



The Fiscal Decentralization Initiative
for Central and Eastern Europe

Property Taxation in Serbia:

*Ownership Rights and Interests
in Real Property Subject to Taxation*

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Property Taxation in Serbia:

*Ownership Rights and Interests in Real Property Subject to Taxation*¹

Boris Begović²

Property taxes in Serbia include all taxes whose levying and collection is related to real property (real estate), with special emphasis on:

- real property sales tax (absolute rights transfer tax);
- inheritance and gift tax;
- property tax (for real property).

1. Absolute Rights Transfer Tax (Real Property Sales Tax)

Real property sales tax in Serbia is levied based on a proportional rate of 5%. A proportional tax rate is no doubt justified in this case, but even at first glance, it seems rather excessive.

The tax base consists of the contract price at the commencement of tax liability (the moment the transaction materialises), if higher than the market value. Since a taxpayer has an incentive to report a lower contract price, the tax authorities are entitled to assess whether the reported price, or value, is below the market value. Tax authorities have to act quickly (within ten days from receipt of the contract, or in case of an official decision on extension, within another ten days; all in all, within twenty days from the receipt of the contract). Assessment

of the market value, or the real value of the transaction, can be accomplished by analyzing: (a) regular real property sales contracts; (b) prices quoted by the real property agencies; (c) by comparison.

Filing an appeal does not delay enforcement of the decision on the tax payable. The second instance authority is the regional centre of the Serbian Tax Authority. After that, there is a possibility of judicial administrative review before the Supreme Court. Annulment of the decision entails costs for the Tax Administration: (a) for additional onsite re-assessment of the real market value of the transaction; (b) for paying interest on the excess of tax collected. Additional onsite assessment is required for family houses, it is not necessary for apartments in a block of apartment buildings. The costs of additional onsite assessment, specifically the opportunity costs of time, are high indeed, especially because taxpayers have an incentive to present their property in an unfavourable light, to decrease the assessed value. Given that the costs of filing an appeal are pretty high, the TA usually estimates a slightly lower value, so that the assessed values are targeted to be between 90% and 100% of the real market value. Thus, the possible risk of an appeal, and entailing costs, are decreased.

One of the attributes of real property is its relatively low sales volume in the relevant period (e.g. in a one year period), which creates a problem for assessment of the value of a given real property, or the value of the capital transaction. Many real property sales are not encompassed by transaction records, so there is no available information for estimation of their value, or the value of transactions. This problem is less conspicuous in Belgrade and other large cities (with lively trade in real property), and far more obvious in smaller towns in Serbia.

Evasion of real property sales tax (absolute rights transfer tax) is very rare, given the strong incentives for taxpayers to fulfil their tax obligation because a change of ownership of real property cannot be registered in the cadastre registry without submission of the proof

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of the sales tax payment. Still, there are cases when the transaction is not registered in full, but “covered” by a fictitious loan contract. Some estimates reckon this to be 10% of non-taxed transactions at the most. And even these are not evaded taxes, but rather postponed, for future taxation.

2. Inheritance and Gift Taxes

Inheritance and gift taxation is applied in cases of second order of succession based on a progressive tax rate of 3% on a tax base of 200,000 dinars (around 28,500 EUR), and 5% on a tax base over 200,000 dinars. In case of the third and subsequent order of succession, both inheritance and gift tax are based on a proportional rate of 5%. This provision is unreasonably complicated, non-transparent and creates additional incentive for taxpayers to decrease the declared amount of tax base. The low threshold of the tax rate change probably leads to a relatively modest reallocation of inheritances and gifts.

3. Property Tax

Property tax is collected from all real property owners, or the owners of broadly defined, property rights, i.e. at least some of the property rights in the real property. There are almost 2,500,000 registered property taxpayers, meaning that a large share of Serbia’s population belongs to the category of taxpayers liable to pay this type of tax. There is no other direct tax with a higher number of identified taxpayers. This fact, along with circumstances related to the acquisition of property rights of socially or state owned housing at very favourable prices for the tenants, resulted in a significant socio-political component in making decisions concerning this type of tax, especially in defining the tax rate and the method of tax base determination. In brief, political considerations and the room for populist policy moves makes real property taxation distinctive compared to other forms of taxation.

Property tax is levied at a progressive rate: 0.40% on the tax base up to 6,000,000 dinars (around 86,000 EUR), 0.80% on the tax base over 6,000,000 dinars plus, 1.50% on the tax base over 15,000,000 dinars (around 215,000 EUR) and 2% on the tax base over 30,000,000 dinars (around 430,000 EUR). This provision is completely inadequate: it is unnecessarily complicated, non-transparent and creates an additional incentive for taxpayers to decrease the declared amount of their tax base. Significant differences in tax rates create incentives

for owners to gift their real property to successors of the first order, in order to disperse their ownership and reduce the tax burden, diminishing the potential fiscal effect of the progressive tax rate.

