

**Reform of the Property Tax and Problems of Real Estate
Appraisal for Taxation Purposes in Transitional
Economies of Central and Eastern Europe**

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Abstract

This paper surveys the property tax reforms in Eastern and Central European countries that joined the European Union on May 1, 2004. Property tax reforms are evaluated in the light of political and economic alterations that began in these countries in the 1990s. Tax reform was studied together with initiatives to decentralize public governance and current European Union enlargement initiatives. The authors employ comparative research, systematic analysis, statistical data analysis and other scientific research methods.

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Reform of the Property Tax and Problems of Real Estate Appraisal for Taxation Purposes in Transitional Economies of Central and Eastern Europe

Introduction

“At least part of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.”

European charter of local self-government (Art. 9, § 3)

Property tax is usually considered a recurrent tax on land and buildings. However, both in legislation and academic literature, various definitions can be found which specify taxes levied on immovable property. According to the tax classifications approved by International Monetary Fund and the Organization for Economic Co-operation and Development such taxes are defined as “recurrent property taxes on immovable property” (cf. Governance Finance Statistics Manual, 2001). Some authors, however, use terms such as “property taxes”, “taxes on land and property”, “real estate taxes” or similar terms (see Muller, 2003, Bird, Slack, 2002, Brown, Hepworth, 2003). Some confusion can arise if one analyzes tax laws and other regulations of Eastern and Central European countries on this matter. The diversity of definitions of applicable recurrent property taxes in Eastern and Central European countries is presented in the table No. 1.

Table No. 1 Property tax definitions in central and eastern European countries

1.	Estonia	Land Tax (1993)
2.	Latvia	Real Estate Tax (1997)
3.	Lithuania	Land Tax (1992), Real Estate Tax paid by Enterprisers and Organizations (1994)
4.	Poland	Urban Property Tax (1991) ¹ , Agricultural Property Tax (1984), Forest Land Tax (1991)
5.	Czech Republic	Real Estate Tax (1993)
6.	Slovak Republic	Real Estate Tax (1993)
7.	Hungary	Land Parcel Tax (1991), Building Tax (1991), Tourist Traffic Tax (?)
8.	Slovenia	Property Tax (1995)

Some of the analyzed countries levy only land (Estonia), some others levy land, commercial building as well constructions (Latvia). Then there are those that have special legal regulations for forest land (Poland), recreational property (Hungary) or certain ships that are longer than a norm determined by law (Slovenia). However, as a rule, the property tax base includes land and commercial property buildings in Eastern and Central European countries. It is also useful to note that many of these countries have special regulations on residential property. This kind of property is usually exempted from the property tax base. Hence, in this paper the term “*property*”

¹ This tax is regulated by the Law on Local Taxes and Duties (adopted in 1991).

tax” will be used to define recurrent taxation of land and buildings (industrial, commercial and residential property)² in the analyzed countries.

Another interesting peculiarity of Eastern and Central European countries is that most of the property taxes are defined in different tax laws³. This can be explained by the following reasons: first, the reform of certain kinds of property taxation was carried out in different periods. As a rule, property tax reform has been carried out with respect to land taxation first. Later, respective modernization of tax laws was carried out in respect to buildings (for instance, Lithuania). *Ad valorem* property tax appraisal systems have also been gradually implemented with respect to land first (Lithuania, Latvia, Estonia). Second, some states have established special laws or other regulations on certain objects. Third, all the transitional economies of Eastern and Central Europe have inherited many features from the Soviet property taxation system, in which land and buildings were identified and appraised for taxation purposes separately. Taxation of land, as a rule, was based on site value (area). Buildings however, were appraised mainly with a nationally approved value (the so called “cadastral value”) or balance sheet value (book value). As most of these countries did not succeed in modernizing these tax laws over a short time period, different provisions in respect to taxation of land and other real estate were left unchanged (for instance, Lithuanian case). In the Czech Republic a single tax was adopted. However, different taxation of land and building is clearly distinguished in separate sections of real estate property tax law (1993). (cf. Czech Republic Report 2004, at 1).

It is worth noting that separate taxation of land and buildings can hardly be justified. It is fairly complicated to establish the values of all components separately in practice, if land and buildings are taxed separately (cf. Almy, 2001, at 69). This is especially relevant in urbanized areas, where land value is mainly dependent on the buildings and other construction on the land. However, many commercial buildings stand *on publicly owned land* in Eastern and Central Europe. Land and buildings are not appraised together because state land is not levied by property tax and therefore must be subtracted from the whole property complex. Consequently, the law sets forth different regulations for appraisal of land and buildings in this region.

The authors advocate a single uniform law that would consolidate all the issues of real estate taxation. The option of replacing several acts with a new consolidated one is viable in the new Eastern and Central European countries. For instance, uniform property taxation was adopted in Latvia in 2002, a relevant law draft is being prepared in Lithuania, certain amendments of the law setting forth taxation of buildings are being considered in Estonia, *etc.* Despite these deviations in terminology and the legal requirements of property taxes in Eastern and Central Europe, the numerous similarities among these taxes create the possibility of attributing them to the same tax category. Considering the worldwide practice of property taxation, the concept of these taxes might be characterized by the following features:

² However, in some jurisdictions of the world this tax is also applicable in respect to taxation of certain machinery, pipelines, etc.

³ It is useful to note that the same divergence of terminology in respect to property taxation is even more apparent in Western Europe. For instance, in England, Wales and Scotland terms such as “non domestic rates” or “council tax” are common, in Northern Ireland – “rates”, *etc.*

- 1) Real estate is levied recurrently by this tax. Usually property is levied once a year.
- 2) Transfer of particular property is not decisive for application of this tax. Property transfer taxes do not fall into the category of investigated property tax.
- 3) The amount of this tax is dependent on the qualities of particular property. As a rule, the financial situation of a taxpayer (*e.g.* wealth, debts of taxpayers) is irrelevant to the incurred tax. Property itself is subject to taxation.
- 4) Property tax is usually considered as a local tax⁴. The tax is partly or in some countries fully administered by local authorities. Furthermore, taxable revenue from this tax is transferred to the financial funds of local government.
- 5) Modern property tax is considered an *ad valorem* tax. Thus, the tax may be calculated according to the value of particular property (usually the same as the market value). However, many Eastern and Central European countries are still employing cadastre value (Latvia), site value (Czech Republic) or other mixed approaches to appraising real estate for taxation purposes. Nevertheless, *ad valorem* land tax has been implemented in Estonia since 1993; some other countries (Lithuania) utilize various elements of market value that influence the final value of the taxed real estate. In some other Eastern and Central European countries (*e.g.* Czech Republic, Poland) proposals regarding reform of real estate appraisal have been considered recently.

In general, international organizations (World Bank, IMF, *etc.*) recommend that the transitional economies of Eastern and Central European countries modernize their tax systems and increase the importance of property tax. It is generally recognized that revenue from property tax should be raised in Eastern and Central European countries, and that this tax can make a significant impact achieving both fiscal and non-fiscal goals of local governance:

- 1) *Fiscally*, property taxes can ensure relatively stable and visible taxable revenues. Real estate cannot be hidden and, hence, taxable debt of the real estate can be easily recovered. By comparison, property taxes are a more reliable revenue source than personal income tax or corporate income tax during economic fluctuations. Many experts usually advocate this tax in respect to the equal abilities of taxpayers to carry out tax duties, the minimal distortion of economic decisions (*e.g.* neutrality of the tax), and the cost-effectiveness of property tax administration.
- 2) From a *non-fiscal* point of view, the tax can achieve at least two goals: (i) it can serve as a financial tool to decentralize public governance; and (ii) taxation increases land-use effectiveness. The municipalities - having their own financial sources - organize their actions independently, taking into consideration their anticipated revenue. Furthermore, this tax is direct and visible. Hence, a local voter would be more interested in the processes of local decision-making and allocation of local finances. Finally, local authorities are better acquainted with the situation than the central government in the particular location and can establish tax rates and

⁴ For instance, Part 6 of Art. 106 of Federal German Constitution (Grundgesetz) sets forth that local municipalities shall have a right to add the revenue of property taxes to their financial funds.

other provisions of the tax, which fit best to the particular location and the particular needs of local government. The balanced taxation of a particular location must also contribute to its sustainable development.

