 1997–2006 (in billions of CZK)



Source: Table 5.10, appendix

Note: Borrowing is not included as it is not considered in our budget classification as revenue. Following the Czech classification, we do not separate shared taxes from corporate income tax receipts. They are reported together.

Shared taxes have represented a U-shaped function in municipal receipts. From a level in the low forties in terms of percentage of total municipal revenues, the revenues dropped over the next few years to the upper thirties, returning to more than forty per cent in 2005 and 2006.

Grants from the centre have tended to vacillate quite significantly in the Czech Republic. In the years 2000 and 2003 they exceeded 40 per cent of municipal receipts. In 1999, they were less than 20 per cent. In 2005 and 2006 they were fairly level at just below 30 per cent of total revenues. From 2001 through 2004, current grants surged to more than double what they had been in the preceding years, due to the public administration reform.

5.3 Property tax as revenue

This section will first endeavour to analyse the Czech property tax as a part of the national tax system and as a component of local government revenues. Then we will consider the incidence and nature of the tax. We note at the outset that the Czech property tax includes not only real estate tax, but also inheritance tax, real estate transfer tax and road tax. We focus in this paper on the traditional property or real estate tax and we use the two expressions as synonyms.

The real estate tax was in place under the central planning regime before the end of communism. It was a rather symbolic tax, perhaps since most other taxes of that period were invisible. The property tax cannot be hidden, so it must be either well understood by its content and not unwilling citizenry, or completely innocuous, representing no serious burden on property owners. The communist situation suggested the nominal property tax. When the new era began, it was not changed in any substantive manner. No effort was made to justify a potential real estate tax burden or to transform it into a producer of municipal revenues. The tax has remained quite static, but in the face of rising incomes and budget revenues, it appears, proportionally, to decline fairly rapidly.

5.3.1 Property tax in the national tax system and in LG revenues

In a number of countries of the Anglo-Saxon world, the property tax represents the most important source of revenue for local governments (Bird and Slack 1991, 83–97). Potentially, it could be an important municipal tax for transition countries, although it has proven difficult to implement (Bryson, Cornia and Holmes 2001). Table 5.3 documents a very small and declining role for the Czech real estate tax as a percentage of GDP and its small importance compared to other taxes.

Table 5.4 confirms the same regarding municipal revenues. Whether one considers the real estate tax as a share of total taxes or of total municipal revenues, they represent only a very small proportion. One sees income tax and VAT as substantial shares of municipal revenues, but these taxes are transferred to the municipalities and do not represent autonomous revenue sources.

Real estate tax revenues grow marginally, in terms of nominal prices, each year. The only exception was between 2002 and 2003, when flats transferred to individuals from municipalities or co-operatives were taxed (not exempt) for the first time. The main factor causing the steady growth of revenues is perceived to be the improved efficiency of audit and searching activities, especially because of improved access to data from the Real Estate Cadastre. This growth can also be attributed in part to the amendment to the Real Estate Tax Act, which identified the responsible taxpayer for rented lands. Czech officials believe this will contribute to a gradual clarification of proprietary relations and improved specifications in land records (Czech Tax Administration 2007).

Table 5.3
Tax revenues as a share of GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
SSC	13.7%	13.1%	13.2%	13.6%	13.2%	13.0%	13.1%	14.3%	14.9%	15.1%	16.1%	16.1%	16.2%
Indirect Taxes	13.1%	11.8%	11.7%	11.7%	10.8%	11.5%	11.3%	11.0%	10.8%	11.1%	11.6%	11.5%	10.9%
• VAT	7.3%	6.5%	6.5%	6.5%	6.0%	6.6%	6.7%	6.3%	6.3%	6.4%	7.2%	7.0%	6.5%
Excises	3.9%	3.9%	3.6%	3.5%	3.4%	3.5%	3.2%	3.3%	3.2%	3.4%	3.5%	3.7%	3.7%
Direct taxes	10.9%	9.9%	8.9%	8.4%	8.7%	8.5%	8.5%	8.8%	9.1%	9.6%	9.6%	9.2%	8.8%
• PIT	4.6%	4.7%	4.8%	4.9%	4.8%	4.6%	4.5%	4.5%	4.7%	4.9%	4.8%	4.6%	4.2%
• CIT	5.4%	4.5%	3.7%	3.1%	3.4%	3.4%	3.5%	4.1%	4.3%	4.6%	4.7%	4.5%	4.5%
Real estate tax	0.3%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%

Note: SSC = social security contributions, VAT = value added tax, PIT = personal income tax, CIT = corporate income tax

Source: Macroeconomic Forecast, January 2002, 41 and October 2007, 46, for real estate tax Provozničková (2007, 114 and 120) and since 1997 ARIS, for GDP see source for Figure 5.1, own calculations.

Table 5.4
Real estate tax as a component of Czech municipal budgets (1997–2006)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Real estate tax (millions CZK)	3,943.2	4,108.3	4,247.6	4,436.5	4,568.6	4,571.1	4,827.9	4,919.4	4,966.1	4,974.0
• as a percentage of total taxes	0.62%	0.62%	0.60%	0.60%	0.57%	0.53%	0.52%	0.47%	0.45%	0.43%
• as a percentage of total municipal revenues	3.07%	2.99%	2.52%	2.75%	2.50%	2.22%	2.00%	2.00%	2.20%	2.06%
Distribution of local taxes – particular taxes as a percentage of municipal tax revenues										
• Income tax	82.7%	82.5%	82.5%	76.9%	48.7%	50.0%	49.8%	50.8%	49.6%	47.7%
• VAT					33.5%	32.0%	31.5%	31.2%	33.5%	34.9%
• Real estate tax	6.0%	5.7%	5.6%	5.3%	5.1%	4.6%	4.5%	4.2%	3.9%	3.8%

Source: ARIS and for total tax revenues Fiscal outlook, October 2007, 43

5.3.2 Nature and incidence of the Czech property tax

The Czech real estate tax is regulated by the Real Estate Tax Act No. 338/1992 Coll. and consists of two parts – building tax and land tax. In 2006, the revenues from the building tax were 3.1 billion CZK and from the land tax 1.9 billion CZK².

All buildings, flats, and non-residential premises located in the territory of the Czech Republic are subject to building tax. A land tax is collected from all the types of land registered with the Land Register as: arable soil, vineyards, hop fields, gardens, orchards, permanent grass plots, forests, water areas, building plots and other areas. All real estate, including property descriptions, their geometric specifications and positions, their property and other material and legally stipulated rights, are recorded in the **Cadastr of Real Estate** of the Czech Republic. Administrative authorities for the cadastre and land survey activities were set up by Act No. 359/1992 Coll. on land surveying and cadastral bodies, which also specifies their material and territorial jurisdiction.

Digitalisation of the Cadastre of Real Estates began in 1993. Part of the Czech Cadastre of Real Estate is The Information System of the Cadastre of Real Estate, implemented in 2001, which increases the quality, accessibility and reliability of property data. It offers the option of connecting to other basic registers of state administration. Data are entered in local databases and replicated within roughly 2 hours in the central database. The system also enables remote access to the Cadastre of Real Estate, enabling up-to-date viewing of the data of the cadastre throughout the entire Czech Republic. Digitisation of cadastral maps proceeds less rapidly. At the end of 2006, maps of 33.8 per cent of the cadastral districts were digitised. (Czech Office for Surveying, Mapping and Cadastre 2007, 6–10)

Taxpayers do not have to pay on buildings and land **exempt** from the real estate tax. There are many different exemptions. Buildings owned by the state, municipality or region, which are located in their cadastral territory or owned by churches, are exempt, as are residential houses returned by restitution up until 2007. New residential buildings, houses and flats owned by individuals are exempt for the first 15 years. Buildings serving to improve the environment and various other buildings enjoy the same treatment.

Several exemptions were only temporary. All flats transferred to individuals from the state or from municipalities or co-operatives, for example, were exempt only until 2002. Buildings with heating systems changed to gas or electricity (today only narrowly specified renewable resources) were exempt until 2000 to encourage energy savings.

2 Důvodová zpráva k vládnímu návrhu zákona o stabilizaci veřejných rozpočtů [Report accompanying the proposal of the law on public budget stabilisation], <http://www.psp.cz/sqw/text/text2.sqw?idd=11050> (20 April 2010)

Among the lands exempt from property tax are those owned by the state, municipalities and regions. These included cemeteries, public parks, and sporting facilities. Agricultural and forest lands can be exempt for a specified number of years, as can other types of land specified by the law. Regarding forest lands, these are subject to taxation only where an economic function prevails. Water areas are taxed only if they are ponds used for intensive and industrial fish farming. Since the beginning of January 2008, municipalities have been able to exempt arable soil, vineyards, hop fields, orchards and permanent grass plots from the property tax by issuing an ordinance.

The tax base is either monetary (in CZK) or it is expressed in physical units (square metres) depending on the type of land. A monetary valuation is used for agricultural land. In the case of arable soil, hop fields, vineyards, gardens, orchards and permanent grass plots, the tax base is defined as the product of the price of one square metre of the land and the real area of the land in square metres, as of 1 January of the tax period. This decree (No. 613/1992 Coll.) has been in force since 1993 and has been updated every year; however, the price change was very small³. In the case of economic forests and ponds with intense and industrial fish farming, the price of 3.80 CZK can be used instead of the one published in the decree. In other types of land, the tax base is defined as their real area in m² as of 1 January of the taxation period.

A building's tax base is the area of the ground plan of the building in square metres as of 1 January of the tax period. The tax base for flats and separate non-residential premises is the surface area in square metres. Basic tax rates are differentiated according to the type of land or to the purpose of the building's use (see Table 5.5). They may be further adjusted with regard to the number of above-ground floors (in residential houses the tax rate of individual floors increases CZK 0.75 for each 1 m² of the finished area). The basic rate, adjusted by possible above-ground floors, is further adjusted by a so-called correction coefficient depending on the size of the municipality where the building is located (see Table 1.6). Other regulations defined by the law do not need to be exposed here.

Due to the construction of this area-based tax, no assessment (of market valuation) is required and none is undertaken. Calculation of the actual real estate tax payable in the Czech Republic is made by the property owners/taxpayers themselves in a **tax declaration**. The decisive date is 1 January of the relevant taxation period. The tax declaration is submitted only in case of any changes from the previous declaration; in the remaining cases the tax authority mails payment orders to the taxpayers. If the tax does not exceed CZK 1,000, it is due to be paid as a lump sum by 31 May of the calendar year. If the tax exceeds CZK 1,000, it can also be

³ A comparison of 293 cadastral units randomly selected out of 12,998 showed that the price increased between 1996 and 2008 on average by 2.9 per cent, ranging from a 40 per cent decrease to a 56 per cent increase.

paid in four equal payments on 31 May, 30 June, 31 August and 30 November of the calendar year, respectively.

Table 5.5
Tax rates

Land type		Building type	CZK/m ²
Arable soil, hop fields, vineyards, gardens, orchards	0.75%	Residential houses	1.00
Permanent grass plots, economic forests and ponds with intensive industrial fish farming	0.25%	Family houses and holiday houses for individuals	3.00
Finished building areas and courtyards	0.10 CZK/m ²	Garages built separately from residential premises	4.00
<i>Building plots</i>	<i>1.00 CZK/m²</i>	Original agricultural production, forest and water industries	1.00
Other areas if they are subject to taxation	0.10 CZK/m ²	Industry, building industry, transport, energy industry	5.00
		Other entrepreneurial activities	10.00
		Other buildings	3.00
		Other separate non-residential premises	1.00

Source: Real Estate Tax Act No. 338/1992 Coll. and its amendments

Note: types of real estate in italics are subject to the correction coefficient

Czech tax administration uses the Automated Tax Information System (*Automatizovaný daňový informační systém*, ADIS) which provides administrative and technical support with a unified technical infrastructure for the tax administration of the entire country. The programme provides modules for processing tax returns for individual taxpayers, as well as modules of common sectional activities, necessary for the administration, registration, collection and enforcement of taxes and for the transfer of financial funds to entitled recipients. It also provides support modules for the system, including modules for the electronic processing of the documents displayed on the website of the Czech Tax Administration. Taxpayers of the real estate tax can check personal tax accounts, and submit documents electronically. The number of electronic submissions grew between 2005 and 2006 from 1,773 to 2,218. (Czech tax administration 2007, 49–50)

5.3.3 Property tax incidence

The tax is generally paid by the owner of buildings, flats, separate non-residential premises (hereafter referred to simply as buildings), or land. In special cases, the tax may be paid by the user or the lessee of the building or land (e.g., on pieces of

land where the owner is unknown). If the building or land is owned (used) by more people, those people are obliged to pay the tax jointly.

The scope and impact of the **incidence** of the real estate tax reflects its minimal burden and very limited variability in the tax rates of different municipalities. However, although the same exemptions apply everywhere, their impacts can vary substantially across municipalities. For example, the above mentioned 15 years' exemption of new buildings is perceived as very unfair in rapidly growing municipalities in close proximity to large cities. In such cases, only the old residents pay the tax; the new residents, those who most require new municipal investments or services, are not required to pay the tax.

Most exemptions are not related to the taxpayer, although a few of them take into account the ability to pay. People eligible for social welfare (příspěvek na živobytí), and handicapped people, qualify for property tax exemption where they have permanent residency.

The tax base and, consequently, the tax revenues of a given municipality, change continuously. This may be due, first, to changes in ownership as a result of privatisation or restitution of properties. However, it has also occurred because the Czech Army was professionalised and they abandoned some garrisons. It may be due, secondly, to new construction. Unoccupied land becomes buildings or streets, which can be exempt (permanently for roads or temporarily for new residential buildings). As examples of such change, consider two small municipalities on the periphery of Prague which have had no change in their correction coefficients.

- 1) Dolní Břežany, with 2,284 inhabitants and a total area of 10.6 km² (with 0.27 km² of newly constructed residential housing), had their revenues from the real estate tax decrease from 732 to 538 thousand CZK from 2001 to 2006.
- 2) Modletice, with 466 inhabitants and a total area of 3.3 km² (with 0.23 km² of newly constructed residential housing) on highway D1 with logistical parks, had their revenues from the real estate tax increased from 863 to 3,345 thousand CZK from 2001 to 2006.

Municipalities have very limited **flexibility** in setting exemptions or influencing tax rates. They have no right to establish their own exemptions except for recent actions permitting them from January 2008 on the issue of an ordinance to exempt arable soil, vineyards, hop fields, orchards and permanent grass plots from the property tax. Currently, they can only influence the tax rate for buildings and land by changing the correction coefficient. These were established by law in 1992 and are reported in Table 5.6. Municipalities have been able to multiply the taxpayer's calculated amount due on the property tax by the stated coefficient. Larger cities could thus charge larger amounts of tax as determined by the coefficient. From 2008 (effective in 2009), municipalities will also be able to change all tax rates by another coefficient set locally (so-called local coefficient) in the value 2, 3, 4 or 5.

Table 5.6
Correction coefficients assigned to different municipal size groups

Municipality Size	1993–2007			After 2008		
	As-signed coefficient	minimum	maximum	As-signed coefficient	minimum	maximum
Up to 300	0.3	0.3	0.6	1.0	1.0	1.4
300–600	0.6	0.3	1.0			
600–1,000	1.0	0.3	1.4			
1,000–6,000	1.4	0.3	1.6	1.4	1.0	1.6
6,000–10,000	1.6	0.6	2.0	1.6	1.0	2.0
10,000–25,000	2.0	1.0	2.5	2.0	1.0	2.5
25,000–50,000	2.5	1.4	3.5	2.5	1.4	3.5
Above 50,000	3.5	1.6	4.5	3.5	1.6	4.5
Františkovy Lázně, Luhačovice, Mariánské Lázně, Poděbrady	3.5	1.6	4.5	3.5	1.6	4.5
Prague	4.5	2.0	5.0	4.5	2.0	5

Source: Real Estate Tax Act No. 338/1992 Coll. and its amendments

We have no data to offer here, but are in agreement with Czech officials who generally express an unwillingness to believe that there is any major effort to avoid the real estate tax. Because it is a very nominal tax, **evasion** would seem imprudent. At the same time, the case for moral hazard on the part of the central collectors of the tax has been made. It would not be worth the great expense on the part of the central government for enforcement, since the revenues are of little consequence. So if there were evasion, the government would doubtless be inclined to ignore it. Table 5.7 shows that the tax revenues equal or even exceed the tax obligations.

Table 5.7
Real Estate Tax Obligations and Tax Revenues (in millions CZK)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Tax obligations	3,092	4,100	4,098	4,336	4,477	4,475	4,604	4,640	4,841	4,864	4,917	4,978
Tax revenues	3,778	3,991	3,938	4,138	4,271	4,469	4,535	4,576	4,840	4,948	4,987	5,017
Revenues/obligations	1.222	0.974	0.961	0.954	0.954	0.999	0.985	0.986	1.000	1.017	1.014	1.008

Source: Annual reports of the Czech tax administration 1998–2006, available at <http://cds.mfcr.cz/cps/rde/xchg/SID-3EA9846D-0AECC542/cds/xsl/325.html?year=0> (20/04/2010)

The tax revenues are very **stable** in terms of their availability for budgeting. Receipts differ across municipalities, but the share of the real estate tax in total revenues is not highly significant. The **elasticity** of the property tax with respect to incomes is zero, due to the design of the tax. Going to a market valuation would change this, but the current area-based valuation does not relate the tax to any income consideration.

There is no **administrative cost** for the municipality, since the tax is collected by the central government. The collection cost for the central government has been estimated by Pudil et al. (2004, 23). They assess the administration costs of the real estate tax at about 13.3 per cent⁴ of the costs of total tax administration. Based on this estimate, the administration costs in 2006 were approximately 976 million CZK or 19.2 per cent of total real estate tax receipts. The average administrative costs for all tax collections, as reported by the Czech Tax Administration, were 1.41 per cent. The number of real estate taxpayers is high; there were 3.3 million of them in 2006 (Czech Tax Administration 2007), or 94 thousand more than in 2005.

5.3.4 Central government administration of the property tax

Some of the problems associated with the Czech real estate tax are quite general to property tax anywhere. A country must first decide which level of government should administer the tax. Even after having identified the appropriate degree of devolution, administration of the property tax can be quite difficult and costly. Moreover, one often encounters widespread resistance to the tax (see Bird 1993, 215–216). This is in part due to its high visibility. It must ordinarily be paid as a lump sum directly to the municipality. If inflation requires an upward adjustment of the tax to finance continued provision of the services taxpayers demand, they become keenly aware of both services and costs. Should the services (such as roads, garbage collection, and often education) be of poor quality, the taxpayer wonders why they are so costly. Inevitably, resentment will spread about the tax. It merely adds insult to injury when, for both political and technical reasons, property assessments begin to diverge from market values within classes of property. When taxpayers compare their property taxes with those of their neighbours, a costly process of appeals about assessments begins. It will doubtless be accompanied by growing demands for tax relief. Especially during periods of inflation, widespread disenchantment with property tax increases can be expected, whether higher rates are applied to unchanged assessed values, or unchanged rates are applied to higher assessed values.

Although the tendency to oppose property taxes is as unpleasant for a tax administration as it is unavoidable, the property tax retains its importance because of the undeniable strengths associated with it. A tax on real property will “make good sense as part of the tax system as a whole ... the property tax scores quite

4 Average for the three years estimated (2001: 13.1%, 2002: 13.5% and 2003: 13.4%)

well in terms of both its efficiency and its equity aspects” (Bird 1993, 215–216). If fiscal decentralisation is the objective for inter-governmental relationships, municipalities require a dependable and autonomous source of revenues that can be harvested independently of the central government. Without such an autonomous revenue source, it is much less likely that local government will enjoy a measure of independence in policy. Without such a revenue source, municipalities remain too dependent on the central government, or they may be under-funded, and thus unable to provide demanded services.

Even if the low level of the property tax in the Czech Republic and other transition governments were increased enough to strengthen the fiscal capacity to supply municipal services, local governments would still have insufficient funding to perform all the necessary tasks. Some grants and shared taxes from the central government would still be essential. But autonomy would be strengthened significantly as a result of strengthening the property tax.

Genuine self-government is inconsistent with central control over municipal fiscal matters. Kameníčková (1996, 16) has described the tax system of the Czech Republic as one in which “there are no local taxes”. The decisive policy prerogatives of all taxes are determined by the central government. Municipalities are, as we observed earlier, able to sell properties or to make loans in the event of revenue shortfalls. But property sales represent a non-recurring revenue source that will not provide an indefinitely sustainable cash flow and dependence on loans for normal operations can be hazardous.

It is evident that there is little pressure on individual taxpayers to actually comply with the demands of the real estate tax. This inference can be drawn from the fact that the system is characterised by moral hazard (Bryson and Cornia 2003). The central government has the responsibility to collect the tax, but gains none of the revenues generated by the effort. The lacking incentives result in low and declining revenues for the real estate tax. This is apparent when one observes that the same institutional rules applied for a number of years in both the Czech and Slovak Republics, simply because the system was developed before the separation of the two countries in 1993. The Slovak municipalities were much less generously supplied with funds from the centre and so were much more dependent on the property tax. Since the municipalities of Slovakia were permitted to perform their own collection of the tax, they worked hard at doing so and their revenues represented a much larger share of local budgets, somewhere around 10 per cent. The significantly smaller yield of the Czech property tax would seem to imply that it is not exceedingly difficult to avoid detection for non-compliance or failure to pay in full. For such a nominal tax, the Czech government must see it as uneconomically efficient to place a substantial amount of resources into its implementation or management, although recent years have made the effort appear somewhat more serious, as has been observed above. Still, the implication for the incidence of the property tax is

that for the holders of property who pay it, the burden is almost as negligible as it is for those who own no property.

5.4 A case study of the town Beroun

The royal town Beroun lies about 30 km west of Prague on the D5 highway connecting Prague and Nuernberg, Germany and on the confluence of the Berounka and Litavka rivers. Beroun has 17,997⁵ inhabitants and a land area of 3,131 hectares (31.3 km² or 7,736.7 acres). It is the cultural, administrative and industrial centre of the region. Due to its location, it attracts new inhabitants, of which there have been 527 since 2001.⁶ Many new flats and family houses, new shopping centres and restaurants have been constructed as the town has expanded in recent years. Beroun is an important centre of light and middle-heavy industry after having added an industrial zone at the beginning of the 1990s. The town's most important employers are Cembrit CZ (a producer of roof tiles), Linde Frigera (a producer of refrigerating equipment), PAI (automobile components), and Českomoravský cement works, a member of the Heidelberg Cement Group.

The town has a number of schools (5 kindergartens, 4 elementary schools), an assisted living home, a cinema and a library. Established either by the region or privately are another seven secondary schools, two art schools (both public and private), a language school, two kindergartens and two special schools established by the region, Středošeský kraj. There are also four private assisted living homes. Health care facilities included a hospital, a health centre, a rehabilitation centre, about 50 other practical and special medical personnel in clinical consulting practice, five pharmacies and emergency clinic facilities (Czech Statistical Office 2007).

Figure 5.4 describes the development of Beroun's municipal revenues and expenditures from 2000 through 2006. The rapid growth of both revenues and expenditures between 2002 and 2003 was a result of Beroun's new status as a municipality with extended functions, helping provide public services for 57 other smaller municipalities (see section 2.1). That growth of expenditures and receipts, especially through transfers from the central government, also reflected the town's reconstruction after a very destructive flood in August 2002. A decline in transfers received between 2004 and 2005 was the result of changes in the financing of elementary education (see section 2.3). Higher non-tax revenues in 2002 were due to revenues from insurance.

Comparison of the shares of individual types of revenues and of *per capita* revenues in Beroun and in the CR shows that tax revenues are less important in Beroun than for the average municipality. This is due to Beroun's greater than normal capital revenues and slightly higher transfers; it also reflects less substantial non-tax revenues.

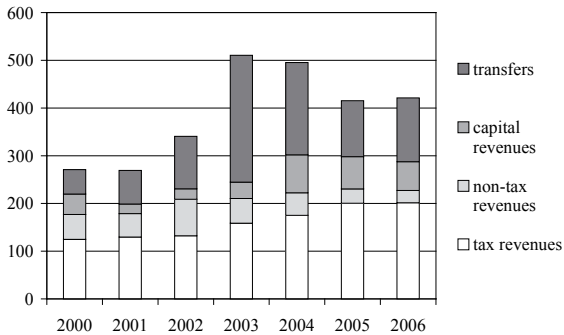
5 1 January 2007

6 http://vdb.czso.cz/vdbvo/tabparamzdr.jsp?vo=tabulka&kapitola_id=18&cislotab=MOS+A04+OB2.2&verze=2, 20. 4. 2010

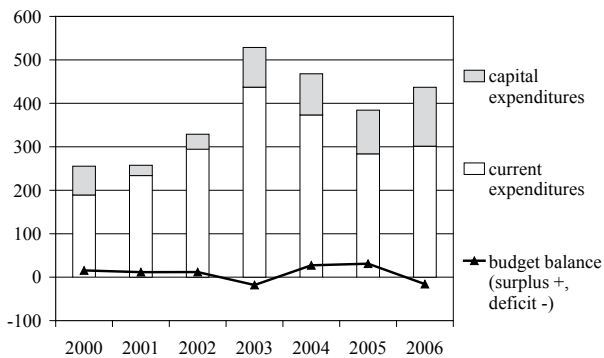
The per capita revenues are about the same for Beroun as the national average for all municipalities. A comparison of real estate tax revenues as shown in Table 5.8 reveals that Beroun, in accordance with tax policy, has a reduced tax coefficient.

Figure 5.4
Revenues and expenditures of Beroun (millions CZK)

Revenues



Expenditures



Source: ARIS, own calculations

The tax is assessed and collected by the Revenue Authority in Beroun (Finanční úřad v Berouně) for the municipal budget. Czech law grants municipalities very limited authority to alter the specifications of the centrally designed real estate tax. These rather consistently applied real estate tax provisions, however, do not mean that the tax provides very stable revenues. Variable receipts are the result of continu-

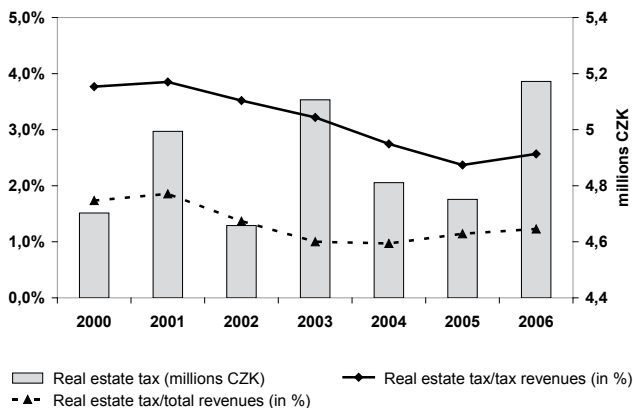
ous changes in the tax base, changes in ownership (Beroun has privatised housing and other immobile property), and of various exemptions in the law. Thus one observes in Figure 5.5 that tax revenues in Beroun are subject to considerable variation. In the years from 2000 to 2006 reported in that figure, tax receipts continued in the same direction for at least two years only – in 2004 and 2005; otherwise, they changed direction each reported year. Property tax revenues as a share of total municipal tax revenues were only about 2.5 to 3.5%. As a share of total municipal revenues they amounted to somewhere between one and two per cent.

Table 5.8
Revenue comparison between Beroun and the Czech Republic

	Beroun	CR
share in total revenues		
• tax revenues	47.8%	54.2%
• non-tax revenues	6.1%	9.6%
• capital revenues	14.3%	6.4%
• transfers	31.7%	29.8%
total revenues per capita (CZK)	23,652	23,507
property tax		
• per capita (CZK)	290	485
• share in total revenues	2.6%	3.8%
• share in tax revenues	1.2%	2.1%

Source: ARIS, Czech statistical office, own calculations

Figure 5.5
Real Estate Tax Revenues in Beroun



Source: ARIS

Until 31 December 2007, municipal discretion over the property tax was maintained through only two local options: they could alter the tax coefficient and they could make exemptions for those, in this case, affected by floods. Beroun took advantage of both options. After 1 January 1999⁷ they applied lower coefficients than originally mandated by the law (i.e. 2.0) with coefficients varying from 1.0 to 1.6 in different parts of the town. In the year 2003, all properties verified as damaged by the flood were exempt from the tax.⁸

5.5 Conclusions

As seen in Beroun and the other municipalities of the Czech Republic, the real estate tax is calculated for land and building plots, is collected by the centre and redistributed to the appropriate municipalities. It is recorded, it is paid and it enters into the national and local statistics each year. But its existence makes little difference in terms of the funds it provides for public services, or the autonomy of local officials who have few resources to effect expenditure decisions after the major and more pressing expenditures have been made and a good number of public service demands remain unsatisfied. The tax represents only a miniscule amount of revenue and policymakers are not prepared to consider the political changes that would make it a meaningful tax. Theoreticians have a feeling for the tax, for its potential for revenues, for its positive welfare characteristics, and for the independence it can deliver to local governments with an incentive to provide the unique mix of public services people in the locality prefer.