According to the new legislation passed through the Parliament in July 2006, local communities and their authorities will be in charge of setting the property tax rate for the properties in their territory within a maximum rate that will be stipulated by the legislation. It is still uncertain what the maximum tax rate will be. Further, it is not stipulated whether local communities will apply a flat or progressive property tax rate.

There is a voluntary property tax declaration by taxpayers. The declaration is filed with the local branch of the Tax Administration, with the proof of ownership (purchasing contract and/or cadastre information). The cadastre book is basically a title book, although is it not consistently practiced throughout Serbia.

The tax base of the property tax consists of the market value of the given real property on December 31st of the year preceding the year in which property tax is levied and collected. Generally, the market value of the real property is determined by applying the basic (floor space and average market price per square meter of the comparable real property in the territory of the same municipality) and adjusting elements (location of the real property, quality of the real property as well as other elements affecting the market value of real property). The method of defining basic and adjusting criteria allows for significant discrepancy between the estimated, assessed tax base, or estimated market value of the real property and the real market value, or value realized on the free market.

The first factor influencing this discrepancy is the completely inadequate use of statistical data in the assessment of the real market value of the given real property. The problem lies in the fact that the average market price per floor space square meter, as a basic indicator for calculating the real market value, is derived from the average declared sales prices of the newly built apartments on the territory of that municipality. However, this declared sales price has very little in common with the real market value of the particular real property. Thus calculated, the average market price of the real property is systematically underestimated, or downward biased. The main cause for this underestimation is that in a number of cases, the market price is calculated as a sum of declared building costs (excluding the costs of primary and secondary preparation and development of the urban land), which is far below the full real market

price. This leads to the severe underestimation of the value of the real property (up to 50%). Possible upward bias, as a consequence of using a non-representative sample for data collection, cannot possibly compensate for the explained systemic downward bias, resulting from the calculation with an underestimated value of the indicator of average market price per square meter of the floor space, which inevitably leads to an underestimated tax base.

Although regulations allow the possibility of using the value established in the process of tax base determination for the real property sales tax, as a base for assessment of the average market price, or the price per square meter of the floor space, it is permissible only when there is no relevant data collected by the statistical bureau. Therefore, superior information, such as an estimate of the tax base for real property sales tax (transfer of absolute rights), is subordinated to the inherently inferior information of the statistical bureau.

The estimated average market price per square meter of the floor space, and of the real property itself, is then adjusted for the location of the real property, by multiplying the price per square meter with a coefficient that cannot exceed one. This procedure is methodologically flawed and inevitably leads to further downward bias. Further on, an adjustment is made for the quality of the real property, with a coefficient which is lower or, in the best case, equals one (only for top quality, luxury homes), which is also methodologically erroneous and leads to further downward bias, or further underestimation of the value of the tax base. Finally, that value is annually reduced for the value of depreciation which is calculated based on the annual depreciation rate of 1.5% (up to 70% of the initial value), which also unjustifiably decreases the tax base. Calculation of the depreciation is, in principle, methodologically acceptable; however in this case, the rate is unreasonably high (total depreciation/replacement of the real property value is planned within 67 years). All of the above leads to severe underestimation of the tax base for all taxpayers (all natural and legal persons) who do not keep accounts.

There is a substantial amount of arbitrariness in assessing the tax base, or determining the market value of real property. For example, determination of the coefficient value, which reflects the quality of the real property (the adjusting element in the market value determination), is calculated based on frequently inaccurate and faulty descriptions of the building, which results in an incorrect coefficient value.

Changes of the valuation regulations at the end of 2004 introduced zoning, i.e. zones that are used for specification of the compensation (fee) for urban land use. These zones are used to specify the multiplier. Nonetheless, in all cases but one the coefficient is no greater than 1; only in the top zone is the coefficient two. There are no available statistics on the tax base changes due to the regulation change, but the probability for a substantial tax base increase (if any) is very low.

For taxpayers that keep accounts (financial books, i.e. balance sheet), the tax base is calculated based on the value of the real property as entered in the accounts (balance sheet). Although this procedure is methodologically correct in principle, the declared value is often well below the market value of the real property, which significantly reduces tax base for property tax.

Tax exemptions from property tax are, in principle, well specified. Exemptions also include the *de minimis* provision, which exempts owners whose tax base value is not higher than 250,000 dinars. Taking into account downward bias in determination of the tax base, the effective exemption limit is actually much higher. Although there is no explicit possibility for tax exemption of the poor, the *de minimis* provision, along with the tax credit, can be interpreted as a mechanism of that sort. Accordingly, it seems that there is no need for introduction of the special safety mechanism (circuit breaker) for the poor in the area of property tax collection. That kind of protection should probably be developed on the existing foundations.

Nonetheless, tax exemptions are also applied for certain property, based on the intended use or the type of ownership (state authorities, diplomatic missions and consular offices, roads, historical monuments, public utility buildings etc.). Some of these exemptions are unconvincing: (1) local public utilities; (2) agricultural buildings – these exemptions favour specific economic activities, without any economic rationale.

