Implementation of the Real Property Tax in Veliky Novgorod: Land Policy Issues

Natalia Kalinina

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Kalinina Natalia

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1. Land Policy Issues: General Context of the Experiment

The transition from the state ownership on land to a *diversified range of ownership types* must be based *on a balance of interests of all the subjects of land relations* (the Russian Federation, the subject of the Russian Federation, municipal formations and individuals).

This balance of interests, however, is not currently ensured due to a number of reasons that may be divided into two groups for convenience:

- Legal: uncertain rights (the set of authorities of a right holder has not been clarified) and instability of the rules regarding granting, formal processing, modification and transfer of rights to land plots and their restrictions (encumbrances, servitude); the absence of statutory procedures and terms regulating the actions of the subjects of land relations in many areas of legal relationships.
- Economic: the current system of land payments and of taxation of land transactions does not ensure a fair, equitable and efficient distribution of income received as a result of disposal of land rights between the economic operators, the state and the local government.

The land legislators mainly focus their efforts on the problems referred to the first group as the problems of the second group must be addressed based on the developments in the tax, budget and civil laws. However, *it is virtually impossible to solve the problem of bringing land into turnover and use of land as a resource of economic development unless the regulation of land turnover is closely co-ordinated with the development of the tax and budget systems in Russia.*

At present Russia’s system of economic regulation of land use has the following specifics:

1. Regular *changes of land payments* (the land tax, rents, normative land value) *and* redistribution of *authorities* in the area of land resource management that occur *almost every year* since the introduction of the land payments.
2. Regular changes in fiscal distribution of land collections between various governments. The land tax as a local tax (Tax Code) is split, according to the Federal law on the federal budget, between federal, regional and local budgets, and so are land rent payments.
3. Rent payments are differentiated according to types of activity, with the base rate growing 100-fold; this results in sharp variations of payments. Local coefficients undergo regular changes as well in order to ensure effective generation of income from various businesses so that in most cases investment opportunities are completely wasted.
4. Modifications of terms of transition of lands from the state (municipal) ownership to private ownership; not only the authorities of various bodies are modified but also economic conditions (size of payments) and the procedure. Any incentives at the federal level for land privatisation by way of setting low buy-out prices (times land tax rates) have been impeded by counteractions of federal and local bodies.
5. There is no legal mechanism for land long-term leasing that would allow borrowing funds against the collateral of the lease rights; there is no practice of fixing rent rates for the whole term of the lease (except in cases where special terms are negotiated by large foreign investors).

6. With the existing land payments the real income from land use is not captured. In addition to formal payments, in practice land tenants and investors are burdened with a number of other obligations “in kind” like landscaping, maintenance and repair of communications, roads, etc. Land compensations are set locally and vary in size; they are not transparent for higher levels of power. *Thus, there is no stability and certainty in the economic conditions related to land use.*

In principle, **the system of economic regulation of land use and turnover is not efficient as this system is:**

- Non-transparent – it is based on a set of formal (statutory) and informal relations; it allows funds (and cash funds!) to flow via the budget and off-budget funds and “supplementary” organisations;
- Unstable and unpredictable – there is no link between the system and the development of tax and fiscal relations;
- Complicated – its multiple aspects are differently regulated in terms of the levels and directions of regulation, and structure of regulating bodies;
- Incomplete - in terms of coverage of the potential subjects as the system has an applicable procedure for recording of objects and rights thereto: there is no regular and complete recording of objects for the state interests nor such recording is planned in future (see the relevant legal and normative acts on inventory and recording). The legal status of objects that are not traded over is not clarified.
- Subjective – as it is based on declared and not real values, incomes, transactions and turnovers;

Therefore – the system *fails to capture the land rent,* which is not related to private investments into land development and improvement.

The local governments of the cities Veliky Novgorod and Tver in preparation for and implementation of the real property tax experiment were forced to recognise the necessity of using an integrated approach to long-term planning and other activities aimed at the improvement of land relationship, taxation and fiscal process.

2. Real Property Tax Experiment – General Results

According to the Tax Code of the Russian Federation the real property tax will replace the current taxes on property of individuals and legal entities, and the land tax. The concept of this tax has been tested during the experiment as per the Federal law No 110-FZ of 20.07.1997 “On the implementation of the real property tax experiment in the cities of Veliky Novgorod and Tver”.

At the preparatory phase of the implementation of this tax the following works were completed in Veliky Novgorod:

1. A real property register for taxation was created. The Register provides for
   - ❑ completeness of records. (All real property objects located in the territory of the city have been surveyed, recorded and entered in the Register).
   - ❑ sufficiency of records. (Recorded were data on the characteristics deemed necessary and sufficient for valuation of real properties of the given type; computer-based mass appraisal methods were used for this purpose).
   - ❑ legitimate records. (The sources of data on real properties, their characteristics and legal status, as well as on legal right-holders have been and remain the bodies in charge of the maintenance of the relevant databases).