But their case has never been made to the satisfaction of the Czech public or of Czech public officials. Nor is there any indication on the horizon that the day will come when the tax menu will be adjusted so that some other form of tax becomes less burdensome, the real estate tax becomes more significant, and the municipalities of the Czech Republic become politically more independent. The recently approved changes in the law – for instance the local coefficient – may increase the revenues from the real estate tax, but not dramatically. However, it will be interesting to observe the willingness of the mayors to increase the tax and directly bear the political costs associated with it.

Much has happened on the fiscal scene in this country since the transition to democracy and market economics was initiated in late 1989. But, the expressed intent to pursue fiscal decentralisation has never been realised. Motions have come before the Czech Parliament, reform movements have been undertaken with the blessing of the European Union and that community has accepted the Czech Re-

7 *Obecně závazná vyhláška města Berouna o stanovení koeficientů pro výpočet daně z nemovitosti č. 5/98* (Public notice on setting tax coefficient, no. 5/98), <http://www.mesto-beroun.cz/,3/3/2008>

8 *Obecně závazná vyhláška města Berouna o osvobození od daně z nemovitostí na území Města Beroun č. 2/2003* (Public notice on exemption from the real estate tax on the territory of Beroun, no. 2/2003), <http://www.mesto-beroun.cz/,3/3/2008>

public as a member. But none of the political changes or reforms appears to have accomplished a true devolution of power.

That has certainly not had any catastrophic implications for the citizens of the Republic. Many Czechs and many Europeans do not feel that there is a great need to achieve fiscal decentralisation. The tiny municipalities have expressed unequivocally their demand for an independent existence. But neither they nor the larger municipalities that do have personnel and financial resources have ever insisted that the central government give them greater autonomy to act with independence.

The Republic is small and the people in the Finance Ministry and in Parliament are competent; perhaps small countries should be able to manage everything from a single city, if not from a single computer. Perhaps preferences in Liberec are not significantly different from those in Češke Budějovice or Ostrava, so that decisions made in Prague are perfectly appropriate and applicable for all those and other Bohemian and Moravian cities. Perhaps it is not important that a decision on the salience of fiscal decentralisation for the Republic has never been reached. The events and vicissitudes that might have produced local autonomy seem to have come and gone. And for this country, as for much of Europe, a strong degree of centralisation is neither feared nor eschewed.

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Table 5.9
Public Budgets, National and Local of the Czech Republic, 1993–2006

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP, current price (billions CZK)	1,020.4	1,182.8	1,381.1	1,683.3	1,811.1	1,996.5	2,080.8	2,189.2	2,352.2	2,464.4	2,577.1	2,814.8	2,987.7	3,231.6
CG Expenditure/GDP (as %)	33.2%	32.6%	31.5%	34.3%	31.7%	32.7%	31.7%	31.1%	34.0%	34.6%	35.1%	32.2%	31.6%	30.4%
Social insurance funds/GDP (as %)	4.7%	5.7%	5.7%	5.4%	5.3%	5.3%	5.4%	5.3%	5.4%	5.8%	5.9%	5.7%	5.7%	5.4%
LG Expenditure/GDP (as %)	8.8%	9.5%	9.6%	12.2%	9.9%	9.8%	9.2%	9.6%	10.1%	11.0%	13.3%	12.6%	11.8%	12.0%

Notes: (1) Central government (CG) expenditures include the state budget and the state funds. The social insurance funds (i.e. health care insurance) are reported separately. (2) Until 2000, local government (LG) included municipalities and districts; after 2001, municipalities and regions. (3) 1993–1995 data on public expenditures use the GFS methodology; data since 1996 on the ESA 95 methodology; data for the GDP since 1996 are revised.

Source: GDP: Czech statistical office. For data published since 1996, this is available at [http://www.czso.cz/csu/redakce.nsf/i/cr:makroekonomicke_udaje/\\$File/92581719.xls](http://www.czso.cz/csu/redakce.nsf/i/cr:makroekonomicke_udaje/$File/92581719.xls). For data up to 1995, see Statistická ročenka 2001, available at <http://www.czso.cz/csu/2001ledicriplan.nsf/publ/10n1-01-2001>. For Expenditures up until 1995, see Macroeconomic Forecast. October 2000, 31. For expenditures since 1996, see Fiskální výhled (Fiscal outlook), October 2007, 48–49, available at http://www.mfcr.cz/cps/rde/xbcr/mfcr/Fiskalni_Vyhled2007Q3. Table 5.1, all data available at 4/20/2010

Table 5.10
Czech Municipal Finance: 1997–2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Shared taxes	57,424	63,737	67,636	74,899	78,803	86,967	93,373	101,215	112,666	113,857
Property tax	3,943	4,108	4,248	4,436	4,569	4,571	4,828	4,919	4,966	4,974
Other tax revenues	4,457	4,254	3,795	4,249	5,459	8,008	9,292	9,978	11,267	11,838
Non-tax revenues	21,110	22,879	23,921	24,368	22,650	23,448	22,487	23,051	22,470	23,020
Capital revenues	9,624	13,167	36,684	16,313	10,517	11,468	11,869	11,040	13,249	15,472
Current grants	21,924	19,796	21,509	28,195	47,028	55,457	80,899	77,726	44,641	48,734
Capital grants	9,888	9,354	10,819	9,094	13,719	16,158	18,830	18,223	16,317	23,121
Total revenues	128,371	137,295	168,612	161,555	182,745	206,077	241,577	246,153	225,577	241,017
As a percentage of total revenues										
Property tax	3.1%	3.0%	2.5%	2.7%	2.5%	2.2%	2.0%	2.0%	2.2%	2.1%
Shared taxes	44.7%	46.4%	40.1%	46.4%	43.1%	42.2%	38.7%	41.1%	49.9%	47.2%
Own revenues	75.2%	78.8%	80.8%	76.9%	66.8%	65.2%	58.7%	61.0%	73.0%	70.2%
Grants	24.8%	21.2%	19.2%	23.1%	33.2%	34.8%	41.3%	39.0%	27.0%	29.8%

Source: ARIS

6. Land Taxation in Estonia

Viktor Trasberg

6.1 Overview of Estonian local governments

Estonia is a parliamentary republic with a single-tier local government system. On 1 January 2008, there were 227 sub-governmental jurisdictions – comprising 33 towns (*linn*) and 194 rural municipalities (*vald*). Estonian territory is also divided into 15 counties, which do not, however, have the status of local governments. The county Governor is a representative of the central government and implements central government policies at regional level. The county administration serves as the administrative apparatus of the county governor.

All the local government units are identical in their legal status. During the last decade, the number of jurisdictions has been slowly declining (about 40 units less) through municipalities' voluntary amalgamation. Most of the municipalities are relatively small regarding population, as 80 per cent of municipalities have less than 5,000 inhabitants. Nevertheless, the population is concentrated across the two biggest urban areas (Tallinn and Tartu), where there is around 42 per cent of the total population.

Local government fiscal activities cover about one quarter of general government fiscal operations. In Table 6.1, the principal revenue and expenditure data for Estonian local governments, during the recent years, is given.

About half of all local governments' revenues come from the various taxes. The biggest tax item is the centrally administered personal income tax (PIT). The second biggest is a land tax, which covers about 3 per cent of total revenues. Despite the local governments' relatively high share of nominal fiscal autonomy, municipalities' real fiscal autonomy is rather narrow, due to their limited discretionary power.

Local governments receive about 32 per cent of their revenues from earmarked and general grants from the central government. The biggest grant transfers are used for education purposes – to cover school and pre-school teachers' salaries.

Non-tax revenues come mainly from user charges. Municipalities provide various public services – public transport, water supply and sewage, day care and they charge consumers for using those utilities.

6.2 Land and property taxation: general overview

Land and property taxes are a natural part of local governments' revenues in many countries. Somehow, they are considered to be almost the perfect tax. They provide a predictable and durable revenue source for local budgets, foster local autonomy and provide fiscal mechanism for decentralisation.

Table 6.1
Local Government budget 2003–2007 (billion EEK)

	2003	2004	2005	2006	2007	Revenue structure, 2007
Revenues	11.70	12.85	14.66	18.10	20.15	100.0%
Taxes	5.44	6.11	6.99	8.48	10.58	52.5%
• personal income tax	4.91	5.54	6.36	7.83	9.85	48.9%
• land tax	0.45	0.48	0.51	0.52	0.55	2.7%
Economic activities	0.98	1.41	1.53	1.63	1.79	8.9%
Equalisation fund (grant)	1.12	0.93	0.95	1.14	1.46	7.2%
Block grant from State Budget (education)	2.18	2.39	2.92	3.09	3.22	16.0%
Other grants from State Budget	0.44	0.49	0.53	0.44	0.51	7.2%
Other revenues (fees, other)	0.58	0.32	0.39	0.62	0.69	8.2%
Expenditures	12.21	13.08	15.02	17.85	20.42	100.0%
Allocations	1.63	1.21	1.56	1.76	1.80	8.8%
Misc. costs	4.74	5.24	5.72	6.30	7.48	36.6%
Economic costs	3.56	4.41	4.92	5.69	6.38	31.2%
Investments	2.00	2.01	2.63	3.94	4.05	19.9%
Other expenses	0.27	0.21	0.18	0.16	0.70	3.4%
Surplus/deficit	-0.51	-0.22	-0.08	0.75	-0.29	
Financial transfers	0.51	0.22	0.08	-0.75	0.29	
Estonian GDP, nominal	136.00	149.90	175.40	207.10	239.60	
LG revenues from GDP	8.6%	8.6%	8.4%	8.7%	8.4%	

Source: Estonian Ministry of Finance

Property tax generates revenue that is rather predictable and relatively steady in short-term changes of income or other factors and it is regarded as a relatively stable revenue source when compared to other local tax sources, such as income or consumption tax. Also, it is difficult for taxpayers to avoid paying property taxes as they are already charged. The government can easily control property rights and authorities have instruments to force taxpayers to pay the tax. Therefore, real property taxes tend to distort private economic decisions less than other local taxes.

There is no common understanding of how property taxation influences the efficiency of land use (Trasberg 2004). Some economists argue that local property taxation promotes efficient location and fiscal decisions on the part of households (Oates 1999). On the opposite side, economists (Mieszkwoski, Zodrow) view local property taxation as having a distorting effect on local decisions. As a result,

such a tax tends to discourage the use of capital, land and property improvements (Oates 1999).

However, the main concern of property taxation is related to identifying a property taxation base and valuation of sites. There might be several objects of property tax or real estate tax. Usually, property tax includes the following objects:

- Land only
- Real property only
- Combination of land and real property

Land tax is usually easiest to administer and it is also often politically less offensive than real property taxation. Otherwise, taxing only land limits the local government revenue base. The land value is usually much lower compared to the total property value and therefore, expected revenue might be insufficient for municipalities' needs. Excluding property and taxing land theoretically only leaves the incentive for further investments and maintenance in both residential and commercial development.

On the opposing side, the low administrative cost of land tax is offset by reduced transparency. Taxpayers have no comprehensive information about the factors which form the real market value of their site. Including other immovable property, besides land, a property tax base can increase local governments' revenues considerably. On the other hand, taxation of immovable property, such as residential and commercial buildings, requires much more sophisticated valuation mechanisms (Trasberg 2004).

6.3 Land taxation in Estonia

6.3.1 General information

The land tax in Estonia was introduced in 1993 with the adoption of the Land Tax Act. In the following years, the Act has been amended several times, but the main features of the law have remained unchanged. Until now, the land tax has remained a single property tax.

Its purpose was to regulate land use, stimulate more productive use of land and provide a wider revenue base for local governments. The Estonian Parliament decided to establish a land tax to encourage its efficient economic use and to avoid a tax overburden on the residents. It should be stressed that land taxation is also an emotionally sensitive issue. The land reform in Estonia has generated, over the last decades, hundred of thousands of new landowners, who had no previous experience of paying land tax. Therefore, hostility against the new tax obligations was rife.

The Land Tax Act also correlates with other various laws, which regulate local budgeting. The *Rural Municipality and City Budgets Act* (1993) sets forth the pro-

cedure for the preparation, passage and implementation of rural municipality and city budgets. The *Local Taxes Act* (1994) provides for local taxes, a procedure for the imposition of local taxes and the requirements for local taxes. Land tax is collected and administered by central authorities and afterwards the tax revenues are transferred to local municipalities' budgets. Land tax collection procedures are the responsibility of the Estonian Tax and Customs office and the system is functioning efficiently. The Estonian Land Board is responsible for the valuation of land for tax purposes

Estonian land taxation based on an *ad valorem* tax system considers the tax on the basis of recent transaction prices. Its positive aspects are related to its potential to support the efficient use of land and property. If property improvements and capital investments are not taxed, the owner will have the incentive to use the land in the most efficient and profitable way. There are also several disadvantages of such a taxation system. The biggest issue is an assessment problem. Land and houses are sold relatively infrequently and therefore it is difficult to indicate properties' "real market value". Therefore, it raises the problem of discrepancy between real market value and assessed value (Trasberg 2004).

Valuation is the major technical challenge in a fair and efficient taxation system. A proper valuation requires a clear definition of the taxable land value, adequate evaluators and reliable data on property values. However, since land markets are underdeveloped and not sufficiently transparent, it is difficult to use market information as a valuation.

Land values for taxation purposes are supposed to be estimated periodically. The valuation of land is based on information concerning land sales' transactions or closely related similar land parcels. Also, other information such as rentals, location and land quality is used for valuation. During the first years after the land tax was established, different simulation models were used to calculate lands' taxable value as there was of a lack of market information. The land markets did not properly exist; most of the land was still owned by the government and the population's incomes were low. Later, land valuation became much more related to actual market prices, revealed within the transaction processes.

An effective administration requires the identification of property and liable taxpayers, the valuation of each parcel subject to tax and the efficient collection of land taxes. Identification of a property's physical size and taxpayers in Estonia are adequate due to the functioning system of cadastral and ownership records.

The land tax is the only significant tax in Estonia over which municipalities have certain discretionary power. The Estonian Parliament has set land tax rates within certain brackets. The tax rate range is established within 0.5–2.5 per cent of the assessed value of the land. The municipalities' councils have the right to decide about tax rates within their territories and within the given brackets. The tax col-

lecting institution sends information to landowners about their land tax obligations and due payments. The land tax is payable in instalments, three times per year.

All land in use is classified into 11 different zones on the basis of the purpose of utilisation. Those land zones are: residential land, commercial land, productive (arable, forest) land, mining area land, social purposes land, land under wetlands, land for transportation purposes, sewage area land, land for national defence purposes, environmentally protected land, agricultural land and land without a use. Agricultural land (arable and forest land) covers the biggest proportion of all land use. The Estonian municipalities have the right to establish differentiated tax rates among the zones. Usually, local governments separate arable land from all zones and tax them with lower rates, compared to all other zones. Mainly in the rural communities, agricultural land receives a privileged tax treatment on the grounds of social and economic reasons. The lower tax rate provides benefits for farmers, who otherwise could not continue their agricultural activities. There are also relatively few exemptions on the land tax subjects; some municipalities allow exemptions for retired people on their residential lands.

Another interesting aspect regarding land taxation in Estonia should be mentioned, i.e. the massive land restitution during the last decades created a somewhat unique situation, where the landowners' place of residence and their actual land ownership are located at a distance from each other. The landowners often reside in different jurisdictions from their land property location. Formal restitution made many people land and forest owners, who actually have no particular interest in cultivating land, or who are not particularly interested in seeking a beneficial use of their land parcels. The new landowners often try to dispose of their land by selling it at any price or simply leave it unused. In fact, the land tax amount is still small enough to force landowners to explore their land in the most efficient way.

The situation in Estonia where landowners and their property are located in separate administrative units, has led to another peculiar situation. Namely, a wide tax burden export takes place from municipalities, where the property is located to other communities, where the landowner resides. The actual landowners do not participate in the decision-making processes over land tax rates and public spending, despite the fact that they have to pay a land tax in that particular municipality.

6.3.2 Land tax dynamics and revenues

Land prices have increased significantly during the last decade in Estonia. The major impact on land price increases has meant a fast economic growth and a European Union accession effect. Economic growth has been correlated with fast income increases and a booming real estate sector. EU accession has brought to Estonia various financial support to agricultural and other land-use related activities. All those factors have had a positive impact on the land price increase. Nevertheless, despite the significant increase of land prices during the accession period to the EU

within the last five years, land prices are still undervalued in comparison with most of the “old” EU countries. The municipalities’ revenue increase from land taxes depends on the growth of the assessed values of various lands. A recent land valuation was carried out in 2001. Therefore, the land assessed value, as a base for taxation, is currently artificially low.

Land value differs widely through the Estonian regions. The country is sparsely and unequally populated. Meaningful land value growth has taken place in urban areas or municipalities around the capital cities. Property prices have also increased in coastline areas and other places with attractive landscapes. In the rural regions, due to the depressing situation in agricultural production during the 90s, land prices have been relatively low. On the other hand, subsidising farming activities through EU funds has, in recent years, also increased the price of agricultural land.

Table 6.2 presents the Estonian municipalities’ land tax revenue dynamics and also their importance to the municipalities’ budgets during the last decade.

Table 6.2
Estonian land tax, 1997–2007

	1997	1999	2001	2003	2005	2007
Land tax, million, EEK	269.9	310.2	397.4	449.2	505.8	552.4
Land tax in total revenues	4.8%	4.4%	3.9%	3.8%	3.4%	2.7%
Land tax in tax revenues	8.3%	7.7%	9.0%	8.3%	7.2%	5.2%

Source: Estonian Ministry of Finance and author’s calculations

As the indicators show, the total amount of land tax during the period has doubled. During this time, intensive land privatisation and restitution have taken place and land became a subject of market transactions. Land privatisation has been accompanied by the significant widening of the tax base – increase of land parcels in private hands and hundred of thousands of new landowners as tax subjects.

Nevertheless, the land tax share in total municipalities’ revenues has fallen significantly throughout the period. In 2007, the land tax proportion in the budgets was only 2.7 per cent, or roughly half as much as 10 years earlier. Intuitively, at first glance, this outcome is illogical because land prices in all zones have increased considerably. The explanation for this controversy is the following. The main reasons for lowering land tax revenues relate to out-of-date land valuations and limitations set on the land tax rate. For several reasons, no land valuation procedure has taken place since 2001. Therefore, the taxable value of land has remained at the EU pre-accession level and does not correlate with general price increases and income growth in Estonia. Also, local governments cannot increase the land tax rate above the given brackets. As a result, as a local sub-national government revenue source, the land tax in Estonia is losing its significance.

6.3.3 Land tax in municipalities' budgets

Table 6.3 provides an overview of the Estonian municipalities' size and main land tax revenue indicators. In reality, and in general, this land tax is not an important revenue item for the municipalities, in spite of the fact that for some municipalities' groups, it remains a rather large share of total revenues.

Table 6.3
Estonian municipalities and land tax characteristics, 2007

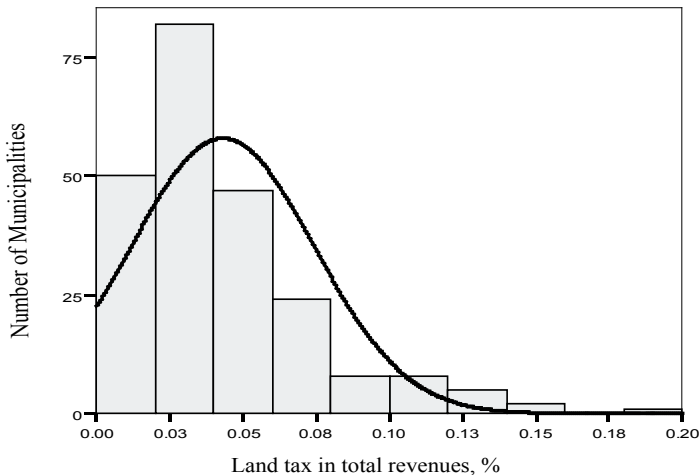
	Mean	Minimum	Maximum	Std. Deviation
Population <i>per municipality</i>	5,914	71	396,852	27,660
Population density <i>per km²</i>	164	1.2	2,608	408
Size of municipalities (km ²)	195	2	1,019	154
Land tax (EEK)	2,433,433	15,849	130,289,147	9,094,000
Land tax in total revenues	4.3%	0.2%	18.6%	0.3%
Land tax per capita (EEK)	695	29	4,151	583

Source: Ministry of Finance data and author's calculations

Land tax importance fluctuates very significantly throughout the Estonian municipalities – from close to zero up to 19 per cent. Also considerable is the land tax *per capita* and its absolute value by municipalities.

In Figure 6.1 we see the given land tax distribution by the municipalities on the basis of land tax share of their budgets.

Figure 6.1
Distribution of municipalities by land tax revenues



The graph presents a rather unequal distribution of the land tax's importance as revenues across all the municipalities. On average, municipalities receive 4.3 per cent of their revenues from land tax. Less than one-tenth of Estonian local governments' revenue exceeds 10 per cent from land taxation.

6.3.4 Correlations

In Table 6.4 are presented some correlative relations among different indicators, related to land taxation. On the basis of statistical significance, there are chosen indicators to characterise land tax's importance and level across all Estonian municipalities.

As the correlation results depict, the total amount of land tax in municipalities is positively linked to:

- The administrative status of a municipality. There are two types of local jurisdictions in Estonia – towns (33) and rural municipalities (194). Total land tax revenue tends to be higher in town-type municipalities, despite rural municipalities being significantly higher in their territory. Clearly, the biggest impact here emanates from the capital city's – Tallinn – significance with the largest amount of land tax collection. Without the Tallinn figures, the administrative status indicator is not statistically significant;
- Municipalities' total population size and density. The larger and more compactly populated jurisdictions collect more land tax than the smaller ones. The reason for this is the impact of the market value of land as a basis for land tax calculations. Rather logically, areas with a bigger concentration of population (e.g. towns) have relatively higher-priced land plots;
- Total revenues and total tax revenues. The higher the total tax share in revenues, the larger the land tax revenues;

The correlated land tax gross amount and distance from Tallinn have a negative result. As land is more expensive around the capital city area, this result is rather predictable. However, one surprising outcome is that the municipality's territorial extent is not statistically significant in correlation with land tax total revenues!

Considering the given indicators, the share of land tax in municipalities' total revenues is positively correlated only with the territorial size of jurisdictions. Many rural municipalities with large territories are more dependent on land tax revenues than urban regions, with their limited territory size. The share of land tax in municipalities' total revenues is negatively correlated with:

- Municipalities' jurisdiction status; The town municipalities budgets from the land tax play a lesser role than the personal revenue level in towns, which is higher compared with the rural regions. PIT revenue for the municipalities is far more important than tax revenue;
- Municipalities' distance from the capital city;

- Municipalities' population density. The higher the concentration of population in a jurisdiction, the less importance land tax has on municipal budgets.

Table 6.4
Land tax factors' correlations, 2007

	Land tax (EEK)	Land tax in total revenues, %	Land tax per capita (EEK)
Town or rural municipality	0.194	-0.373	-0.344
Distance from Tallinn (km)	-0.258	-0.148	-0.195
Territory (km ²)		0.329	
Population density per km ²	0.425	-0.368	-0.330
Population per municipality	0.935		
Total revenue (EEK)	0.948		
Tax revenue (EEK)	0.960		
Personal income tax revenue (EEK)	0.957		
Land tax in total revenues (%)			0.883
PIT per capita (EEK)			0.270

Source: Ministry of Finance and author's calculations

Note: Correlation is significant at the 0.01 level

Across the municipalities, *Land tax in total revenues* is positively correlated only with the territorial size. At the same time, a negative correlation is indicated regarding the municipalities' status, distance from Tallinn and population density. Rural municipalities receive more from land taxation than urban municipalities.

The indicator, *Land tax per capita*, is positively correlated with the indicator for *Land tax in total revenues* and *Personal income level per capita*. The related land tax level per capita within a certain distance from Tallinn and the population density indicator is negative.

6.3.5 Case situation: land tax administration in Tallinn

The municipal taxation system serves several objectives – from revenue collection for the local budget to serving wide-scale social economic purposes. The right to establish property tax rates somehow puts local governments into a delicate position. On the one hand, the fiscal aspect of property tax collection is definitely an essential source of revenues, which motivates governments to establish as high as possible tax rates. Another aspect is related to the local elected bodies' behaviour in attempting to maximise their political position. Hence, higher taxation of your primary electorate is certainly not a very popular idea.

At the end of 2007, the Tallinn City government increased its rate of land tax to add revenue to the city budget. The tax rate was increased from 0.6 per cent to 1.5 per cent on the basis of the land's taxable value. More than doubling the land tax rate particularly hit the lowest income population (pensioners), who live in high-value residential areas in Tallinn. As a reaction to the land price increase, there were many protests, which became heated because of some opposition political parties.

To summarise, the situation attracted attention on some sensitive issues in Estonian society.

First, the territorial location of residents was not correlated with the population's income levels and value of their location. Many residential areas, developed during the Soviet time, became very prestigious and were of a high value. Previously, many people became landowners of areas through land restitution or an extremely low land privatisation price. Since previously, the cost of owning land was relatively low, land taxation was not a factor, which was important for residents in choosing a location. The classical *Tiebout* understanding of population location on a cost-benefit basis did not work properly due to the artificial low cost of use of the sites in many places in Estonia.

However, in today's situation that controversy has become very apparent – on most of the valuable land in Estonia there often resides a relatively low-income population. It is difficult to estimate, how this situation will develop in the future.

The second aspect is related to land valuation. As mentioned earlier, the last land valuation was carried out in 2001, before Estonia's EU accession. After that, land prices in Tallinn (as with the whole of Estonia) have increased several times. With the current regulations, land value is assessed on the basis of market sales transactions in particular areas. Therefore, if the next land valuation process takes into consideration actual land prices in those areas – the expected high land tax burden might cause very serious social problems. The situation again brings about the necessity to establish a differentiated property tax, which somehow allows making the overwhelmingly high tax burden for low income persons easier.

The third aspect is related to the cost of public provisions. The public choice approach of property taxation focuses attention on the tax role of promoting effective decision-making in the public sector. The tax system has to provide an accurate set of signals or "tax-prices" that make it clear to local taxpayer-voters the cost of public programmes. The local tax system, therefore, should be highly transparent and understandable. Individuals and businesses should have a clear understanding of the financial commitment implied by the proposed programmes of public expenditure.

6.4 Conclusions

In the current situation, the land tax revenues in Estonian municipalities are relatively low. There are certainly natural limits of land and property tax as a municipalities' revenue item but Estonia's particular problem is its low land value as a basis for taxation. However, prospectively, property taxes may have more potential as a revenue source for municipalities, if compared with the current situation and system.

There are also discussions over introducing a wider property tax and including buildings and improvements to the tax base. Nevertheless, in the current Estonian political situation, establishing such a new property tax is not widely acceptable. The negative impact of property taxation is related to the disproportionately greater administrative cost, and potential discouragement of property improvements and investments.

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7. Property Tax in Kosovo

Gani Asllani

7.1 Introduction

The objective of this paper is to analyse the current situation in the field of local finance in Kosovo, through which the advantages and existing weaknesses will be identified. It is extremely important to find possibilities for municipalities to be able to self-finance through their own sources.

The paper presents the institutional structures and their competencies, the Special Representative of the Secretary-General's (SRSG) co-operation with local Provisional Institutions of Self Government (PISG), as well as the relationship between central and local institutions.

Part of this paper looks at the tax system and its evolution, the participation of tax categories and municipality tax in GDP, central and local budgets and other fiscal analyses. The paper reviews the level of dependence of the municipalities on central government, grants and their share, as well as other issues which have an impact on fiscal decentralisation.

Specific accentuation is given to property taxation, its role in the taxation system and local finances. The paper analyses the method of functioning, legal regulations in this field and many other implications. A case study for Podujeva Municipality is elaborated, which is ranked among the average-developed municipalities.

The paper is mainly based on analyses of the legislation in force, which regulates financial issues at the central and local levels, the practice of local finances, study of achievements in this field, indicated problems and finding their solutions through a comparison of the data on planned and realised revenues, managing them, and other interactions of the municipalities with the central level.

After 1999, Kosovo, supported by the International Community, created and is continuing to create its democratic institutions. Although progress has been made in many segments of economic and political life, there is still a need for further improvement and progress. The functioning of local finances is certainly facing many problems and it requires finding adequate solutions.

7.2 Structure of government and inter-governmental relations

Kosovo has been under United Nations administration since 1999. The country is governed by the United Nations Mission in Kosovo (UNMIK) and the local Provisional Institutions of Self-Government, and security is provided by the NATO-led Kosovo Force (KFOR). In May 2001, UNMIK promulgated the Constitutional

Framework, which established Kosovo's Provisional Institutions of Self-Government (PISG). Since 2001, UNMIK has been gradually transferring governing competencies to the PISG, while reserving some powers that are normally carried out by sovereign states.¹ On 17 February 2008, the Kosovo Assembly proclaimed the Independence of Kosovo, pursuant to the Ahtissari Package and under the supervision of the EULEX mission of the EU in Kosovo. Kosovo's independence is recognised by the majority of democratic countries in the world, meaning that we have a new reality in south-east Europe.