Judging by the way that tax credits are specified in the law (40% for taxpayers who live in their own apartments and 10% for every member of the household, but cumulatively not more than 70%), they are, most probably, introduced as a form of welfare protection for the poor. However, this measure includes redundant protection for rich households too, since every three-member household, regardless of its total income, pays only 30% of the amount of the property tax. On the other hand, a single member household, for example, a poor retired person, pays up to 60% of the property tax amount. Furthermore, since tax credits are granted

exclusively to households, this implicitly introduces a differentiated effective tax rate, so that legal entities pay property tax based on the effectively higher tax rate than the rate levied for natural persons, i.e. households. All in all, a fundamental examination of the current policy of tax credits is called for, since it has not accomplished the goal of welfare protection for the poor, but rather, has succeeded in significantly reducing fiscal revenues.

The possibility of property tax evasion in the case of real property is significant and stems from the system of voluntary filing of tax declarations (returns) and two other phenomena. One is related to the fact that a large number of buildings are not registered – cadastral books are not regularly updated. The other phenomenon in Serbia is the practice of building without a permit, resulting in a large number of illegal and unregistered buildings. Since these buildings are not formally registered, their owners are not recorded as taxpayers for property tax purposes. Finally, regular taxpayers do not have a strong incentive to fulfil their obligations, unlike in the case of real property sales tax (transfer of absolute rights).

The general assessment of the legal provisions regarding property tax is not a favourable one. On the whole, this tax is badly designed. The tax base is assessed based on poorly defined procedure, which entails a number of methodological errors. This leads to an intentionally depreciated tax base, probably out of social policy considerations, although without explicit protection for the poor. That policy leads to a dual tax base: one, which is almost equal to the market value of the real property, used in case of the real property sales tax (absolute rights transfer) and the other, systemically underestimated, used in case of property tax. The progressive tax rate is unnecessarily complicated and does not contribute to a significant increase in fiscal revenues. Tax evasion is relatively widespread. All of the above results in relatively low fiscal revenue from property tax collection.

4. Property Taxation Fiscal Revenues

The property taxation share of total taxation revenues in Serbia is very small and decreasing (Table 1). This is mainly due to the underestimated tax base.

Table 1. Share of the property taxation in tax revenues

Year	2000	2001	2002	2003	2004
Share of the property taxation in total tax revenues	2.5%	1.6%	1.3%	1.0%	0.9%

Source: Ministry of Finance of Serbia.

According to the data for year 2003, total revenues from collection of real property sales tax amounted to approximately 1.5% of the total amount of collected tax revenues, which is significantly higher than revenues from collected property tax. This anomaly is a consequence of: (a) excessive tax rates, (b) realistically assessed tax base (market value of transaction) and, (c) high level of tax collection, i.e. low tax evasion.

According to the data for year 2003, total revenues from collection of inheritance and gift tax amounted to approximately 0.1% of the total revenues from collected taxes – from the perspective of total fiscal revenues this tax is not very significant.

According to the data for the year 2003, total revenues from collection of this type of tax amounted to approximately 1.0% of the total amount of the collected taxes (0.6% of this amount comes from revenues from legal entities, and 0.4% are revenues from natural persons), which is lower than the revenues coming from collection of the real property sales tax (transfer of absolute rights). This is, by all means, an anomalous phenomenon resulting from: (a) relatively low property tax rate; (b) low property tax base, estimated far below the market value, and (c) relatively widespread evasion of this type of tax.

5. Other Property Related Fiscal Instruments

Besides the above listed tax instruments, the compensation (fee) for use of urban land is one of the instruments for collecting fiscal (public) revenues in local communities. Specific criteria, as well as measures for specifying the amount of this compensation (fee burden) are established by the local communities. In principle, this compensation is paid per square meter of built floor space and per unit (per square meter). The amount of this compensation varies depending on the property location and the type of the urban land use. The fee is calculated by local authorities, as they have a data base with all the relevant information for the fee calculation (location, floor space, use, etc.). The fee is imposed by local ordinance and the fee is paid by the owner of the building (improvement) in the case of private ownership, or by the tenant in the case of state or social ownership. The manner of specifying variation of the unit amount and the total burden of the compensation implies that the amount of the compensation would be proportionate to the value of the real property, even the individual one.

This compensation has substantial features of the property side. On the burden side, the total amount of

the levy depends on the floor space of the improvement, its location (zoning is used as a proxy) and the type of land use. The bigger the floor space, the better the location and the more profitable urban land use, the bigger compensation burden and the bigger value of the real property. In other words, there is substantial similarity of the variation of the property tax burden and the compensation burden – the only difference being that compensation calculations are based on proxies of the real property value, rather than on the property value itself. On the public expenditure side, revenues generated by the compensation are used for provision of local public goods – the same type of expenditures that are associated with real property taxation revenues. Taking into account that this compensation as a fiscal instrument was introduced in all republics of the former Yugoslavia (SFRY) in the 1970s, within the framework of social ownership of urban land and the majority of the housing, it seems that the basic idea of its creators was to introduce a substitute for the real property tax in an ideological and institutional framework that did not allow introduction of a real property tax. The corollary of this finding is that now that all the ideological and institutional obstacles have been removed, the compensation for use of urban land has lost its *raison d'être*.