In the worldwide practice the burden of property tax is not very heavy. The corresponding tax rates normally do not exceed 2% of real estate value. For instance, in many OECD countries the share of taxable revenue from property taxes remains at little more than 1% GDP or about 4% of all the tax revenues (Bird, Slack, 2002, at 33). The corresponding share in Eastern and Central European countries amounts to something between 0.4% and 3% of total tax revenues (for instance, in 2004 the share of these taxes was 0.4 % of GDP in Lithuania and 0.8% in Latvia)⁵. This share is, however, similar to many other Western and Northern European countries. On the other hand, it is generally accepted that transitional economies apply relief measures that are too generous and should additionally improve bill delivery procedures (cf. Almy, 2002, at 42). Taxable revenue from property taxes is usually larger in British Commonwealth countries and the USA than in European Union (subsequent: EU) member states⁶.

Nevertheless, property taxes are a very significant source of taxable revenue for local governments. For instance, the corresponding share of property tax amounts to about 8% of tax revenue of total local autonomous revenues in Eastern and Central European countries (see also Brzevski, 2001)⁷. Hence, the fiscal function of property taxes should not be underestimated.

Although there are many advantages of the property tax and the corresponding taxable burden is not very heavy, modernization of this tax has not been implemented promptly in most of the Eastern and Central European countries. Moreover, the experiences of many other developed countries certify that property tax reform lasts much longer than other tax reform initiatives.

On the other hand, the success of this tax cannot be generalized. The legal requirements of this tax are very different and the comparison of legal frameworks is encumbered with many factors. The peculiarities, which are very important for this tax (for instance, tax rates, tax exemptions), sometimes differ dramatically between different municipalities of the same jurisdiction. Furthermore, the success of this tax cannot be explained solely through particular legislation framework. This can also be achieved by improving tax administration procedures and/or implementing new real estate appraisal techniques.

This paper examines the role of property taxation and its reform in Eastern and Central Europe. The research is mainly focused on the new Eastern and Central European countries that joined the European Union on May 1, 2004. Thus, the authors observe the experience of Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia as case studies and on

⁵ Source: data of the Ministry of Finance of the Republic of Lithuania and Ministry of Finance of the Republic of Latvia.

⁶ It is worth noting that the countries with the highest revenue from recurrent property tax do not tax income on imputed rent (see more Müller, 2003, at 6).

⁷ However, due to the low contributions of property tax, working out of the reliable data on comparison of these taxes to the total municipalities' revenue is connected to various problems.

this basis describe general trends in the success of this tax reform. In particular, the authors analyze in this paper:

- 1) Factors which contributed to the protracted reform of property taxation in Eastern and Central European countries and the interaction of membership in the EU with property taxation policy in the countries of the observed region.
- 2) Constitutional implications and possible limitations of property taxation in Eastern and Central European countries.
- 3) Legislative framework and possible future legislative developments on property tax in this region.
- 4) Reform of real estate appraisal and other tax administration issues.

Development of property tax reform in transitional economies of Eastern and Central Europe since the 1990s

General trends

Property tax reform is not only a legal reform. Successful application of this tax requires reexamining more than just the respective legal frameworks. Functioning tax administration procedures and a friendly tax administration environment should be created in order to appraise real estate (relevant land value maps, real estate registration system, *etc.*), to deliver tax bills and, eventually, to collect taxes. If a tax is not properly administered or municipalities misuse their funds, people will not understand the links between the taxes and public services rendered by local municipalities. The reform of real estate tax is a very controversial issue in many of European countries. In *common law* countries there are almost no hesitations on application of this tax (see: Rosengard, 1998, at 3, Plummer, 2004, at 739). However, this is not the case in Continental Europe. Although this tax is not very significant for the public revenues of Continental Europe, inhabitants as well politicians steadily resist any attempts to modernize this tax, if an increase of the tax burden is the consequence. For instance, the problems of irregular appraisal of real estate for taxation purposes are apparent not only in Eastern, but also Western European countries (*e.g.* Germany⁸, France). Different criteria of appraisal of real estate as well as the lack of updated reevaluations decrease confidence of taxpayers in this tax. In addition, this might have the effect that the burden of this tax will not correspond to the equal taxpayers' abilities to pay it. German scholars advocate that fundamental or at least partial modernization of this tax is necessary while taking basic constitutional principles into consideration (Lembrock, 2001, p.78). Thus, there are many common problems of property tax that lead to generalizing tendencies in Europe.

⁸ In Germany for instance, general revaluations of the property should be carried out every 6 years. However, the land revaluation took place the last time in 1964 (cf. Brown, Hepworth, 2003; Almy, 2001, at 106).

Eastern and Central European countries are, however, very different from their Western European counterparts as well as from each other as far as their cultural background, legal systems and economic reforms carried out after the downfall of USSR are concerned. For instance, according to the political regime before the 1990s one can distinguish the following Eastern and Central European state groups: (i) *countries which were incorporated to the USSR* (Lithuania, Latvia, Estonia, Byelorussia, Moldova, Ukraine), (ii) *the former Soviet satellite countries which were permitted to have more autonomy in self governance matters than the republics of the USSR* (Poland, former Czechoslovakia until 1993, Eastern Germany until 1990, Hungary, Romania, Bulgaria, former Yugoslavia, Albania). According to the political attitudes and integration processes the countries of this region can be classified in these groups: (i) *countries which already at the beginning or in the middle of the 1990s expressed their readiness to join the EU, NATO and switched to the free market economy* (Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia⁹, Hungary, Romania, Bulgaria, Slovenia, etc.), (ii) *countries which retained tight links to Russian Federation after the 1990s* (so called Commonwealth of Independent States group as well as some Balkans region states). These countries did not show an initiative to integrate to Western European organizations or weren't able to join the EU in the following years due to economic circumstances, political regimes, lack of cooperation with international organizations, or other reasons (Albania, Croatia, Belarus, Ukraine¹⁰, Moldova, etc.)¹¹. Hence, the authors will observe comprehensively only those Eastern and Central European countries that as of 2004 joined the EU¹². The property tax reforms as well as some other economic reforms towards liberalization of market in the other Eastern and Central European countries (e. g. Belarus, Moldova, Bulgaria, etc.) have not reached an advanced stage thus far. Thus, the taxation problems in respect to modernization of property tax are still emerging. All of these countries liberalized their economies at the beginning of the 1990s and simultaneously implemented similar economic reforms (privatization, restitution, etc). Joan Youngman and Jane Malme have also emphasized many similar factors that were typical for transitional economies of Eastern and Central European countries reforming their tax systems:

“The introduction of taxes on land and buildings in the 1990s reflected the varied approaches taken to key elements of transition – privatization and the establishment of private property rights, devolution of public decision-making and service delivery, development and maturation of real estate markets, and the restructuring of legal and administrative systems needed for market-based economies and democratic governments (Youngman and Malme, 2004).”

⁹ After Velvet divorce in 1993, Slovak leaders were eager to reject not only partnership with Czechs, but also transition to free market economy (Bryson, Cornia, Čapková, Konček, 2001 at 51-52). However, this attitude changed at the beginning of the 21st Century.

¹⁰ However, after the election of Viktor Yushchenko - the new president of Ukraine in 2004 - Ukraine is tending towards changing its course and has expressed a wish to become a member of the EU.

¹¹ Currently three more ex-Yugoslav states – Serbia and Montenegro, Bosnia and Macedonia, as well as Albania have declared their wish to join the EU, but remain far from starting membership negotiations.

¹² In some economic and legal literature the Baltic is defined as a separate region, not really belonging to the other Eastern and Central European countries. This distinction, however, is basically made due to cultural and former political peculiarities of the Baltic states. In this paper they will be counted to the other Eastern and Central European countries.

Thus, the development of these countries could serve as an example for the other Eastern European countries, which decide in favor of a future integration in the EU. On the other hand, all of the observed countries have inherited property tax systems that were more or less similar to the system applied under Soviet law. In the Soviet tax system property taxes were employed only to a limited extent. For instance, there was a Building Tax as well as a Land Rent Tax in the former USSR republics until the 1990s (Estonia, Latvia and Lithuania which joined the EU since 2004). The Soviet Building Tax was applicable in respect to all buildings except for general state buildings, defense buildings and certain other structures. Land which was used by state organizations, land for military purposes, railways, and other land for specific purposes (cf. also Ott, 1999, at 41) was exempted from the Land Rent Tax. However, the role of these taxes was not meaningful because tax rates were relatively low and many tax exemptions were set forth (see also Martinez –Vazquez, McNab, 2000). The goals of the tax were of neither fiscal nor land planning relevance. All the decisions regarding property tax policy and distribution of public services were made by the central government. Local authorities were expected to implement the planned decisions of the central government concerning what types of public services were to be rendered (Bryson, Cornia, 2000). As a result, the modernization of this tax after the 1990s was also very important for ensuring fiscal independence of local governments. In addition, the modernized property tax has to be very significant for changing land use patterns in Eastern and Central Europe. Administrative allocative decisions on public planning were often distorted in this region. For instance, industry was frequently concentrated in the center of cities rather than in the peripheries (see more: Maurer, Paugam, 2000, at 2, Paugam, 1999, at 27). This increased costs of production and impeded the utilization of plots in the center of the city in the most effective way. Thus, the taxation of real estate should lead to the more effective allocation of commercial, industrial and residential property in Eastern and Central Europe. Further in this chapter the factors that impeded or otherwise contributed to the protracted reform of this tax in the observed Eastern and Central European states after the 1990s will be separately observed.