In November 2001, the OSCE supervised the first parliamentary elections for Kosovo. From the results of the second parliamentary elections held in October 2004, a coalition government between DLK (Democratic League of Kosovo) and AFK (Alliance for the Future of Kosovo) was established. On 17 November 2008, new elections (Local and Parliamentary) were held, which resulted in the establishment of a new government.

Regarding the responsibilities that Kosovo Institutions have, these are divided into Provisional Institutions, an Institution with reserved powers, and Institutions of the local government. Since the new reality created in Kosovo, there have been major changes in transferring competencies from international staff to local staff. In PISG there are: the Presidency of Kosovo, Assembly of Kosovo, Government of Kosovo and the Office of the Prime Minister of Kosovo. Institutions with reserved UNMIK Powers are: UNMIK Customs Service, Kosovo Police Service, Kosovo Trust Agency, The Kosovo Property Agency, Office of the Auditor General and the Independent Media Commission. Actually Kosovo has 30 Municipalities and another 3 pilot (experimental) municipalities (Junik, Mamushe and Partesh).

7.2.1 Local government – funding sources

Kosovo municipalities have two sources of finance available: own-source revenues and inter-governmental transfers. Municipalities are entitled to funding from the Central Authority. The Central Authority is supposed to notify municipalities in advance, for the forthcoming fiscal year, of the amount of the planned transfers to them. This is a dominant revenue source for municipalities.

The own-source revenues that municipalities are able to generate are insufficient to meet their needs. The legal basis for the financial resources for municipalities is UNMIK regulation 2000/45, which provides the responsibility for municipalities to prepare balanced and transparent budgets, by compiling and executing a budget plan.

In 2004, the Working Group on Local Government, chaired by UNMIK, developed a Framework for the Reform of Local Self-Government in Kosovo, which

¹ Working Group on Local Government, 19 July 2004, Framework for the Reform of Local Self-Government in Kosovo, Prepared by the Working Group on Local Government

was endorsed by the government. With regard to local government financing, the Framework recommends the adoption of a comprehensive law on Local Government Finance as soon as possible. In the absence of a law for local finances, the Ministry of Economy and Finance (MEF) and the Ministry of Local Government, in co-operation with the Association of Municipalities, issued Administrative Instruction No. 2007/2 by which are defined own source revenues of the municipalities (fees and other municipality charges).

7.2.2 Governmental structure and contacts with local level

The roles, responsibilities and relationships between municipalities and other governmental and international authorities – UNMIK (United Nation Mission in Kosovo), central government ministries and agencies – are not clearly defined in the legal base. Municipal officials do not fully understand the scope of their roles, responsibilities and competences. Many responsibilities that municipalities would normally exercise are held by UNMIK, which is responsible for exercising the powers reserved by supervising and monitoring municipal activities and decisions. UNMIK competencies are expected very soon to be transferred to the Institutions of Kosovo, under the supervision of EULEX.

7.2.3 Responsibilities of municipalities

The previous enforceable Regulation 2000/45 defined the responsibilities of the municipalities, where an important part was the funding. Based on this Regulation and Administrative Instructions issued by the respective Ministries there is now a promulgated new Regulation for Municipalities no. 2007/30, which defines the competencies of municipalities and their institutional structure.

Municipalities should have the authority to manage their own budgets as follows:

- All municipal services should be financed through municipal budgets which include own source revenues, central to local budgetary transfers, and extra budgetary funds;
- The authority is to set rates and exemptions for local taxes, fees, tariffs and fines, which should be guaranteed as a municipal prerogative although central authorities may set allowable rate ranges;
- Criteria that determine the allocation of grants to municipalities should be set by law;
- Municipal grant calculations should include measures to mitigate disparities among municipalities;
- A mandatory and consistent format for municipal budgets should be set by law;

- Municipalities should have the right to borrow in both internal and external capital markets in conformity with the law on Public Financial Management and Accountability.

7.2.4 Inter-governmental fiscal relations

Table 7.1 presents GDP according to the derived figures in billion €, then participation of national expenditures in GDP as well as participation of the local expenditures in GDP expressed in per cent. From the table, it can be seen that participation of total expenditures (central level and local level) in GDP is around 30 per cent, whilst at the local level the percentage is lower.

Table 7.1
Participation of national and local expenditure in GDP (billion EUR)

	2002	2003	2004	2005	2006
GDP in current figures (in national currency – billion €)	2,246	2,249	2,282	2,209	2,250
Expenditure of National Government as a percentage of GDP (%)	23.2%	25.0%	33.4%	31.0%	27.0%
Expenditure of Local Government as a percentage of GDP (%)	4%	6.1%	9%	7.5%	7.3%

Sources: Macroeconomic Department, Ministry of Economy and Finance

Table 7.2 presents the level of fiscal decentralisation, the importance of municipality grants in central expenditures, together with the importance of the social transfers in municipal budgets. It can be seen that the budget of municipalities comes from two sources of funding; from governmental grants (administration, education, health and own source funding fees and property taxation) and own source revenues. In the Table, the overall budget of central level, overall budget of municipalities, general grant of administration, health and education grant and finally own source revenues of the municipalities are presented. Details are based on treasury reports and they represent facts ascertained during the budget planning, according to the revenues planned and transfers from previous years.

Table 7.2
Participation of central grants and local revenues in the overall budget
(thousands EUR)

	2002	2003	2004	2005	2006
Overall budget	240,529.3	811,751.2	940,475.5	744,881.8	727,301.6
Municipality grants – in total grants + own source revenues; (1+5)	111,484.6	187,472.3	229,495.9	171,887.4	187,380.8
1. General grant for administration (2+3+4)	88,103.0	149,992.6	186,681.0	131,789.3	142,074.5
2. Governmental grant for health and education	25,697.1	60,558.3	88,953.6	38,127.5	45,685.6
3. Health grant	19,546.0	21,518.9	22,961.9	20,548.4	21,628.4
4. Education grant	43,356.3	68,747.4	78,752.0	78,042.4	80,315.2
5. Own source revenues of municipalities (without health and education)	22,885.2	36,647.6	38,828.3	35,169.2	39,751.7
Participation of municipal budget in overall central budget	46%	23%	24%	23.4%	25%
Participation of the central grants in municipal budget	79%	80%	81%	76%	75%
Participation of own source revenues in municipal budget	21%	20%	19%	24%	25%

Sources: MEF, Treasury reports 2007

7.2.5 Methodology and criteria for municipal grants distribution

Budget Circular (BC) 2008/01-Municipalities set out initial instructions, procedures and a timetable for the development of the 2008 Municipal Budget. The purpose of the Budget Circular 2008/02 was to provide information on the initial amount of inter-governmental transfers for 2008 and to advise Municipalities on the preliminary projections for 2009–2010.²

This Budget Circular contains the Government priorities embodied in the draft Medium-Term Expenditure Framework (MTEF) and is in accordance with the recommendations of the International Monetary Fund (IMF).

1. The General Grant will be available to fund all aspects of municipal operations. The General Grant is distributed to municipalities based on the 2001 official population estimates with adjustments for a fixed amount available to all Municipalities:

² Budget Circular 2008, Municipal Budget Priority Review Instructions; 11 June 2007, Ministry of Economy and Finance

- Each Municipality receives a 100,000 Euro fixed amount from the total General Grant funds available for municipalities.
 - The remainder of the General Grant is divided between Municipalities, based on their percentage share in the 2001 official population estimates.
2. The Health Grant is distributed on the percentage of population in the Municipality, based on the official 2001 population estimates. The methodology of calculation is carried out in such a way that it firstly defines the overall number of population, and then takes the number of population in the municipality and afterwards looks at the participation of the municipal population in the overall population and finally this percentage is multiplied by an overall grant for health.
 3. The Education Grant uses a formula developed by the World Bank, which differentiates between the majority and minority populations to determine the percentage of the funds available through the Grant to each Municipality.

The formula is utilised as follows:

Wages and Salaries: Number of minority and majority pupils in municipalities from the official MEST report submitted to the MFE, which is separately divided by the pupil/teacher ratio for that population type. The resulting number of teachers is then multiplied by the Kosovo-wide average salary per teacher.

Pupil/teacher ratios are set by the World Bank formula at 1 to 21.3 for majority pupils and 1 to 14.2 for minority pupils. The formulas are:

No. Majority Teachers (NMAT) = No. Majority Pupils (NMAP)/21.3 (Rounded Up)

No. Minority Teachers (NMIT) = No. Minority Pupils (NMIP)/14.2 (Rounded Up)

Teacher Cost Need (TCN) = (NMAT+NMIT) x Kosovo-wide Average Salary/Teacher

The number of administrative and support staff is reported in the payroll, times the average salary for an administrative and support employee. The formulae are:

Support Staff Cost Need (SSCN) = No. Admin & Support Staff x Kosovo-wide Average Salary/Staff; Total Wage Bill (WB) = TCN + SSCN = WB

Goods and Services: a fixed amount per school (500 Euro for each pre-primary and primary school, 1,000 per secondary school) is added to a fixed amount per student differentiated by majority and minority students.

Fixed amounts for student goods and services are set by the World Bank formula at €18 per Albanian student and €22.5 per other ethnicity student. The formula is:

Goods & Services (GS) = (NMAP x 18) + (NMIP x 22.5) = GS.

Capital Outlays: €5 per student is allocated to the municipality. The formula is:

$$\text{Capital Outlays (CO)} = (\text{NMAP} + \text{NMIP}) \times 5 = \text{CO}$$

Master Formula Calculations: Estimated Education Need (EEN) = WB + GS + CO = EEN. EEN/Combined Total of All Municipalities' EEN = Percentage of Available Education Grant Funding to that Municipality.

7.2.6 Composition of LG revenues

From Table 7.3 – A large dependence of municipalities from central grants can be seen. It is also noted that property taxation began to be applicable in 2003 and there is a continuous increase in revenue collection.

Table 7.3

Composition of LG revenues – according to the planned budget in thousand EUR (including grants)

	2001	2002	2003	2004	2005	2006
1. Own revenues	9,819.1	23,381.6	33,996.7	37,296.6	33,414.6	37,670.5
2. From this: property tax	–	–	3,482.9	5,518.2	6,683.6	7,635.9
3. CG grants	27,484.3	88,103.0	149,992.6	186,681.0	131,789.3	142,074.5
Total municipality budget = 1+2+3	37,303.3	111,484.6	187,472.2	229,495.9	171,887.4	187,380.8

Source: MEF, Department of Central budget

Table 7.4

Planned incomes and those realised in thousands EUR (municipality revenues)

Revenues	2001	2002	2003	2004	2005	2006
Planned revenues	9,819.1	23,381.6	37,479.6	42,814.9	40,098.1	45,306.4
Realised revenues	–	17,918.4	13,765.1	23,166.9	25,447.9	27,755.1
% realised	–	76%	36%	54%	63%	61%

Source: MEF reports, for years: 2002, 2003, 2004, 2005 and 2006

7.3 Historical background

After the conflict, Kosovo began to build tax policies, oriented towards the market. These policies include building and implementation of modern concepts of taxation. This concept of taxation is in full compliance with international and EU regulations. The building and development of a taxation system (direct and indirect taxes) as well as other taxes at the central and local levels are carried out for a relatively short period of time. Thus, in 1999, began the implementation of the UNMIK Customs

Service Regulation (customs tax and excise), followed by the UNMIK Regulation No. 2000/45 on self-government of municipalities, the Regulation on Pre-judged tax (May 2000), VAT (May 2001), Income tax (1 April 2002), Taxes on profit (2002), Property tax (June 2003), Road Tax (March 2005) Tax on royalties (2005), Taxes on monopoly profits in the telecommunication field (2005) and others, including the application of other non-tax incomes at both central and local levels came into force. At the central level, non-tax revenues are given specific importance with taxes related to using roads, royalty taxes, different licences for businesses (business registration), revenues from health, agriculture, transport education, travel documents and others at municipal levels by developing municipal regulations on fees, tariffs, charges and property tax.

7.4 Property tax in the national tax system and in LG revenues

Table 7.5 presents the importance of the real estate tax related to the national tax system and based on a percentage of GDP for the period 2002–2006. The participation of local taxes realised in GDP which is over 1 per cent, while real state tax for 2006 is 0.33 per cent, can also be seen. With the highest participation in GDP are the indirect taxes (VAT, Excise and custom taxes).

Table 7.5
Contribution of incomes in per cent to GDP (2000–2006)

Years	2000	2001	2002	2003	2004	2005	2006
Overall incomes	12.1	19.8	28.8	32.8	32.7	28	31
Taxes	11.4	17.5	25.6	29.0	28.1	24	25
Border's Taxes	10.8	15.0	21.0	23.6	22.9	19	19
Direct internal Taxes	0.6	1.8	2.8	3.5	3.6	4	4
Internal Local Taxes	0.0	0.8	1.6	2.2	2.3	2	2
Reversion of taxes	-	-	-	-0.9	-0.7	0	0
Non tax incomes	0.7	2.2	3.2	3.8	4.5	3	4
Local Taxes	-	-	1.05	1.05	1.8	1.1	1.5
Property Tax	-	-	-	0.15	0.24	0.30	0.33
Overall expenditures	19.2	15.1	23.2	25.0	33.4	31	27

Sources: Kosovo authorities and fund estimates 2005, 74; KOSOVO Gearing Policies Toward; Growth and Development of Macroeconomic in MEF;

Table 7.6
Participation of real estate tax in overall central and local revenues

	2002	2003	2004	2005	2006
Local taxes in relation to total taxes in percentage	6.1%	4.5%	4.4%	4.4%	3.8%
Fees and other charges in relation to total central government revenues in %	6.1%	3.8%	3.8%	2.9%	2.9%
Property tax in percentage in relation to total taxes	–	0.66%	1.03%	1.06%	1.15%
Fees and other charges in relation to total local revenues in %	100%	85.5%	76.8%	72.7%	68.2%
Property tax as percentage of total local tax revenues	–	14.5%	23.2%	27.3%	31.8%

Source: MEF, Department of Central budget

7.4.1 Tax incidence analysis

In the following Table many indicators are presented through which is given a detailed review regarding the real estate tax, tax payers, tax efficiency, reaction to the tax and its consequences, the problem of tax evasion, and other financial analyses, related to real estate taxation.

Table 7.7
A simplified analysis of tax incidence

Criteria	Description of the Criteria/indicators	Property Tax
Formal incidence: Who pays the tax?	owners/tenants, local residents/foreigners households/businesses	Individuals and legal persons must pay property tax. The owner of a property is the person responsible for the property tax payment. If the owner of the property cannot be designated or cannot be found, the taxpayer is the person who legally uses or keeps the immovable property. If the legal owner or user of immovable property cannot be designated or may be designated but has no access to immovable property, the taxpayer will be the person who is the user of property.
Effective incidence:		
A) Economic analysis		
• Efficiency		
by scale (yields)	the yields of tax revenue and share of collected tax in the total local revenues	The participation of property taxation in the overall revenues of the municipalities is over 30 per cent
by distortion of local economy	people/businesses move from the jurisdiction	There are no frequent movements by jurisdiction.

• Equity/ Fairness	measured by the exemptions	The regulation on property taxation excludes a small number of the tax payers
by horizontal	exemption applies to all taxpayers	The number of complaints for property taxes for 2006 was 3.000. Approximately 60 per cent of them were reviewed and their participation in revenues is approx 0.4 per cent.
by vertical	exemption applies to same group of taxpayers or progressive rating	In some cases, municipal assemblies may decide to release from the taxes certain social categories.
B) Financial analysis		
• Limitation	A self-limit is the number of tax unit/taxpayers or the size of a tax object. Limit by the law e.g. regarding rating (maximum rate, minimum rate)	The number of property taxation municipal units is distributed in 30 units, including the division of property taxation from MEF. The total number of employees is 163. The determined limit for tax rates is from 1 per cent to 0.05 per cent
• Flexibility	The right to change the rate setting, to install exemption by LG	The municipality keeps the right to change tax rates every year, within the limits defined by the central regulation.
• Avoidance, tax evasion	Taxpayers avoid and evade paying tax measured by rate of collection (levied tax/collected tax)	From overall planned revenues more than 52 per cent of them are collected and their trend is growing, e.g. for 2005 the planned revenues were 337.650€ of which 176.238€ have been realised, and approximately 48 per cent uncollected.
• Reliability	Difference of budgeted and realised tax yields. If the difference is large, it is hard to estimate the tax revenue for the next years/periods (unstable budgeting)	Evidently there are problems with the planning of revenues from property taxes and as a real parameter are taken revenues realised in the previous year and based on that, we do planning. The difference is not so high.
• Volatility	The change of tax yield from one year to another. If there are high waves year to year, it is hard to estimate the tax revenue for the next years/periods (unstable budgeting)	Changes in the revenues from this taxation is in linear proportion; we see a considerable increase in revenue collection, thus from 2005 in 2006 we have an increase in revenue collection of 8.6 per cent.
• Elasticity	How do tax yields reflect the change of income of taxpayers or the number of tax payers? (income elasticity, population elasticity)	The impact of revenues from property taxation in overall revenues to taxpayers and their number which is very small, it can be seen that the number of property taxpayers for residencies is small, while there are notable tax payments for those who are carrying on a business or industrial activity.
• Cost of administration	What is the share of tax administration costs in the tax revenue?	Taking into account the overall revenues from property taxes and the number of employees in tax administration, and the cost, participation is relatively high. For example, in 2006, one employee collected 46.800 €. Additional costs are related to operation costs, invoice issuance, information on taxpayers, obligatory collection, claims procedures, information etc.

7.5 Property tax as a procedure

Initially begun as a pilot project (a project funded by USAID), based on UNMIK Regulation 2001/2, which was in force until the new Regulation on Property Taxation No. 2003/29 was issued (5 September 2003) by the Assembly of Kosovo and promulgated by UNMIK (this regulation is still in force).

7.5.1 Those obliged to pay property tax

Those obliged to pay property tax are private persons and legal persons. The person responsible for a property tax payment is the owner of property. If the owner of the property cannot be designated or found, the taxpayer is the person who legally uses or keeps the immovable property. If the legal owner or user of the immovable property cannot be designated, or can be designated but has no access to the immovable property, the taxpayer will be the person who is the user of the property. Such a decision does not give ownership rights to the user.

The tax base is the market value of the property, defined in the compliance assessment standards. For residential buildings, by law, there is a permitted discharge in the amount of 10.000€ from the tax base for residential buildings.

Tax rates are set by municipal assemblies within parameters of 0.05 per cent to 1 per cent defined by central regulation 2003/29 on property taxes. These tax rates may change, depending on property categories, and always with consideration of the defined rate. Tax rates will be defined each year from municipal assemblies and within the parameters defined by central regulation 2003/29. Regarding medium rates of property taxation and medium prices per m² of the property categories in Kosovo – the analyses take into account 27 municipalities in which the property taxation is applicable. Three municipalities populated by a Serb minority did not apply property taxation for 2003–2006, and they are within these limits:

Table 7.8
Tax rate

Property category	2003	2004	2005	2006
Residential	0.13%	0.11%	0.11%	0.11%
Commercial	0.23%	0.21%	0.20%	0.20%
Industrial	0.19%	0.16%	0.15%	0.17%
Agricultural	0.11%	0.09%	0.09%	0.09%

According to the property law, property was classified as residential property (immovable property which is used for residential houses and apartments), commercial property (a property used for commercial purposes, wholesale and retail purposes, recreational services etc), industrial property (a property used for production, processing, handling storage of goods, plants, storage areas and other work

shops), agricultural property (land and buildings used for agricultural purposes) and other properties. One exclusion is land since, for the time being, no taxation for land has been applied.

Table 7.9
Average price m² (2006)

Property category	Evolution zone				
	I	II	III	IV	V
Residential (Apartment)	404	394	371	291	-
Houses	382	339	268	224	201
Commercial	955	772	597	539	401
Industrial	871	781	526	501	371
Agricultural	205	181	141	139	120
Store	150	150	-	-	-

Sources: MEF, Department of Property Tax and municipalities reports

Regulation 2003/36 clearly defines properties which are excluded from taxation. From the property taxation, properties of Kosovo institutions, property used by foreign governments the UN, KFOR, NGO for public benefit status, property of the religious institutions and categories belonging to social cases are excluded.

7.5.2 Property assessment

Municipalities carry out a property assessment based on administrative instructions, issued by the central level. Municipalities review and reassess the market value of a property every three or five years. MEF, with administrative instructions, defines the assessment standards and these standards include the relevant variables of assessment such as revenues produced by a property, the cost of construction, location, area and the status of the property. These standards are based on overall assessments, except in specific cases for specific properties. Market value is the price at which a buyer is willing to buy and a seller is willing to sell immovable property when he/she is not under any compulsion to act or is not in any relationship between the parties through family ties, marriage, common ownership or business affiliation.

7.5.3 The methods of property assessment

Determination of market value is carried out through the following methods:

- a) **Comparison method of transaction** – We use this assessment for assessing houses, apartments, shops and offices. The sales comparison approach to property valuation uses information from recent open-market sales prices. The aim is to decide how the characteristics differ in the different types of property sold

– use, size, location, quality of buildings, and others that have an impact on their prices.

Table 7.10
Example of the Comparison method

Sale Number	Zone	m ² of objects	Price in Euro	Address	Price/ m ² per object		
1	1	153	14,316	Bardhosh	94	Mean	406
2	1	80	23,519	Bardhosh	294	Median	330
3	1	40	30,677	Bardhosh	767	StDev	276
4	1	40	32,211	Bardhosh	805		
5	1	500	33,234	Bardhosh	66		
6	1	170	35,790	Bardhosh	211		
7	1	157	37,324	Bardhosh	238		
8	1	62	43,971	Bardhosh	709		
9	1	100	51,129	Bardhosh	511		
10	1	230	84,363	Bardhosh	367		

b) **The Cost method** is used for industrial properties for specific purposes. The cost approaches to property valuation involve estimating and combining three components:

Value = replacement cost of improvements – accrued depreciation + land value.

Replacement cost is what it would cost to replace the existing structures and other improvements with a new construction of equivalent usefulness, but not necessarily the same design and construction technologies and materials. Accrued depreciation is the loss in value due to physical depreciation, functional obsolescence, and economic obsolescence. Land value is what vacant land with the same location, area, shape, physical characteristics and allowable uses would sell for in the open market.

c) **The Income method** is used for properties rented such as offices and large market buildings. The income approach to property valuation involves estimating the future income stream that can be ascribed to the property over its remaining economic life and using a “discount rate” or rate-of-return on investments of comparable risk to “capitalise” the income stream into a present-day value as of the valuation date.³ The basic mathematical relationship is:

³ Overall rate = investment rates + depreciation + municipal tax obligation rate = 15% + 1% + 0.3% = 0.163

Value = income/rate. Income is estimated as the rents from the subject property or comparable properties, net tax, insurance, operating costs and adjusted for expected occupancy rates.

Table 7.11
Example of the Cost method

Property details	
Use	Industrial
Description	Plant
m ²	5,000
Economic life (years)	30
Year of construction	1983
Effective life	Last improvements in structure and regulation of the equipment in the last two years have made the effective life of the property shorter
Actual life	20
Effective life	15
Physical amortisation %	50%
Functional amortisation	The power network is influenced by industrial needs and fire fighting is limited
Functional depreciation in price and property details	5%
Construction price per m ²	300
Land value m ²	15
Value calculation	
m ² X construction price	5,000 X 300 = 1,500,000
Physical depreciation	-50% X 1,500,000 = -750,000
Functional area let aside	-5% X 1,500,000 = -75,000
Land value	5,000 X 15 = 75,000
Value index	1,500,000-750,000-75,000+75,000 = 750,000
Value per m ²	750,000/5,000 = 150 EUR

7.5.4 Municipality responsibilities related to property taxation:

Every municipality is responsible for the following functions related to the administration of property taxation, information management regarding property taxation, property assessment, preparation and issuance of invoices, collection and obligatory collection and review of administrative claims.

Municipalities issue taxation invoices prior to 31 March of each fiscal year. Taxation invoices include the following information: data base identifier, the name of taxpayers, property address, the assessed value of the property, tax rate, and to-

Table 7.12
 Example of the Income method
 (calculation of average price per square metre through renting)

Desti- nat.	Zone	m ²	Rent per month in euro	An- nual Rent (Rent per month x 12 months)	Rent / m ²	Vacan- cy %	Rent after vacancy (annual rent x % of Vacan- cy)	Ex- pendi- ture in %	Expen. (Rent after vacan- cy X 10%)	Net Income (Rent after va- cancy - Expen.)	Over- all Rate	Value (Net In- come / Over- all Rate	Value / m ²
Office	1	27	271	3,258	123	5%	3,095	10%	310	2,786	0.163	17,089	644
Office	1	125	639	7,669	61	5%	7,286	10%	729	6,557	0.163	40,229	322
Office	1	145	741	8,890	61	5%	8,446	10%	845	7,601	0.163	46,633	322
Office	1	23	230	2,761	121	5%	2,623	10%	262	2,361	0.163	14,482	637
Office	1	64	982	11,780	184	5%	11,191	10%	1,119	10,072	0.163	61,791	965
Office	1	47	475	5,706	123	5%	5,421	10%	542	4,879	0.163	29,930	644
Indicated Value per M ² Office Zone I:												589	

tal amount for tax, date of issuance, place and method of payment of the taxation invoice and the right for claims procedure. The tax invoices are prepared in three languages (Albanian, Serbian and English) and their distribution is carried out by municipal officers to certain zones.

The special computer programme for the property tax is prepared by a private company, KISS (Kosovo Internet Software Services). This is a software programme for registering contracts of transactions, which is loaded onto the computers in the property tax offices. The computers are connected to a network; there is also a supply of permanent offices, with appropriate computers, which are used for several procedures. At the moment a new process with the development of new software is being funded by the Swedish SIDA.

Municipalities have the right to collect property tax as an own source revenue. The tax payment is carried out through commercial banks, functioning in the territory of the municipality. This is the only method of payment, and there are no other methods of direct payment. Offices of the property tax issue a tax invoice with an account number and then this invoice is processed for payment through the banking system where the bank issues the bill for the payment of tax.

7.5.5 Problems during implementation of the property taxation

The main challenges in the area of implementation of the property taxation include a lack of updated information from the cadastre, unclear definition of addresses, an insufficient number of assessors of property tax, difficulties for specific properties' taxation and a method for the calculation of amortisation.

Municipalities have a responsibility to give information and to communicate with taxpayers and the media. Municipalities and Property tax departments are connected electronically and may use methods of exchange information through direct contacts, TV, radio, brochures, posters, and a website that is in the process of being prepared.

Municipal officers and regional officers have several abilities available to them; suspension of services, confiscation of equipment and property and mortgage. Suspension for carrying out these services is defined by Regulation 2003/29 on Property Taxation and those services are related to other services related to the property, but not with the services that municipalities offer to their citizens.

Administrative Instruction No. 11/2003, Property Tax Appeal Procedures – defines the Municipal Appeal Board for tax complaints on immovable property (“Municipal Board”). The board shall carry out the following tasks: receive and resolve applications for reduction of deferral of payment of the property tax, application procedures, reasons for appeal, appeal for deferral of payment of the property tax and any decision taken by the municipal board etc. At the central level there is also a Board of Claims Review, established by law, on tax administra-

tion procedures No. 2004/48 and lastly, a claim may be submitted to the Supreme Court within 30 days. The majority of claims concern the overestimation of a property and the minority number of claims are linked to the description of the premises.

7.6 Case study

7.6.1 Podujeva municipality

Podujeva municipality is situated in the Llap region. Podujeva municipality includes 78 villages and has over 110.000 inhabitants. For the municipal territory, Podujeva town is the centre of economical, educational, administrative, health, cultural and political importance. It is only 30 km from the Pristine Capital city of Kosovo.

The present administrative organisation of Podujeva Municipality has been in existence since the sixties. It has been estimated that its economical development was achieved in the 1980s. During this period, 16 economical organisations, with approximately 2500 employees, have developed their activities. During the 1990s, 200 companies with private capital, mainly in the trade and services sector, were established. During the conflict in Kosovo all these companies were destroyed. After the conflict, based on donor assistance, but mostly with own capital, economic activity began in the municipality and therefore, based on evidence, there are 2,251 businesses registered, mainly in the field of trade and services. Around 75 per cent of employers belong to the private sector. There are 10.500 employees and while, according to the institution for employment, 8500 unemployed are registered, it has been calculated that around 30.000 people are looking for jobs. As with any other Municipality in Kosovo, Podujeva Assembly carries out its work on the basis of UNMIK Regulation 2000/45, which organises the assembly bodies.

7.6.2 The structure of own source of revenues of the municipality

Podujeva municipality realises its own source funding through: a) fees and charges for services and b) property taxes. Those two types of revenue are regulated with the respective regulation and are reviewed every fiscal year.

The regulation on fees, charges and fines determines the size of the fees, charges and fines for services from the competences and field of activity for services; issuance of official documentation, drafting notes, offering professional services, requests by the various parties, issuance of licences for carrying out a business, vehicle registration annual fees for businesses, utilisation of municipal property, utilisation of natural resources and traffic fines etc. In general, there are a small number of fiscal instruments.