As to the fiscal revenues, all the revenues collected based on the compensation for use the urban land are directly allocated to the local budget and are used for financing the provision of services considered to be local public goods.

6. Allocation of the Property Related Fiscal Revenues

All the revenues collected from the property tax are transferred to the local authorities. This shows that, notwithstanding the existing provisions in the law, property taxes are *de facto* considered a local tax. This is well justified, since these taxes are considered to be typical local taxes. According to the best international practices, in most cases these taxes are local taxes, or original revenues of the local community.

According to the new legislation passed through the Parliament in July 2006, property tax became an original fiscal revenue of the local communities, i.e. it goes straight to the local budget.

7. Tax Administration

Property taxes, according to the current regulation, are defined and implemented by central authorities, i.e. authorities of the Republic, apart from the tax rate that is specified by local communities. It is not clear whether local communities will also be in charge of tax credit will also be the laws and regulations prescribed at the level of the Republic. Implementation of these regulations, particularly levying and collection of taxes, is within the authority of the central (Republic) Tax Administration, which delegates its powers to its local (municipal) units. Devolution of the tax administration is still far from certain.

8. Evaluation of the Existing Property Taxation

Evaluation of the existing property taxation that follows is based on some of the IAAO standards on tax policy as criteria.

As to **uniformity** and the “ability to pay” components, the existing tax system is far from it because the tax base as calculated right now is not a good proxy for the ability to pay principle.

The **neutrality** of property taxation is substantial due to its character and the insignificant tax burden that results.

As to **public acceptance**, there is no unambiguous position of the existing taxation system. On the one hand it is rather closed and few benefits are received, generating a low level of public acceptance, but on the other hand the level of the burden is low, hence it is accepted.

The crucial problem of the tax system is, however, its poor performance in generating tax revenues.

9. The Concept of the Tax Reform

9.1 Absolute Rights Transfer Tax (Real Property Sales Tax)

The legal provisions regarding real property sales (absolute rights transfer) tax are, in principle, well thought out. Regarding the tax policy, possibilities of future decreases of the tax rate should be examined, while planning for the expected decline in fiscal revenues. This means it is necessary to project expected fiscal revenues, especially taking into account the possibility of raising fiscal revenues through property tax reform. General guidelines

for alteration, or decrease of the tax rate on transfer of absolute rights, should ensure collection of a higher total amount of fiscal revenues from property tax than the fiscal revenues from the transfer of absolute rights.

The tax base assessment in this case is satisfactory; therefore no radical new solutions are needed. Furthermore, this information should be used as an input for the real property valuation for the property tax base. However, it is necessary to increase the resources of the Tax Administration (especially local branches) to facilitate execution of their tasks. Also, provisions should be made to facilitate information transfer from the most developed municipalities, which record the highest sales volumes of real property (thus being the most experienced in estimating value of real property) to the less developed municipalities.

Fiscal decentralization *should not* result in abandoning a single, centrally determined, tax rate for real property sales tax (transfer of absolute rights), nor should it lead to abolition of the unique procedure for assessing the tax base.

Taxpayers' incentives to fulfil their tax obligations are sufficiently strong in this case, so there is no need for substantial additional incentives. Residual tax evasion could be dealt with through measures, or development of institutions beyond the realm of the tax policy (mortgage credits, pledge etc.), which could create additional incentives for registration, or certification of the transfer of absolute rights.

9.2 Inheritance and Gift Tax

As far as inheritance and gift tax is concerned, introduction of the proportional tax rate is necessary and it should be uniformly applied in all cases liable to this kind of taxation, regardless of the actual inheritance or succession order. Furthermore, there are good reasons for bringing this tax rate to the level of the real property sales tax, to eliminate incentives for making fictitious inheritances and gifts. By the same token, changes in the inheritance and gift tax rate should mirror changes in the tax rate on transfer of absolute rights.

Inheritance and gift taxes have a small fiscal effect, and a significant increase in revenues from this tax should not be expected.

9.3 Property Tax

Property tax should not have an allocative effect – the only effect it should generate is a fiscal effect. Allocative effects should be managed within the sphere of the urban land management reform (based on its privatization),

establishment of the market for this resource (urban land) and reform of the urban planning system.

The property tax rate should be proportional and identical for all types of real property, which implies that the current progressive tax rate should be abandoned. The issue of whether this rate should be determined by the central (republican) or local authorities belongs to the debate on fiscal decentralization – in other words, both solutions are legitimate.

If local authorities determine the rate of the property tax, central (republican) authorities should define a quantitative range for determination of this rate. In principle, the central authorities may formulate this range in two ways: a) by specifying the lowest and highest value of the tax rate; b) by specifying only the highest rate. The suitability of either of these provisions should be determined with regard to the fiscal decentralization policy.