Privatization

Before the 1990s only a small share of property in Eastern and Central Europe belonged to private owners. At the beginning of the 1990s all the transitional economies of Eastern and Central Europe commenced privatization of state ownership. Even though the course of privatization and the particular methods applied were fairly divergent in the various countries, the transfer of state ownership to private ownership was carried out relative quickly in most Eastern and Central European countries. For instance, by mid 1995 about 70% of all property in Czech Republic was privatized, in Estonia and Slovakia the corresponding share was 60%, *etc.* (Malme, Youngman, 2001, at 3). Relatively rapid privatization was carried out in the Baltic countries. Currently more than 80% of enterprises have been privatized in Eastern and Central Europe overall. At the beginning of the 1990s some state property was also transferred not only to private owners, but also to local authorities. The redistribution of public property was based on the idea that property ought to be owned by the person utilizing it. However, rapid privatization has also had negative consequences. The real estate was not – at all times - privatized according to best offers (cf. Rural property tax systems in Eastern and Central Europe, 2002, at 17).

The privatization of real estate was an objective factor that slowed the pace of reshaping property tax systems and introducing *ad valorem* property tax in these countries at the beginning of the 1990s:

1) To this day privatization of state property has not completely been finalized in this region. Successful privatization and eventual taxation of this property requires not only a transfer of property to private proprietors, but also the establishment of registers of private property, cadastral databases, respective tax administration procedures, *etc.* For instance, the State Land Cadastre and Register (SLCR) was grounded in Lithuania in 1997 (as of 2004 - State Enterprise Centre of Registers)¹³. Nevertheless, Lithuania is supposed to be one of the leaders among the Eastern and Central European countries in the elaboration of integrated cadastre, register and system for the valuation of real estate (cf. Malme, 2004, at 5). The new taxpayers and their property should have been the first to be identified and registered. Lack of complete information on the owners and their property has impeded successful reform of these taxes in the transitional period.

2) A large percentage of property has already been owned privately since 1995. However, the corresponding property tax burden could not increase significantly during the transitional period for economic reasons. During the transitional period most of immovable property could not generate enough profit. The introduction of *ad valorem* property tax at the beginning of the 1990s would have hindered a rapid privatization and deterred foreign investors. In addition, many countries of this region applied some other temporary tax relief (duration of up to 5 years) with respect to some other taxes (*e.g.* corporate tax) in the middle of the 1990s in order to make the tax regime more attractive for investments.

3) During the transitional period in Eastern and Central European countries, privatization was carried out with respect to residential property as well. Many of these countries are, however, still exempting residential property from this tax. Especially at the beginning of the 1990s, taxation of residential property was hardly possible because of the poor financial situation of many inhabitants. The transitional period of shifting to the free market economy has also contributed to a large part of inhabitants having lost their savings and having experienced a decrease in their living standards. Up to now, many Eastern and Central European governments have encountered huge resistance to the application of property taxes on residential property. Inhabitants who have invested a large percentage of their savings in real estate in order to avoid losing the money through inflation or in order to receive a permanent income by the means of rent would be strongly affected by this tax. As a result, the governments of Eastern and Central Europe are hardly prepared to increase the tax burden on this kind of property considering the benefits (which are, however, not very significant¹⁴) and related risks. It appears for instance,

¹³ The SLCR is not a completely new state enterprise and emerged after reorganization of Inventorization, project and planning offices. These offices were established after the World War II and assigned to collect information on the owner of land as well as buildings and transaction of real estate.

¹⁴ According to the Convergence Program 2005 of the Republic of Lithuania establishing a property tax levy on residential property it is expected to receive additional revenue which amounts to 0,2 GDP.

that after a long discussion - taking political resistance and tax revenue into account - the Lithuanian government will tax residential property only to a very limited extent¹⁵.

Reestablishment of property rights

Most of the Eastern and Central European countries have adopted special laws regarding the reestablishment of the property rights that were expropriated by the USSR or Soviet satellites (i.e. governments of Eastern European countries which were influenced by the communistic regime of the USSR after the World War II) in the mid 1940s. At the beginning of 1990s citizens and their descendants were allowed to reestablish their proprietary rights to the remaining real estate. However, the process of restitution in most of these countries has lagged. For instance, a Law on Restitution of Real Estate was adopted in Lithuania already in 1991. Originally, persons under Lithuanian law were authorized to submit applications for reestablishment of their proprietary rights before December 31 of 2001 (this term has been subsequently prolonged). In other words, restitution should have been finalized in 10 years. However, not all individuals concerned received access to the archives. Some of the archives were lost or found in Belarus as well as in other countries. Long lasting litigation processes have also protracted restitution of expropriated property. As a consequence, in 1999 only 37% of all farmland property, 13% of urban land, and 9% of forest land were private property in Lithuania (*Mikuta, 1999*). Thus, only a small percentage of the national land could be taxed¹⁶. The protracted restitution has also impeded identification of private owners. Therefore, taxes on land could not generate much taxable revenue at the beginning of the 1990s.

It is worth noting that restitution did not contribute to effective land use. After the 1990s proprietary rights for land were more often reestablished than newly acquired in many countries of Eastern and Central Europe. Land was frequently reacquired and owned by persons who actually had no interest in agriculture or any other useful exploitation of the land. Landowners frequently settled not on their regained land but in other places (cf. *Trasberg, 2003*). Given the inefficiencies of land restitution land taxation can be an effective tool to motivate landowners to utilize land in a more effective way.

Another interesting peculiarity in Eastern and Central European countries is that in most of these countries the land market was not liberalized before their accession to the EU¹⁷. Such a solution was rather reasonable as the prices of the land at the beginning of the 1990s were much less than in the other Western European countries. Such special legal requirements allowed the preservation of land mainly in the hands of the citizens or permanent inhabitants of these countries. On the other hand, these provisions had negative effects as well: establishment of certain limitations on the acquisition as well as transfer of land slowed the development of real

¹⁵ It was decided to apply 1% property tax rate in respect to natural persons' property utilized for commercial purposes from 1 January 2006.

¹⁶ It is worth noting that until 1 January of 2003 there was a state land lease tax in Lithuania. The tax imposed on the lessee of the state land at 6%. This tax accounted for 0.6% of national Lithuanian budget in 2000.

¹⁷ However, such restrictions for citizens or permanent inhabitants other than EU member states have remained.

estate markets and resulted in only a few of these countries having reliable data on market prices. Furthermore, even though all of these countries have laws concerning land taxation, persons who reestablished (reacquired) proprietary rights were reluctant to sell or otherwise transfer their land parcels since they were waiting for liberalization of the land market and consequently for a price boom after accession to the EU. Despite incurred tax - landholders were unwilling or incapable of cultivating their land or profiting from it. Such expectations – which were also a motivation for many to keep their land - were however, reasonable as the land and real estate market was fairly undeveloped and prices of real estate have been permanently increasing since the 1990s. After joining the EU all the restrictions regarding transfer of land to the citizens of the other European Union countries were abolished (some countries have, however, retained some temporary restrictions). Applicable land tax rates (1-1,5%) are relatively low in many of these countries by now and they do not discourage landowners from ineffective use of the land. Therefore, the authors support the idea that special provisions on taxation of unused land can serve a more effective exploitation of land. Moreover, elevation of land tax tariffs should also be considered, as this would allow the reduction of land prices and could stimulate development of land markets. On the other hand, landowners are persistently resisting any attempts to increase the burden of this tax.

Lack of capacity in the transitional period

As a rule, land and its improvements were public property under former Soviet planned economy. Former Soviet Building and Land Rent taxes were also administered centrally. The local municipalities were not allowed to participate in fixing property tax base, tax rates, or otherwise influence property tax administration. Most Central and Eastern European countries have not been prepared to modernize this tax in a short time period because of their *undeveloped real estate market, lack of registries, and lack of qualified personnel*. For instance, the absence of free markets before the 1990s resulted in the base of property taxes being calculated according to the site value, approved inventory value or book value of particular real estate¹⁸. Most of the transitional economies did not inherit developed cadastre and real estate registry systems. Those problems could not be eliminated in a short time, as the local governments have not received sufficient financial support for administration of property taxes.