According to Central Regulation No. 2003/36 and in full compliance with this, the Municipal Assembly each year approves the Municipal Regulation on Property Tax, by which is determined the criteria for property assessment, zoning, price per m², tax rate and other issues linked with the functioning of property taxation for the territory of the municipality. Based on the provisions of this regulation, residential properties, business properties and industrial properties which are on private property, companies in the public sector and agricultural properties with a commercial character are taxed. Zoning, based on the market value of the property on the territory of Podujeva municipality, is divided into four tax zones:

Property assessment is carried out by property taxation officers in Podujeva municipality and they use a few methods. The most acceptable method is the one analysing property transactions. There are other methods for data collection such as questionnaires, information collected by citizens and leasing contracts etc. Table 7.13 summarises the tax rates and average price per m².

Table 7.13
Tax rate and average price per m² for 2006

Description	Tax rate	Value per m ² in zone I	Value per m ² in zone II	Value per m ² in zone III	Value per m ² in zone IV
Residential property (apartment)	0.1%	370€	–	–	–
Residential property – house	0.15%	290€	250€	200€	100€
Commercial property	0.25%	700€	450€	350€	200€
Industrial property	0.2%	150€	150€	100€	–
Agricultural property	0.1%	100€	100€	100€	100€
Forgotten property and uninhabited structures	0.05%	100€	100€	100€	100€

Table 7.14 shows the realised budget for the years 2003–2007 at municipal level, participation of property taxation in the total of own source revenues for the municipality and central grants.

Table 7.14
Overall budget for Podujeva municipality from grants and own resources
(thousand EUR)

Year	Governmental grants	Own source revenues of municipality (3+4)	Revenues of property taxation of municipality	Other municipality revenues	Total budget (1+2)
2003	5,823.7	782.0	100.4	681.7	6,605.8
2004	7,169.0	1,303.8	155.3	1,148.4	8,472.8
2005	5,937.4	692.1	165.7	527.0	6,629.5
2006	6,807.5	1,236.0	189.3	1,046.0	8,043.4
2007	6,777.7	1,000.0	119.7 (January–September)	–	7,777.7

Source: MEF, Department of Central Budget

7.6.3 Future orientation of Podujeva municipality

The economy of this municipality is actually supported mainly by private initiatives, respectively on the development of small- and medium-sized enterprises. A fact which makes the economical development of this municipality more difficult is the lack of private capital and production investments. But, on the other hand, this municipality is only 30 km away from Prishtine, the capital centre of Kosovo, which has an impact on many segments of economical development of the municipality and other benefits. In the Local Economic Development Strategy of Podujeva municipality (2003–2006), Podujeva is seen to be a modern municipality that would offer a suitable environment for businesses, mainly supporting private initiatives, using agricultural resources, tourism, products and traditional services, accompanied by an effective local administration which offers active support in the development of small and medium enterprises, with the ability to increase the quality of life of its citizens. The future orientation of the municipality should concentrate on the elimination of the different barriers for a stable economical development in the municipality. The barriers identified are: lack of an urban plan, mixture of competencies between central and local level, fiscal policy; non-favourable loans from commercial banks on funding businesses, management and human capacity building and an increase in transparency in the management of public funds.

7.7 Summary and recommendations

Taking into account the above, we can conclude by making recommendations regarding property taxation and local finances in general. Property taxation is a considerable source of own source revenues, exclusively local revenues. It was imple-

mented in 2002 as a pilot project and even if there have been some positive results in its functioning there is a need for improvement in many segments. The priorities would be:

1. Improvement of the cadastral maps, with which it would be easier to identify roads and properties,
 2. Improvement of the software for property tax and finding the ability to put into the database those properties with a specific character, because their assessment is very complicated,
 3. To clearly define the calculation of property amortisation, the quality of objects and life of objects,
 4. To increase the awareness of citizens of the payment of taxes, continuous training of local officers on the functioning of the local taxation, particularly in the issues related to property and their taxation,
 5. Provide technical assistance to property tax officials in all municipalities, with the emphasis on education, job descriptions, qualifications of employees, new working standards and procedures,
 6. Establish a national association of assessors,
- and finally
7. Take into consideration the possibility of implementing taxes on land.

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8. Property Tax in the Republic of Moldova: Basis for Local Autonomy?

Boris Morozov

8.1 Introduction

The study of the countries in Central and Eastern Europe has focused mainly on how to develop a democratic society, based on values of private property, market economy, plurality of opinions and freedom of speech. The initial argument was that market mechanisms would facilitate the efficient and effective allocation of resources, compensating for interim distributive inequalities and macroeconomic destabilisation.

Although that hypothetically compensatory relationship between the efficiency of resource allocation and distribution inequalities and macroeconomic stabilities is yet to be empirically proven, major policy projects aiming to achieve greater efficiency in resource allocation took the form of some sort of decentralisation (also referred to as *fiscal decentralisation*) of the central authority.

The phenomenon of “fiscal decentralisation” has been primarily a discussion issue among public practitioners and scholars for more than a decade now. The role of local governments in the provision of public services and goods has been discussed through the lens of fiscal decentralisation.

A significant body of knowledge on fiscal decentralisation, instruments and strategies of implementation as well as the criteria for the evaluation of the degree of a country’s decentralisation was developed during the last decade. The phenomenon of fiscal decentralisation is being actively studied and pursued throughout the world because of the benefits associated with it. A properly designed and implemented system for delegation of public responsibilities and authorities creates conditions for the better provision of public services and goods. The improvement in service provision could be achieved through the movement of government closer to the population to be serviced. The proximity of governments to its constituents allows for a higher degree of governmental responsiveness to citizens’ needs, which results in better governments’ accountability, citizen’s willingness to pay for these services through their taxes, and hopefully economic development of the region. At the same time, a fiscally sound and economically viable degree of decentralisation might be achieved only in the presence of an adequate system of checks and balances on local public authorities. Existence of such a system of balances and checks is required for the achievement of the optimal mix of public services to be provided in a community. Given this constraint, the necessity of fiscal decentralisation becomes a function of a country’s level of democratic and economic development. Therefore, decentralisation should not be viewed as a cure for all problems.

At the same time, successful fiscal decentralisation of a state is a function of local governments' ability to levy and collect its own revenues, i.e. sub-national governments should not be dependent upon the centre for all revenues (Bird, Ebel and Walish 1995). Such local activity increases the visibility of choices made by elected and appointed public officials, and accountability increases *pari passu* with visibility (Litvak, Bird and Ahmad 1998). Therefore, local governments should be able to set and collect at least part of their taxes and revenues. Economic literature suggests that identification of the appropriate tax base should be a function of economic incidence and tax base volatility. The property tax satisfies both of these requirements since it is relatively stable and the tax burden is supposedly on these citizens who are financially better off. In this way, proper administration of local real estate taxes is of direct positive influence on the success of decentralisation efforts in a country.

This exploratory and qualitative study will evaluate the existing practices in the area of immobile property taxation in the Republic of Moldova. It will describe the criteria for evaluation, current achievements, and major problem areas (e.g. property assessment for taxation purposes, taxation mechanisms, local tax base and real estate valuation, etc). Finally, this manuscript will provide some practice-oriented suggestions and recommendations on achieving the appropriate level of decentralisation in the country under discussion.

8.1.1 Government structure and inter-governmental relations government structure: legal and regulatory framework

The Republic of Moldova is a representative democracy in which the people's elected deputies (representatives), not the people themselves, vote on legislation. The Moldovan Constitution provides for the fundamental rights and freedom in a democratic society. The Election Code, (1997, amended 1999, 2000, 2002 and 2003), is a solid foundation for democratic elections. Other relevant laws are the Law on Parties and Socio-Political Associations (1991, amended 1993, 1998, 2002 and 2003), the Law on Administrative Procedures (2000), and the Code on Administrative Offences (1985, amended 1988, 1990, 1993, 1995, 2001 and 2002). Several other laws were recently adopted, redrafted or significantly modified, such as the Law on Administrative-Territorial Organisation (1998, amended 2003), the Law on Local Public Administration (2003), and the Law on Judicial Organisation (1995, amended 1997, 1999, 2001, 2002 and 2003).

Chapter VIII of the Constitution establishes the framework for public administration and local self-governance. The Election Code defines the procedures for the elections for Raion (local "districts") Councils, Municipal Councils and municipal mayors, as well as Districts (cities, villages and communes) Councils and local mayors, are all elected for a four-year term. All citizens residing in Moldova who are 18 years old or older, have the right to vote in local elections and stand for local councils. Exceptions are those declared incapacitated or sentenced to impris-

onment, by a final decision of a court of law. Military personnel and citizens absent from the country on election day cannot participate in local elections.

Chronologically, one can identify four distinct stages of public administration reform in Moldova. The first stage is from December 1990 to December 1994. This period begins with the Supreme Soviet Committee's decision on Local Self Administration and Local Economy of the Moldavian Soviet Socialist Republic (MSSR) to create an independent group of experts that would critically analyse local government laws and regulations. This legislative proposal met with resistance from the administrative and Communist Party nomenclature, which interpreted it as an attempt to split the rayon branches of the communist organisation. However, the parliamentary committee succeeded in preparing a set of new draft laws regarding the Territorial-administrative Organisation (according to this law, the Republic of Moldova was reorganised in just nine bigger Judets instead of the old forty Raions) and laws on Local Public Administration. After political and ethnic conflicts in 1992–1993, the topic was dropped from the legislative agenda. The newly created ruling coalition, the Democratic Agrarian Party and Socialist Unity, which emerged after the February 1994 general elections, decided to freeze the process of local government legislation adjustment, reasoning that it was too expensive and there was no time for experiments of such magnitude in Moldova. Public officials argued that “the existing network of small Raions accommodates the needs of the population entirely.”

The second stage began on 29 July 1994 with the adoption of the new Moldovan Constitution and ended in December 1998 with the adoption of the new legislation on local government. The new Constitution embodied many fundamental principles and procedures of territorial-administrative reform, stipulating the basic principles of the newly emerging system of local government. The most important stipulations can be found in article 109, which provides the foundations for actual reform: local autonomy, decentralisation of public services, election of local public authorities and citizen consultation on all public issues of local interest. Soon after, the Parliament of the Republic of Moldova agreed to revise the entire legislative framework for local government, establishing the prerogatives, powers and specific competences introduced by the Constitution. The objective of this reform was the enhancement of local public authorities' capacities to react to economic challenges and the involvement of the general public in exercising its rights and freedom within an environment defined by law.

In December 1994, Parliament adopted laws that literally paved the road for the implementation of a new system of local public administration. These laws had several ambiguities that in fact conflicted with the principles of the Constitution. According to these stipulations, the President could appoint local mayors. Due to the existence of such provisions, many political parties denounced the

1995 Election Law as “undemocratic,” and the Constitutional Court of Moldova as unconstitutional.

Various actions aimed at bringing the government closer to the people are based on implicit assumptions that (1) local government’s responsibilities are clearly defined and (2) sufficient public funds are made available to local governments to deliver on people’s expectations (Sevic 2007). At the time, that was not the case in the Republic of Moldova. The lack of clarity on local governments’ responsibilities produced frustration among local public officials, resulting in a situation in which they represented dual status: as officers, appointed by superior authorities, and as locally elected independent authorities. This also created a divergence from the expectations of the local and regional officials, who felt themselves incapable of acting as the “real local power.”

The next period began in December 1998 with the adoption of two fundamental laws that redesigned the existing local public administration: the Law on Territorial-administrative Organisation and the Law on Local Public Administration. According to the new territorial arrangement, the country was organised into 9 territorial-administrative units of the second level (called Judets). This allowed the new regions to improve their relative significance in accordance with the trend toward regional development throughout Europe, as well as to foster the economic and social potential of their local components (communes and municipalities). The new Law on Local Public Administration aimed to enforce principles and techniques that would ensure separation of powers among different levels of government in the Republic of Moldova.

According to the new legal framework, the administrative organisation of the territory in the Republic of Moldova is instituted on two distinct levels:

- First level: villages (644 communes), 51 cities and 14 municipalities;
- Second level: 9 districts (judets); and
- Gagauz Autonomous Territorial-Administrative Unit (UTAG) and the Municipality of Chisinau.

The fourth stage of public administration development began in November 2003 with the promulgation of Law no. 764-XV regarding Public Administration. Essentially, the Republic of Moldova returned to pre-1998 territorial organisation with Raion as the second level of local PA. The result of this law was to increase the number of first level units (this number increased from 728/644 units to 982/898 units of first level) because of a decrease in the minimum number of residents required for the first unit level to be organised from 2500 to 1500 citizens.

8.1.2 System of public finance: inter-governmental fiscal relations.

The Law on the Budgetary System and the Budgetary Process, the Law on Local Public Finance, and the annual central budget define the revenue sharing mechanisms and transfers between the central and the upper level of local government.

Local Revenues: There are three main revenue sources for local governments in Moldova: own revenues, shared revenues, and transfers from central government budget (grants). Combined together, these sources account for up to 90 per cent of local government's revenues. Own sources of revenue represent a combination of taxes collected by the respective local authority within its jurisdiction (e.g. property tax, user charges (fees), income tax, etc) and proceeds from sale/rental of public property. Own sources provide up to 40 per cent of local government revenues.

Shared revenues are the cash flows, part of which is kept locally, while the remaining portion belongs to the central government budget. The percentage of shared revenues is annually defined in the budget law (e.g. FY 2006 State Budget, Appendix 23). Generally, shared revenues are the cash flows from corporate income tax, personal income tax, and charges from road exploitations. The specific feature of this regulation is that the minimum percentage of shared revenues to be kept by the respective local government should not be less than 50 per cent. In fact, given the economic reality of Moldova, the only local governments that share their revenues with central government are local authorities of the municipalities of Chisinau (the capital) and Balti (the second largest city). All other territorial units keep all their revenues from "taxes on business activity" (FY 2006 State Budget, Appendix 23). User fees from road usage are equally split between local and central governments. Revenue from the road tax is shared equally between the central and local governments throughout the country. In addition, each of the two local government levels has its own tax and non-tax revenue sources to finance its spending. On average, shared revenues account for about 30 per cent of local authorities' revenues. (See table 9.1 for the norms in 2006–2008)

Inter-governmental transfers: The last source of local government revenues is inter-governmental transfers. This type of revenue is defined by the Law on Public Finance as "financial resources allocated with final claim and absolute amount as provided by law, from the state budget to the Judets budgets, to the budgets of the autonomous territorial unit and Chisinau municipality or from the corresponding budgets to the local budgets for the purpose of performing the established state functions or financing the activities performed by local governments receiving the transfers" (Article 1). The administration and implementation of the inter-governmental transfers is defined in Articles 10–12 of the Law on Public Finances.

Essentially, there are two types of transfers: general and special allocations transfers. General transfers are calculated according to the formula provided in the previously mentioned articles. The amount of the general transfer is a product of

the difference between local per capita revenues (these revenues are calculated as a product of tax rate and tax base) and expenses and the population within the specific jurisdiction of the local authority (Article 11, paragraph 3, e.). The local governments which have revenues per capita which exceed the average expenditures per capita by 20 per cent should transfer their excesses to the Central budget for redistribution of this excess among other local governments.

The second type of inter-governmental transfers in Moldova is *special purpose transfers*. These grants and conditions for these transfers are defined in article 13 of the Law on Public Finances. According to the previously mentioned article, the state budget is to provide for special purpose transfers to the budgets of the administrative-territorial units in case the central government delegates some assignments to the public authorities in the region or it promulgates new laws that jeopardise local governments' revenues.

Basically, inter-governmental transfers are nothing more than an equalisation technique employed by central government to address the issue of horizontal imbalances among different local authorities. Existing equalisation grants in Moldova are based on per capita amounts of public services to be provided by the respective local government. Although this approach is theoretically sound, the achievement of inter-regional equalisation might be jeopardised by the inadequacy of the norms used for the calculation of the total amount of the transfer. Also, existing documentation does not provide information on the qualitative aspect of the norms used for the calculation of the transfer amount. This represents a shortcoming for the identification of the level of public services to be provided. The study of the existing Moldovan inter-governmental transfer system, in terms of equalisation of inputs and outcomes of public institutions, represents an area for future fruitful research.

The first level local governments are free in allocating revenue and transfers to the lower-level local governments. These transfers are regulated by the Law on Local Public Finance. Expenditure transfers from the State vary across upper-level local governments, with the objective to reduce territorial disparities in service provision and living conditions. The distribution of transfers to first-level local governments is transparently shown in the State budget. In addition, an annex to the State budget provides forecasts for total budgets of this level of local government, as well as transfers from the upper level to the lower level of local government. These projections are defined in a comparable manner as the transfers from the central authorities to the upper-level local governments (Article 10, Law No. 397-XV/2003).

However, local public practitioners assert that *de facto* functioning of the transfer mechanism from the upper to the lower level of local governments is subject to unjustifiable discretion. In general, information on the distribution of budgets between the two levels of local governments, and data on budget execution broken down between the two levels, is not easily available. Current law on local public finance defines tax sharing procedures and transfers to "local governments". The "lo-

cal governments” referred to in this law are one of the Rayons. The law does not provide clear guidelines on revenue sharing between two levels of local governments. It is the Rayon councils who determine the share of each of these taxes that will go to each individual local government. One of the consequences of such a vague definition of intra-local government relations is the break between local administrations’ responsibilities for service provision and accountability. Subsequently, this results in a disincentive for local governments to mobilise local revenues.

The borrowing regulations for local governments are defined in the Law on Local Public Finance (Articles 13 and 14). These regulations have been enforced by the central government to avoid local governments’ borrowing undermining overall fiscal stability. Local governments can borrow short-term from banks for cash management purposes. These loans have to be repaid within the fiscal year. Total outstanding debt and interest payments on such short-term lending cannot exceed 5 per cent of own revenue during the fiscal year. Also, local authorities can borrow for capital investment purposes. The annual amount of such debt cannot exceed 20 per cent of local revenues. Banks often require an endorsement from the central government before lending to local governments, but the central government does not recognise these loans as contingent liabilities or guarantees. Local governments report monthly to the Ministry of Finance on borrowing.

Local Expenditures: the responsibilities of local governments are defined in the Law on Public Finances and the Law on Local Public Administration. The Law on Public Finances provides guidance for the types of public services to be provided by each level of local government. The competencies for funding public expenditures are shared between budgets of administrative-territorial units based on the Law on Local Public Administration. Confusion regarding local administrations’ obligations for service provision occurs because the responsibilities for public service provision are shared by different levels of government. These overlapping responsibilities are briefly summarised in the following table:

Table 8.1
Service responsibilities of local governments in Moldova

Service Responsibilities of 1st Level of Government (Communes, Towns, and Municipalities)	Service Responsibilities of 2nd Level of Government (Rayons, Gagauzia, and 2 Municipalities)
Social security and unemployment benefits management; Public Parks; Environment Protection; Public Safety; Social Services; Public Health Protection.	Social security and unemployment benefits management; Public Healthcare; Environment Protection; Public Education; Public Safety; Social Services; Public Health Protection.

Source: Law on Public Finances and Law on Local Public Administration

The aggregate structure of local governments' expenditure is summarised in the following table:

Table 8.2
Actual Structure of Local Government Expenses 2002–2005
(MDL million)

	2002	2003	2004	2005
General Public Services	118.39	139.53	429.84	543.61
Public Safety	51.18	63.57	180.87	221.06
Education	616.73	809.05	2,613.09	3,651.91
Healthcare	319.27	441.09	100.65	84.94
Social Security	26.22	41.06	136.41	210.03
Social Programmes	45.06	63.00	241.97	362.04
Environment Admin. and Protection	19.18	19.75	84.95	317.69
Transportation and Communications	16.55	19.04	94.22	103.25
Housing	209.62	224.69	968.27	1,429.83
Other Expenditures	77.99	153.33	587.24	1,029.85
Total Expenditure	1,780.80	1,974.10	5,437.50	7,954.20

Source: Ministry of Finance of the Republic of Moldova 2006. Based on Budget laws 2002–2005.

Generally, local governments have formal authority over local spending decisions. However, central government frequently intervenes with “recommendations” on local spending through delegation of unfunded responsibilities from central to local budgets. This results in a vertical imbalance. Supplementary expenditure obligations for local authorities come from state-owned enterprises, which provide many public services, including local infrastructure (e.g. roads, heating, water and sewerage), health clinics, and day care facilities. Given the limited local tax base, local governments are not in a position to fully finance these services.

Reports on Moldova's public revenues and expenditures are prepared and submitted on a monthly basis by the State Tax Inspectorate for the government. The aggregate monthly reports and more detailed quarterly reports regarding public expenditures are easily available. Such reporting allows an assessment and monitoring of the financial situation. The information provided in these reports is fairly detailed, providing data about current spending (wages, goods and services) and capital outlays. Aggregate data on both revenue and expenditure arrears are provided to the government and parliament. This aggregate data is included in the budget documentation. The evolution of public revenues and expenditures between 2002 and 2006 is summarised in the following table:

Table 8.3
Moldovan Public Revenues and Expenditures
(MDL million unless noted otherwise)

	2002	2003	2004	2005	2006
Central Government Revenues *	3,503.9	4,700.8	5,477.0	8,738.2	9,690.2
Local Revenues	1,580.5	1,919.7	2,044.5	5,789.5	8,159.8
Consolidated Revenues **	5,084.4	6,620.5	7,521.5	14,527.7	17,850.0
Transfers from CG to LG	n/a	654.9	614.7	819.0	994.0
Transfers as % of LG Revenue	n/a	34.1%	30.1%	14.1%	12.2%
Central Government Expenses *	3,693.9	4,402.6	5,416.0	8,511.8	10,024.8
Local Expenses	1,500.2	1,780.8	1,974.1	5,437.5	7,954.2
Consolidated Expenses **	5,194.1	6,183.4	7,390.1	13,949.3	17,979.0
Central Government Expenses * % of GDP	16.4%	15.9%	16.9%	22.6%	22.8%
Local Expenses % of GDP	6.7%	6.5%	6.2%	14.4%	18.1%
Consolidated Expenses ** % of GDP	23.0%	22.4%	23.1%	37.1%	40.8%
Central Government Deficit (-)/Surplus (+)	-190.0	298.2	61.0	226.4	-334.6
Local Deficit/Excess	80.3	138.9	70.4	352.0	205.6
Consolidated Deficit/Excess	-109.7	437.1	131.4	578.4	-129.0
Central Government Deficit/Excess % GDP	-0.8%	1.1%	0.2%	0.6%	-0.8%
Local Deficit/Excess % GDP	0.4%	0.5%	0.2%	0.9%	0.5%
Consolidated Deficit/Excess % GDP	-0.5%	1.6%	0.4%	1.5%	-0.3%
Gross Domestic Product	22,555.9	27,618.9	32,031.8	37,651.9	44,068.8

Notes:

* – Based on Central Government Budget laws 2002–2006

** – Central Bank Data http://www.bnm.org/en/docs/macroi/34_5898.pdf
URL retrieved 27 February 2007

*** – Republic of Moldova: Statistical Appendix. IMF country report. May 2006.

NA – Last year of Judets Structure. Data is available, but not comparable with data for next years.

8.2 Historical background of property tax legislation in Moldova

8.2.1 The structure of the tax system

In accordance with the Law on the Basis of the Fiscal System and the Fiscal Code, the following taxes are collected in the Republic of Moldova:

- a. National taxes and duties;
- b. Local taxes and duties.

The Central Government has jurisdiction over the following taxes:

- a. Income tax;
- b. Value-added tax (VAT);
- c. Excises;
- d. Tax on property;
- e. Custom duties;
- f. Road duties.

The local taxes and dues include:

- a. Land tax;
- b. Property tax;
- c. Tax on use of natural resources;
- d. Duties on territory arrangement;
- e. Auction and lottery fees;
- f. Hotel dues;
- g. Advertisement dues;
- h. Dues on the right to use local symbols;
- i. Dues on commerce units;
- j. Market dues;
- k. Other duties and taxes.

In the Republic of Moldova, the tax system was set up shortly after Moldova's declaration of independence in 1992, following the passing of the Law on Tax System Bases (17 November 1992, no. 1198-XII, and later repeatedly amended). The tax system created during the first stage of the transition period, from a planned to a market economy, had to be adjusted to new market realities. The newly developed system was difficult and confusing. In many cases, people perceived the lack of worldwide familiar taxation principles as becoming an obstacle to local and foreign investors and negatively influencing economic growth. From the social point of view, the tax burden was distributed unevenly. During the first stage, (before the adoption of the Fiscal Code in April 1997, Chapters I, II) the tax system suffered from both horizontal and vertical inequities.

The process of its reform began in 1995, after which, in 1996, the Parliament of the Republic of Moldova adopted the Concept of Fiscal Reform. The main goal of the Fiscal Reform programme was to simplify the system in order to make it comprehensive and clear. It had to guarantee taxpayers' adherence to a number of laws (before the Fiscal Code was adopted in Moldova, the provisions on income tax

and profit tax were stipulated in more than 30 different laws), as well as the effective administration of the state Fiscal Service.

Chapters I and II of the Fiscal Code were approved by the Parliament of the Republic of Moldova on 24 April 1997 by adopting the Law of the Republic of Moldova no. 1164-XIII dated 24 April 1997 (with later modifications and adjustments of the laws no. 1570-XIII dated 26 February 1998, no. 112-XIV dated 29 July 1998, and no. 1064-XIV dated 16 June 2000 on income tax administration and the enforcement of Chapters I and II of the Fiscal Code).

Chapter III on Value Added Tax was approved by Parliament on 17 December 1997, while Chapter IV on Excise was adopted on 27 October 2000. Chapter VI on Real Estate Tax was approved on 16 June 2000 and Chapters IV and VI were enforced (except for some articles) in January 2001. Thus, fiscal reform in Moldova is currently on its way towards completion.

Throughout its short history, chapter VI of the fiscal code went through several revisions and updates. Initially published as the Law of the Republic of Moldova No. 1056-XIV from 16 June 2000, it was revisited in 2005 and 2007. The latest modification of the regulations of property tax administration took place on 1 January 2007. The major change enacted was a re-calculation of property values for tax purposes. According to this modification, the property tax would be calculated, based not on book values/historical records, but on current market valuations. This stipulation applied to urban residential properties. Rural residencies and commercial real estate would not be subject to that legislation until 2009 (preliminary data). For the purposes of property assessment, the Agency of land relations and cadastre developed a model that considered different factors of influence on property price. The municipality of Chisinau was divided into 33 zones with specific valuation coefficients per square metre. As suspected, the major problem areas were valuations of single family residential buildings. If, in case of apartment valuation, property owners did not express major dissatisfaction with their properties' valuations, the owners of individual houses contested the assessed values of their properties. As a result of this, the agency had to extend the deadline for property assessment until the end of the fiscal year 2006.

Soon after, additional problems followed. While apartment valuations were somewhat accurate at the assessment time in 2005–2006, market trends pushed these values up. This created a serious imbalance because of the culture in Moldova. Apartments were going up in price as a consequence of remittances from workers from abroad (estimated to be around \$800 million in 2007). This caused the discrepancy between household income and property taxes. Such a discrepancy raises issues of equitable taxation. The issue of equitable property taxation in Moldova will be discussed in the next chapter.

8.3 Tax incidence analysis

8.3.1 Rationale for recurrent taxes on property

The existing finance theory, aimed at sustainable growth, is based on the principle of risk diversification. Various revenues are viewed and analysed from two points of view: actual cash flow from a specific source and the volatility of that specific source. Often, the volatility of a source is approached from the risk point of view. Thus, the doctrine of diversification emerged (For additional information see “Efficient Portfolio Theory” by Markowitz). Under that doctrine, revenues of an entity are viewed as a function of two factors: risk (volatility) and return. The essence of the diversification doctrine is to maximise the return while minimising the risk associated with that return. Multiple theoretical inquiries were conducted to better understand the nature of the relationship between risk and return. The general conclusion of these explorations is that the relationship between risk and return is not linear. At one point, the ratio of the marginal return, associated with marginal risk, becomes negative. In economics terms, the marginal benefit of taking additional units of risk is less than the marginal cost of undertaking that risk. This violates principles of efficient production and resource allocation. That is generally why public finance experts advocate for a well-diversified and balanced revenue system.

Given the nature of public entities and the multitude of conflicting policy objectives, a diversified revenue system that consists of multiple tax revenues and other sources is more likely to overcome negative influences of temporary economic downturns and provide public services. There are multiple candidates for public taxation. Income taxes, property taxes, excise taxes, and other sources of public revenues are the best-known of these sources. Property tax may take multiple forms such as “tax on land,” “tax on building,” etc. For laconic purposes, the multitude of these taxes will be referred to as “property tax” further in this essay.

Property tax is an important part of the system of public revenues. This tax has a stable and reliable base. The stability and reliability of the property tax base is an attractive feature, as it reduces the volatility of public revenues during economic downturns. Another advantage associated with property taxation lies in the dimension of vertical and horizontal equities that are the cornerstones of the taxation system in a democratic state. Property owned by an individual is usually a pretty accurate measure of that individual’s overall wealth. An accurate estimation of an individual’s overall wealth is important in establishing an individual’s ability to pay the taxes, which allows governments to design systems of taxation and fiscal decentralisation that ensures vertical and horizontal equity among its constituents.