The most significant problems of the property tax lie in the difficulty of determining the tax base, or assessing the value of the real property subject to this tax. If these problems cannot be resolved in a satisfactory manner, it is necessary to consider the possibility of replacing property tax with some other local tax or appropriate fiscal mechanism, which would compensate for lost fiscal revenues from this type of tax. The only tax of the sort is a community poll tax, which is collected from every inhabitant (or every inhabitant over 18), of the local community (lump-sum tax). By implementing this kind of tax, the problem of defining the tax base for property tax, or the problem of real property valuation would be resolved. Furthermore, a community poll tax is allocatively neutral (economically efficient), implementation friendly (administrative costs are low) and the possibility of evasion is relatively small. However, this tax radically violates the principle of vertical justice (equity), which is discrediting enough to preclude recommending its implementation. Furthermore, the political costs of implementing this kind of tax is prohibitively high, as illustrated by the fate of this tax in Great Britain at the end of 1980s. That is why this tax cannot be presented as a realistic alternative to the property tax.

In principle, the tax base of the property tax should be: a) *ad valorem*; b) based on the total value of the real property; and c) based on the capital value of the real property. The *ad valorem* principle, which defines the value of the real property as a tax base, is the only possible solution which would not violate the principle of horizontal and vertical justice (equity). Also, there is a trend (especially in the transition economies and developing countries, since this was accomplished a

long time ago in the developed countries) of recognizing this principle when specifying the tax base for real property taxation.

The tax base should be based on the total value of the real property, i.e. it is not advisable to differentiate between urban land and buildings on it (improvements). The current situation in Serbia is that, even if some general reason against the implementation of this principle existed (and it does not), it would not be feasible to implement differentiated taxes, in view of the still existing monopoly of state ownership on urban land. In other words, urban land would be excluded from taxation and only buildings (improvements) could be taxed, which violates the *ad valorem* principle. As long as urban land in Serbia is not privatized (and the privatization process requires a new Constitution and appropriate new law on urban land), there is no possibility of implementing differentiated taxes on urban land, on the one hand, and constructed buildings (improvements), on the other.

The concept of a tax base grounded on the total value of the real property in Serbia is legally based on the implicit transfer of virtually all property rights in urban land to the land tenant – owner of the improvement. Right of use as a property right is formally transferred to the land tenant – the transfer of that right is not specified in time, effectively this can be considered a permanent transfer. As to other property rights, they are implicitly almost completely transferred to the land tenant. Because the tenant can sell the real property on the market (both rights in land and improvement), the right of disposal (*abusus*) has been effectively transferred to him/her. Because the tenant can lease the real property on the market (both rights in land and improvement), the right of enjoying revenues (*usus fructus*) has also been effectively transferred to him/her. The explained constellation of the property right transfers enables the application of the real property tax base consisting of both of urban land and improvements even though urban land is still formally publicly owned.

Even if the legal and operational prerequisites for implementation of differentiated taxes are met, the tax base would still be based on the total value of the real property. The reasons for this lie in the easier assessment of the total value of the real property, and the fact that contemporary best practices show that more and more countries are switching to this method of tax base assessment, and recognize the principle of allocative neutrality of the property tax. Isolating the urban land as a separate tax base is usually justified as a means of creating an opportunity for allocative intervention on the urban land

market through a particular (differentiated) tax policy. By adopting the principle of allocative neutrality of property tax, this argument is rebutted.

The tax base should be based on the capital value of the real property, i.e. the value of the real property recorded on the date the capital transaction (transfer of absolute rights) takes place. Adopting this principle means discarding the alternative principle of rental value of the real property, i.e. presenting the value of the real property based on the total annual rent obtained, or that could be obtained, by renting that real property. Implementing the rental value principle leads to problems related to the determination of the tax base, mainly in acquiring accurate information about the amount of market rent (it is easier to obtain information about the market value of capital transaction), as well as the inevitable arbitrariness in valuation of the tax base. Additionally, this principle is being abandoned in contemporary tax laws, even in the former British colonies that have had a very long tradition of its application.

Adopting the first and the third principle, results in discarding the existing dual system which recognizes different tax bases in the case of real property sales tax (absolute rights transfer tax) and property tax. Introduction of a uniform tax base for real property results in increased transparency and efficacy in property taxation. Furthermore, this unification would open possibilities for a significant rise in fiscal revenues which could compensate for the existing systemic underestimation of the tax base in real property tax.

