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Property Taxation in Local Finance Reforms of Transition Countries

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I P T I

Presentation Outline

- Economic transition and public finance reforms
- Imperative of enhanced fiscal space to finance public investments
- Intergovernmental fiscal relations and local finance
- Property taxation choices for local finance
- Specificies / challenges of property taxation in CEE countries
- Property taxation in Poland – large revenues, inefficient formula
- Points to ponder in reforming property taxation

Overriding CEE Transition Challenges

- Higher econ growth to catch up EU income levels and living standards
- Current hi growth rates still mean 15-20 years of catching up EU avg
- High growth requires more efficiency, but what about less social equity?
- Reconciling economic efficiency with social equity:
  - *low efficiency (less employment) and low equity (more poverty): Poland, Baltics, Slovakia – similar to Greece, Spain, Italy*
  - *low efficiency (less employment) and high equity (less poverty): Hungary, Slovenia, Czechia – similar to much of continental EU*
  - *high efficiency (more employment) and high equity (less poverty): Nordic countries*

❖ Strategic aim for CEE is higher efficiency and higher equity economy, which requires enhanced public spending size

Strong Public Investment Imperatives

- High and equitable growth requires huge publicly driven investments in infrastructure and human capital
- Larger fiscal space needed to finance more public investments
- Larger fiscal space is needed also for access to EU dev funds
- More investment requires additional private funds through PPP
- All investments are to improve quality and efficiency of public service delivery to the economy and society
- Better public service delivery requires sound public finance system with sufficient local autonomy and governance

Public Finance in CEE Transition

- Assignment of roles betw State and local gov (decentralization) +
- Assignment of roles among various local government levels
- Intergovernmental finance to fund the reassigned roles
- Mechanisms for mobilizing revenues from physical and legal persons
- Mobilizing aid funding from donor countries and institutions
- Interacting with capital markets for public debt financing through loans and bonds – need for creditworthiness
- Citizen oversight over public spending and political accountability
- Public finance reform strategy: rationalizing expenditures and improving revenue mobilization to create larger fiscal space

Pros and Cons of Decentralization

- Advantages of decentralization:
  - *Better match supply/demand of public services*
  - *More efficient and effective service provision*
  - *Increased political stability*
- Disadvantages of decentralization:
  - *Aggravations of spatial / geographic disparities*
  - *Less efficient budgetary macro-economic management*
  - *Higher fixed costs of territorial administration*
  - *Risk of local regulatory capture and expenditure indiscipline*

❖ Weak correlation between decentralization and economic growth

Challenge of Larger Fiscal Space

- *Def:* „budgetary room that allows government to provide funds for desired purpose without threat to sustainability of its financial position"
- Capacity risk of govt's limited absorptive capacity for additional, productive public spending (too much money)
- EU - need for fiscal deficit < 3% GDP, and debt levels < 60% GDP
- Already compressed social spending confronting aging population
- Fiscal space can expand mostly via less public spending (social insur)
- Reducing deficit through investment cuts is politically easier, but compromises prospects of sustainable economic growth

Potential for Expanding Fiscal Space

- Countries with large public sectors can reduce wasteful spending
- Fiscal space can increase by broadening of tax bases and sources
- Reduce social transfers, health, education, public administration
- Better tax administration reduces costs and increases net revenues
- Privatization of public enterprises reduces fiscal subsidies
- Leveraging scarce public funds through public-private partnerships
- Strengthening public finance management (procurement, debt, …)
- Deficit financing through debt issuance at capital market (loans, bonds)
- Broader tax base and tax sources – the way to expand fiscal space

Inter-governmental Fiscal Relations

- More reliance on social contribution and indirect taxes, as heavy income taxation hampers stronger economic growth
- Subnational finance important part of public finance – 20-25%
- Subnational share in GDP varies: SK 3%, H 13%, PL 15.5%
- Subnational debt around 2% GDP in PL vs. 10-20% GDP in EU
- Local budgets more balanced under tight borrowing constraints
- Local social services = health, education, social assistance
- Local infrastructure = water, sanitation, heat, waste, transport, streets
- Functional decentralization requires more local revenues, but …
- Local fiscal autonomy could undercut State fiscal and equity objectives
- ❖ Local governments need own revenue sources not competing with State revenues and do not discourage economic growth

Local Government Revenues

- Discretionary and dedicated local government funding
  - *Shared revenues + local taxes, fees, charges*
  - *Dedicated funding mostly to health and education*
  - *Shared revenues mostly on income taxation*
  - *No major unrestricted tax base to local governments*
  - *Problems with easy access to capital market debt financing in 1990s*
  - *Imposition of prudential limits on local borrowing and debt service*
  - *State bailouts in most countries, some have bankruptcy law – H, LV, SK*
- Directions for further local finance reform:
  - *Fine-tuning of inter-governmental transfer system; and/or*
  - *Local gov'ts decide on expenditure level and own-source funding (PIT); and/or*
  - *States retain total tax policy control, „locals" not eager to impose own taxes*
- Many local governments still try to avoid the onus of own taxation (and accountability) and prefer the State to retain full tax policy control

Property Taxation Choices

- Variety of formulas from area-based to full *ad valorem*
- Advantages of *ad valorem* model of property taxation:
  - *Revenue buoyancy*
  - *Locally carried tax burden*
  - *Not regressive*
  - *Taxes tangible benefits*
  - *Positive land use efficiency effects*
- Disadvantages of *ad valorem* model of property taxation:
  - *Little revenue if improper rates and poor coverage*
  - *Difficult and costly administration*
  - *Judgmental assessment*
  - *Taxes unrealized income*
  - *Highly visible to taxpayers*
  - *Difficult to enforce*