It should also be noted that East Germany (so called before reunification) was the only Eastern and Central European country that could afford to import *qualified personnel* from its Western counterpart. After the 1990s, East Germany adopted the legal system of West Germany. Therefore, experts from West Germany were able to work on East Germany's tax system without special preparation. However, none of the other Eastern and Central European countries could afford "importing" personnel from Western Europe or the USA. Eastern and Central European countries had employed mainly assistance of international organizations (*e.g.* OECD) and international experts (the Lincoln Institute of Land Policy). The reform of property taxation in the Baltic countries is being carried out with the assistance of Finnish and Danish experts as well. Hence, the lack of human resources also contributed to the protracted reform of property taxation.

¹⁸ About appraisal of real estate in Eastern and Central Europe see more in the Chapter IV.

Decentralization of public governance

The reform of property tax should be observed in connection with trends to decentralize public governance and the need to increase taxable revenues of local municipalities. It is generally acknowledged that municipalities of Eastern and Central European countries have not achieved the same degree of decentralization like those in Western Europe (Maurer, Paugam, 2000). For instance, although taxes in Lithuania made up over 80% of their income before 2002, the rates of these taxes were controlled by central governments (cf. Chandler, 2003). Lithuanian municipalities were allowed to apply limited relief on the expense of their own budget. Due to the inherited centralized soviet public governance system, the role of local municipalities as autonomous decision-makers remains insignificant thus far. The strengthening of decentralization of public governance requires creating independent sources of revenue for the municipalities. In general, even after the 1990s most of the revenue of local governments was limited to shares of central taxes and grants from central government (e.g. in Lithuania, Latvia, Czech Republic). Decentralizing public governance would make the procedure of adopting decisions in the municipalities more transparent and more local inhabitants would be more involved in the activity of municipalities at relatively low costs.

In many Eastern and Central European countries the reform of property taxes has been carried out concurrently with reform of local governance. For instance, a local governance reform regarding strengthening the role of municipalities began in Lithuania only in 1994 (adopting a special Law on Local Governance). Currently it is proposed to reorganize local authorities once again in order to increase a number of local municipalities and get them closer to the local community. However, small municipalities may lack financial, institutional or technical capacity to administer new property taxes. The reform of local governance should have been finalized prior to reform of taxation. Local municipalities will be involved in property tax administration is to be conducted to ensure that municipalities are capable of performing certain tax administration procedures (for instance, sending tax bills, tax collection). On the other hand, the tasks of local authorities are to correspond to the financial resources available. The reform of property taxation should have been carried out in correspondence with a long-term strategy regarding the mechanism of local governance.

As was noted above, property taxes are supposed to be local taxes in the worldwide practice. Local authorities of *common law* countries enjoy vast discretion in participation of property tax administration. The practice regarding the role of local governments in property tax administration matters in Eastern and Central Europe is rather different. In some countries of this region municipalities are not entitled to fix or otherwise influence property tax rates (e. g. in Lithuania). In some other Eastern and Central European states (Estonia, Poland) municipalities are permitted to establish tax rates within the limits determined by law. Furthermore, there are also such countries (e. g. Hungary, Estonia), in which municipalities are allowed to decide whether or not to tax some real estate (cf. Almy, 2001). Low involvement of municipalities in property tax administration could be explained *inter alia* by constitutional provisions, pursuant to which of the most important taxation matters should be prescribed by the law (see more Chapter II).

It is also worth noting that the major objective of the modernization of property taxes in Eastern and Central Europe was not the involvement of local authorities in the administration of property tax matters and the changing of land utilization patterns. The main goal was rather the increase of taxable revenue for local authorities. This would eventually allow decreasing the corresponding grants from the state budget. This goal was, however, not realized completely in most of the observed countries. The base of the property tax is usually not very extensive, in practice the law sets forth too many tax exemptions. For example, most of the governments of these countries avoid levying (to be precise - to submit relevant proposals to the Parliaments) residential property with this tax. The approved value of real estate is also often much less than its capital value, *etc.* On the other hand, taxation of residential property or abolition of certain other tax exemptions and the elevation of tax rates could decrease the political popularity of any government that dares to introduce such amendments.

Accession to the European Union

Preparation to access the EU has also contributed to the failure to quickly reform property tax in many Eastern and Central European countries. Most of the tax reforms executed in Eastern and Central European countries were aimed at harmonizing their tax systems with *Acquis Communautaire* (*i. e.* EU law) requirements. However, EU institutions pay most attention to the harmonization of indirect taxes, which generate the most of taxable revenue in EU member states¹⁹. Thus, the tax systems of the candidates for joining the EU before 2004 were evaluated mostly in the light of their compatibility with EU regulations on VAT (Value Added Tax) and excises (cf. Regular report from the Commission on the Czech Republic's progress towards accession, 2000, at 61). Furthermore, after approximation of indirect taxes to the EU standards, national governments of Eastern and Central European states have contemplated modernization of those direct taxes, which generate much more taxable revenue than property taxes (*e. g.* personal income tax, corporate tax). Property taxes, nevertheless, were and remain not very meaningful in the gross taxable revenue of most of the member states of EU. Hence, the new EU member states of Eastern and Central Europe have postponed substantial modernization of this tax. Furthermore, property taxes have always been evaluated as national taxes, whereas real estate does not move across borders (cf. also Youngman, Malme, 2004).

It is also important that the EU *expressis verbis* did not require decentralization of public governance from the new candidates of Eastern and Central Europe. The issues of financing of local government were left to national competence. In this context the financing of local municipalities as well as the modernization of property tax weren't priorities of the tax reform policies in any of the observed transitional countries. However, the role of European institutions should not be underestimated. The need to strengthen the role of local municipalities could be foreseen in the light that the EU requires stability of institutions, which guarantee democracy; human rights, functioning market economy, *etc.* (cf. Bryson, Cornia, 2000). In addition, the

¹⁹ Harmonization of the taxes in European Union zone is based mainly on the Article 93 of Consolidated version of the Treaty establishing the European Community. The Article provides "that harmonisation of legislation concerning *turnover taxes, excise duties and other forms of indirect taxation* should be carried out to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market of European Union".

Council of Europe (it is not an institutional body of the European Union) also stimulates decentralization of governance.

Constitutional implications of implementation of property tax

Constitutional frontiers of taxation

Though property taxes are advocated by many arguments, especially for their fiscal and non-fiscal advantages, application of this tax should also be evaluated in the light of compatibility with constitutional requirements. Constitutional control means that the validity of any law or regulation, which is incompatible with Constitution, must be abolished²⁰. Indeed, a tax itself is not considered to violate constitutional rights or freedoms, as the general fiscal needs of the states legitimates taxation as itself. However, some provisions of taxes (*e. g.* tax tariffs, particular tax administration rules) can be challenged with respect to compatibility with constitutional principles. The problems of compatibility of taxes with the Constitution are also relevant with respect to property taxes, as some principles of property taxation might be challenged because of the alleged infringement of freedom to carry out economic activity or of their limiting some other rights. On the other hand, rapid legal reform carried out in Eastern and Central European countries since the 1990s have contributed to the lack of a unanimously recognized constitutional doctrine concerning which taxation regimes should be deemed to be acceptable with respect to constitutional imperatives.²¹ Constitutional limits of taxation are very important in all of Europe. For instance, a proportionality doctrine with respect to tax legislation was developed in many Western European countries (*e.g.* Germany, France and Switzerland). The Federal German Constitutional Court - in its ruling of 17 June 1984 revealing the proportionality doctrine - stated that the financial burden of every person must be distributed considering their equal capacities to pay it. Hence, in this paper compatibility of property taxes with Constitution will be considered taking into consideration the following aspects: (i) *guarantee of inviolability of ownership* (ii) *principle of equality against law*, (iii) *principle of rule of law*.

Inviolability of ownership

The principle of inviolability of ownership suggests that a proprietor as a holder of subjective rights to his property shall have a right to require that no third person impede him in making use of his rights to possess or dispose of his property. Inviolability of ownership must also be guaranteed positively by the government, which protects the rights of an owner to treat his ownership with discretion. On the other hand, property should also execute a social function. Therefore, the constitutional courts of many European countries have established that an

²⁰ The issues of compatibility of the laws with the legal requirements of the Constitution are usually scrutinized by a special institution – the Constitutional Court – in Europe.

²¹ Albeit structure and particular legal requirements of Constitutions deviate from each other in Eastern and Central European countries, general principles – such as equality against law, rule of law and right to carry out economic activity are either *expressis verbis* entrenched in the Constitutions or have been recognized by the jurisprudence of Constitutional Courts of these countries. In this paper the authors employ jurisprudence of German and Lithuanian Constitutional countries as a basis of research.

imposition of pecuniary obligations on particular property does not mean a violation of proprietary rights (cf. a ruling of Federal German Constitutional Court of 23 June 1993, a ruling of Lithuanian Constitutional Court of 15 March 1996). A levy on property tax can be substantiated not only by general financial interests of the country, but also by special needs to improve local governance and the quality of local services. This would suggest that pure property taxes *per se* cannot be considered incompatible with constitutional provisions which guarantee inviolability of ownership.