Defining basic principles of the desirable tax base for real property taxation opens the question of the method for assessing the value of real property, the tax base. Specifically, the procedure for determining the particular amount which should be taken as market capital value of the taxable real property. Principally speaking, there is the possibility of introducing self-evaluation, or taxpayer obligation to assess the value of their own property subject to a property tax, and file a tax declaration (return) with the assessed tax base. Self-evaluation of the tax base, as one of the alternative options, is based on the possibility of introducing new, effective and powerful incentive to the taxpayers to realistically estimate the value of their property. In the case of self-evaluation of the tax base, every taxpayer has an incentive to declare a lower value, i.e. underestimate the value, to reduce their tax burden. Without a new, effective and powerful incentive for taxpayers to realistically present the value of their property, self-evaluation as an alternative option is not advisable, since it would inevitably lead to a sig-

nificant fall in the value of the tax base, and consequent decline in fiscal revenues. Consideration of the suggested proposals for formulating these incentives (Allais' suggestion), concluded that they are not applicable, because they are not effective, and can even result in the creation of a perverse incentive structure. Therefore, it can be concluded that there is no feasible proposal for that kind of incentive at this moment, which means that the basic precondition for implementation of a self-evaluation system is not met.

Even if an incentive against systemic underestimation of the tax base for self-evaluation could be formulated, the problem of imperfect information, or lack of knowledge on the part of the taxpayers, still persists. In other words, even if an effective incentive exists (and there is none), values of the self-evaluated tax base could still be very far from the market value of that property. This creates the need to monitor that assessment by the Tax Administration, which eliminates the basic advantage of self-evaluation – a low administrative burden. This finally clarifies that self-evaluation of the tax base is not a realistic option.

Therefore, the only realistic solution is that the Tax Administration should be the authority to assess the tax base for property tax purposes, and assess the market value of the taxpayers' property. This raises two essential questions: the issue of the content and assessment procedure, and the issue of incentives for the officers of the Tax Administration (particularly their local branches) to implement the given procedure in an effective and impartial manner, in short, to do their job properly.

From the perspective of the content and the procedure of real property assessment, the only acceptable provision is the one already implemented in a number of countries. That provision is based on utilizing: (1) already established estimates of values of the real property (previously used as a tax base in the case of absolute rights transfer tax, i.e. real property sales tax), and (2) existing values of the assessed tax base for property tax and all material characteristics of the real property (location, quality, amenities etc.). Based on mentioned input data, the model of the computer based mass assessment of real property values for property tax base determination (*Computer Assisted Mass Appraisal – CAMA*), calculates the value of every individual property, regardless of whether it was ever sold.³

For purposes of this report it is not necessary to go in details of CAMA model functions, but it is useful to clarify its basic concept. The model uses different specific inputs for every individual property: the price of the property (if ever traded or sold), tax base used for determining absolute rights transfer tax (static base), as well as location and other characteristics of the individual property, including all the elements for determining the quality of the building. Based on the listed data, a set of regression equations is estimated, taking into account all available factors influencing variation of discrepancies between the static and dynamic base (tax base in the cases of real property sales tax and property tax), in order to assess the influence of these factors on the observed variation. Upon estimating values of the regression equations parameters, the next step is formulating a forecast i.e. projections of the discrepancy between the static and dynamic base (which is considered to be an indicator of the market value of the real property, or its value per square meter). That is the procedure for calculating a new value of the property tax base, by equalizing the static and dynamic tax base (market price).

Two important elements of the CAMA model should be pointed out. First, calculating the value of every individual property in a certain area does not require data about all sales transactions (although data from different years can be used), rather it can be sampled at the municipality or local community level. According to initial estimates, the successful functioning of the model in Belgrade, for example, requires data from roughly 600 sales of real property. This shows that the model could be used for a swift efficient estimation of the value of real property (the new tax base). Also, there is the possibility of developing a single model for Serbia as a whole, for real property within Serbian territory, in which belonging to a particular local community would be just one of the attributes, defined as an input, for every individual piece of real property. This feature demonstrates that the model of real property evaluation (assessment) could be efficiently organized on the level of the central Tax Administration of the Republic. The role of the local (municipal) branches of the tax administrations would then be to send updated information about the estimated value of the real property, used as a tax base for absolute rights transfer tax (real property sales tax).

Implementation of the proposed CAMA model reduces the number of incentives required for Tax Administration officials, to only incentives for assessment of the tax base of real property sales tax. These incentives would facilitate, first of all, control over the whole

³ The CAMA model has been developed Joe Eckert and his associates at the BearingPoint.

procedure, with a special, already mentioned, requirement to avoid appeals to the second instance authority. In addition, internal audit measures of the assessment process should be developed. The central Tax Administration is a second instance authority in this case, and the legal remedy against its decisions involves filing an administrative procedure.

Implementation of the CAMA model would not, in its own right, significantly raise the administrative burden of the Tax Administration. Some estimates show that a single CAMA model, if implemented on the level of Serbia as a whole, would employ up to three persons. Since the results of this model depend on the quality of information about the value of traded real property, it is necessary to establish unique procedures for processing information on enacted decisions about taxes on transfer of absolute rights, in order to keep the CAMA model updated through new and timely input data. Also, there is a need for a constant flow of information and know-how, especially between the municipalities with significant real property sales volume and municipalities with less lively real property markets, to overcome problems in local communities lacking experience and know-how in evaluating real property.