Another important feature of property taxation is its normative influence on citizenry behaviour. Ideally, taxes (property tax is not an exemption) should be neutral, i.e. taxes should not distort how taxpayers behave. This neutrality ensures the minimisation of dead-weight losses resulting from government involvement in the

market. However, taxes are often deliberately non-neutral for purposes of different social and economic policies.

Another important aspect of any tax is the level of administration. Certain taxes are better administered at the national level (e.g. VAT, which has country-wide incidence), other taxes are better administered purely by local governments (e.g. user charges for trash collection, sewers, etc), while some taxes are better administered by both local and central governments. Property taxation is an example of the latter type of taxes. While central government may set the general tax rate for all taxable properties, local governments are much better equipped to evaluate the local values of taxable properties and collect these taxes. However, if local government lacks its own rate and is “piggybacked” on central government’s rate, then the local authority lacks any incentive to be accurate in its assessments and property valuations. Such lack of local autonomy in revenue administration is detrimental for citizens’ trust in government, governmental accountability, and general fiscal decentralisation. Another argument for the joint administration (with local governments holding the leading role) of property tax results from local governments’ proximity to the tax base. Local authorities provide services directly to owners/renters of property subject to taxation. The tax captures, for local administration, some of the increases in the value of land that are partially created by public expenditures. This promotes local autonomy. Finally, property tax is known for its increased visibility. Attention to such a tax has a positive influence on the overall quality of governance and promotes accountability.

Administration of property taxation is relatively simple. Unlike the corporate income tax base, the tax base is easily identifiable. This results in property taxes being easier to collect. Of course, re-evaluations of local tax base values should be conducted on a regular basis to accurately reflect the changes in valuations for tax purposes, especially during periods of economic growth and/or inflation. There are multiple advantages associated with accurate information on taxable properties. The information from such databases (“Fiscal Cadastre” in Moldova according to Fiscal Code, Article VI) could be used for the evaluation of the adequacy of a property owner’s declared income and income taxes paid. The accurate information on property taxation would minimise cases where a \$400,000 property owner declares an annual income of USD 1,000. Another advantage of an accurate property valuation database is that such data can play a key role in the development of orderly real estate markets.

Despite their advantages, property taxes are often an underused source of public revenues. The perceived unpopularity of property taxes with taxpayers encourages “legislative neglect.” These causes, in combination with the perception that property taxes are costly in administration, (major part of design, implementation and administration costs is incurred before the revenues while development of the property cadastre and valuation of these properties) often results in sub-par fund-

ing. Therefore, problems with property tax administration and taxation equity become self-fulfilling prophecies.

8.3.2 Tax incidence analysis

Economic theory distinguishes two types of incidence of any tax: formal incidence and economic incidence. While formal incidence is easily identified (in Moldova taxpayers are identified in the Tax Code), estimating economic incidence in the true sense requires extensive economic data, which in Moldova's case, is fragmentary. (The author's opinion is based on the latest available Governmental Financial Statistics (GFS) data set by the World Bank). Despite GFS data consistency, the fragmentary nature of the data available does not allow an execution of a regression analysis to identify the elasticity of public revenues as a function of the property tax rate. Additionally, property tax revenues represent a minor source of public revenue in the Republic of Moldova. The structure of public revenues in Moldova is summarised in the following table:

Table 8.4
Public Revenue Structure (MDL Million unless noted otherwise)

	2000	2001	2002	2003	2004	2005
Taxes	730.7	1,118.2	1,118.7	1,670.5	1,662.7	1,820.4
Corporate Income Tax	403.5	577.6	754.8	989.4	1,294.0	1,369.3
Personal Income Tax	261	341.7	465.1	609.3	793.1	839.4
Taxes on goods and services	140.3	348.3	363.9	482.5	143.4	218.6
Property Tax	186.9	192.3	0	198.6	225.3	232.5
Total Tax Revenue	1,722.4	2,578.1	2,702.5	3,950.3	4,118.5	4,480.2
Property Tax as % of Total Tax Revenue	10.85%	7.46%	0.00%	5.03%	5.47%	5.19%

Source: GFS Dataset

Within this Table, one can identify the evolution of property tax revenue as a percentage of total revenue. While 2002 is the year of change in the legislation that influenced the property taxation administration, the role of property taxation is decreasing.

8.3.3 Formal Tax Incidence

Property tax administration is defined in the Tax Code Law of the Republic of Moldova № 1055-XIV of 16 June 2000 (Official Monitor, № 127–129, part 1, article 884, 12 October 2000). According to the Law, “the legal and physical persons, residents and non-residents of the Republic of Moldova shall be subjects of taxation”

(Chapter 2, Article 277 of the above mentioned Law). Thus, the formal incidence of property taxation in the Republic of Moldova is on the title holder of the property. Furthermore, the same law clearly defines objects of taxation:

The objects of taxation shall be immovable property, including land (agricultural land, land used for industrial, transportation, telecommunication and other purposes) located within the community or beyond and/or its improvements – buildings, constructions, apartments and other isolating premises – as well as the improvements that are completed by 80 per cent and have been under construction for more than five years since the beginning of the construction works.

It is important to notice, however, that although formal incidence is on owners of a property, economic incidence (aka *effective incidence*) varies as a function of type of the owner. It is safe to conclude that in the case of the general citizenry the effective property tax incidence lies with formal tax incidence. Citizens do not have the opportunity to transfer the burden of taxation. However, this is not the case for corporations and private businesses. In this case, property tax is an operational expense. Such qualification implies that the economic incidence of the property tax becomes a function of a type of goods/services provided by a certain business entity. If a good/service is a necessity (e.g. bread), then the economic incidence of property tax on production facilities lies with consumers because the demand for bread is relatively inflexible. However, in case a company provides a “luxury” type of goods/services, then the effective property tax incidence is on the supplier of that good/service. The producer will have to internalise the property tax because the demand for its products/services would be relatively elastic.

Equity of property taxation in Moldova resembles its economy: it is in a transition process. Careful analysis of public revenues and inter-jurisdictional transfers reveals significant imbalances among local governments’ contributions to the state budget. These transfers and revenues are outlined in the annual Budget Law of the Republic of Moldova. Existing conjuncture reveals that only the municipalities of Chisinau (the capital) and Balti are transferring financial resources to the central budget, while other local governments are recipients of transfers from the central budget. This fact is the evidence of significant horizontal inequity when comparable administrative units are treated differently. Also, given the existing concentration of the economy in Chisinau, the property taxation algorithm might seem to be less than perfect.

The latest edition of the Moldovan Fiscal Code was enacted on 1 January 2007. According to that piece of legislation, property assessment for tax purposes will be based on market valuations. However, implementation of the market valuation will not be carried out simultaneously across the country. While properties in Chisinau are already taxed, based on market valuations, the remainder of the country will not be held to comparable requirements until FY 2009. Also, local government’s ability to modify its tax rate is not uniform: all local governments with the exception

of Chisinau have the ability to adjust the tax rate up to 10 per cent of the previous year's value.

The administration of property taxation is also outlined in the Tax Code of Moldova. Specifically, articles 285, 286, and 287 provide information regarding the provision of information on taxable properties, calculation of the tax bill, and keeping the information in the fiscal cadastre up-to-date. In terms of costs of administration, property taxation in Moldova should not be expensive because the entire infrastructure needed for this project is already in place. However, a major problem area for the administration of the property taxes lies in proper and up-to-date cadastre data as well as dissemination of that information.

8.4 Property tax procedures

This chapter describes property tax procedures in the Republic of Moldova. Property tax procedures are outlined and described in title VI of the Tax Code of Moldova. Tax on immovable property, as well as types of properties, procedures for valuation, tax rates calculations, etc are defined in articles 276 through 287. The tax code clearly defines types of taxable property, as well as formal incidence of real estate taxation, in the first two chapters of the Title VI. According to these definitions, objects of taxation (immovable property) are "property, including land (agricultural land, land used for industrial, transportation, telecommunication and other purposes) located within the community or beyond and/or its improvements – buildings, constructions, apartments and other isolating premises, as well as the improvements that are completed by 80 per cent and have been under construction for more than five years since the beginning of the construction works" (Article 278). The same article also defines the tax base of a community as 50 per cent of assessed property values. The formal responsibility for payment of the appropriate property taxes lies on "legal and physical persons, residents and non-residents of the Republic of Moldova."

- Owners of real estate in Moldova; and
- Holders of patrimony rights (the right to possess, manage and administer) over immovable property located in the Republic of Moldova.

Valuation and Property Appraisal: According to the tax code, territorial cadastre agencies shall appraise the immovable property, using a single methodology for all types of immovable property, according to the techniques and deadlines established by the legislation. A mass appraisal approach shall be used for standard immovable property, and an individual appraisal approach for specific (non-standard) property. It is also allowed to appraise immovable property using an individual appraisal approach upon the court decision. The market value of immovable property shall be determined according to its destination by the application of three appraisal methods:

- Market comparison method of appraisal;

- Income/Rent method of appraisal;
- Cost method of appraisal.

The Territorial Cadastre Agencies shall re-appraise immovable property every three years, according to the procedures established by the Government. Finally, it is the responsibility of the central government to finance the assessment process performed by territorial agencies.

In general, the Tax Code of Moldova distinguishes two types of subjects of property taxation: urban property and rural property. There are five different types of properties that are assessed and taxed differently as a function of their location (urban vs. rural). Finally, private residences are valued, based on both market values and surface. For example, a property in Chisinau with a surface of up to 100 square metres would have a property tax associated with it at 0.2 per cent of the property value. However, if a property is over 300 square metres, then the annual property tax associated with that specific residence would be 3 per cent of its value. This mechanism represents the Government's attempt to ensure vertical equity among its constituents.

Tax Calculation and Collection: The immovable property tax amount shall be computed on an annual basis by tax collectors within the Mayor's offices, with the participation of regional tax authorities for each object of taxation based on its tax base of immovable property computed as of 1 January for that fiscal year. If the subject of taxation changed after the tax year began, then the tax collectors within the Mayor's office, with the regional tax authorities, shall compute the immovable property tax amount for the new subject of taxation on the date of state registration of immovable property owner's rights, or on the date the right to possess, use and manage immovable property is granted. If the subject of taxation acquires immovable property by request or donation, the tax liability unfulfilled by the previous subject of taxation shall be totally imposed on the new subject. If the due tax liability exceeds the cost of immovable property received by bequest, then the new subject of taxation shall execute the tax liability within the limits not to surpass the value of the immovable asset. The subject of taxation shall pay immovable property tax in equal instalments by 15 June and 15 October of the current year.

Tax Exemptions: Article 283 and 284 provide a list of the types of properties and subjects exempt from real estate tax. Local governments also have the ability to provide property tax relief under certain circumstances such as natural disasters, etc.

Enforcement & Penalties: The general practice in Moldova is to fine the owner of the property with unpaid property taxes in the amount of the outstanding debt and force these owners to pay the taxes due. However, the enforcement mechanism is still under development.

Computerisation: A content analysis of the existing publications in Moldova revealed that the latest notice of an attempt to computerise fiscal cadastres dates

back to 26 May 2006.¹ “We must concentrate all data on real estate in one place in such a way that a tax officer would have online access to complete information on a piece of property,” said the chief of the IT Department of the Tax Service, Oleg Sarbu. “This objective was set in the concept of fiscal cadastres in [year 2005] and it was approved by the Ministry of finance.”

However, the deadline for computerisation bids was moved to 14 June 2006 after participants in the tender could not provide competitive offers. Other searches for press releases and publications revealed no new information on the computerisation of the fiscal cadastre.

8.5 Summary, policy recommendations, areas of future research

Throughout this report, the importance of property taxation was emphasised. Analysis of existing information on the situation in the Republic of Moldova revealed some great achievements in the area of taxation in general and in the area of property taxation. The adoption of the tax code is an important step in building a state that is governed by laws based on principles of democracy. Although the adoption of such pieces of legislation is important, the existing taxation system is far from being perfectly suited to Moldovan specifics. There are multiple areas for the improvement of the Moldovan tax code regarding property taxation.

One such area of improvement is the valuation process. Although the respective legislation identifies the methodology of property assessment, further adjustment of that methodology to local conditions is needed. A system that uses up-to-date market values (capital or rental) as a basis does not distort the market provided the categories of exemption are those conventionally used. It will tend to reduce the market value and may thus make property more accessible. While property taxes that are based on market values are generally economically neutral, the valuation methods might result in different results as a function of the assumptions for each specific method. Variations arising from different assumptions are briefly summarised in the following table:

Although market value-based property taxation is economically neutral, Moldova’s situation is complicated by its economy. Market values of dwellings are formed partially under the influence of remittances from abroad. This is a potential problem as the market is demand-driven resulting in real estate overpricing. While property values are increasing rapidly, the population’s real income does not. Such overpricing could result in a situation in which people would be living in properties that have real estate taxes exceeding residents’ ability to pay. The recommenda-

1 “Госзаказ по Контролю Недвижимости” [State Request for Proposal of Fiscal Cadastre Computerisation].

<http://logos.press.md/Weekly/Main.asp?IssueNum=660&IssueDate=26.05.2006&YearNum=20&Theme=3&Topic=18587>

tion here would be to carefully determine the acceptable level of property taxation. While property taxation is the local administration's responsibility, there is little motivation for them to collect these taxes. Additional motivation could be provided through conditioning transfers from central government on local administration's collected local taxes.

Table 8.5
Comparison of bases of assessment

	Valuation assumption: Value restricted to "existing use" only.	Valuation assumption: Valuations taking into account the "highest and best use" of the property.
1. Capital value. The price that the property would sell for in the open market.	1A: Well-known basis of appraisal, based on the value of the property in its present condition. Probably the most widely used. Easy to understand. Potential value from property improvement is ignored unlike 1B.	1B: Well-known and well tried. Thought to have economic advantages in encouraging best use of the property. It requires a clear physical planning legal code so that the highest and best use is clearly apparent. Not as easy to collect as bases 1A & 2A.
2. Rental value. The price at which the property could be rented on a yearly basis.	2A: Well-trying basis of assessment. Works in almost any circumstances. Lots of fiscal advantages. The easiest tax option to collect. Less well understood than 1A in situations where there is a limited or controlled market.	2B: Not an easy option and rarely worth considering. Not realistic to take into account potential value from redevelopment in relation to an annual value.
3. Site value. The value of the land only. The price that the property would sell for without buildings and other facilities.	3A: Well-known basis of valuation that often works well. It can have administrative advantages and be a cheap system to run. Less easy to understand than 1A or 1B which may affect ease of collection. Correlates less well with ability to pay than 1A or 1B	3B: Feasible choice in some circumstances. The different uses that may be considered are only those permitted by physical planning or zoning classes.

Adopted from "Rural property tax systems in Central and Eastern Europe"

Another issue in Moldova that is specific to transition economies is the horizontal equity. Properties that have generally comparable market values are treated differently in terms of taxation. Moldova is basing its property taxation on both market values and the square surface of a residence. This results in situations in which an apartment of 199 square metres costs about the same as one of 201 square metres. However, tax wise, the latter has taxes associated with it that are about 9.5 times higher than these for the former. This represents a violation of the principle of horizontal equity according to which, people in comparable living conditions should be paying comparable property taxes.

The next dimension of horizontal inequity is along the dichotomy of urban vs. rural properties. While it is not a problem in clear-cut cases, the municipality of Chisinau is surrounded by rural settings. One such example would be the Stauceni village that is literally 5 km outside of the Chisinau municipality and whose properties are taxed as rural while, to all extents and purposes, it is an urban area. The potential solution here could be the annexation of these surrounding communities by Chisinau, thus eliminating this type of inequity.

Internationally, there is clearly a trend away from a “flat rate system” (the same rate of property taxation regardless of location of that property) towards a true ad valorem system of property tax. The fiscal and economic advantages of such a market-based system are widely recognised. However, there is one unspoken factor inhibiting this move: fear of a new system that seems to depend more on individual judgment than it does on fixed rules. The perception is such that this new system will leave even more opportunities for corrupt officials to engage in extortion. However, international experience suggests the opposite. The underlying reasons are probably related to the lack of transparency of a flat rate system. Certainly it is known from examples elsewhere in the world that flat rate taxes do not stop corruption. This may also be the case in some transition countries where the flat rate and the lack of opportunities to appeal against the officially determined value increases the opportunities for corruption in official hands. As an alternative, it is more probable that a change to an ad valorem system would actually lessen the opportunities for corruption, given that it is based on up-to-date values, that the entire valuation list is open for public inspection, and that there is ready access to a judicial appeal system that is free to the taxpayer. When the system works well, the basis of comparability means that the freedom for officials to manipulate values is minimised because:

- Officials cannot afford to undermine their own list by individual injudicious reductions; AND
- It will be cheaper for the taxpayer to go to an appeal than to pay a bribe. The practice of mass valuation of properties for taxation purposes leaves very little room for corruption practices as all properties are handled simultaneously without paying special attention to any particular property.

The way in which transparency is introduced will depend on the particular circumstances of each country. Where there are concerns of corruption at the local level of government, methodologies for mass valuation should be developed at the national level. The responsibility for setting tax rates should be assigned to local elected councils, assemblies or parliaments, and should not be left to local administrators. Local legislators should also be given the right to set the time of the next properties re-appraisal.

8.6 Conclusion

One recurring characteristic observed during this research was the number of countries that were either currently going through a tax reform or had recently finished such reforms. This observation is true for both developed and developing countries. While these countries have different types of problems in their property taxation, it was generally recognised that existing taxation systems needed to be brought up-to-date with existing socio-economic conditions. Even in the emerging democracies, there was evidence of relatively new systems being reviewed and reformed in the light of activity taking place in other countries.

The introduction of the Single European Market has resulted in the removal of trade barriers and the elimination of customs duties among EU members. The opening up of internal markets to foreign competition meant that businesses are no longer protected by trade barriers and customs duties, nor can they rely on state aid any longer². How competitive a business is now depends on how efficient they are and the amount of taxation imposed on them by the government of their country of primary residence/incorporation.

Probably the first signs of problems caused by national levels of taxation were identified by the Ministry of Finance in The Netherlands in the early 1990s. The Ministry identified the problem that businesses were not only locating in the most tax favourable areas, but could now buy goods and services from other countries where tax rates and other costs were lower. The close proximity of The Netherlands to Germany, France, Belgium and Luxembourg as well as the good transport systems among the countries exacerbated the situation.

No single tax can be viewed as a totally stand-alone tax. The reform of one tax will often have consequential effects on other types of taxation and a country's economy. For example, capital gains tax and its design are likely to be a factor considered by those investing in property. In most countries, houses used as primary residences are exempt. This does distort the market in favour of owner-occupation of residential properties, but this is regarded as a benign result in most countries. This tax need not affect the operation of the land market or the operation of property tax. Another example is Transfer taxes or Stamp Duties. If the total cost, including tax, of officially transferring property becomes too great, the market will not use the official systems, thus leading to a less secure and less transparent market. Capital or wealth taxes have multiple influences on property market and taxation. The income tax system affects the property market in a number of ways. The treatment of capital allowances (how capital investments in property may be written off against income) will affect the decisions of investors. Arrangements can be made to assist farmers, but unintended effects may occur: concessions often result in increasing land prices and impeding access to land. Applying property tax to rural property

2 There are exceptions, of course.

will tend to correct this distortion. Taxes on inheritance can have a beneficial effect. Its redistributive nature can cause more land to come on the market. Value added taxes have significant influence on sales and building costs. The design of the tax, categories of exemptions and zero rating and level of tax payable are all factors relevant to property as an investment and the market. Property taxation in all its forms is no exception. Many forms of non-annual property taxes exist in Europe but these are usually levied at a national level, although in some cases, they can be levied by local government.

Property tax is an ancient and very well understood tax. There is plenty of experience from countries all over the world and it is well-known what works and what does not. There are probably no circumstances in which property tax cannot be introduced if there is the political will to do so. The overall message is that property tax is technically feasible and will benefit local governments' autonomy and capacity building.

It is widely recognised that the incidence of taxation on land and property can have extremely distorting effects on real estate markets. Many taxes impinge on property and the design of each has the potential to influence the market in various unintended and undesirable ways. But there may also be ways in which the tax system encourages rewarding and potentially positive consequences.

Clearly, any review of the effect of taxes on property as an investment or how tax affects access to land and property must have regard to many other factors such as a country's economy, the existing taxation systems and its formal and economic incidence. Taxation is, of course, primarily about raising revenue and is therefore an issue that goes well beyond the property market and land administration.

The first action is to review the incidence of taxation on land and property and identify any distortions caused by taxation. Remedies can only be devised in the light of the larger economy, the need to raise revenue, the national capacity to implement new taxes and political realities.

In the final analysis, property taxes can play an important role in developing sustainable rural livelihoods and communities. The tax is transparent, cheap to administer, efficient to collect and well understood by the taxpaying public. It is administratively feasible in virtually any circumstances. It is particularly suitable as a source of locally generated revenue for local government. It enables local communities to provide for locally determined needs. This is important in transition countries because central governments may find it increasingly difficult to respond to local needs. Local livelihoods will be inhibited without a sound rural infrastructure. Property tax has an important part in providing it.

Most tax reforms take time and property tax is no exception in this regard. The longest and most unpredictable stage is the public debate and policy planning. Only when this stage is completed, can the execution begin. Thereafter there are a

number of inter-related steps which will take no less than two years. Thus, the time from initiation of the policy debate to the flow of tax revenue is likely to be about five years. Time is thus an important element. The single most complex step is the assessment process which must be completed within a certain period because the information captured will become out of date and undermine the credibility of the tax. The most important step is setting the tax rate. If the tax rate is set too high, there will be widespread resistance. If the tax rate is set too low, the system will not be cost-effective. The aim should be to set the tax rate at a level high enough to generate sufficient revenue to make it worthwhile, but not so high that it becomes impossible to collect the taxes because of an “inability to pay”.

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9. Property Tax and Inter-Governmental Fiscal Relations in the Republic of Moldova

Eugenia Busmachi

9.1 Introduction

Moldova is a unitary state, which became independent as a result of the Soviet Union collapse. Since the declaration of its independence in 1991, Moldova has initiated a series of reforms aimed at establishing a modern and autonomous local administration system. The major purpose of the reform was to implement the European practices of public administration, based on principles of decentralisation and local autonomy.

The unavailability of coherent budgetary-fiscal policies on sustainable development of administrative-territorial units creates uncertainty and deprives local authorities of autonomy in their budget development and establishment of own revenues, neglecting the principles of local autonomy and of financial and fiscal decentralisation. The fiscal capacity of Local Government remains limited and insignificant.

The substantial result of these relationships materialises in a budgetary structure which differs between them, depending on the budget destination. Local budgets need own financial resources and the responsibility of local communities in promoting the local interests in correlation with national strategies.

Analysis of incomes' and revenues' distribution between the components of the budgetary system, mainly between local government budgets, is of special interest in order to emphasise the quality of inter-budgetary financial relations and concrete delimitation of the activities and obligations of each component, aimed at mobilisation and distribution of financial public funds.

The decentralisation of the functions of public finances has also become a characteristic feature of the budget-tax policy of the Republic of Moldova. Moldova has already changed some laws to give local governments additional autonomy but has not yet resolved many important questions regarding how local governments should be financed, specifically, the reform aimed at bringing government closer to citizens, making it more responsive to their particular preferences, and finding new and more efficient ways to provide higher levels of public services.

Property taxes can be considered one of the most popular options for raising revenue for financing public services. The traditional role of the property tax, as an important source of revenues of local governments in the Republic Moldova, has been greatly increased over the last years. To create a local tax base in Moldova, the Government implemented Title VI "Property Tax". Real property tax is often

identified as a major source of local government finance that has the potential to contribute substantially to locally raised revenue.

The present paper is concerned with analysing the current property tax system and some alternatives for improving this system in Moldova.

9.2 Government structure and inter-governmental relations

9.2.1 Government structure

The reform of the present system of fiscal and inter-budgetary relations is carried out in order to achieve a higher level of transparency, stability and predictions that would lead to poverty reduction and an improved quality of public services with the aim being the establishment of *direct financial relations* between the Ministry of Finance and administrative territorial units. Inter-budgetary relations should contribute to the major functions of public finance: resources allocation, resources distribution and financial stability maintenance.

Normally, there is a close relationship between the central administration's budget and the local authorities' budgets. The financial policies of the central public administration have a great impact on local authorities. And vice versa, the financial policies of local authorities influence the general economical and financial performance of a country. Therefore, development and implementation of financial policies should correspond to general economic priorities and objectives and should be favourable for economic growth.

The Republic of Moldova has two levels of government: central government and sub-national government. The first level government in Moldova includes *villages, communes, towns and municipalities*. The Second level government includes rayons, the municipality of Chisinau and Balti and the Autonomous region of Gagauzia.

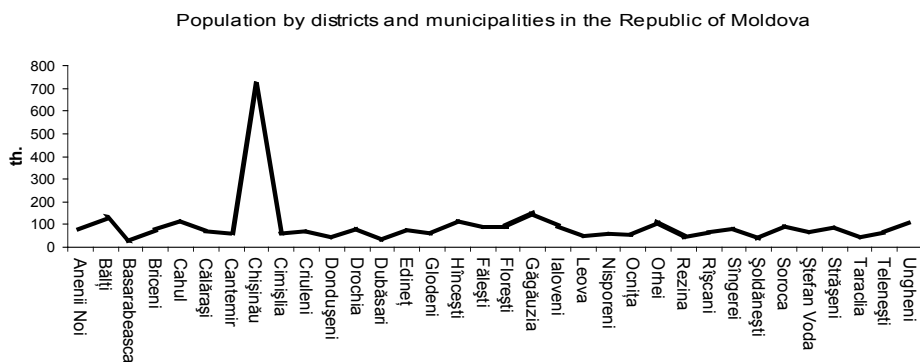
According to the current Law on Territorial-Administrative Organisation, approved in 2003, the territorial-administrative system of Moldova comprises 32 second-level territorial-administrative units, 3 municipalities (including Chisinau, the capital city), the Gagauz Autonomous Unit¹ (with the status of a second-level territorial-administrative unit) and first-level territorial-administrative units (municipalities, cities, villages and communes).

The rayon is the main subject of the inter-budgetary financial relations within the existing financial system of the Republic of Moldova. Specifically, they have the right to form the budgets of towns and villages, with specifically, the transfers of money to the budget of towns for the implementation of authorities established

1 Gagauzia is a small, autonomous region located in the Southern part of Moldova. The 1994 Gagauz Autonomy Act gave the regional government in Comrat sovereignty over such issues as education, culture and the local budget.

by the legislation. It is complicated to establish inter-budgetary relations between rayons, towns and villages, under conditions of a vague determination of authorities in the law, limited own resources, lack of expenditure-planning at the local level medium-term perspective, as well as taking into account the existing situation with the labour force and the economic development imbalance in the country.

Figure 9.1
Population by districts and municipalities



Source: Elaborated by author based on National Statistical data

The rights of towns are limited, both at the stage of budgetary planning and at the stage of financing in implementing their authorities. If, at the state level, there is budget expenses planning and forecasting on programmes and results, which allows consideration of the perspectives of budgetary spheres' development, at the town planning level this is only projected for one year and financing depends on the rayon.

At the same time, local autonomy does not exist independently and exclusively, being influenced by the activities of the central public authorities, since the local authorities function in the framework of the state. Therefore, the current situation shows that the principles of local autonomy, proclaimed by the Constitution and supported by the current legal framework, are not fully exercised and elected officials are not vested with sufficient decision-making powers to follow the agendas mandated by their voters.

9.2.2 Inter-governmental fiscal relations

Most of local governments' budgets lack a fiscal basis to cover minimum necessary expenditures and that is why budgetary equalisation is carried out by transfers from funds for financial support of territories, approved annually by the law on the state budget.

Theoretically, five broad economic arguments for central-state transfers have been developed: fiscal gap, fiscal inequity, fiscal inefficiency, interstate spillovers and fiscal harmonisation. Each is based on either efficiency or equity. To the extent that the central government is interested in redistribution as a goal, there is national interest in redistribution that occurs via the provision of public services by the sub-national governments.

As Bahl and Linn (1992) show, the most appropriate form of transfer depends, to a large extent, on its objective. Regardless of the particular design, however, experience demonstrates that good inter-governmental transfer programmes have certain characteristics in common: transfers are determined as objectively and openly as possible, ideally by some well-established formula; they are not subject to hidden political negotiation; they are relatively stable from year to year to permit rational sub-national budgeting, but at the same time, sufficiently flexible to ensure that national stabilisation objectives are not thwarted by sub-national finances.

The political economy of grants and tax shares looks at the effects of political factors that ought not to affect distribution according to the equalisation policy of the country concerned, but which in fact, do. (OECD 2007, 24)

The level of transfers in Moldova is conditioned by the allotments from general state revenues, own revenues and expenditures of local governments. Transfers from general revenues and from taxes on immovable property represent a form of inter-budgetary relation, the use of which is necessary to avoid deficits and approve balanced budgets.