Nevertheless, taxation of property does not mean that a government has the right to increase a tax burden without reasonable grounds. In other words, imposition of too heavy of a tax burden could actually violate constitutional imperatives. It is generally recognized that a government should not have the right to expropriate a significant part of property by way of taxation. Furthermore, taxes cannot take away income that is inevitably necessary for taxpayer's personal needs. If a person, due to the established taxes, is not able to satisfy his minimal existence needs, it should be admitted that a government infringes on her right to life or any other rights. For instance, Germany has developed a doctrine of "*satisfaction of necessary existence needs*" which finds application in the tax legislation of some other European countries as well. According to this doctrine, a government is not allowed to take away a part of property or income that is necessary for the basic personal needs (cf. Ruling of Federal German Constitutional Court of 25 September 1992). Thus, property tax laws should also prescribe relevant exemptions and other provisions that enable a person to retain his property (*e.g.* residential property) used for the basic personal needs. An argument against application of such tax relief could be that a government does not guarantee a constitutional right for everyone to have or even own residential property. However, this imperative - *not to deprive a property used for necessary personal needs* - could also be derived from general constitutional principles, such as a right to life, prohibition to intervene in the dignity of a person, *etc.* Therefore, the tax laws should set forth particular provisions that enable a person to retain his flat or house used for basic personal needs. However, if the value of a flat or other residential property exceeds some established threshold (it implies luxurious property, taking into consideration standards of separate country), this residential property or a part of it could be taxed.

In this context one should also contemplate whether property taxes are compatible with the right to develop freely where economic activity is concerned. Indeed, if a tax burden is too high, it might discourage a person to carry out business activity or transfer real estate, *etc.* In general, taxation should be consistent with the purposes according to which taxes are collected. In other words, if certain property taxes are substantiated by the need to finance local services, relevant tax rates and other provisions should be proportional to the expenses which local government have incurred. For instance, Federal German Constitutional Court in its ruling of 22 June 1995 stated that when establishing a tax burden, a balance between public and private interest should be upheld. Taxes should not "subtract" *more than half of the earned income* (*Halbteilungsprinzip*). Such an imperative is to be derived from constitutional provisions, which establish that property should also serve for the prosperity of the people. In other European countries (for instance, Austria, Switzerland, some Eastern and Central European countries) the view that taxation might infringe inviolability of property ownership if taxes take a larger part of property predominates. These taxation principles are also relevant to property taxation. For instance revenue, from utilization of land normally does not exceed 5 - 6.5% of its value. Hence,

land tax rates should not exceed 2.5-3.5% (cf. Josten, 2001, at 73). Such taxation limitations might also be drawn in respect to the improved land. Considering revenue to be received from residential and commercial property, it is recommended that the rates of taxation of residential property should not exceed 2-3% and that the rates of taxation of commercial or industrial property make up 3-4 % of the value thereof. Should a state establish higher tax rates, considerations would follow whether such tax rates are compatible with the freedom to carry out economic activity and whether a fair balance between private and public interest still remains. Furthermore, some attention should also be paid to the gross tax burden. If the incurred tax duty (including property taxes) exceeds 50% of all revenue received from particular source, a respective violation of balance of private and public interests may be established.

In summary, property tax in and of itself should not be considered to violate proprietary rights. However, taxes must not be utilized as an instrument leading to the expropriation of property or of a significant part of it. A special consideration requires protection of socially sensitive people. A person should not be compelled to transfer property that is necessary for his personal minimal needs because of an established property tax burden.

Equality before the law

The principle of equality before the law maintains that any discrimination on the ground of sex, age, nationality, language or social status should be prohibited. This principle finds place in most Eastern and Central European states' constitutions. The aforementioned list of the grounds, which are supposed to be discriminatory, is not exhaustive. In other words, a violation of equality before the law could be identified if persons are treated differently, albeit there is no relevant difference that justifies such different treatment. However, in the European constitutional law doctrine it is unanimously recognized that *different* legal regulation is permitted in respect to *different* categories of persons. In the tax law this principle finds its application in the fact that all the taxpayers should be *de jure* and *de facto* taxed according to the same principles. Moreover, the tax burden should be distributed in such a fashion that persons are taxed according to their actual capacities to pay the tax. On the other hand, tax exemptions and relief must have a clear justification, to which goals they are aimed and whether these aims are necessary and proportional in respect to goals. The constitutionality of property tax, as violating a principle of equality against law, could be challenged in the following aspects:

1) As a rule, the base of the property tax only embraces immovable property in Eastern and Central European legislation. Normally this tax does not levy other property (according to the civil laws some property could – however - be attributed to real estate, for instance planes, certain types of machinery, *etc.*, but not levied by this tax). Hence, one could allege that *property tax discriminates persons who possess certain types of real estate (particularly owners of immovable property)*. On the other hand, application of this tax could be explained, as services rendered by local government and financed by this tax have tight links with immovable property located in a particular municipality. Value of immovable property is directly dependent on the infrastructure and environment of a particular location. Arguments that sometimes an owner of such immovable property does not profit from such public services financed of the property tax or does not even need any local services (*i.e.* public libraries, parks, better infrastructure) are not convincing. If libraries, communal services, development of infrastructure are financed only

through direct contributions of the persons who use these services or approve such public investments, the direct price of exploitation of such infrastructure or services would be much higher. There would always be individuals trying to profit from the contributions of the other individuals. Hence, a public interest legitimizes property tax. The inclusion of immovable property or some other objects to the tax base can be explained by the fact that owners of this property reside in this location more often than others and, therefore, are the actual users of these services. If an owner does not use his property (for instance, property is rented), the tax is economically transferred to the actual user of particular property. Therefore, taxation of immovable property is not to be considered as violating equality against law. However, this does not deny that certain provisions of the property tax could actually discriminate certain groups of taxpayers, if their tax burden is distributed unequally.

2) The principle of equality before the law also implies that the calculation of the tax value should be based on the same principles. Thus, similar taxable objects should be taxed according to the same valuation principles. In general, taxation of property would be fairer, if a taxable burden is distributed according to the equal abilities of taxpayers to pay. It is very important that the tax value of particular property would be determined according to the revenue (according to Adam Smith's terminology, it is "*value in use*" rather than "*value in exchange*"), which the particular property generates. However, many valuation methods have little relationship with revenue to be received from a particular property (e.g. site value). For instance, during inflation the market value (or exchange value) of property may be much higher than the revenue property generates. During inflation immovable property is used as a measure to avoid devaluation of money. Thus, in some cases a property tax could distribute the tax burden unequally. On the other hand, tax administration would be very costly if one were to attempt to establish individually, how much revenue could be received from a particular taxable object. Many jurisdictions apply mass appraisal techniques. Mass appraisal of immovable property should not be, however, evaluated as infringing the principle of equality before the law. Mass valuation techniques concern all the persons whose property is appraised for taxation purposes. Thus, application of such a system would appear fair as it allows the standardization of the valuation procedure, which is necessary for reducing costs of property tax administration.

Rule of law in the context of taxation of property

Most Eastern and Central European countries have recognized the principle of rule of law as a basic principle of their legal systems. The content of this principle is usually explained in the practice of Constitutional courts and constitutional law doctrine. In the European constitutional law doctrine it is generally recognized that implementation of the rule of law principle suggests *inter alia* recognition of such principles as legal certainty, legitimate expectation, legal stability, *etc.*²². This is especially relevant for the taxation of immovable property, as it is debatable whether persons could *reasonably expect* that their property, especially residential property, will or will not be taxed. Currently many Eastern and Central European countries still apply numerous forms of tax relief to residential property, forestland and some other kinds of immovable property. Furthermore, taxation of property decreases its capital value and increases expenditure of the use of such property. Therefore, one could allege that such taxation is not

²² Most of those principles are also derived from the jurisprudence of the European Court of Justice.

compatible with legitimate expectation, as a person acquiring property was not informed that particular tax relief with respect to such property would be struck. However, as mentioned above, taxation of property is based on the financial needs of local authorities and it should not be deemed as discriminating against particular taxpayers. One could hardly expect that local services as well as the whole local infrastructure will be developed only on the expenses of free contributions of a small part of local inhabitants. This leads to the conclusion that taxation of property should not be evaluated as contravening the principle of rule of law. On the other hand, a government should inform taxpayers as early as possible when anticipated taxation of new kinds of real estate will be introduced.