2. A methodology for computerised mass appraisal of market values of real property objects for taxation was developed, including different assessment models by real property types (apartments, individual houses, industrial and commercial property); mass appraisal of all the real properties in the Register was completed.
3. Budget tax revenues and changes in the tax burdens by taxpayers' groups under various scenarios of tax rates, tax base and tax benefits were analysed. It was found that with the instant transition to the new tax a 1% tax rate of the market value would be enough to exceed the revenues collected from substitutable taxes. This step, however, would result in increase of the tax burden on housing owners by 60 times, in average. No need to say that this variant was absolutely rejected.

A decision was taken on a phase-in increase of taxation of housing property that would match the payment capabilities of the local communities. It was also decided not to link the tax rate to the property value, since progressive taxation may impede real estate development.

Then various options of the tax rate levied on non-residential objects were considered, with a simultaneous levelling of land rents (reduced was differentiation by types of activity). As shown by the estimates, the instant transition to the new tax, provided the tax revenues remain at the same level, could trigger extremely sharp changes (100 times) of the tax burden. This may happen due to considerable differences in the assets structure, areas/land and property location, but the major reason is a high degree of deformity in the system of property taxation and land payments. The point is that real property payments are used for withdrawal of economic rent *that a taxpayer receives as a result of evasion from other taxes.* In such circumstances any attempt to equalise real property taxation by one, single step would mean either a dramatic increase of the tax burden for some taxpayers with a simultaneous reduction of the tax burden for others, or considerable budget losses.

Having analysed various scenarios and recognising that the instant replacement of the land and property tax by the real property tax would undermine the tax situation, a conclusion was made on the necessity of *a transition period* for implementation of the new tax. This approach was reflected in the Federal Law No 196-FZ of 21.11.1999 "On amendments and additions to the Federal Law "On the implementation of the real property tax experiment in the cities of Veliky Novgorod and Tver".

The real property tax was effected in Veliky Novgorod from January 1, 2000 (Decision of the city Duma of January 27m 2000, on the basis of the regional law of Novgorod oblast "On the implementation of the real property tax experiment in the city of Veliky Novgorod" of December 30, 1999).

The transition to the real property tax in the first phase was allowed to legal entities only who are full owners, in other words, those who have property right to the buildings, structures, premises and land parcels where those buildings, etc. are located.

The following rates of the tax were established according to the Methodology of Valuation of Real Property for Taxation Purposes:

- individual living houses, apartments, living premises, dachas owned by legal entities – 0.05% of the tax value thereof;
- real property objects used in industrial production - 2% of the tax value thereof.

In 2000 the city budget received from the new tax 386.8 thousand Rubles which is a loss of 497 thousand Rubles compared to the planned revenues from the substituted taxes. The budget loses were planned as the tax was levied retrospectively. *According to the 2000 tax revenues* in respect of the taxpayers participating in the tax experiment *the planned tax losses were compensated at the expense of increasing revenues from the EPT* paid by those organisations (the surplus of revenues in all the budgets was 492 000 Rubles).

With the transition to the real property tax the tax burden on legal entities may be reduced, mainly due to the exemption of the active assets from the tax base. This forces legal entities setting *single real property objects* consisting of the land plot and the objects (buildings, structures, building structures) located on that land by way of *land buy-out. The local governments are also interested in this process of the formation of single real property objects.*

Thus land buy-outs are encouraged, and opportunities are created to balance budget revenues under the conditions of reduction of the tax base; by doing this the enterprises that have real – immovable assets – will get reduced their taxes on equipment, machinery, goods and inventory stock.

The more efficient is the use of land, the better (more profitable) is to buy it out and the higher (if the supply is fixed) is the demand and market value of real estate. Two tasks are addressed due to increasing land value - efficient land tenants and investments in production modernisation are encouraged with a simultaneous focus on the fiscal matters. The city by selling land will keep a stable source of revenues as a share of the market value (ad valorem tax and land rent). The city is interested to develop the market, to establish stable and transparent rules of turnover, to expand the class of private owners. From the other side, stability in taxation (the rate is established as a per cent of the market value) protects the owners and investors from unpredictable, arbitrary changes of the tax burden that take place as a result of indexing land tax rates or revaluation of main assets.

In 2000 the city developed recommendations on the procedure of calculation of a purchase price of land when selling land to private ownership. The city administration adopted Resolution No 130 of 19.09.2000 "On realisation of land plots in privatisation of municipal enterprises in Veliky Novgorod". The city proposed to fix the price at 12-fold land tax rate (not 5-fold like in the Novgorod Oblast) but the regional authorities rejected the proposal.

A priority of the first phase and a pre-condition to the transition towards the second phase is the development of a long-term policy of economic regulation of land use. It means that the city based on the results of comparative analysis of the total tax revenues from the real estate under various scenarios of the tax rates and rents and land demand will develop a plan of selling land plots to (private) ownership and of leasing land for a long-term period, and determine rent payments from the market values for future (in other words, the city will develop a schedule for transition from the current, distorted rent system with coefficients, to the "normal" level of 10-14% of the capital value, irrespective of types of activity). As a result, investment climate will be greatly improved, and investors and buyers attracted into urban development, thus strengthening the city economy.