In this context, it is necessary to reflect on the modalities of inter-budgetary relations' implementation and the role of the state budgets in the establishment of local budgets' revenues. The allocation norms from the state's general revenues to the budgets of local governments of the first and second levels and the budget of Chisinau and Balti municipalities for the years 2006–2008 can be seen in Table 9.1.

Allocations from the state general revenues to the budgets of local governments represent a stimulant of revenue stability that remain at the disposal of the local authority. Thus, allocations constitute an important source and modality to supplement budgets of local governments. Allocations from taxes on immovable property in accordance with the percentage established by representative and deliberative authorities of the second level administrative-territorial units represent own-source revenues approved for local budgets.

The competences in making public expenses are determined between the budgets of the local administrative units (see Table 8.1). From the budgets of the villages (communities), cities (municipalities except Balti and Chisinau) the following expenses are financed: urban design and urbanism; construction and maintenance in the area of the community, roads, streets, local bridges, construction, maintenance and operation of the water supply, sanitation, and cleaning systems, management

of production and household waste; management of pre-school, primary, secondary, gymnasia, middle schools, secondary schools and non-compulsory educational institutions, other educational institutions serving the respective community; management and operation of cultural institutions and organisation of cultural public activities, and the management and operation of libraries and museums etc.

Table 9.1
Allocation norms from the State's general revenues
to the budgets of local governments

State's General Revenues	Allotments (Deductions) to:		
	Budgets of rayon	Budgets of Chisinau and Balti municipalities	Central budget of AUT Gagauzia
Income tax on entrepreneurial activity (%)	100	50	100
Road tax levied on vehicle owners registered in the Republic of Moldova (%)	50	50	50
VAT (%)	0	0	100
Excises on goods produced on the territory subject to excise (%)	0	0	100

Source: Elaborated by the author based on official data www.minfin.md

From the rayons' budgets the following expenses are financed: construction and maintenance of regional roads; construction of regional public buildings; management of lyceums, except those referring to the first level local administrative units; secondary vocational institutions; orphanage schools; orphanage-gymnasia with special conditions; educational activities as well as other activities and institutions serving the population of the respective local administrative unit, offering social assistance and managing social assistance institutions; coordinating and developing sports activities, as well as other activities for teenagers; manage theatres; local public television; assure public order, coordinate, organise and supervise, within the limits of its authority, administrative-military activities; execute court decisions, through which the local public administrative authority is obliged to affect certain payments; the activity of the executive authority and departments subordinated to the respective regional council; management of other institutions and development of other activities attributed to the regional public administration authorities as per legislation.

Expenditure norms defined by the Ministry of Finance are fixed according to the number of the population living in a particular town or village, or the number of particular beneficiaries, such as pupils. Despite the fact that the transfer is intended to compensate for differences in fiscal capacity, generally, the more money a

community can earn, the more it can spend. According to the Law on Local Public Finances, no community can spend more than its annual estimated or generated amount of revenues.

Table 9.2
Weight of public expenditure in the GDP

Indicators	2006	2007	2008*	2009*	2010*
GDP in current price (millions MDL)	44,069	49,700	56,000	61,900	67,300
Expenditure of National Budget as a percentage of GDP (%)	40.8	42.0	41.9	39.6	43.0
Expenditure of Local governments as a percentage of GDP (%)	11.5	7.3	8.9	8.8	8.4

Source: Elaborated by the author based on official data *www.minfin.md*

Funding for the financial support of territories consists of: annually approved deductions to the state budget, deductions of local governments and budgetary expenses which exceed by 20 per cent the medium level of budgetary expenses per one inhabitant on the respective territory.

To assure equal budgeting of local administrative units, through the annual budget law, from the state budget to the budgets of the local administrative units of second level, the following types of transfers are set: transfer from the account of the financial support fund of the local administrative units, to balance their financial possibilities and transfers with a special purpose.

The 2003 Law on Local Public Finance identifies both general transfers for operating revenues and two types of special purpose transfers. Together, these amount to more than 60 per cent of the local government budgets. The Law of local public finance does not define transfers intended to cover capital investment costs; these are funded through a Social Investment Fund that has very limited resources. Article 10 of the Law on Local Public Finance specifies that transfers from the Financial Support Fund for administrative territorial units should cover the gap between projected revenues and necessary operating expenditures, in order to balance the budget of local governments.

Transfer calculation is carried out, taking into account average public expenditure per capita, which in the following year should be supported by local governments in accordance with the legal norms. Average public expenditure per capita is calculated annually for every group of expenditures at the stage of macroeconomic forecast for the next budgetary year.

For local governments, which in accordance with the legal norms, support specific expenditures, a readjustment coefficient is applied for the calculation of average expenditures per capita. The fiscal basis of every local government, exclud-

ing local fees approved by the local council, is forecast taking into account special revenues generated by paid work execution, services and other activities of budgetary public institutions and transfers from other budgets. Based on a fiscal basis prediction, the income tax rate per inhabitant is calculated (v), but the difference between average public expenditures per inhabitant from every administrative territorial unit (Y_c) and, the income tax rate per inhabitant from the respective territory represents the transfer per inhabitant (t):

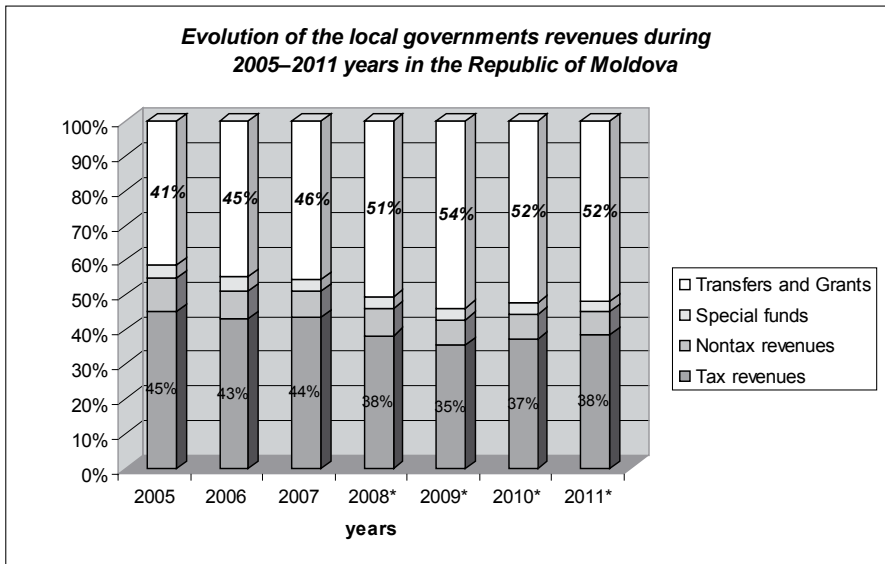
$t = Y_c - v$. The volume of transfers (T) for every local government is calculated by multiplying the sum of transfers per inhabitant by the total number of inhabitants from the respective territory (n): $T = tn$. Administrative territorial units in the framework of which, the income tax rate per inhabitant exceeds average expenditures per inhabitant by 20 per cent, transfer to the fund of the territories' financial support, the sum of incomes (revenues) which surpass by 20 per cent the minimum necessary expenditures of the corresponding administrative territorial units.

Annual budgets of the local governments units cannot be approved and executed with a budgetary deficit. Public administration authorities of local administrative units are required to take all the measures necessary to maintain budgetary equilibrium. If incomes are not received in the amount approved, the inherent representative authority is requested to reduce expenses, which includes the liabilities and payments set to the end of the year with a balanced budget, by rectifying the budget of the respective local government.

Transfer levels have varied widely, as a result of frequent changes in the regulations governing transfers and shared revenues. As the amount of shared revenues received by 1st tier local governments has diminished, the amount of transfers has increased to compensate. The main reason for the decrease in shared revenues and increase in transfers in recent years is that VAT ceased to be shared revenue. However, shared revenues are extremely unpredictable in Moldova, as the annual budget law determines the shares of general government revenues to be distributed among 2nd tier local governments and these, in turn, determine how the general government and regional revenues will be distributed among the 1st tier local governments (or retained by the 2nd tier local government).

While shared tax revenues increased and then decreased somewhat during this period, transfers steadily rose. One would expect with the increase in transfers, calculated with a formula based on projected revenues, local governments would have a greater incentive to underestimate own revenues and perhaps, even less incentive to collect own revenues.

Figure 9.2
Evolution of the local governments' revenues during 2005–2011



Source: Elaborated by the author based on National Statistical data and MTEF for 2009–2011

9.2.3 Composition of Local Government Revenues

The revenues of the budgets of local governments consist of taxes, fees and other collections specified by law, which are divided into: own-source budget revenues of administrative-territorial units that consist of local taxes and fees collected in whole and directly to these budgets; special resources from paid services, works or any other activities performed by the budget institutions; transfers from shared state revenues established under the annual budget law. The Councils of rayons, autonomous territorial unit, Chisinau municipality shall establish these normatives annually in the case of the local budgets: transfers from the state budget to the rayons, to the autonomous territorial unit, Chisinau municipality budget or from the budget of rayons, the central budget of the autonomous territorial unit and the municipal budget to the local budgets. The budget revenues at any level shall not include loans provided from the state budget or from another budget, or loans from the banking system.

Many countries attempt to achieve several of the objectives approved through the systems variously described as revenue sharing. Tax revenue sharing is different from one country to another. In establishing the methodology and regulations on tax revenue sharing we see different problems.

- If they are partial, that is, do not apply to all national taxes, but only to a sub-set of such taxes, they may bias national tax policy.
- If – as is often the case – they share the revenues from origin-based taxes to the jurisdictions from which the revenues are collected, they break the desirable link between benefits and costs at the local level and hence reduce accountability and the efficiency of decentralisation.
- Since in such systems tax rates are invariably set by the central government, and in addition since the sharing rate is often applied uniformly throughout the country, once again, the accountability link is broken and sub-national governments have no incentive to ensure that the amount and pattern of their spending is efficient².

Sharing revenues between budgets of local governments: The revenues of the local budgets (villages, communes, cities and municipalities) shall be generated from: transfers in whole of the following types of taxes, fees and other revenues: real estate tax, land tax, fee for entrepreneurial patent, income received from selling apartments to citizens, income from selling land, local taxes and fees established by local councils as provided by law, private tax, collections from the sale of confiscated property, payment for release of licences for the right to perform certain types of activities, returns from leasing the local patrimony and other revenue sources collected as provided by the legislation in force.

Transfers from the following types of shared state revenues: income tax on entrepreneurial activity performed by legal persons located within the area of the Mayor's Office, income tax on individuals, special resources collected from charged services provided by public institutions financed from the local budgets, transfers from the budget of the rayon, autonomous territorial unit and Chisinau and Balti municipality to the local budgets.

Revenues of the central budget of the autonomous territorial unit with special juridical status consist of:

1) Direct and integral collection of the following taxes, fees and revenues

Income taxation of natural persons: tax on natural resources, private taxes (in accordance with ownership), other revenues, as provided by law.

2) Allocations from the following state general revenues

Income taxation of legal persons in the framework of corresponding administrative territorial units – 100 per cent; VAT on goods and services provided on the territory of the autonomous territorial unit with special juridical status – at least 10 per cent; road tax levied on vehicle owners registered in the municipality – 50 per cent; Excise on goods subject to excise fabricated on the territory of the autonomous territorial unit with special juridical status – at least 50 per cent;

2 www.ciesin.org/decentralisation/English/Issues/Transfer.html

3) Transfers from the state budget to Local Governments**4) Special means****5) Special funds**

Revenues of the Municipality of Chisinau and the Municipality of Balti consist of:

- **Direct and integral collection of the following taxes, fees and revenues**

Income taxation of natural persons: taxes on immovable property, tax on natural resources, income from the sale of land that belongs to the private domain of Chisinau Municipality and Balti Municipality as provided by law, local taxes and fees applied by the local councils as provided by law, private taxes (in accordance with ownership), income generated by sale of seized goods (affiliation based), fees for licences and authorisations for entrepreneurial activity issued by the 2nd level local authorities as provided by law, fees for entrepreneurial patent to the local budgets and other revenues as provided by law.

- **Allotments from the following state general revenues**

Income taxation of legal persons in the framework of corresponding ATU – 50 per cent; Road tax levied on vehicle owners registered in the municipality – 50 per cent.

- **Transfers from the state budget of local governments**

- **Special means**

- **Special funds**

Table 9.3

The evolution of the revenue structure of Local Governments during 2006–2007 (millions MDL)

Indicators	2006	2007
1. Own revenues	2,608.6	3,034.7
2. From this: property tax(es)	232.7	226.3
3. CG grants	0.6	2.2
4. Specific grant for capital expenditure	26.1	45.1
5. Transfers from State Budget	2,089	2,469
6. Other revenues	54.5	95.8
Total = 1+2+3+4+5+6	4,776.8	5,646.8

Source: Elaborated by the author based on official data www.minfin.md

The incomes of the budgets of the local governments in 2007 compared to 2006 registered an increase of 18.2 per cent.

9.3 Historical background

The Law on Fiscal System Basics was adopted on 17 November 1992. The fiscal system provided for 10 general state and 10 local taxes. Local taxes, among others, included land tax and real estate tax. The tax for every plot is determined by the land area and application of a coefficient, based on the estimated land productivity capacity. Therefore, the budgetary revenues from land tax do not adequately reflect the land or real estate market value. Originally, the tax base of land and real estate taxes were insignificant and differential, so were the revenues generated by those taxes. As compared to 1992, the revenues collected from land taxes show an increase of up to 1, 1 per cent and those collected from real estate 0.5 per cent.

Since 1995, agricultural enterprises have been subject to a single land tax, which also included real estate and road taxes, previously paid separately. Due to these circumstances, the tax base of land tax increased: for agricultural land the calculated amount of the road tax as a component of the land tax was 9,4 per cent, real estate 1.02 per cent. The real estate tax began to be paid by all legal persons possessing fixed productive and non-productive assets, as well as by citizens owning buildings. As a result of the improvements to the fiscal legislation of Moldova, land and real estate taxes are collected into the budget every year.

Since land tax has been transferred to the special budgetary accounts of local administrative bodies, this tax collection is seen to have improved.

In the timeframe 1994–1999 the taxes collected into the budget from agricultural households, in particular from farms and equivalent land owners, bore an unregulated character.

Most of the land tax was collected due to the introduction, in 1999, of the Law on local Public Finances, as a result of improvements to the legal framework of the public administration reform and increase of tax base for agricultural land.

Beginning in 2000, a 15 per cent reduction was applied to taxes paid in advance, prior to 30 June of the current year, a measure taken for the purpose of a more uniform implementation of local budgets, (both revenues and expenses), as well as to encourage tax payers. Therefore, in 2000, the amount of land tax paid by economic entities by 1 July increased by 20 per cent, compared to the corresponding timeframe of 1999, and respectively, in the same timeframe of 2001, the sum increased by 78,4 per cent, compared to 2000. In 2001, economic entities were offered 2.1 million-MDL as a tax land reduction for tax payment in advance. Certain categories of tax payers, pursuant to Title IV of the Fiscal Code, were exempt from land and real estate tax.

Pursuant to the provisions of the Fiscal Code, beginning in 2006, new mechanisms of taxation began to be applied for real estate, including non-privatised estate, based on real market price. Currently, the real estate tax takes into account

its estimated cost at the moment it is built and subtracting wear and tear, which is sometimes estimated up to 60–80%.

Pursuant to Law no. 448-XVI of 28 December 2006, the tax base for housing real estate in Chisinau municipality, except the towns and villages pertaining to it, was set at 0,02 per cent of the estimated real estate market value, compared to 0 and 3 per cent of the normative real estate value. Correspondingly, the tax base in 2007 decreased 15 times. Bearing in mind that the market value of real estate in Chisinau municipality increased on average by 15–25 per cent in relation to its normative value, the fiscal burden has not increased significantly. In the case of other cities, towns, (including Chisinau) and municipalities, the tax rate will be established by local public authorities in an amount allowing the increase of fiscal obligation on average by 10 per cent as compared to the previous year, according to section (2) art. 278 of the Tax Code. The taxable base is the real estate estimated value, at a market price evaluated by territorial cadastral bodies of the Cadastre and Land Evaluation Agency.

9.4 Property tax in the national tax system

Property taxes are defined as an annual tax on land and buildings. Property taxes are considered easy to understand and easily enforced. They are cheap to collect and administer, difficult to evade, capable of producing a large and predictable yield, and easy to allocate to a particular local authority in terms of revenue. In addition, they represent a familiar concept to local administrators. In spite of their high popularity in integrating taxation systems, property taxes are not free from imperfection. Indeed, administrators of property taxes face serious difficulties in establishing their systems. Property taxes are strongly criticised due to the inequities present in current systems.

According to the Tax Code of the Republic of Moldova, the *tax on immovable property* is a local tax, which constitutes a compulsory payment to the budget on the immovable property value. The legal persons and individuals, residents and non-residents of the Republic of Moldova shall be subjects of taxation: owners of immovable property located in the Republic of Moldova; holders of patrimony rights (the right to possess, manage and administer) over immovable property located in the Republic of Moldova, which comes under public property of the state or under public property of the administrative-territorial units or private property, including lessees who rent the object of taxation for more than three years and unless the lease agreement provides otherwise.

The objects of taxation shall be immovable property, including land (agricultural land, land used for industrial, transportation, telecommunication and other purposes) located within the community or beyond and/or its improvements – buildings, constructions, apartments and other isolating premises, as well as improvements that are completed by 80 per cent and have been under construction

for more than 5 years since the beginning of the construction works. The tax base of immovable property is 50 per cent of the appraised property value.

The Territorial Cadastre Agencies shall re-appraise immovable property every three years, according to the procedures established by the Government. The territorial tax authorities shall keep the fiscal cadastre based on the data submitted by the cadastre agencies and continuously monitor the information per subject and object of immovable property taxation. The immovable property tax amount shall be computed on an annual basis by tax collectors within the Mayor's offices, with the participation of regional tax authorities for each object of taxation based on its tax base of immovable property computed annually on 1 January of the fiscal year. If the subject of taxation changed after the tax year began, then the tax collectors within the Mayor's office, together with the regional tax authorities shall compute the immovable property tax amount for the new subject of taxation on the date of state registration of the immovable property owner's rights, or on the date the right to possess, use and manage the immovable property was granted. If the subject of taxation acquires immovable property by inheritance or donation, the tax liability unfulfilled by the previous subject of taxation shall be totally imposed on the new subject. If the due tax liability exceeds the cost of the immovable property received by inheritance, then the new subject of taxation shall execute the tax liability within limits not surpassing the value of the immovable asset.

All juridical persons are payers of real estate taxes, irrespective of the ownership type or organisational or legal structure, who have, in their possession, ownership, or who use assets located on the territory of the Republic of Moldova. Here, the taxation objects are the buildings and installations included in the fixed assets in accordance with the "Fixed Asset Classification Blueprint for the Economy of the Republic of Moldova" approved through resolution №40 from 16 September 1993 by the Statistics Department. The average annual value of the taxable real estate objects is defined as the average chronological, sum of the remains for each month of the reporting period, in correspondence with the data. The residue for the beginning and end of the period are collected in two halves. The resulting sum is divided into the number of months in the period.

The calculation of the real estate tax for natural persons is carried out in relation to the cost, area and location of the real estate. Both registered and unregistered property with the cadastre authorities is taxable according to the following procedure: in the municipalities of Chisinau and Balti 0.3 per cent of the real estate cost; in other municipalities and towns 0.2 per cent; in rural areas 0.1 per cent. The stipulated tax rates are imposed on housing estates (main buildings), the general area of which does not exceed 100 m².

Section VI on Real Estate Property of the Fiscal Code was recently modified. For Chisinau, the tax rate was set at 0.02 per cent of the re-assessed value of taxable property. All other municipalities should set their own tax rates (0.02% being

the minimum allowed), so as to achieve an average increase of 10 per cent in revenues from this particular tax compared to the previous year. For large properties (with surfaces comprising between 100 and 200 square metres), the tax rate is 3 times bigger, and for very large real estate (more than 200 square metres), it is 28 times bigger.

In the Republic of Moldova, land is used against payment. The payers of the land tax are juridical and natural persons, who have been granted the right of ownership, possession or use of a land area and who qualify as the owners of the land.

The land tax objects are the land areas offered into ownership, possession or use, irrespective of the duration, purpose or location of the land area. For land that belongs to the state and is rented out, the land tax is paid by the tenants, according to the rental contract. It is in the competency of local public authorities to issue documents, which prove the possession rights of a land area, certificates proving the right to temporary use of the land, as well as contracts for the rent of land in cases of rental arrangements.

The cadastre register of the landowners contains the cadastre information about all registered landowners. Agricultural grounds are taxed through two tax rates, which apply to hayfields and pastures and to all other agricultural grounds.

These tax rates are set for 1 ha of land, either without an estimated cadastre value for 1 point-hectare of land, or with an estimated cadastre value. A 1 point hectare of land equals the sector, the area of which equals to 1 ha and the quality indicator is 1 point.

The areas of land located within inhabited regions are sections within their borders and in the possession of the local public authority. The sum of the land tax payable to the budget is determined through the multiplication of the land area with the cadastre value (only for those areas which had been assigned a cadastre value) and with the tax rate.

Factors that influence the establishment of the land tax and income tax so that the concrete rate of taxation, adopted annually by the decision of the local public administration, the application of a tax which is different from the concrete tax for the given local administrative unit is a risk factor concerning the reduction of fiscal liabilities; use of the land and evaluation of the land's reliability; diminishing or increasing the surface of the lands, which depends on the efficiency of the activity and co-operation with the cadastral service, facilities granted in accordance with the provisions of the fiscal Code and the reductions granted for advance payment of the land tax amount. For real estate, it is important to determine correctly the balance value, which depends on the amount of inflows and outflows of real estate, as well as the depreciation accumulated. The property tax is imposed at local government level.

Table 9.4
Property Tax within the National Tax System and in GDP

	2006	2007
GDP (millions MLD)	44,069	49,700
Social Security Contribution, %	8.3	8.7
Indirect Taxes, %	17.3	18.9
• Value Added Tax, %	14.05	15.3
• Excise tax, %	2.43	2.8
Direct Taxes on Income, %	4.05	4.33
• Profit Tax, %	5.0	5.5
Custom duties, %	1.88	1.81
• Property Tax(es), %	0.52	0.46

Source: Elaborated by the author based on official data www.minfin.md

According to the data in Table 9.4, revenues from property taxes represented around 0.5 per cent as a percentage of GDP in 2007. In 2007, there was a tendency to increase taxes on social insurance compared to 2006. The total revenues from property tax in 2006 were 232,6 mln MDL and 226,3 mln MDL in 2007, which represents a decrease.

9.5 Conclusion

The actual fiscal basis of most local administrative units in Moldova is not sufficient to assure their financial independence and necessary level of own fiscal incomes. The major directions of the real estate tax imply an extension of the ways to receive real estate taxes; the application of efficient methods of assets' evaluation and an efficiency analysis of the facilities granted on payment of land and real estate taxes

To increase the efficiency in the use of financial resources and in order to improve inter-budgetary relations amongst budgets at all levels and reevaluate the existing reserves in public finance, a certain stability and equilibrium of the budgetary system is necessary and this could be achieved by implementing certain management practices of public money management – practices acquired through research of international experience in the domain.

The method by which the general transfers are calculated also creates disincentives for local governments to project revenues accurately, and possibly may affect their collection efforts. The formula should not consider projected revenues, but rather, fiscal capacity. A proxy for fiscal capacity can be revenue from taxes for which the local government does not have collection responsibility. The transfer formula should not punish local governments for greater fiscal efforts.

In general, local governments should be granted greater financial autonomy by allowing them to set the rates of their own taxes. However, if these disincentives persist, local governments are unlikely to utilise financial autonomy and increase their tax efforts.

The progress in decentralisation of real estate tax administration at the level of local public administration authorities depends on the efforts of a proper evaluation of real estate, as the market value on real estate, determined as the evaluation result, serves as a basis for real estate taxation.

Difficulties in assessing the property tax base are common for local authorities in many countries. The low performance in valuation for taxation purposes may be related to the poor access to market information, omission of important attributes in estimating the tax base, use of non-representative samples on which the estimates are based, a lack of frequent revaluations and inaccuracies present in the real estate cadastre.

The European and international practice of real estate evaluation is based on the concept of market value, which leads to important economic and social effects. The implementation of market value in the economic analysis and taxation improves the efficiency of using land and constructions, reduces the “voluntarism” in placing the real estate, creates equal conditions for tax payers and increases the incomes of the state and local public administration from taxing real estate. Special attention was paid to the campaign organised to inform taxpayers about the payment of income taxes and the declaration of incomes by citizens, as well as the campaign on payment of real estate taxes by the population.

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10. Property Tax in Ukraine: To Be, or not to Be – Is this the Question?

Sergii Slukhai

This paper aims to analyse the existing proposals concerning local property taxation, as reflected in the recent draft legislation with regard to the appropriateness of proposed approaches and their potential capacity to generate sufficient revenue sources for local government. The alternatives in constructing an efficient property tax in Ukraine are discussed and the most appropriate approach formulated. It is argued that a simple lump sum or flat rate approach will suffice for the first stage of tax launching.

10.1 Introduction

Local government finances in transition economies are still far from being formed according to international standards. This is especially true for the Republics of the former Soviet Union. Despite some attempts to reform the existing situation, local governments suffer from central government dictate and lack of fiscal autonomy.

Ukraine is no exception. Local governments here depend heavily on the central government in all fiscal aspects of their activity, being on a short leash of state grants of varying types.

Despite the changes in inter-governmental fiscal relations introduced by the Budget Code in 2001, the degree of local fiscal autonomy and accountability remains low. Moreover, local governments are still treated as sub-divisions of the central government and are put in a position whereby they must pay the centrally-delegated expenditures out of their own revenues.

Such a situation is very frustrating for most self-governing units, which are subordinated to the local state administrations of the regional and district levels. That is why many Ukrainian researchers try to address this issue and suggest expanding the revenue base and introduction of new revenues sources; one of those most frequently referred to is property tax.

The argumentation in favour of such a tax, as a local revenue source, can be traced to recent literature published by both international and domestic experts. We find strong argumentation for the local property tax in papers published by Swianiewicz and Thirsk (Свяневич, Сірск 2006), Lunina (Луніна 2006), Slukhai (2006) and others.

Politicians also add their voices to the issue, offering draft legislation reflecting their political biases.

The proposed paper aims to find out whether we really need property taxation to be implemented in order to have a sound system of local finance. In addressing this issue, the following objectives were set: (1) to analyse the current structural and institutional problems of Ukrainian local finance; (2) to compare existing legislative approaches to property taxation and to find out which one is most appropriate for the current situation in the country; (3) to sum up the main traits of a suitable property tax structure.

The outcome is a set of recommendations concerning the design of the local property tax in its simplest form.

The paper is structured in the following way: first, we describe the existing governmental structure and inter-governmental relations; second, we analyse the ongoing discussion on property taxation and select the most promising options amongst those advocated by different political forces and finally, we try to make an outline of the structure of the tax that is most appropriate to Ukrainian conditions.

10.2 Government structure and inter-governmental relations

10.2.1 Government structure

Local administration in Ukraine is regulated by a set of national acts, comprising the Budget Code (2001), the Law on Local Self-Government (1997), and the Law on Local State Administration (1999). These legislative acts create a basic legal framework for local government activity. As in many other transition countries, some secondary legal acts provide significant input into the legal environment within which local governments act, especially annual budget laws and regulations of the Ukrainian Cabinet of Ministers.

The Law on Local Self-Government provides a broad definition of the responsibilities of local governments on different tiers, defines their tasks in different spheres of public service delivery and declares the independence of local budgets.

The Law on Local State Administration sets the framework for local state administrations' activities and their interaction with local self-governments. These bodies represent the executive power at the respective territorial level and, being directly subordinated to the Presidential Office, have a wide range of responsibilities, ranging from managing the delivery of basic social services to preparing and executing regional (*oblast*) and district (*rayon*) budgets. The functional departments of local state administrations serve simultaneously as territorial departments of the respective functional ministries.