Reconstruction of the legislative framework of property taxes

Taxation of land

All the jurisdictions of Eastern and Central European countries levy land with recurrent property tax. (i) Taxation of land is quite simple in terms of its administration. This aspect was very important for the jurisdictions of this region, as sophisticated tax administration procedures could not have been created over a short time period in the 1990s. (ii) Taxation of land is consistent with the need to increase efficient land use. It is expected that such taxation would enhance turnover of the land and its effective exploitation. (iii) Land levies its owners (sometimes – possessors) and, therefore, is supposed to be consistent with equality of taxpayers. Therefore, hardly any arguments can be found which reject the taxation of land as such. It should be observed which taxation regime is the most effective achieving the most effective land use and fiscal objectives. Thus, special consideration should be devoted to the taxation of agricultural, vacant, and forest land.

It could be assumed that *agricultural land* should be treated as privileged, as agricultural land can not generate as much revenue as other land types. Such preferential treatment of agricultural land should be reasonable in terms of equality against law. Moreover, a government could choose as a priority of its policy that some land must be utilized for agricultural purposes. On the other hand, preferential use of agricultural land does not guarantee that this land will actually be utilized according to the foreseen purpose. For instance, Maurer and Paugam have noticed that “*the objective of preserving rural land cannot be obtained simply through the tax preference, which is insufficient to prevent conversion into urban use*” (see Maurer, Paugam, 2000, at 6). Such a taxation regime might also cause the land to be acquired for speculation (for instance, land at urban fringes). As it was noted above, land prices in transitional countries of Eastern and Central Europe are permanently increasing before they achieve the same level as in western European countries. Therefore, such land could be acquired without any contemplation for its effective utilization. Moreover, preferential treatment of agricultural land is also disputable taking into consideration fiscal objectives. Because of preferential treatment of the land the decreased tax revenue could lead to an increase of property taxes on commercial land, buildings, and other constructions due to a necessity of compensating the “lost revenue”. Thus, the authors would support the idea that a flat tax rate for agricultural and improved land should be applied.

It could also be assumed that *unused land* should be taxed heavier as this could stimulate effective utilization. Furthermore, higher taxation of vacant plots should discourage speculation and encourage more rapid and dense urbanization (see Maurer, Paugam, 2000, at 6). On the other hand, although such taxation is justified because of land use efficiency arguments, high taxation of vacant land could be problematic, as it produces less revenue than the improved or otherwise usefully utilized land. Thus, the authors would support the idea that flat tax rate land should be applied in respect to unused as well as other sorts of land. Such flat rate taxation makes property tax administration simpler.

Some jurisdictions of this region have approved special taxation provision on *forestland* (e. g. forest tax in Poland). Some other jurisdictions, however, apply exemptions to forestland (e.g. Lithuania) or do not tax forestland with newly planted forests, i.e. for a time period of 40 years (Latvia). The taxation of forestland is a controversial issue. Considering the taxation of forests issue, it should be decided whether the plots of forest should be increased, or not. For instance, Lithuania applies this tax exception as it has approved a strategy to preserve and increase forestland plots. Furthermore, forests do not generate revenue each year. Thus, inclusion of forestland to the recurrent property tax base is as it were problematic. On the other hand, some other countries have a forestland surplus and seek to increase taxable revenue.

Taxation of commercial and industrial property

The elimination of commercial/industrial real estate of property tax base might be based on the idea that taxation of improvements could restrain urbanization. One could allege that not taxing improvements could lead to land owners attempting to urbanize their land plot as much as possible and consequently maximize the profit thereof. However, there are plenty of arguments against application of such tax exemption on buildings. (i) Application of tax exemption on buildings is more relevant to small, urbanized territories, which have a clearly undeveloped capital market. In the urbanized territories property taxes are not a decisive factor for the further development of land. (ii) If buildings are not taxed, the state and eventually municipalities lose much tax revenue, which could have been received taxing commercial or industrial property. Consequently, lower tax rates might be applied on land. Hence, particular tax relieves or exemptions on commercial or industrial property might be reasonable only in the transitional period. However, in most Eastern and Central European countries privatization and restitution processes are at the final stage of finalization. Moreover, most of the countries (with the exception of Estonia) apply this tax anyway.

Taxation of residential property

Residential property (for example dwellings) isn't taxed in some Eastern and Central European countries (e.g. Latvia, Lithuania). Some countries are applying terminated exemptions for new houses and apartments (e.g. Slovakia). At the beginning of the 1990s, in the course of privatization, taxation of residential property was not effective because the population did not have enough financial resources to pay this tax. On the other hand, the application of tax exemptions is also controversial. (i) Different taxation of residential and commercial/industrial property disturbs the real estate market and impedes the most rational decision-making regarding investment in certain types of property. For instance, a company might utilize

residential property for its commercial activity in order to avoid a tax. Unreasonable tax relief or exemptions might discriminate against particular groups of taxpayers (in our case entrepreneurs against inhabitants). (ii) Application of tax exemptions diminishes the tax revenue of the state. (iii) The tax burden of property tax paid by entrepreneurs might be economically shifted to consumers, as this tax might be calculated as costs of production. Nevertheless, not all the consumers who acquire particular products are located in the jurisdiction/location where these property taxes are collected. This also decreases links between local voters and their authorities, and the responsibility of local authorities to local voters. However, many governments are afraid that taxing residential property could cause the loss of political support of local inhabitants. Moreover, such taxation might cause numerous social turbulences while only providing an insignificant increase of the tax revenue. Therefore, some countries tax residential property, but the taxation regime isn't very rigid. (i) appraisal of residential property isn't conducted as strictly as that of other types of property; (ii) tax rates on residential property aren't extremely high' and, (iii) some countries apply particular tax relief to all or part of residential property. Considering constitutional problems of taxation with respect to the most social sensitive inhabitants, the authors would suggest that certain tax relief should be applied only to those taxpayers, who might loose their minimal living apartments due to the established levy. Other residential property should be taxed.

Tax rates

Tax base and tax rates indicate how much revenue is to be expected from particular tax sources. The definition of property rates of property taxes in Eastern and Central Europe will be discussed in the following aspects:

1) *Tax competence to establish property tax rates.* Both local and central governments participate in determining tax rates in most of Eastern and Central European countries. However, the degree of participation of local governments is very different. In many cases, tax rates of property taxes are stipulated by central government in the law (e.g. Lithuania, Latvia). The central authorities centrally plan how much revenue is to be received from property taxes. Local municipalities are entitled to exempt certain property only at the expense of their own budgets. In some other countries (e.g. Estonia, Hungary, Poland) property tax rates are established by local authorities not stepping over the limits approved by central governments, or municipalities are entitled to apply particular coefficients to the property tax rates which are established by the law (e. g. Czech Republic). In law and economic literature an opinion that fiscal powers of local municipality should be extended is predominant. The municipalities know the situation best in a particular location. Therefore, property tax rates might be specified according to their plans to promote local infrastructure (see also McCluskey, Williams, 1999, at 26). This should also increase taxpayers' confidence in the activity of local authorities. However, strengthening the autonomy of local municipalities might be problematic due to the principle of rule of law, which is entrenched in many Constitutions of Eastern and Central European countries. It suggests that the major principles of taxation, including but not limited to tax tariffs should be established in the law (not regulations adopted by municipalities). Furthermore, in the case municipalities are granted absolute freedom to determine a tax rate, they could compete with each other for the most favorable tax regime. "Tax dumping" might bring positive short-time results, as legal and natural persons choose the most favorable tax jurisdictions. On the other hand, such competition

might decrease national taxable revenue, and consequently - tax rates might be determined considering competition between municipalities rather than land development perspectives and incurred expenses of municipalities. Hence, the authors would suggest that it would be more rational to establish maximal and minimal property tax rates in the law. Later on, local municipalities could determine the most effective tax rates for particular locations or particular types of property.

2) *Progressive and proportional tax rates.* Application of progressive tax rates means that tax rates are being increased according to the value of property. A consequence of such taxation is that owners of more valuable property should pay proportionally larger taxes (horizontal equity of taxpayers). Even though some jurisdictions are applying such a proportion taxation system (e.g. Brazil), it is not recommended to implement this system in Eastern and Central European countries. Such taxation might lead thereto that valuable property will be split to receive a more favorable tax regime (see also McCluskey, Williams, 1999, at 26). Moreover, such a tax system makes the whole taxation system more complicated, and local municipalities may not be capable of administering very sophisticated property tax systems.