The tax experiment revealed controversies of the budget policy. The role of upper echelons of power in regulation and distribution of revenues of the lower budgets has been strengthened as a result of strengthening of fiscal rights and the policy of fixed revenue sources. *For three years of the tax experiment* the share of revenues *remained in the budget of Veliky Novgorod decreased almost two times* against the total tax revenues collected from its territory. It means, the greater are the efforts to realise the tax potential, the more revenues come to the local budget – the bigger revenues are snatched away by the oblast using the mechanism of tax revenue regulation (also in respect of local taxes like the land tax). The only way for the city in such situation is to hide the real revenue potential. For the second phase of the experiment we are planning a number of measures that will increase the real property tax revenues. However, *the actual transition to the second phase is made dependable on whether the system of fiscal relations is stabilised.*

During the second phase (2001-2002) the following steps will be implemented:

1. Structures will be included in the tax base. For this it is necessary to complete their recording and to finalise the methodology of mass appraisal of structures using cost method.
2. Levy the real property tax on physical persons, the owners of non-residential property.

   To levy the tax on individual owners of commercial and industrial real estate will become possible next year. However, this requires that the land right issue be settled. The fiscal effect from the inclusion of this taxpayers' group is obvious. Thus, the tax revenues from the garage owners will bring to the budget an additional surplus of 1,67 mln to 4,774 mln Rubles (without tax benefits) at the average burden on a garage owner being 76 to 340 Rubles.

3. Correction of appraised values accounting for changes in market values on the basis of price monitoring.
4. The issue of bringing to the real property tax net of buildings and premises owners is being considered, provided they will enter into long-term leases of land plots.
5. Land plots under the right of life-long possession will be transferred to the owners of individual one-family houses.

During the third phase (2002 – 2003) the following steps will be completed:

1. Individuals - owners of houses and apartments – will start paying the tax on real property.

   This necessitates the transfer of land rights:

   - for multifamily buildings – long-term lease rights on land plots under multifamily buildings will be given for free; land rent payments under the long-term lease will be determined as a per cent share of the appraised value times the tax rate for apartment owners;
   - for individual development – land into private ownership or lease for free (the terms of buy-out into long-term lease are linked to the terms of buy-out/receipt of the land; the lease should be not less than for 25 years); the rent is calculated as a per cent share of the appraised value times the rates not lower than the tax rates.

   Thus, a single real property object will be created (building/apartment and land/land share in the interest), and the owner of such object will be treated as a full-fledged player on the real estate market.

2. Land rent will be calculated as a per cent share of the land market value, thus ensuring more efficient use of land and buildings.

   To modify land rent calculation policy – this will help stabilising land use conditions and forecasting income on investments. Land will be used more efficiently and profitably.

The local government of Veliky Novgorod believes that for further realisation of the tax experiment the following must be done:

1. The real property tax should be made local, and all the revenues from this tax should be remitted to the local budget.
2. Stable rates of contributions to the city budget from revenue sources should be established which would make local government bodies more interested in raising tax revenues to the budget from the real property tax.
3. Close co-operation of bodies in charge of formation, recording, valuation of real property (parts thereof) and registration of rights to real property should be ensured during the implementation of the concept of the real property tax in the Russian Federation, the creation of the single register of real property objects, the development of the model methodology of real property valuation for taxation purposes.
4. Information exchange between the bodies authorised for maintenance of the single register of real property objects and the tax authorities of the city and the region should be established.

5. The tax authorities should be properly trained for the implementation of the real property tax for individuals – physical persons.

3. Land Policy Alternatives.

The policy choice in respect of conditions and procedures of land uses is conditioned by several alternative parameters:

1. To maximise revenues in a short-term and ensure a fast establishment of the land market: the best policy will be to stimulate land buy-outs into ownership and develop the secondary land market throughout the city. This should be accompanied with liberalisation of prices – the land must be transferred for free or for a small fee.
2. To maximise the aggregate payment for land rent: by establishing extremely high prices to stop buying lands into ownership and sell only the right to a long-term lease; the rent will be systematically modified following market changes. Such policy may be successful only as a long-term goal if a city is exceptionally attractive for investors and entrepreneurs (like Moscow), and the land use policy in neighbouring regions is beyond competition.
3. To maximise the aggregate proceeds from sales and leasing of land in a long-term perspective. This implies the coexistence of various land use mechanisms – ownership, short and long-term leases. Traded on the market may be property rights as well as the rights to long-term lease. The policy should selectively encourage privatisation of lands, use economic levers (starting prices, bids, etc), manage land users and regulate the ratio of owned and leased lands.

The concept and the tools for implementation of the real property tax tested out in Veliky Novgorod create the context for and support implementation of the third alternative that would maximise the general effect of the land market development and the balance of interests of the state, local governments and economic operators.

This approach, however, may be feasible if the appropriate policy is developed at the federal and regional levels. Unfortunately, those levels continue to adhere to commanding style and administrative procedures and reject economic motivations. The land policy at the federal level is being formed with no account for the on-going tax and fiscal reforms. As it is virtually impossible to build a rational system of economic regulation of land uses in one city, the question on the perspectives of the real property tax reform in Russia remains open.