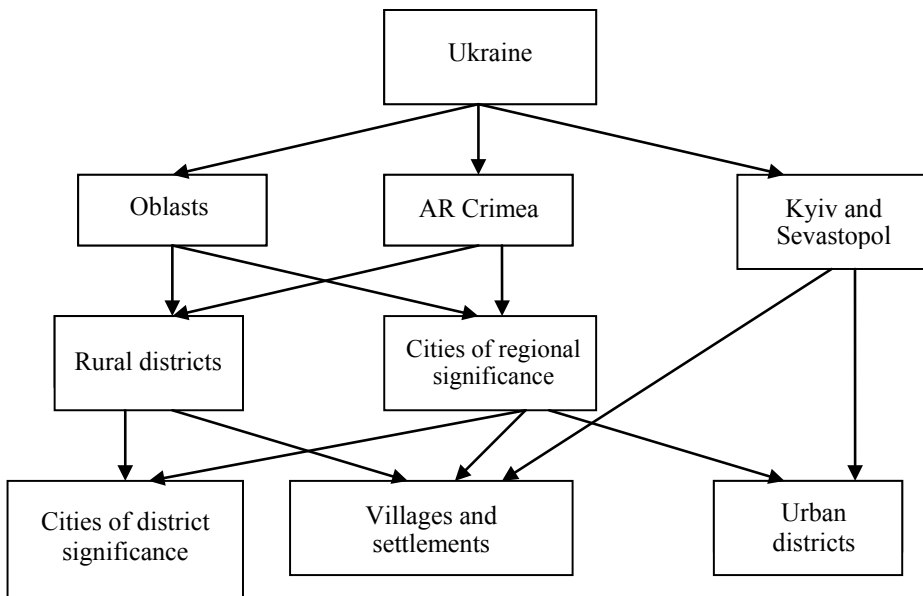
We can conclude that currently, Ukraine has two types of local authorities. First, there are local state administrations at the region (*oblast*) and district (*rayon*) levels. The heads of local state administrations are not elected, but appointed directly by the President of Ukraine, upon recommendation of the Cabinet of Minis-

ters. (In fact, this constitutional provision concerning recommendation is ignored by the President). The other ones are bodies of self-government at the *oblast*, *rayon*, and municipal levels. The elected councils of the *oblast* and *rayon* levels have no executive bodies which is why they are not in a position to run the subordinated budgetary institutions.

The elected councils in cities, villages and settlements form their own executive bodies so they can formally manage issues of local importance in some way.

The local authorities extend over jurisdictions which are based on the current administrative-territorial composition of Ukraine: one autonomous republic (Crimea). (Unlike the other territorial units at regional level, the Autonomous Republic of Crimea has some attributes of independent governance: its own Parliament, Cabinet of Ministers, constitution and legislation (which should not contradict the national one). But, in terms of public finance, its status is not much different from that one of the other units at the regional level); 26 *oblasts* (including two cities of national significance, Kyiv and Sevastopol), 490 rural *rayons*, 458 cities and towns (including 179 of oblast significance), 118 urban districts, 886 settlements and 28,540 villages (Державний комітет статистики України 2007). The relations amongst the different units of the public sector are depicted in Figure 10.1 below.

Figure 10.1
Administrative hierarchy of Ukrainian territorial units



This structure has not changed greatly since independence, but the fragmented structure of self-government bodies at the grass-root level (sub-district units) calls for changes in the administrative-territorial composition of the country, because most of them are not self-reliant from a financial point of view.

One of the problem issues experienced by the local government system in Ukraine is that the number of local communities, especially in rural areas, is quite large. But, at the same time, until now, most of them have not been in a position to execute their own rights granted by legislation: only about one-third of the total have even formed councils. The obsolete territorial structure has many inconsistencies. For example, some territorial units, such as large cities, administer not only urban districts, but also other units at the same territorial level – small cities, villages and settlements, which comprise, according to the Law on Self-Government, the self-governing communities, and even rural districts.

According to the current legislation, council members are elected by the community for a period of four years; the local voters simultaneously and directly elect the council and the mayor (head of the respective council).

Local governments at all levels are elected through direct election, based on the proportional system. This system was enacted in 2005 after the “Orange Revolution”, when the changes in election legislation were introduced. The lists of prospective council members are formed by political parties or election blocks. Before these changes were enacted there was a majority system, under which the voters voted, not for lists presented by political actors, but for individuals, some of whom could be non-party members.

As a result, the political composition of the local councils throughout Ukraine differs greatly because supporters of different political parties are distributed unevenly across regions. In southern and eastern regions, local councils are dominated by representatives of the Party of Regions, in western and central regions – BUT (Yulia Tymoshenko Bloc). So, we have a kind of political divide in local governments, as well as at the national level. The politicisation of local government activity, due to proportional elections, contributed little to solving the issues of local importance.

Despite these important features, the legislation did not fully eliminate the soviet legacy in public sector organisation. The local councils are called “*radas*” just like in the soviet time, but their functioning has really changed: local councils are now elected, not appointed, as they were under Soviet Union rule.

For a long time after independence, Ukrainian local finance was, in general, treated like a supplement to the state finance, so the central administration of fiscal flaws was commonplace. A new era began with the enactment of the Budget Code (2001) which substituted the old Law on Budget System (1995) and other linked acts. The Budget Code introduced new approaches to the budgetary process; it set-

tled budgetary issues on solid ground, minimising subjectivity and arbitrariness in fiscal issues; at last, the local governments received clearly-defined sources of revenue, together with a comprehensible definition of what they were responsible for.

In the course of reforms undertaken throughout the years of Ukrainian independence, the following changes in relations between the central government and local governments happened:

- local governments were recognised as a formally independent body of power, with assigned specific functions and fixed revenue sources;
- the hierarchical relations between levels of local government were eliminated;
- changes in the method of local budgeting occurred: a switch from the obsolete infrastructure-oriented to the revenue-oriented one based on formula; the reform was undertaken in several steps, the last one being in 2004, when the formula-based approach was applied to councils of sub-district level.

Nevertheless, local governments are still highly dependent on the state in all aspects of their activities: their accounts could only be held in the State Treasury, not in commercial banks; at the regional and district levels, the state administration run the budgets and public service delivery.

10.2.2 Inter-governmental fiscal relations

Due to the broad range of functions vested on local governments in Ukraine, the relative importance of local governments in the national economy is quite high. As one can see from Figure 10.2 below, the local government share in GDP fluctuated between 17.5 per cent (maximum registered for the year 1995) and 10.0 per cent (2000). Its fluctuations were not as significant as that of central government share, which peaked at 36.5 (1994) and dropped to 14.2 (1999).

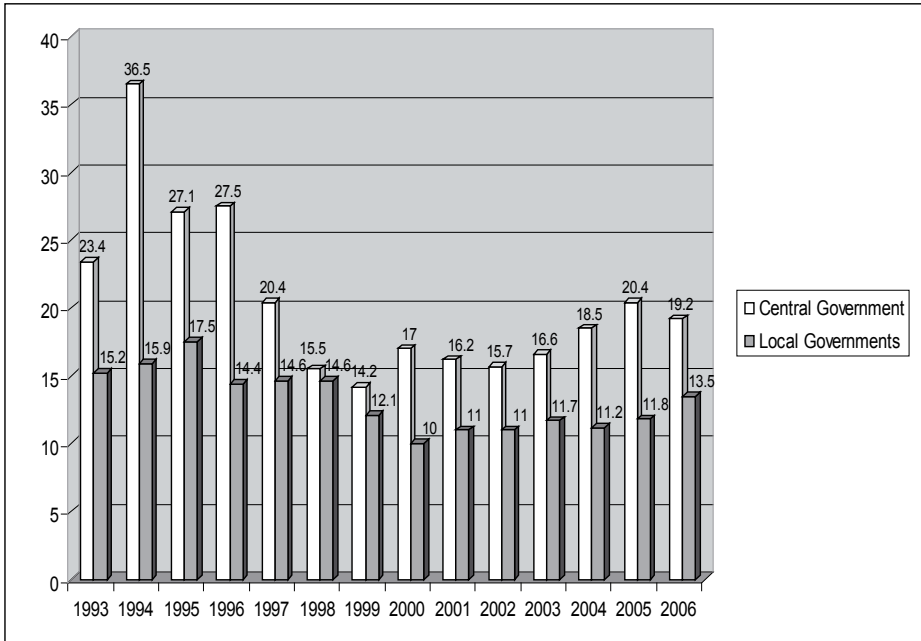
It is interesting to note that the shares of governmental levels move in the same direction, the only difference being that the local government share varies with a one-year lag.

The ups and downs in the public sector economic role could be explained by the institutional changes in the national economy. Mass privatisation in the period 1995–2000 contributed to a drop in the combined government share.

The data above demonstrate that the ratio between the central government and local government share has not changed much throughout the period of independence. After the adoption of the Budget Code in 2001, the local government share dropped; only in 2006 do we see that the local government share in expenditures demonstrated a trend towards growth. But, without taking into account the actual division of responsibilities and sources of revenue, we cannot say whether it really means decentralisation. Some experts express the opinion that the local government share increase observed in the years 2006 and 2007 has nothing in com-

mon with fiscal decentralisation because this increase was caused by growing social benefit payments to the population, funded through earmarked central government subventions (see Ганущак 2007).

Figure 10.2
Governmental shares in GDP, per cent (MoF 2000, 2007)



Source: Own calculations based on the Ukrainian Ministry of Finance data.

As concerns responsibilities, we have to admit that most public functions at the local level are performed by the local state administrations. The ultimate case when local self-government plays a significant role in public service delivery is the case of cities of national and oblast significance which have the rights of oblast or district authorities.

Until now, the fiscal autonomy of local government has remained quite constrained; their activities concentrate mainly on fulfilling centrally mandated tasks which are not funded fully. Their revenues devoted to these tasks are granted by the state and range from about 90 per cent to the total. It means that they are very limited in responding to local public service demands.

Local governments possess a very limited autonomy concerning revenues. Their autonomy concerning expenditures extends to re-shifting funds obtained through ceded taxes and transfers amongst different tasks. Our previous analysis

of the issue (Slukhai 2006) proved that this situation has not shown any improvement over time.

Analysis of local government revenue composition shows us that local governments in Ukraine rely heavily on the central government transfers. Table 10.1 below gives some insights concerning the degree of local discretion with regard to the most important revenue sources.

Table 10.1
Shares of some local revenues in total revenues (including transfers)
and respective degree of local discretion (2006)

Duty	Share in local total revenues	Discretion concerning:		
		Legislating	Tax-base setting	Tax-rate setting
Personal income tax	30.0	No	No	No
Enterprise Profit Tax	0.4	No	No	No
Motor vehicle tax	1.4	No	No	No
Land payments	4.1	No	No	Limited
Excise	0.1	No	No	No
Licence fees	0.7	No	No	No
Trade patents	1.0	No	No	No
Local taxes	0.8	Very limited	No	Limited
Fixed agricultural tax	0.2	No	No	No
Unified small business tax	1.8	No	No	Limited
Non-tax revenues	6.3	Partly	n/a	n/a
Capital gains	3.5	Yes	n/a	n/a
Targeted funds	1.9	Yes	n/a	n/a
Official transfers	45.0	None	n/a	n/a

Source: own calculation and assessment based on Міністерство фінансів України (2007).

There are only a few duties which could lend local governments some capacity in revenue-raising activities. To these belong local taxes (the list is set by legislation and includes 16 duties of different types, all with quite a limited possibility of setting tax rates) and the unified small business tax; in total, these deliver a meagre 2.6 per cent of total revenues for the aggregate sub-national sector in 2006.

As one can see from Table 10.2, the last decade has been characterised by the growing state fiscal support of local governments. Since 1999, the grant share in the state budget expenditures dedicated to local governments has almost doubled; the grant share in local government budgets soared from 18 per cent to 45 per cent.

Table 10.2
The share of transfers in central government expenditures
and local government revenues

	1999	2000	2001	2002	2003	2004	2005	2006
Local government transfer share in central government expenditures	13.2	12.4	17.8	19.9	20.9	20.9	20.6	24.9
Central government transfer share in local government revenues	18.0	23.5	28.8	31.2	34.2	42.5	43.5	45.0

Source: Own calculation based on Міністерство фінансів України (2000, 2004, 2007).

These facts signal that local governments in Ukraine are, in reality, not as self-reliant as could be suggested by the data on expenditure share. The real grade of decentralisation is quite low and tends to diminish.

This conclusion could be reinforced if we consider the composition of inter-governmental transfers received by the local governments.

Local governments in Ukraine are entitled to several types of inter-governmental transfers: (i) equalisation grants; (ii) donations for maintenance of local social infrastructure; (iii) subventions for fulfilling centrally mandated social tasks (mainly social benefits' payments for different groups of beneficiaries); (iv) earmarked subventions for investments; (v) compensations of lost revenue due to central government decisions.

The composition of the inter-governmental grants received is presented in Table 10.3. It shows that nowadays only two important components of the transfers are present: donations and earmarked subventions. The other non-transparent *ad hoc* transfers such as mutual settlements and budget loans are not in use.

The dominating grant form is the equalisation formula grant introduced by the Budget Code since 2002. Before its introduction, equalisation was performed through a combination of regionally differentiated sharing rates for some state levies and donations calculated as deficit grants.

Basically, the equalisation grant is calculated in the following way:

$$Gi = \alpha(\bar{E} - \bar{R}),$$

Where the expression in parentheses represents the difference between standardised expenditures and revenues (both of them calculated by use of formula sets), α is the equalisation coefficient.

Despite the fact that this formula approach is better than the previously employed *ad hoc* deficit grant approach, there is a general consensus amongst econo-

mists concerning disincentives for tax revenue collection generated by the current equalisation system (see e.g. Луїна (2006); Тарангул (2003) for a more detailed discussion of this issue).

Table 10.3
Composition of inter-governmental transfer payments, per cent

Year	Mutual settlements	Donations	Budget loans	Subventions
1991	34.8	55.9	9.2	–
1992	48.6	0.1	51.4	–
1993	89.8	–	10.2	–
1994	36.5	58.7	4.7	–
1995	51.7	40.3	8.0	–
1996	33.8	60.6	5.6	–
1997	18.0	81.9	0.05	–
1998	0.0	99.7	0.3	–
1999	27.4	70.0	2.4	0.2
2000	0.2	96.5	1.9	2.4
2001	0.0	58.5	0.4	41.1
2002	0.02	52.8	–	47.2
2003	0.3	55.3	–	44.5
2004	1.0	55.4	–	43.6
2005	–	61.9	–	38.1
2006	–	53.1	–	46.9

Source: Own calculations based on the Ukrainian Ministry of Finance data.

The trend in revenue composition calls for reform because the current composition cannot ensure sufficient revenue adequacy, even for funding delegated functions. That is why it is very important to find ways in which to expand the local revenue base.

The prospective candidates to be included in local levies are taxes on land and property, and local motor vehicle tax. The tax on land is still a national levy ceded to local governments; the motor vehicle tax is a national levy assigned to sub-national budgets. In assigning these taxes fully to local governments, the centre could retain control by defining the tax basis and marginal rates of taxation in legislation.

Concerning property taxation, the need to introduce it is urgent. No doubt this tax should be implemented and assigned to the local authorities, on the one hand. On the other hand, it will make the distribution in society fairer by putting the better-off social groups (namely those that accumulate very valuable property objects) into a position of making more contributions to funding public outlays.

10.3 Property taxation in Ukraine: It is time to start

Introducing property taxation is a big challenge for Ukraine since in this issue we are far behind most transition nations which have introduced property taxation in some form.

Such a tax has several advantages from an economic point of view. First, the tax base is obvious and immobile, which secures quite an observable and stable revenue source for the local government on whose territory the property object is located. Second, this tax creates a potentially fairer distribution and provides the opportunity to shift the burden of local expenditure to those who are richer. The latter is hot on the agenda in Ukraine, where the income gap between the well-off minority and the majority of the population is rapidly growing.

At the same time, this tax is associated with some problems which do not make its administration an easy task. First, it needs well-trained staff and careful administration; that is why it is connected with quite high administrative costs. Second, its sophisticated structure could generate significant space for administrative misbehaviour. Third, in the case of under-developed markets, it is difficult to find an appropriate tax base. Finally, it is politically very sensitive.

Of course, such a tax intervenes with the economic interests of different groups of the population, especially of the richest, who are not interested in sharing their fortune with other people.

Because of this, property taxation in Ukraine is still under construction; there is only one tax which could be judged as one closely related to property taxation and that is the land tax. The land tax still does not play a significant role in the local budgets, generating only 4 per cent of their revenues and not being an elastic revenue source.

Imposing a local property tax is currently a weighty point under discussion. This problem has been an object of intense discussions for many years. There are many issues for which no reasonable solutions have been found: (i) who are the taxpayers (legal persons or individuals)?; (ii) what are the tax objects (buildings, inventories or luxuries in possession)?; (iii) how to assess the value of property by the given under-developed market relations; (iv) the rates to be implemented and (v) means of social protection of disadvantaged households. The intense draft legislation (there were several variants of the law on property taxation drafted) did not have any feasible result.

Currently, several options concerning property taxation are being discussed in Parliament committees. Table 10.4 below summarises selected approaches out of a number of those represented in some legislation drafts.

As one can see from this Table, there are quite serious discrepancies in the approaches of the legislators, which reflect their ideological biases. For example,

Table 10.4
Comparison of the existing legislation drafts on property taxation

Author of a draft	Pavlovsky (BUT) (draft # 2113)	Melnychuk, Socialist Party (draft # 3066)	Simonenko, Alexeev, Communist Party (draft # 3359-1)	Stretovich, NSNU (draft # 3359-2)	Katerynychuk, NSNU/Narodna Samooborona, Tax Code (draft # 3405)
Tax payers	Legal and physical persons	Physical persons	Legal and physical persons	Physical persons	Legal persons
Tax object	Buildings, offices, private apartments	Buildings	Land plots, buildings, private apartments	Buildings	Land plots and buildings
Tax base	Facility size	Property value (estimated by state register office or local state tax administration)	Property value or facility size	Market valuation	Market or normative valuation of land plots; balance sheet value for buildings
Rates	Percentage to minimum subsistence level related to the facility size schedule (from 0.5 to 5 per cent)	1 per cent to the valuation	For land plots in per cent to value differentiated due to value, location and purpose (directly not specified); for buildings in UAH per sq m ranging from 5 to 100 UAH due to size schedule	From 0.05 per cent up to 1 per cent of market value due to valuation schedule	In per cent to 1 ha valuation for land plots depending on the purpose and type of administrative unit; 1 per cent to base for buildings

10. Property Tax in Ukraine: To Be, or not to Be – Is this the Question?

Local government rate discretion	No	No	No	Yes, basing on schedule brackets	Yes for taxing land plots due to brackets; no for buildings
Tax exclusions and reductions	Private homes and apartments below 300 sq m as well as business facilities below 100 sq m are not taxable	Property valued below \$70,000 is not taxable; disabled people, war and labour vets, single elderly people, Chernobyl liquidators are excluded from taxation	Tenants of public property excluded; for physical persons, property up to 100 sq m excluded; the following categories are excluded: pensioners, war and labour vets, disabled, Chernobyl liquidators etc (8 categories in total)	Disabled people, war and labour vets, Chernobyl liquidators are excluded from taxation. Local governments could impose additional reductions	Land plots and buildings in possession of the state and territorial communities are excluded; disabled, families with more than 3 under-age children, pensioners, war vets, Chernobyl liquidators are excluded if they possess a land plot based on set by the Land Code; 200 sq m of private homes are deducted from the tax base
Tax administration	State tax administration	State tax administration	State tax administration	State tax administration	State tax administration
Budget to which the proceeds are assigned	Local	State special fund for compensation of lost soviet bank deposits	State and local budgets (not specified explicitly)	Local	Local

drafts submitted by left-wing politicians (representatives of the Socialist and Communist parties) are biased, so as to make the tax into an instrument of achieving a more even distribution of wealth, proposing many exclusions from taxation for different categories of payers. They also tend to assign this tax to the central government. There is some logic to this approach, but it leaves open the question of strengthening local government finance despite the fact that both parties often use decentralisation rhetoric.

The most promising approach from the local government perspective is the one represented by a draft Tax Code where property tax is considered as a major local tax with some local rate setting discretion concerning land plot taxation. But it also contains some problematic issues that must be resolved in some way:

- (1) there is no distinction made between commercial and non-commercial property. It looks like private homes could be taxed differently in comparison to commercial property;
- (2) one per cent tax rate for value of buildings without differentiation, based on purpose, must be frustrating for some types of non-commercial activity;
- (3) 200 sq m private homes excluded from tax base looks too generous for Ukrainian realities, where most private apartments and homes are far below this limit;
- (4) there is a problem with the market valuation of land and property because there is no official agricultural land market in Ukraine and the markets for private apartments and homes are very fragmented and not complete;
- (5) no local self-government efforts are foreseen in collecting property taxes.

That is why we think that even such comprehensive approaches to property taxation, as presented in the draft Tax Code, must be improved and brought closer to the current realities of the Ukrainian economy.

While imposing local taxation on property we must take into account the many problems which make this act very difficult to manage and put some constraints on it.

Technical. There are problems with having complete information on a property object. Land registers and buildings' registers in many locations are not even computerised because local authorities in the villages and small cities do not have computers.

Administrative. There should be a sufficient administrative staff of trained professionals to assess the property.

Economical. Markets for property assets are very incomplete and could not give true signals about property valuation. There is no official market for agricultural plots because of the legal ban on land trade; in many locations the land is still not apportioned among rural dwellers.

Social. Most of the Ukrainian population lives below civilised living standards; that is why making them pay more taxes looks unfair.

Psychological. There was no property taxation in Ukraine before, so people are not accustomed to paying this kind of tax.

In any case, imposing such a tax requires lots of preparatory work and a step-by-step introduction. At present, we can only evaluate whether it is possible to introduce it just now.

The most important question is whether or not we could use a market valuation approach for property assessment. In our opinion, this is a very weak point in the proposal discussed above.

More suitable and less costly would be a simplified approach: flat rate per sq m of buildings adjusted for different factors such as location, age and type of building, purpose etc. Such an approach is well used in many CEE countries. For example, in Poland, this method grants local self-governments of basic level (*gminas*) 15 per cent of their revenues (45 per cent of own revenues) mobilising 1 per cent of GDP. A similar approach is being used in the Slovak Republic and the Czech Republic.

10.4 Practical issues in property taxation

While introducing a new tax, some questions must be asked in order to justify this action. Concerning property tax, the following questions are topical: (a) whether we have sufficient information on tax objects and (b) whether it really could generate significant revenues for local governments.

As a field research performed by CyΦATP (2006) in the Ivano-Frankivsk region has shown, there is some optimism concerning both issues mentioned above.

In the regions, some information has been collected concerning households' property. In the urban locations, the Bureaux of Technical Inventory hold information on the location and size of privatised homes and apartments which extends from 30 to 80 per cent of households, as well as their initial value (market price). Housing departments have complete information on all immobile property in the location. In rural areas, the local governments keep information on local households, their private homes and land plots.

The problem is that this data is still incomplete (especially concerning commercial property) and is stored mostly on paper.

Nevertheless, even with such incomplete information, only the hypothetical taxation of private homes and apartments performed at the flat rate per sq m taken as one-tenth of that employed in Poland (0.1 UAH per sq m of dwelling space

per annum and 2.9 UAH per sq m for commercial property objects¹⁾ brought some promising results: in some districts this tax could yield, on average, up to 25 per cent and even more (in some locations 70 per cent!) of current revenues without grants.

This demonstrates that potentially, property taxation even in such a simplified and non-onerous form (e.g. an owner of the 100 sq m large flat would pay 10 UAH annually whilst a kilogram of beef costs 40–50 UAH) could be quite an important source of local revenues and constitute some kind of local fiscal autonomy in case the proceeds will accrue the local budget. Even if the mode of lump sum tax per dwelling is chosen, as is the case in Hungary, this will swell local budgets.

The introduction of the property tax assigned to sub-national budgets will help urban and neighbouring communities in the first line. The large cities of national and oblast significance will receive a generous source of revenues because valuable property objects are concentrated in the cities and in suburban localities. But, the rural communities will also benefit greatly from this fiscal innovation.

This conclusion is based on the miserable state of their budgets. In case of property taxation they could receive quite large revenues from taxing private dwellings and, according to the report cited above, this could, in some cases, double their revenues. Of course, the final result depends on the concentration of dwellings; bigger rural settlements will be better-off in comparison to the smaller ones with respect to budgetary proceeds. To endow the latter with more revenue sources, one should look for some other options. One option is changing the land tax structure after the land market is launched.

Summarising the above facts, we could argue that the introduction of the property tax in Ukraine will really enhance local revenue sources and make local governments fiscally more independent. Technically, it is possible even now, within a short period of time, to make this tax work. On the other hand, the uneven concentration of property objects would widen the gap in territory-related fiscal endowment, which will call for an improvement in fiscal equalisation procedures, now extending only over ceded revenues and delegated functions.

Consequently, the relevant legislation may be adopted within a short time, followed by the introduction of the tax as early as 2009. We opt for the simplest form of tax (lump sum or flat rate) with some adjusting coefficients to begin with. Most socially motivated exclusions must be omitted (or radically reduced) in order to make people accustomed to paying property taxes and to avoid the danger of massive fraud such as registering property with a category of payers exempt from taxation (retirees in the first line). After some time (3 years at least), a more sophisticated approach, possibly one based on market evaluation, could be applied.

1 We agree that such a difference in rates existing in Poland is economically not well motivated (see Brzeski 2008 for an extensive discussion of this issue); the rates here are applied only to illustrate that property taxation in Ukraine does have a significant revenue potential.

10.5 Conclusion

Unlike many other transition countries, Ukraine has no explicit property taxation at either the local or the national level. Instead, there are some property quasi-taxes such as the land tax, the motor vehicle tax, and natural resource utilisation levies which are assigned to the local budgets. The revenue capacity and local rate-setting discretion concerning these levies is very limited.

The need for introducing the local property tax is based on the fact that current local taxes are far from satisfactory for financing local governments' own expenditures with a trend of relatively diminishing in importance.

On the one hand, there is no doubt that this tax should be implemented and assigned to the local authorities. On the other hand, it will make the distribution in society fairer by pushing the better-off social groups (they accumulate very valuable property objects) into the position of making more sizeable contributions to funding public outlays.

Under the current conditions, with markets incomplete and local government not efficiently institutionalised, the property tax could not have a sophisticated structure. It is argued that such a tax is to be introduced in its simplest form, with a lump sum or flat rate. Even with low rates, this tax could do much to improve the local fiscal capacity of local communities in urban and rural areas alike.

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11. Property Tax and Local Finances in Ukraine

Artem Rudyck and Iryna Scherbyna

11.1 Introduction

The issue of strengthening the financial basis of local budgets is one of the most urgent in Ukraine. Prosperous communities will make the whole state prosperous.

Presently, the lion's share of local budget revenues falls on inter-budgetary transfers and national taxes delegated to the communities to carry out functions of the national state. That makes local self-government very much dependant on Central Government and prevents launching a fiscal decentralisation process in Ukraine.

Property tax as such is not among the taxes and fees currently levied in the country, although it is named in the list of taxes in the Law on *Taxation System in Ukraine*. For a long time, all attempts to pass and implement a legislation defining principles and requirements to immovable property taxation have proved to be futile, regardless of the fact that a dozen draft laws on the issue were developed and proposed for the Ukrainian Parliament's consideration.

However, it does not mean that any form of property is not taxed in Ukraine. Property taxes are levied in the form of land tax and vehicle tax. This article will deal with the immovable property taxation in Ukraine, which is to say that it will focus on Ukrainian land tax, its current role as a revenue source for local budgets, structural weaknesses, and, finally, some solutions for improving the situation with the tax will be suggested.

The first part of the article provides an insight into an institutional framework for inter-governmental fiscal relations. Then, the land tax role in local finances is analysed from the point of view of its role in the general tax system of Ukraine and its relative importance for local budgets. This part is followed by a description of the administrative procedures, loopholes in legislation which are used for minimising tax liabilities, and finally, some recommendations on the improvement of the tax will be suggested.

11.2 Inter-governmental relations in Ukraine

11.2.1 Inter-governmental relations

The first step in the creation of autonomous local budgets in Ukraine was made when Ukraine adhered to the European Charter for local Self-Government on 6 November 1996. According to Clause 9 of the Charter, local authorities have the right to own adequate resources, which they can use with discretion within the

prescribed responsibilities. The volume of own resources was stipulated to equal the local authorities' functions envisaged by the Constitution and laws.

The period of 2000–2002 was a time for drastic changes in the system of local and regional governments in Ukraine. The Budget Code of Ukraine, passed by Verkhovna Rada in June 2001, began the process of transformation of inter-budgetary relations. It decreased the financial dependency of local budgets upon state bodies at the upper levels and abandoned the rigid vertical subordination which was the characteristic of inter-budgetary relations, even after the local self-government system was introduced after the soviet period was over.

The budget system, set up by the Budget Code, consists of the state and local budgets and envisages direct relations with 686 local budgets (171 budgets of oblast level cities, 488 budgets of rayons, and 24 budgets of oblasts, cities of Kyiv and Sebastopol). Issues of budget autonomy of towns, villages and settlements were partially resolved in a separate Law on inter-budgetary relations between budgets of rayons and towns, villages and settlements (of 1 July 2004).