3) *Rates of the tax.* Implementation of high property tax rates is problematic because of political resistance. Due to this resistance, the government might be pushed to abolish property taxes in general. On the other hand, lowering tax rates too much could lead to tax administration expenses exceeding tax revenue. In Eastern and Central Europe property tax rates do not normally exceed 2%, and this is compatible worldwide practice establishing property tax rates. For instance, in Latvia the rate of the property tax lies at 1.5 %. In Lithuania the land tax rate is fixed at 1.5% while the enterprisers' and organizations' real estate tax rate is 1.0%. In Estonia land tax fluctuates between 0.1- 2.5% according to the municipalities' decisions. In Czech Republic particular coefficients are applicable according to the location of real estate. Tax rates exceeding 2.5% by far might counteract certain constitutional provisions. (cf. also Chapter II). Furthermore, an unreasonable high tax burden might impede a rapid urbanization as well as decrease investments in the real estate market.

Exemptions

In general, application of numerous property tax exemptions should be evaluated negatively, as they distort equality of taxpayers and make tax administration more complicated. Tax exemptions normally achieve only short-term political goals since people eventually get used to the tax exemptions and expect even more exceptions to be made. The following tax exemptions as are applied in Eastern and Central European countries will be discussed in particular:

1) *Property that serves for social purposes.* Land tax exemption for cemeteries, other graveyards (applicable in Latvia, Lithuania), objects of historical cultural meaning (Poland, Latvia), real estate of religious organizations, real estate which is utilized for charity purposes, hospitals, other medical institutions, etc. can be attributed to this group of exemptions. However, this tax exemption should be applied only if particular property is directly utilized for these socially important purposes.

2) *Property owned by publicly owned institutions* (applied in Lithuania, Latvia, Poland, Czech Republic, etc.). Application of this tax exemption is explained by the fact that governmental and municipal institutions are financed by taxes. Thus, if this kind of property is levied, a government or municipalities will incur additional tax administration costs. Later on, to receive the same tax revenue, it will be needed to raise respective property tax rates or broaden a tax base. Nevertheless, some Eastern and Central European jurisdictions (e.g. Estonia) do not apply tax exemption in respect to some governmental land. This might be substantiated by the following arguments: (i) it is assumed that property tax is a local tax. Therefore, property taxpayer and tax receiver are not the same person. Taxation of central governmental property is very significant to those municipalities, on whose territories are concentrated most of governmental institutions. (ii) If state institutions are granted tax exemptions, they have more favorable competitive conditions to use this property than private users. (iii) Numerous examples of public governance certify that government does not use its property in the most cost effective way. This can distort land utilization patterns, as public institutions might be located according to non-market criteria (Maurer, Paugam, 2000, at 8, Paugam, 1999, at 42). Moreover, governmental institutions normally do not incur any sanctions for ineffective utilization of property (see also: Rural property tax systems in Central and Eastern Europe, 2002, at 29). Effective utilization of property is not the main task of the organizations. Thus, it might be assumed that establishment of this tax levy will stimulate a more effective utilization of real estate. On the other hand, effective administration of property can also be achieved by attracting more professionals/governmental control who advise on effective utilization of real estate.

3) *Property used for diplomatic or consular institutions*. According to the international agreements, which set forth principles of settlement of diplomatic or consular institutions, the sending State and the head of the mission shall be exempt from all national, regional or municipal dues and taxes in respect to the premises of the mission, whether owned or leased, other than such as represent payment for specific services rendered (cf. Vienna Convention on Diplomatic Relations 1961, Vienna Convention on Consular Relations and optional protocols 1963). Most of Eastern and Central European countries have ratified these international instruments and, therefore, apply respective tax exemptions for foreign property. However, this exemption is applied on the reciprocity principle.

4) *Low-value property*. Some Eastern and Central European jurisdictions apply tax exemptions for properties that are not valuable. This concept is based on the assumption that - economically speaking - tax administration costs should not exceed tax revenue received from a particular source. On the other hand, such tax exemptions also mean that taxable burden might be shifted to the other taxpayers who own more valuable property. Even though such exemptions could be justified in respect to economic policy, they can also distort investment decisions. Persons might try to split their property in order to receive tax relief. Moreover, such tax exemptions might raise dissatisfaction amongst those who dispose not very valuable property, but due to some reasons are not granted tax exemptions (cf. also Rural property tax systems in Central and Eastern Europe, 2002, at 30).

5) *Protection of social sensitive persons or honored persons*. Some countries apply respective tax exemptions to certain categories of persons: retired persons (e.g. Estonia), disabled persons (e.g. Czech Republic, Poland, Estonia), veterans of war, persons who received state honors, etc.

Although certain tax exceptions are more or less unavoidable (for instance, real estate is used for non-profit social purposes and if it is taxed, one might hardly believe that such property will be used for these purposes), a wide list of tax exemptions make tax administration very difficult and might induce tax fraud. Therefore, property tax exemptions should be stipulated only if it is absolutely necessary for realizing certain goals of social and economic policies.

Reform of real estate appraisal for taxation purposes

The prospects of implementation of an ad valorem property tax

Successful collection of property taxes requires exact identification and determination of the value of real estate (*ad valorem*). Most of the developed Western European countries apply either *rental value*²³ (e.g. in the United Kingdom) or *capital value (or open market value)* (Denmark, Sweden) to appraise real estate for taxation purposes. The advantages of implementation of an *ad valorem* market value real estate appraisal system are rather simple: (i) appraisal of property according to its market value can stimulate the development of a real estate market. Taxpayers know that their property is to be appraised taking into consideration the most effective utilization of a particular property. Hence, an owner must either optimize profit of such a property or transfer it to others, who can utilize the property more effectively. (ii) Quite often market value of the real estate has direct ties with taxpayer's equal capacities to pay this tax. The richer owner can normally afford paying bigger property taxes. (iii) Because the value of property fluctuates permanently, a property tax based on its market value reflects these fluctuations. (iv) The value of the property normally increases due to public investments in particular property (e. g. development of local infrastructure). Therefore, a market value approach to appraisal of real estate "reimburses" public investments to the local structure.

1) Appraisal of the land. Many Eastern and Central European countries are still utilizing a *site value* real estate appraisal system or an appraisal system, in which site value elements co-exist (Czech Republic, Hungary, Poland, Slovakia, etc.). For instance, there is a "normative value" applicable in Lithuania. The "normative value" is based on the site value as well as on certain coefficients (fertility of land, location, sort, etc.). In 2002 a ruling of the Government of the Republic of Lithuania according to which land value maps on the basis of comparative sales prices of the land should have been drawn was issued. Unfortunately, implementation of an *ad valorem* land tax was postponed in Lithuania. In Latvia, State Land Service approves a "cadastral value", which is based mainly on market value and some criterion (location, area, land use, agricultural productivity, etc.). Although the law sets forth that taxable value is equal to market value in Latvia, in reality valuation of agricultural land is sometimes based on non-market values (Tomson, 2003, at 14).

²³ Rental value might be criticised as well, as it is based on current use value rather than the most effective utilization of real estate. On the other hand, it can be argued that the principle of equality against the law implies that tax should be calculated according to the taxpayers' actual abilities to pay it rather than "highest and best value" thereof. Sometimes, however, the approved market value of property for taxation purposes is a little bit less than the actual market value.

2) *Appraisal of buildings and constructions.* The approved value of building and other constructions still deviates from respective market value or rental value in Eastern and Central Europe countries. Some countries (e.g. Latvia) apply book value for legal persons as well as inventory value for individuals. Legal persons evaluate the value of their real estate according to the approved rules themselves. In Lithuania a property is appraised according to the cost of the construction approach taking into consideration depreciation of this property (*depreciated replacement cost approach*). However, the applicable system does not consider a moral and technological depreciation of property. Thus, this approved value doesn't always correspond to the market value in Lithuania. In Slovenia a "point" system is utilized. The value of property is determined according to a number of points, which depend on age, equipment, location, and other factors of a particular building (Almy, 2001, at 100).

The application of the *site, book or cadastral value* was inherited from the Soviet legal and economic system. Under command economy conditions no free market value could be established. Thus, the value of real estate was determined according to so-called "approved prices". After the shift to the free market economy the value of the same area land plots differed dramatically according to its location, environment and other qualities. Even though the site value system is not fairer in terms of taxpayers' equality against law, such valuation system did not meet much resistance among the population in these countries. In most Eastern and Central European countries the burden of land tax is, however, not heavy. Thus, at the beginning of the 1990s it was generally recognized that introduction of *ad valorem* market value property tax was not expedient due to the lack information on the real estate market (sales, rent prices, etc.)