Calibrating Area Basis to the Market

- Area basis persisting in many transition economies
- Some countries moving to market calibrated area basis – Gujarat (India) shifting away from rental values to calibrated „carpet area"
- Some market countries continue with area basis
- Market calibration of area basis on the way to full CVS
- Political perception and admin simplicity of area basis provide strong appeal to taxpayers and tax administrators
- Objective and simple measurement vs. subjective estimation
- Gradual market calibration to area basis might be the way

❖ *Unit value area basis a compromise – "market calibrated simplicity"*

Specificities of CE economies

- No land and real estate markets for long time
- High incidence of income-poor asset-rich taxpayers
- Subject (taxpayer) based property taxation systems
- Non-value tax base in property taxation
- Little tradition of wealth taxation of individuals
- Significant grey sector evading income taxation
- Big potential non-fiscal benefits from better land use
- Big potential non-fiscal benefits from equity / efficiency
- Difficult to move to ad valorem reforms due to political economic concerns and impediments

Problems with CEE Property Tax Reforms

- Administrators happy with area based
- Local politicians wary of direct accountability
- *Ad valorem* is expensive and needs robust revenues
- Businesses are “rich” and people are “poor”
- Equity not an issue when small tax is seen as a “fee”
- Low taxes already capitalized into high property values
- Institutional / professional infighting for running *ad valorem*
- Inequality between “rich” and “poor cities”
- Worrying about asset-rich but income-poor households
- Inconsistent experience in Western countries
- Little market evidence in smaller cities and towns
- Focus should be set on weaknesses of the existing formula

Local Real Property Taxation in CEE

- Most widespread form of local revenue is property tax
- Market calibrated taxes often do not produce high revenues
- Significance of property tax revenues varies widely:
  - *Poland: 1.4% GDP*
  - *Latvia: 0.9% GDP*
  - *Lithuania: 0.5% GDP; Estonia: 0.4% GDP; Slovakia: 0.4% GDP*
  - *Hungary and Czech: 0.2% GDP; Slovenia: less than 0.2% GPD*
- Definitions of property tax base vary widely
- Local discretion over tax rates and tax relief varies widely
- Billing, collection and enforcement varies widely
- Political economy - main reform impediment in some countries
- *Local revenues need to grow, but own sources from business taxation and privatization are drying up, with State not willing to transfer more*

Role of Property Taxation in Poland

COUNTRY	Property taxes relative to the economy: GDP	Property taxes: share of government revenues	Property taxes: share of total local revenues	Property taxes: share of local autonomous revenues
Poland	1,2 %	3,0 %	13,9 %	31,8 %
Average for the CE	0,6 %	1,7 %	8,1 %	15,3 %
Average for the EU	0,9 %	2,2 %	7,3 %	32,5 %

Features of the Polish Property Tax (1)

- Residential tax kept at minimal levels:
  - *home 120 m2 on 400 m2 parcel pays 21 USD in 4 installments*
- Business tax 35 times higher than residential
- Business buildings yield 50% revenue, but store 5% value
- Residential buildings store 70% value, but yield 10% rev.
- Effective taxation in *ad valorem* equivalent:
  - *business use buildings: 7.8% of capital value*
  - *business use land: 1.4% of capital value*
  - *residential use buildings: 0.062% of capital value*
  - *residential use land: 0.046% of capital value*
- Land rates 8 times smaller than building rates
- Land use efficiency is low and riddled with speculation

Property Tax Trends in Poland (2)

- Self assessment by businesses
- Businesses pay lion's share of property tax revenues
  - *Business buildings yield 50% revenue, but store 5% of value base*
  - *Residential buildings store 70% value base, but yield 10% revenue*
- Incomplete coverage:
- Numerous exemptions and rebates
- No PR or taxpayer education activities
- Tax bills full of threats rather than encouragements
- High residential compliance, few appeals
- Tax administrators and voting taxpayers not looking for change

Some Points to Ponder

- "Ineffective" ad valorem vs. "effective" area-based
  - *from ineffective rental value to market calibrated carpet area – India*
  - *from subject based area to market calibrated cadastral area – Poland*
  - ❖ Perhaps market calibrated area based system is optimal as first phase
- Tax formula for small / rural vs. large / urban jurisdictions
  - *little value differentiation makes it cost-ineffective to use ad valorem*
  - ❖ Perhaps jurisdictions could make a choice about tax base formula
- Contribution from business vs. residential properties
  - *businesses often contribute the most of property tax revenues*
  - *most of valuation efforts often given to residential properties*
  - ❖ Perhaps more focus on valuing business properties

Some Points to Ponder *(2)*

- Point of departure for the reforms
  - *In Poland the reform initially driven by praising ad valorem virtues*
  - *In India the reform initially driven by poor collection of ad valorem*

  - Start with solving the problems of the existing system

- New tax or modification of the existing
  - *In Poland modification easier to sell to tax administrators and public*
  - *In India new tax easier to sell to public (equitable, rational)*

  - Political economy decides on packaging and marketing
  - Market calibration, revenue collection, or both ?

Local Revenues in Krakow - Poland

- Own-source revenues constituted 36.75% total revenues
  - *Property tax: 14.39 %*
  - *Other own taxes and fees: 1.86 %*
  - *Local taxes/fees collected by gov't tax offices: 3.21%*
  - *Income from fixed assets: 7.48 %*
  - *Liquor concessions: 0.62 %*
  - *Other own-source revenues: 9.19 %*
- Government transfers constituted 61.07 % of total revenues:
  - *Share in government budget revenue: 27.46 %*
  - *Subsidies and grants (general, dedicated): 33.61%*
- Foreign source grants: 2.18%

Thank you!

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