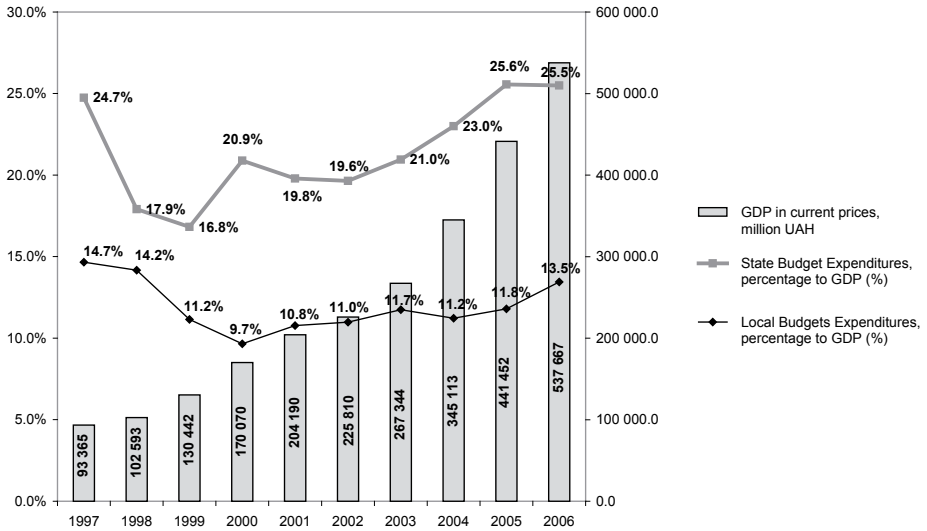
The importance of budget reform goes beyond the issue of financial dependency. Only then could local governments be fully responsible for the communities, when there are stable local revenue sources and if the governments can foresee the amount of budget transfer for financing delegated powers.

The Budget Code became a crucial element of the financial system of Ukraine as long as it:

1. outlined the underlining principles of the budget system of Ukraine;
2. determined the budget process stages;
3. clearly delineated the functions of all participants of the budget process and stipulated all the basic budget procedures;
4. assigned on a permanent basis revenues and expenditures of different levels of the budget system;
5. envisaged a formula-based approach of inter-budgetary transfers' calculation;
6. introduced a basis for budget control implementation;
7. introduced a uniform budget terminology.

The delineation of functions and assigning of the revenues and expenditures sources stabilised the share of local budgets' expenditures at a certain level and even ensured a slow growth in 2006 (see Figure 11.1).

Figure 11.1
GDP in current prices and state and local budgets expenditures
as a percentage of GDP, 1997–2006



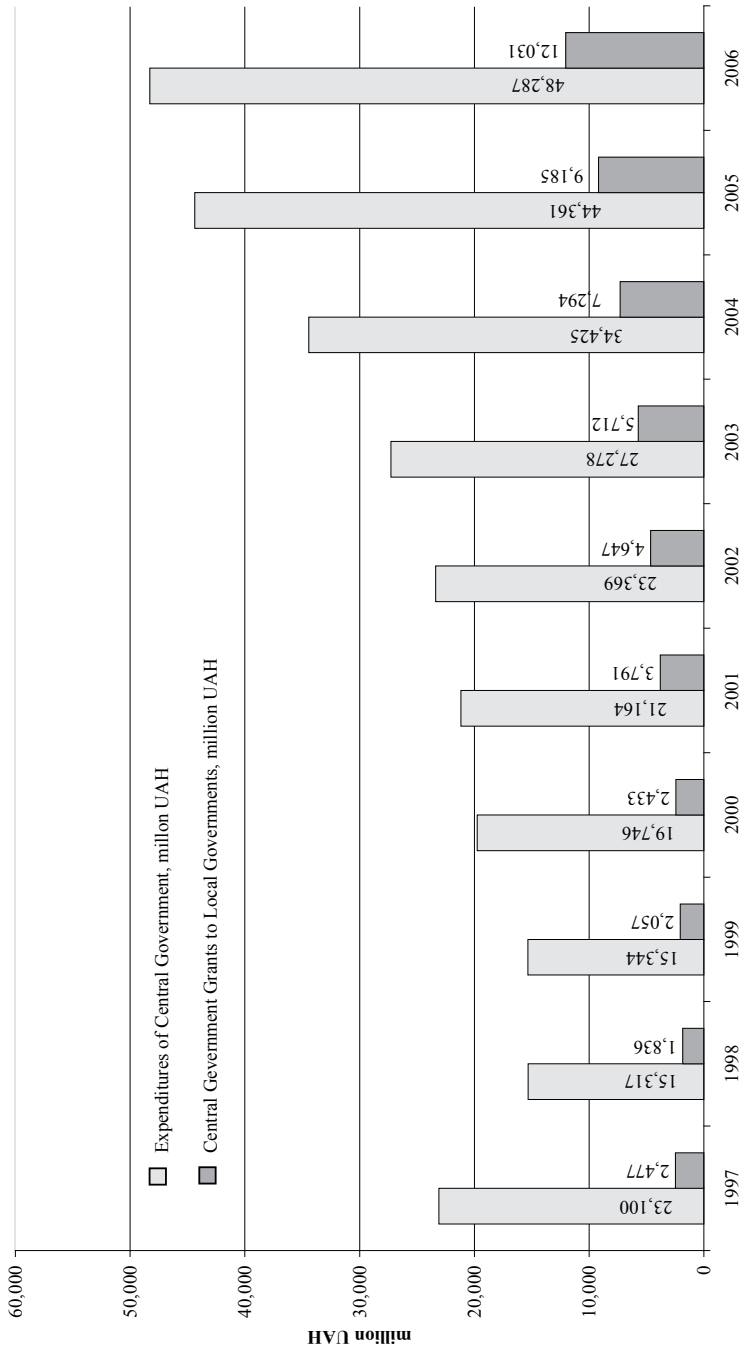
Source: Ministry of Finance

Despite the fact that the Budget Code of Ukraine has permanently assigned certain sources of revenues for local budgets, there is still no clear justification of the economic essence of the decentralisation level needed for Ukraine. Though the Budget Code put the number of budget procedures in order, the level of fiscal decentralisation remains an issue of the Ukrainian budget policy. In particular, the share of inter-budgetary transfers of the state budget expenditures is constantly growing and reached 20 per cent in 2006. This trend is shown in Figure 11.2.

The level of decentralisation could be measured by such an indicator as the GDP share redistributed via local budgets. The dynamics of this indicator in the last seven years is shown in Figure 11.3.

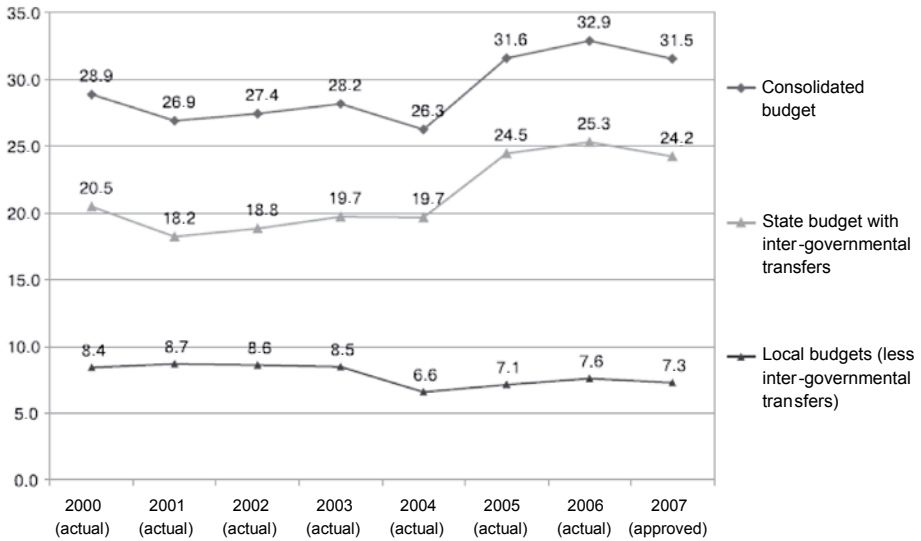
The share of GDP redistribution via local budgets stabilised at an average level of 7.8 per cent during 2000–2007; even compared to the early 90s, when Ukraine was building its independent budgeting system, this share decreased from 11.5 per cent in 1992 to 7.3 per cent in 2007, which equals about a quarter of the GDP share redistributed through the consolidated budget of Ukraine today (see The Commentary to the Budget Code of Ukraine).

Figure 11.2
Expenditures of state budget and inter-budgetary transfers
in real terms in 1997–2006



Source: Ministry of Finance

Figure 11.3
Share of GDP Redistribution via Consolidated, State,
and Local Budgets of Ukraine in 2000–2007

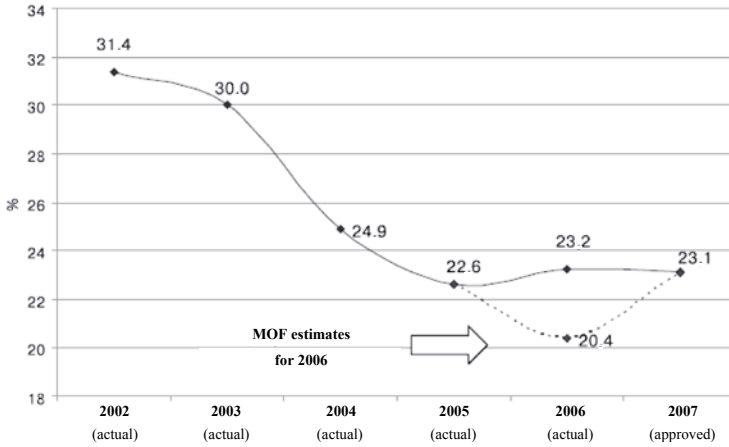


Source: Ministry of Finance

During the last seven years, the share of local budget revenues (less inter-governmental transfers) in the consolidated budget structure was also diminishing from 31.4 per cent in 2002 to 23.1 per cent in 2007 (when calculating the State budget and local budget revenues for both the General Fund and Special Fund). The respective indicators are shown in Figure 11.4.

The growth in the amount of transfers from the State budget points to a growing dependence of local budgets on the State budget. Where the share of transfers in the local budget revenues amounted to 31.2 per cent in 2002, 34.2 per cent in 2003, 42.5 per cent in 2004, and 43.5 per cent in 2005, it further increased to 46.1 per cent in 2006.

Figure 11.4
The Share of Local Budget Revenues in the Consolidated Budget of Ukraine in 2002–2007



Source: Ministry of Finance

11.3 Land tax as revenue: execution of local budget revenues in 2006

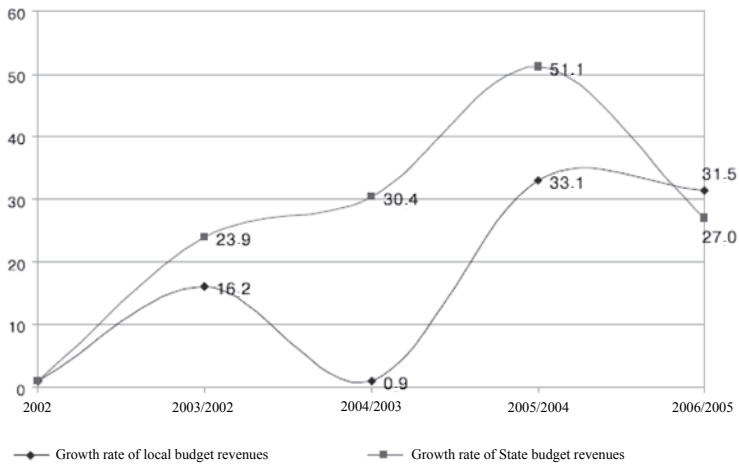
Compared to 2005 indicators, the nominal local budget revenues (both the General and Special fund combined) increased in 2006 by UAH 9,544.2 million or 31.5 per cent. The execution of local budget revenues continues the positive trends of previous years. The rate of growth of local budget revenues in 2006 is nearly identical to that of 2005. This indicator equalled 33.1 per cent in 2006 year on year (35.1 per cent in 2005 vs. 2004). It is the first time in 2006, after enactment of the Budget Code that the growth rate of local budget revenues exceeded that of State budget revenues. (see Figure 11.5).

11.3.1 Structure of local budget revenues and the place of the land tax in it

In the reporting period, the structure of local budget revenues was as follows:

- tax revenues amounted to 77.6 per cent of all local budget revenues (without inter-governmental transfers);
- non-tax revenues amounted to 12 per cent of all local budget revenues;
- revenues from capital transactions amounted to 6.7 per cent;
- revenues of targeted funds amounted to 3.7 per cent.

Figure 11.5
Dynamics of State Budget and Local Budget Revenues in 2002–2006



Source: Ministry of Finance

Compared to the same period of 2005, the structure of local budget revenues largely remained unchanged. A detailed structure of tax revenues in the reporting period is shown in Figure 11.6.

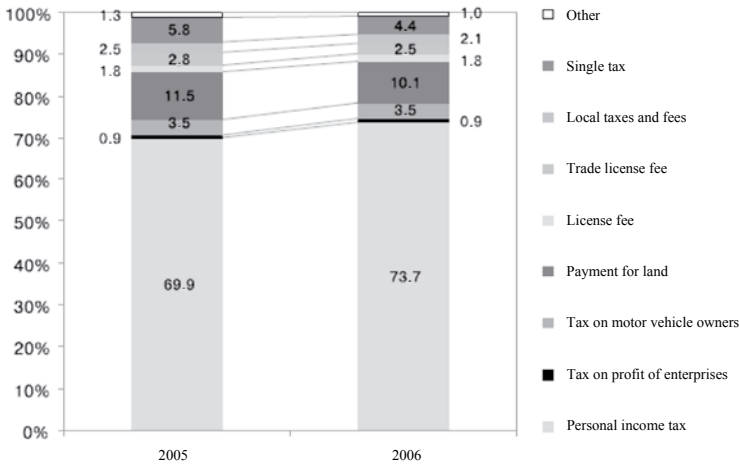
The tax revenues of local budgets amounted to UAH 30,931.6 million in 2006, which is UAH 7,342.8 million or 31.1 per cent more than in the respective period of the last year. These revenues mainly increased due to growth in revenues from the following sources:

- personal income tax revenues growing by UAH 6,304.6 million or 38.2 per cent;
- payment for land by UAH 404.2 million or 14.9 per cent; and
- tax on owners of motor vehicles and other self-propelled machines and mechanisms growing by UAH 251.5 million or 30.2 per cent.

The non-tax revenues of local budgets amounted to UAH 4,790.6 million in 2006, which is UAH 1,249 million or 35.3 per cent more than in 2005.

The revenues from capital transactions amounted to UAH 2,663.6 million in the reporting period, which is UAH 584.8 million or 28.1 per cent more than in 2005. The receipts of targeted funds increased by UAH 367.6 million or 33.2 per cent compared to 2005.

Figure 11.6
Structure of Tax Revenues of Local Budgets in 2005–2006



Source: Ministry of Finance

The land payment remains the second most important source of local budget revenues. In 2006, this type of revenue amounted to UAH 3,122.3 million, which is UAH 404.2 million or 14.9 per cent more than in the respective period of 2005. The plans approved by local councils for this type of revenue were exceeded by UAH 73.9 million or 2.4 per cent.

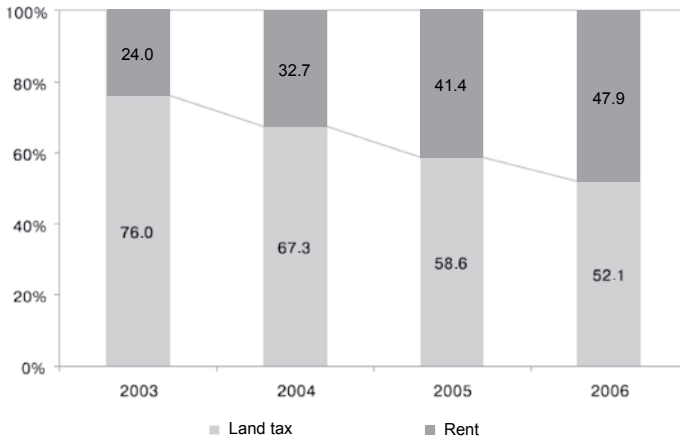
Land tax (on legal and physical persons) accounts for the largest share in the structure of the payment for land. This source generated UAH 1,628.2 million in the reporting period, which makes up 52.1 per cent of the total revenues from the payment for land.

The revenues from rent (paid by legal and physical persons) amounted to UAH 1,494.1 million or 47.9 per cent of the total revenues from the payment for land.

As seen from Figure 1.7, the local budget rent revenues started to grow in 2004, with their share in the revenues from the payment for land growing accordingly. This was due to improved administration of these revenues, improved records for land tenants, as well as an inventory of landowners in the land cadastre.

Higher revenues from the payment for land would be further supported by a revision of rent rates, completion of the processes of monetary land assessment, etc. The experience of EU countries in this issue, especially in view of the need for adapting the Ukrainian tax laws to EU legislation, could be extremely useful for Ukraine.

Figure 11.7
Structure of Payment for Land in 2003–2006



Source: Ministry of Finance

As of 1 January 2007, the tax debt (arrears in taxes and fees, which are re-mitted into local budgets) amounted to UAH 613.9 million, which is UAH 31.4 million or 7.9 per cent less than in 2005. The arrears decreased by UAH 41.8 million (36.6%) for the Special Fund and increased by UAH 10.5 million (2%) for the General Fund.

The arrears mostly increased for the tax on profit of municipal enterprises by UAH 58.2 million (74.4%) and personal income tax by UAH 12 million (11.5%). The arrears decreased for the fixed agricultural tax by UAH 26.6 million (38.9%) and payment for land by UAH 34.7 million (14.5%).

11.3.2 Prospects for the introduction of immovable property tax in Ukraine

Presently, immovable property tax is not levied in Ukraine, though such a tax is foreseen in the Law on Taxation System in Ukraine. For a long time, all attempts to pass and implement a legislation defining principles and requirements to immovable property tax administering have proved to be futile, although a dozen draft laws were developed and proposed for Verkhovna Rada's consideration.

Lack of this tax explains the deficiency of local budgets funds, which makes them very much dependant on transfers from the state budget, which means dependency of local government upon the Central government and deprives local self-government of the funds needed for carrying out investment projects at local level.

The basic reason which prevents implementation of the tax is a lack of an efficient system of immovable property assessment. Besides, the introduction of the tax is held back due to the reluctance of certain members of parliament, who are owners of elite real estate in Ukraine, to tax themselves. The absence of registries of immovable property and the owners is yet another impediment for the tax's introduction.

This situation has been ongoing for more than 10 years, and even if the immovable property tax in the form of a tax on buildings and constructions is introduced, it seems it will be defective from the very beginning due to its structural imperfections. For instance, the intention to impose the tax on the prosperous section of the population will lead to a concentration of tax revenues in the budgets of well-to-do localities, while under-developed territories will suffer from a lack of financial resources further on.

Despite the above mentioned difficulties, property taxes may become a reliable source of local budget revenues, provided the existing property taxes are reformed. In other words, property tax may be implemented in the form of a land tax, which is currently levied in Ukraine. It is worth mentioning that the taxation of a land parcel without improvements is not a novelty in the fiscal practice in other countries. This variant of property taxation is implemented in such countries as Australia, New Zealand, the South-African Republic, Taiwan etc.

For Ukraine, such a variant of immovable property taxation is more advantageous in comparison with the introduction of a new tax, for several reasons. First of all, there is a land assessment system in place, which is based on existing registries of land taxpayers, as well as of land parcels (cadastre). Land pecuniary assessment was conducted in all cities with a population exceeding 100 thousand inhabitants.

However, land tax was introduced at the beginning of 90s, almost immediately after Ukrainian independence. Today, a number of provisions of the legislation that regulates land tax levying proved to be ineffective and obsolete.

Yet, the land tax has been administered in Ukraine for 15 years and taxpayers are used to paying the tax and tax authorities have learned how to collect it. Although today, tax registries (data bases) of land parcels and land taxpayers have been created and put to work, albeit the problem of the comprehensiveness of the data contained in the registries persists. Nonetheless, these databases are used for the calculation of land tax liabilities.

For the land tax to become a real replacement for the regular property tax, the legislation stipulating its levying should be reformed and brought into line with the requirements of the time. The current system of land taxation in Ukraine is proposed to be reformed in the following ways: 1) improvement of administrative procedures and liquidation of the existing legislative loopholes; 2) bringing the land assessment system in line with the assessment standards used in the world, in par-

ticular, the introduction of an assessment system based on the market value of land parcels; 3) endowing local authorities with the power to establish land tax rates and grant tax privileges; and 4) imposing tax on lands with residential buildings and constructions. Let us consider these issues in more detail.

Improvement of administrative procedures and liquidation of the existing legislative loopholes: Current legislation provides that the only basis for land tax calculation is state land cadastre data (Land Tax Law, Clause 13). Taking into account the fact that problems with the comprehensiveness of data of the state land cadastre still remain unresolved, restricting the basis for land tax accrual seems unjustified. Thus, big parcels of land may fall out of the scope of land tax, in particular those land parcels that are occupied illegally or used without documents attesting to the right to own or use them. Taxation of land may be distorted in those cases where parcels are used not according to the functional earmarking. In fact, today, there are no legal grounds to tax such categories of land.

The problem could be resolved if current legislation is amended to provide for land tax calculation on the basis of tax returns data, along with data from the state land cadastre. In order to allow tax authorities to apply such a tool as a desk audit, legislation should prescribe the design of the land tax return form to be able to capture data of normative land assessment, including land parcel location, its area in general and area of each of its parts in case they are used for different purposes, functional use of the land parcel, as well as land parcel value.

If sufficient data for the correct calculation of tax liabilities cannot be found, either in the state land cadastre, or obtained from tax returns, tax authorities should have the right to use alternative sources of information, such as notary offices, banks, bureaux of technical inventory, real estate companies, registries of property and rights for property objects, data of state land agency examination reports, as well as local authorities' decisions concerning planning of land use.

In the case of unwarranted occupation of a parcel of land and untimely reversion of temporarily occupied parcels of land, the basis for tax calculation should be data from the examination reports or administrative protocols drawn by the state land agency.

Current land legislation does not define clearly the moment when liability to accrue and pay land tax arises. In particular, this happens when right of ownership to a parcel of land is transferred under civil contracts. Current legislation stipulates that landowners and land users should pay land tax beginning on the day when the right to own or use the parcel of land arises. And, according to Clause 125 of the Land Code of Ukraine, such a right arises only after the owner receives a document attesting the right to own the parcel of land and after the document is registered in the land cadastre. Consequently, if the actual owner of a parcel of land fails to receive the document attesting to his right to the land parcel, the liability to pay

land tax does not arise. It is worth noting that the absence of such a document does not prevent the owner using the parcel, because he may receive the document at any time when he needs it (sale, donation, inheritance etc.), by presenting his civil contract (say, the land parcel purchase contract) to the local body in charge of land use. And there is no responsibility foreseen in the law for not having on hand such a document.

In order to resolve this problem and for taxation purposes, the moment when land tax liabilities arise should be linked to the moment when the appropriate civil contract is concluded. Another possible change in land legislation aimed at the improvement of the situation, could be imposing an obligation on entities, which calculate land tax liabilities on their own (mostly, these are legal entities), to obtain documents attesting to the right of ownership of a land parcel before or at the moment of concluding a legal contract on a building or its part purchase, exchange, donation, or transfer of property object into non-residential premises.

A stand-alone problem in Ukraine is the taxation of underground commercial space. Presently, commercial activity in underground premises can be conducted without being taxed by any type of property taxes. Such a situation leads to a distortion of business activity conditions and puts business entities into a different commercial situation. For instance, a café or a restaurant situated on the ground floor of a building is supposed to pay land tax, while the same restaurant located in an underground trade centre is not liable to any property or resource tax at all.

Several variants to resolve the problem of taxing commercial premises under land surface were analysed. Taking into account that immovable property in Ukraine is taxed in the form of land tax only, the most effective way of bringing underground space into the scope of property taxation is to treat such premises as land tax objects.

If passed, these legislative amendments will improve the procedures of land tax administration, eliminate several loopholes that are used to minimise or evade tax liabilities, and bring the land assessment system in line with the assessment standards used in the world.

The taxation base of land tax is capital rental income, calculated according to the methods of normative pecuniary assessment. Normative pecuniary assessment of land parcels is the assessment of land parcel value using a number of pre-set norms. These norms are based on some economic indicators and are intended to take into account rental income and the term of its capitalisation. The assessment is then adjusted by coefficients of functional use of the land parcel and its location. However, the market value of land parcels is not taken into consideration when applying such a method of assessment. Normative assessment of land may be initiated only by the respective self-government body and financed wholly by it. Normative assessment is conducted every 5–7 years.

Still, there are localities, where normative assessment of land has not been conducted. For the purposes of calculation of land tax liabilities for such land, the law envisages “average tax rates”, which are a pre-set amount of tax per square metre. These “average tax rates” are within a range of 0.9 to 38.6 US dollars per square metre.

In spite of the moratorium on agricultural land sale that was introduced in Ukraine, the land market is formed and operational. In particular, it concerns the residential land market in and around large cities, oblast centres and resort areas. Over the last years, investment in real estate, and in particular in land parcels, was and still is one of the most profitable types of investment. That is why the land market in Ukraine is very dynamic and quickly developing. A lack of fiscal factors on market development is one the reasons for profiteering tendencies and corruption in local self-government bodies. At the same time, the existing system of normative assessment of land parcels cannot react adequately to the changes that take place in the land market, and that is why it has to be reformed by including elements of market value assessment in it.

Taking that into account, land assessment can be improved if a new assessment method based on market value, which is mass land assessment, is introduced, together with the existing normative land assessment.

Mass pecuniary assessment of land parcels is the probable sale price of a land unit in the open market determined by means of comparing sale prices for a number of similar land parcels within a defined territory (tract of similar land parcels). Mass assessment of land parcels can be conducted, provided the land market is formed within a given tract of similar land parcels and the responsible municipality passed a decision to conduct such an assessment.

Taking into account that there is no continuous land market (in particular, due to the moratorium on the sale of agricultural lands), land assessment, on the basis of market factors, can be conducted selectively within areas with a functioning land market. Land market within the tract of similar land parcels can be considered functioning if, during the last 3 years (36 calendar months) subsequent to the date of the assessment, the transfer of title of ownership for at least 10 per cent of lands took place within the tract of similar land parcels.

Tract of similar land parcels’ borders can be determined within the course of a normative assessment of land of the territory of an administration unit. So, when conducting a normative assessment, the assessor shall carry out an additional function, which is establishing borders of similar land parcels’ tracts.

Another mandatory condition for mass land assessment is a decision about such an assessment, taken by the respective self-government body. This proposal is aimed at a balancing of powers to regulate the tax burden with increased responsibility for the decisions taken.

So, the mechanism of mass pecuniary assessment on the basis of the market value of lands should work according to the following scheme: 1) similar land parcels' tracts' borders are established in the course of normative land assessment; 2) these land tracts are monitored to establish the moment when the land market within the borders of the tracts arises; 3) the local self-government body passes a decision to conduct a mass land assessment within similar lands tracts with a functioning land market; 4) and, finally, mass land assessment is conducted.

The proposed system will help to resolve several problems, among which are the following:

- land tax revenues increase at the expense of prosperous population segments;
- increase in the responsibility level of local authorities for the decisions taken;
- taxation of lands, which are the most lucrative profiteering investments and so impeding profiteering tendencies on the land market in Ukraine.

11.3.3 Imposing tax on lands under residential buildings and constructions

According to the current legislation, lands under residential buildings, parking lots, garages, and summer houses are taxed at a 3 per cent rate of the accrued tax liability. Taking into account that the general land tax rate in Ukraine is 1 per cent, the lands under residential houses, garages, and dachas are taxed at a 0.03 per cent rate, which means that tax for such lands is negligible.

Yet another characteristic of the land tax system of Ukraine is that tax on lands under tenement-houses is calculated and paid to the budget, not by the apartments' owners, but by tax agents. Most often, these are municipal housing and communal bureaus. So, there occurs a sheer rupture in the link between local self-government bodies in charge of land tax revenues, which are paid to the local budget, and citizens, who pay the tax. This link breakage impacts both citizens, who do not consider themselves to be communal service customers, and local self-government bodies, which used to receive funds from the state and so become more and more irresponsible.

If brought into the scope of land taxation, the tax on land under residential buildings could provide a stable revenue source evenly distributed among the whole territory of the country and restore the link between citizens and local self-government bodies. Taxing this category of lands, together with the implementation of a mass assessment system on the basis of market value, may put an end to the search for the most effective and smooth introduction of a fully-fledged system of immovable property taxation. All the issues related to the additional assessment of real estate objects and the creation of new registries of such objects and taxpayers, which are so urgent now, would be removed.

11.4 Conclusions

Analysis of the current situation of local finances shows a lack of own resources of local budgets and their severe dependency on revenues passed by the state to the local level and on inter-budgetary transfers. The major source of local budget revenues is personal income tax, which is a national level tax “delegated” to the local level by the state and which is earmarked to finance national expenditures also “delegated” to the local level, such as primary education, health care etc.

Introduction of an immovable property tax is considered by many experts as the most preferable way of strengthening the revenue base of local self-government. However, the lack of an efficient system of property assessment, together with the failure to establish an efficient registry of immovable property, impedes the implementation of the tax in Ukraine.

A reform of the current system of land taxation would be an alternative to the introduction of an immovable property tax. This reform implies such steps as the liquidation of existing legislative loopholes, which are used for minimising tax liabilities, bringing the land assessment system in line with the assessment standards used in the world, and imposing tax on lands under residential buildings and constructions.

The reform of land tax in Ukraine will provide a stable revenue source for local budgets, an increase in the responsibility level of local authorities for the decisions taken, and improve the administrative procedure of levying the tax.

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