The observed transitional countries were, however, engaged in many pilot projects to prepare a methodology for indicating the more or less consistent real estate value maps. For instance, in 1995 the Ministry of Finance of Czech Republic with assistance of OECD and private valuation companies carried out a project to develop simple price-per-square-meter models. The following propositions to introduce *ad valorem* property tax were rejected in the Czech Republic in 2001, even though the change would have most likely increased taxable revenue in the municipalities (cf. Almy, 2002, at 32). The respective law drafts concerning introduction *ad valorem* property taxes have not been prepared in Hungary and Slovakia thus far. Estonia was one of the first countries in Eastern and Central Europe to introduce an *ad valorem* property tax in 1993. However, only land was included into the base of property tax. *Ad valorem* property tax in respect to other immovable property than land required a much more sophisticated valuation mechanism (see also Trasberg, 2003). Albeit, early introduction of *ad valorem* tax was positively evaluated by foreign experts (cf. Almy, 2001, at 8), Estonia has faced numerous difficulties when attempting to determine a precise market value of land. For instance, after reevaluation of the land in 2001, the amount of the appeals has increased to up to 0.4% of the number of tax bills (cf. Tomson, 2003, at 12). Furthermore, a comparative share of taxable revenue of land tax in the gross taxable revenue of Estonian municipalities remains rather small (e.g. about 4% in 2002, cf. Tomson, 2003, Trasberg, 2003) when compared to counterparts in the rest of Eastern and Central Europe. The respective share of taxable revenue Latvia, where buildings were also included in the base of this tax, was about 9% of all municipal taxable revenue. It was hardly possible to implement an effective *ad valorem* property estate tax in all Eastern and Central European countries at the beginning of the transitional period.

Currently, the most essential problem of switching to the new real estate appraisal system is political resistance. As a consequence, due to the alteration of property appraisal system, a taxable burden could increase. Site value real estate appraisal systems are popular, as they establish less tax burden. Some objections against *ad valorem* property tax could also be seen, as some people find themselves uncertain that the amount of tax is connected to a general value fluctuation in the real estate market. On the other hand, political resistance against site value approach could be, likewise, even bigger, if the approved site value exceeds market value or the rates of property tax would be substantially increased.

The implementation of *ad valorem* property tax has gathered pace in the recent time. On the other hand, the experience of many countries worldwide has confirmed that prolonged reforms meet subsequent challenges and difficulties that must be overcome again and again.

“The longer reform is delayed, the bigger the shifts that are likely, and the more likely that reactions will be strong with the result that further changes will be made to reduce changes (and, hence, in all likelihood, fairness). Even if reform improves the equity, efficiency and ease of administration of the tax, there are invariably winners and losers. Those who benefit from reform tend to remain silent but those who lose tend to be vocal.” (Bird, Slack, 2002, at 74).

According to the worldwide practice and constitutional challenges of property taxation it is recommended to finally implement *ad valorem* real estate tax in Eastern and Central European countries. However, different approaches might be utilized in respect to different kind of property. Municipalities should be given more authority to decide which particular approaches of *ad valorem* real estate appraisal might be utilized. However, when implementing *ad valorem* property tax taxpayers' equality should be considered. Therefore, it is recommended to apply a comparative sales approach to ascertain the value of residential property. Commercial property as well as industrial property should be appraised mainly on the base of the income approach or – if it not possible to ascertain typical income - according to the cost approach. The value of the land should be appraised taking into consideration the opportunities of its best use.

Mass appraisal of real estate in Eastern and Central Europe

Implementation of *ad valorem* property tax implies that particular properties should be *reevaluated* in order to update data on the market value of real estate (especially it is relevant because of inflation). For this purpose new land and other real estate value maps should be drawn, cadastre information should be collected and a permanently indexed value of real estate²⁴ should be established. Even some Western European countries that have already employed *ad valorem* property tax systems for a long time, do not manage to update information on the value of real estate regularly. For instance, in some countries no reevaluation has been carried out for the past several decades (Germany, France, Switzerland, *etc.*). Consequently, some taxpayers profit from this, as the value of their property has not been indexed in a very long time²⁵. The

²⁴ However, another approach might be utilized according to which re-evaluation will be conducted only if fundamental changes in the market take place.

²⁵ Whereas level of value of real estate is much less than its market value (for instance, agricultural and forestland value amounts to less than 10% of their market value in Germany), such systems are little contestable. However, they are not fair.

deviating values distort equality of taxpayers' against the law. Some other countries (Denmark) manage, however, to update information on real estate every year (cf. Müller, 2000, at 11).

In order to carry out the appraisal of real estate regularly many countries have implemented mass appraisal systems. Mass appraisal of real estate is a specific kind of property valuation, which is based on the standardized administrative proceedings, application of statistical methods, utilization of computer programs (advanced computer assisted mass appraisal systems- CAMA, systems integrated with tax administration and geographic information systems – GIS), unanimous monitoring systems, market researches *etc.* (see also Tomson, 2003, at 6, Gloudemans, 2001). Due to the centrally handled methodology of mass appraisal, all taxpayers can be treated according to the same rules without arbitrary privileging or discriminating some groups of them. Additionally, the expenses of implementing mass real estate appraisal are much less than performing single appraisal of real estate. Finally, mass appraisal is normally carried out by one institution. Mass appraisal systems enable institutions to deal with information centrally.

On the other hand, it is fairly complicated to standardize all the circumstances that influence the value of real estate (for instance, evaluation of environment, neighborhood, and some significant individual features of object). Therefore, the value of property appraised according to the mass methodologies might deviate from the single-property appraised value. In such cases, the priority should be given to single-property value.

Mass appraisal techniques are being gradually implemented in Eastern and Central European countries as well. The first steps towards implementing mass land appraisal techniques were carried out in Estonia in 1993. The consequent mass reevaluations of the land took place in Estonia in 1996 and 2001 (see also Tambet, 2003). The mass appraisal of urban land commenced in Latvia in 1999; the valuation of rural land took place in 2001. However, only improved land was concerned (Tomson, 2003, at 15). A pledge to design land value maps as well as implement mass appraisal technologies was set forth in Lithuania at the end of 2002. Lithuanian National Land Service was assigned to control and coordinate land valuation works. However, the implementation of this system has been postponed. In general, there are no substantial functional obstructions that prevent the implementation of mass appraisal techniques in Eastern and Central European countries. The government or its authorized institution must only acquire necessary computer programs and employ the necessary personnel. Some special provisions that enable a taxpayer to appeal against established mass value and ascertain single-property value should be approved. However, lack of political determination to finalize reform of *ad valorem* property taxes has prevented application of mass appraisal techniques to all types of taxable real estate thus far.

Conclusion

Due to political and economic circumstances, reconstruction of property taxation was simply not possible immediately after the 1990s. Modernization of property taxation could be implemented only after finalizing privatization, restitution and other economic processes. Furthermore, poor

social and economic situation of inhabitants of the observed transitional countries have contributed to the fact that many national governments of Eastern and Central Europe are still hesitant to tax residential property or increase the property tax burden. A necessary precondition for application of *ad valorem* property tax is also a functioning real estate market. There should be a possibility to receive exact information on real estate transactions and other qualities of real estate.

On the other hand, the role of property taxes in transitional economies of Eastern and Central European states should not be underestimated. Prices of real estate are increasing in these countries. Thus, taxable revenues of this tax are steadily increasing as well. Moreover, property taxes can and must be utilized as a tool for deliberate land planning and decentralization of local governance.

Analysis of European constitutional law doctrine demonstrates that national legislators are not completely free to set forth all the property tax issues on their own, even those issues that are compatible with approved social and economic rationales. National legislators as well as governments are bound by constitutional legal requirements, which guarantee inviolability of ownership, equality against law, rule of law and other constitutional principles. Thus, the reform of property taxation could not be carried out arbitrarily nor by taking only fiscal or land planning advantages of property taxation into consideration. At least two limitations should be considered drawing property tax laws: (i) interests of socially vulnerable persons who may lose dwelling residences because of an increased property tax burden should be considered; (ii) all taxpayers should be taxed according to their equal abilities to pay.

It is recommended that Eastern and Central European countries apply a wide property tax base, which includes land, building, constructions, and residential property. Moreover, in order to uphold the principle of equality before the law, there should be as few tax exemptions as possible. Consequently, a government would be able to receive the same tax revenue without increasing tax rates or shifting a taxable burden to a specific group of taxpayers. Local municipalities should be also entitled to participate actively in setting forth the most effective property tax rates within the minimal and maximal limits established by the law. It is also recommended to overcome political resistance and implement *ad valorem* property tax in this region. Particular approaches to ascertain a market value of real estate might, however, deviate for different kinds of property. Implementation of an *ad valorem* property taxation system should be carried out concurrently with the establishment of mass real estate appraisal. This would enable regular updating of information on the value of the taxed real estate.

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