As far as the legal formulation of the procedures for assessing the tax base is concerned, appropriate laws and regulations should stipulate precise and accurate definition of the principles and form of the procedure itself (sequence of steps), information to be used in the evaluation process, without further specification of the content of evaluation (complicated formulas, point based grading etc.). As far as classical evaluation is concerned, specification of the stipulated principles and procedures should be left to the experienced and skilled officers of the Tax Administration. For computer evaluation, its content is predetermined by specific statistical procedures that should not be tampered with.

Another important issue is reviewing/adjusting the level of the tax base as the time passes. The value of real property changes over time, so it is necessary to provide for the change of the tax base accordingly. The most important changes cover: a) the retail price index; b) depreciation rate of buildings; c) dynamics (economic outlook) of the real property market. Implemented CAMA models enable continual evaluation of real property in the territory of the Republic, with a low administrative burden, i.e. it is not very demanding on human resources. Regular and timely input of real property value assessment data, for purposes of absolute rights transfer tax (real property sales tax), is an indis-

pensable prerequisite for continuing evaluation – which induces a slight increase in administrative burden. Also, the difference between the new and the old value of the real property can be defined in the model, and the model automatically adjusts the value of the tax base. Since the CAMA model always encompasses virtually all factors influencing the value of the real property, the new value assessment can be lower or higher than the old (existing) estimate.

Implementation of the CAMA model should lead to establishing the tax base for property tax for all taxpayers, including those that keep accounts. This could also serve as a method for overcoming the problem of systemic underestimation of the bookkeeping value of real property in the balance sheets of legal entities. The CAMA model could be tested first exclusively in the case of taxpayers who do not keep accounts and after review of the first experiences, application could be extended to taxpayers which do keep accounts, practically causing transformation of their tax base. Further study of the CAMA model in Serbia, as well as its adjustment will show if there is a need for a differentiated approach towards these taxpayers, i.e. the need for a phased approach in the introduction of the new system of determining tax base for the property tax.

In addition, it is necessary to define the threshold value of real property (tax base) below which no property taxes shall be applicable, as it is currently envisaged in the law. A sufficiently high threshold (based on empirical testing or simulation) should serve to protect the poorest. Since it can be expected that market values of real property (new tax bases based on market values) could vary significantly, this threshold should be specified at the local (municipal) level, i.e. separately for every particular local community. The threshold can be generally defined as a certain share in (or percentage of) the average value of the real property (the tax base) on the territory of a given local community. Implementation of a thus defined general criterion for specification of this tax threshold facilitates a centrally organized and executed tax exemption for appropriate taxpayers. The effects of different thresholds on the number of the exempted taxpayers (and some of their characteristics) and on fiscal revenues will be shown by the simulations of the effects of different tax base value thresholds when tax bases (assessment results) are available.

Defining the lowest value of the real property as a mechanism for protection of the poor will create an incentive to the households which are cash poor and rich in fixed assets (property), to reallocate their property from

stock to flow. However, flows should also be taken into consideration, by defining the lowest level of taxpayer's income below which no property taxes should be levied. Nevertheless, tax exemption should come into force only if both criteria are met, i.e. if the values of property, as well as the amount of income of a given taxpayer, are both below specified thresholds.

Tax credits, as currently defined in the law, should be replaced by a unified tax credit at an appropriate percentage of the value of total tax liability for all taxpayers' housing. In that way, determination of the tax credit would depend exclusively on the effectively differentiated tax rate between living and business related real property. Decisions about the applicability and proportion (the percentage) of tax credits should be made by the tax authorities at a particular level (central or local) which will, after the implementation of fiscal decentralization, be authorized to decide the level of property tax rates.

As far as curtailing evasion of real property taxes is concerned, the basic prerequisite is improving the real property data base, i.e. acquiring accurate information about each item of real property (land and buildings) and their owners or users. Providing this information will also enable effective application of the penal provisions of the existing Property Tax Law. It is also necessary to examine the modest achievements of these penal provisions, and maybe even propose their amendment.

9.4 Other Property Related Fiscal Instruments

Apart from the already mentioned tax instruments, on the local level there is also a compensation for the use of urban land. All revenues based on this instrument represent revenues of the local community. Judging by the calculation method and the intended use of collected revenues (financing local public resources), this compensation is a typical local tax, and a typical property (real property) tax.

Therefore, it is necessary to integrate the compensation for the use of urban land into the property tax. This may be achieved through abolition of this compensation in the current form, and its integration into the property tax through appropriate raising of the property tax rate in order to, at least in the short run, reimburse the loss of fiscal revenues due to the said abolition. There are several advantages to integration of the compensation for the use of urban land into the property tax. First, it means realizing the idea of compensation as a substitute, or a form of local tax – since now, there is institutional

facilitation for its development into the property tax, calculated on the *ad valorem* tax base. Second, the total costs of collecting fiscal revenues are decreased, since all the costs related to calculation and collection of the compensation vanish. Third, this facilitates establishment of full control by the Tax Administration and competent local authorities over the flow of fiscal revenues and expenditures and assists implementation of budget unity in local public finances.

Since the compensation for use of urban land is paid monthly, perhaps annual property tax could be divided into six equal monthly instalments, in order to evenly distribute the annual tax burden. The advantages and disadvantages of this system should be compared to the existing system of quarterly collection of the property tax.

In the course of the specified inclusion, the status of the compensation for servicing urban land **should not** be altered, since it is not public revenue. The pending privatization of urban land, as well as reform of the system for its utilization, will inevitably transform the nature of this compensation, but it will never develop into public revenue of the local community.

9.5 Fiscal Effects

The proposed reform of the property tax will inevitably lead to increased fiscal revenue. A rapid increase of revenues based on property taxes is expected for two reasons: (1) significant rise of the tax base, through acceptance of the real market value of the real property as a tax base; and (2) including compensation for use of urban land into the property tax. It is estimated that the effects of these two factors on fiscal revenues based on the property tax, will be more than enough to offset any possible decline in fiscal revenues from the possible reduction in the tax rate of the real property sales tax (transfer of absolute rights).

More specific estimates of the fiscal effects of the tax reform will be possible only after information on the range (band) of the future tax rate policies of local authorities becomes available. Therefore, more elements on fiscal effects will be offered upon obtaining more specific data, i.e. even preliminary results of the CAMA assessment procedure for Serbia. Preliminary results of the model regarding the tax base valuation imply that a revenue-neutral property tax rate is 0.12% compared with the existing 0.4% (Begovic *et al.*, 2004). If the compensation for the use of urban land is integrated into the property tax, the revenue-neutral property tax rate would be 0.29%.

Continuous comparison of the fiscal effects of different tax policies (tax rate, tax credits, etc.) and more accurate results of this testing, would be made possible only upon full development and continuous maintenance of the CAMA model. This will allow *ex ante* testing of the fiscal effects of considered tax policies for every local authority managing a local community.

9.6 Allocation of Fiscal Revenues

The total amount of the collected revenues from property tax shall constitute original revenue of local communities, and other forms of local government (city and municipal), as it has been stipulated by the legislation passed through the Parliament in July 2006. In city authorities, the method of allocation of these revenues to the constituent municipalities should be pre-defined. This provision in allocation of fiscal revenues paves the way for transfer of responsibilities in the formulation of the tax policy to the local authorities. Since these revenues from property taxes would become original revenues of the local communities, they will have a strong incentive to formulate efficient local taxes, and cooperate with the central Tax Administration concerning all aspects of efficient collection of taxes.

9.7 Tax Decentralization

All the important parameters of property taxes, as well as their implementation, should be clearly defined in laws and regulations by central (republic) authorities. These parameters include: tax rates on transfer of absolute rights (real property sales tax), inheritance and gift tax rates, method of calculation and collection of taxes and the method of tax base determination etc.

Local authorities should be free to determine the effective property tax rate, i.e. local authorities should specify a proportional property tax rate which is to be applied in their territory (as stipulated by the July 2006 legislation), as well as a percentage of the general tax credit applicable to all households in their territory. These provisions should certainly be consistent with provisions prescribed for the whole territory of the Republic, as defined by the central authorities. Guidelines should define highest and lowest tax rates, as well as the maximum amount (percentage) of the tax credit that local authorities can approve. The permitted range should be large enough to provide for choices between different effective tax burdens that local authorities may impose on their citizens, since they are, through the elections mechanism, accountable to their citizens. Besides, since

significant variations of the tax base between municipalities are expected, a wide range of permissible tax rates will create the opportunity for a more justified allocation of the tax burden between citizens.

In this situation, local authorities face conflicting incentives – one encourages increases and the other decline of the tax rate, and/or tax burden. However, local authorities would obviously prefer a situation with the lowest possible tax burden and highest possible grants from the central government for local budget financing. Accordingly, the system of a sharing formula for local communities could be adjusted to enable those local communities investing more effort in real property tax collection (greater tax burden), to receive greater amounts from central authorities. This will be an incentive for higher local tax burdens and effective tax collection.

Local authorities should be given the power, at least in the beginning of implementation of the new property tax, over annual re-adjustment of their tax rate. Later, only after a few years of implementation, this provision should be reassessed and possibly limited, by legally determining a fixed period (e.g. two or three years) in which the same tax rate must be maintained. The rationale is that in the first period, local authorities should be given an opportunity to alter tax rates every year, and through a method of trial and error, find an optimal tax rate and optimal local tax burden.

Implementation of the tax regulation of the property tax and actually levying and collecting these taxes, should continue to be within the jurisdiction of the local branches of Republic Tax Administration, with a significant improvement in communication between local authorities and local branches of the Tax Administration. In view of the fact that there is a different level of capabilities between existing local branches of the Republic Tax Administration, it is essential to facilitate the transfer of knowledge between these branches of the Tax Administration.

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