

# THE AREA SYSTEMS OF REAL ESTATE TAXATION. SELECTED PROBLEMS AND WAYS OF REFORMING

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## Abstract

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The area systems of property taxation practically bring a fixed base for calculating property taxes. It should be emphasized that the consequences of such structure affect both active and passive taxation subjects. For local authorities the main problem resulting from the imperfection of the taxation base is that the growth of their tax income is curbed. On the other hand, in case of taxpayers – referring to the principle of equity, which says that the tax system should treat citizens in the same way as far as their features, positions and conditions are concerned – their payment capabilities are only partly taken into account in distribution of tax burden.

**Key words:** property taxation, real estate, area systems

## Introduction

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In some Central and Eastern European countries the other – area – system is used. It is applied in Bulgaria, Czech Republic, Poland and Slovakia. The third option is a mixed model, a combination of the features of two previous systems, and it is used in Romania and Hungary. Area systems of property taxation are based not only on the area, but also on other factors. We can discern several solutions referring to property value in these systems. Some types of real estate are taxed by referring the rates to their value, defined for other purposes. An example here is the taxation of buildings in Poland, where the tax base is the value adopted for the fixed assets depreciation and only when the taxpayer does not depreciate them, their market value

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is adopted. Another example of value reference in area systems is tying the amount of taxation to the type and use of the property. Generally, real estate located in cities and used for running business activity taxed more heavily than, for example, properties used exclusively for residential purposes.

### **Area systems of property taxation**

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The area systems of property taxation practically bring a fixed base for calculating property taxes. It should be emphasized that the consequences of such structure affect both active and passive taxation subjects. For local authorities the main problem resulting from the imperfection of the taxation base is that the growth of their tax income is curbed. On the other hand, in case of taxpayers – referring to the principle of equity, which says that the tax system should treat citizens in the same way as far as their features, positions and conditions are concerned – their payment capabilities are only partly taken into account in distribution of tax burden. This is manifested in solutions adopted in area systems of real estate taxation.

When determining the amount of tax according to a unit value (a unit of property area), we omit factors which could affect the taxation base, reflecting its location, market conditions and quality of the property. As a result, the quantitative determination of tax is socially unfair, as it puts the same burden on the owners of valuable properties, located in prestigious areas of cities as well as properties of lower standards with less attractive locations.

The use of the equity principle with reference to property taxation constitutes a separate and unique issue. At first glance, it seems that everybody should be obliged to bear tax burden in an equal way, that is for a particular, identical or similar item, tax should be the same. The method of calculating due taxes is then extremely simple, clear and cheap (for tax bodies). Nevertheless, we may observe that in the name of broadly understood taxation justice, we should first of all divide the properties into residential ones and those related to running business activity. In the latter, it is reasonable to introduce further division, in which properties related to forest and agriculture activity will be significantly less taxed. Moreover, certain “inequality” may be attributed exclusively to location, since commune authorities (within their tax powers) may, to a certain extent, shape the level of tax rates. Taking into account all elements indicated here, we may wonder whether it is just and fair to make exceptions in the taxation equity. The above-mentioned deviations have not caused serious objections. However, we should analyze them and consider why such solutions were implemented and whether it is still necessary to keep the currently used constructions.

In the Central and Eastern European countries, where the state was practically the only property owner and the state determined the conditions on which the property was passed (in various legal form), it was impossible for the free market – which would determine the real value of the property – to develop. As a result, the state, in order to ensure income from passed property, developed by particular owners, created an area-related taxation system. Constitutional changes after 1989 led to the origin of free market, as a result of which we have witnessed significant economic differentiation related to the use of the real estate, leading to considerable changes to their value. Currently, the use of real estate significantly influences the amount of income obtained by a particular entity, what is more, there is a real possibility of making a market valuation of the property. A question needs to be posed, then, whether the justice as determined before the constitutional reform, still reflects the current actual state or not. In order to answer it, we need to analyze various – economic and social – aspects of the changed situation. In my opinion, the current legal status protects the owners of large properties, who only “keep” them, that is, they do not use them either for residential or strictly economic purposes. Obviously, this negatively affects the development of the region, since entrepreneurs wanting to invest in a particular area encounter difficulties, while local authorities do not receive significant budget revenues. It is also worth emphasizing that the current taxation system may constitute a barrier to particular types of economic activity (for example, it is practically impossible to run a golf course in Poland due to the amount of tax burden imposed on such property). It is also hard to consider as fair the same taxation of, for example, an exclusive and profitable jewelry shop located in the city center and an undeveloped building in the suburbs, desperately needing renovation, whose area is the same. Such situations are possible, since it is enough for the entrepreneur to possess a taxation object in order to be forced to bear the burden imposed at the rates stipulated for buildings related to running economic activity.

### **Advantages and disadvantages of area-based taxation**

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Our analysis of the advantages and disadvantages of area-based tax should not omit its simplicity. There is no doubt that the lack of complicated calculation procedures allows to lower administration costs. The current level of administration costs as well as the costs of taxpayers’ adjustment is not – in Poland and other countries with area system – too excessive. In a situation where the property taxation system has already been well-

established, the task of providing a certain fiscal amount for the state and local authority is not too complicated and does not consume too much time, either (time needed to prepare, fill in and provide proper forms to tax administration bodies, number of tax return forms submitted by taxpayers in a year and amount of necessary information on the property). The costs absorption (alternative costs of a time unit needed for fulfilling tax obligation, costs paid to tax counseling companies) are also lower.

In area systems we may discern certain solutions referring to the value of property. Some types of property are taxed by referring rates to their value, determined for other purposes. Another manifestation of referring to value in area systems is tying the level of taxation to the type and use of property<sup>2</sup>. As a rule, properties located in cities and used for running business activity are taxed with higher rates than those serving only residential purposes. The tie between the amount of tax and the value is visible in area systems also when determining tax rates and exemptions by means of passing local law. Classifying properties into tax districts depending on their location and area development, exempting properties which do not bring income or which are used for conducting socially-beneficial activity (welfare, cultural, etc) they all constitute an attempt at legally relating the amount of taxation imposed on a given property to its broadly understood value.

A typical feature of area systems is preference taxation of agricultural and forest property. In these systems we use various solutions aimed at alleviating the taxation burden imposed on arable land and forest owners. In area-related taxation systems, properties used in conducting business activity are taxed very high as a rule. The amount of tax imposed on the area owned by an entrepreneur is a few times higher than the area used by other entities. In extreme cases, this makes it impossible to conduct some types of economic activity at all, whereas in other cases, it makes such activity more expensive, since tax on property constitutes a cost of conducting activity. Property tax paid on the area in some cases distorts the real costs of conducting business activity in a given area. This is attributed to the fact that the amount of tax is treated on the entrepreneur's side as an element of the costs of such activity. The same tax and thus the costs is shown both by the taxpayer using the property of low value and the taxpayer of very well-located and developed (and thus expensive) area. Tax costs are in such cases detached from the actual value of property used for conducting business activity. This is visible when comparing tax costs with depreciation costs

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<sup>2</sup> See: Bahl, R., Martinez-Vazquez, J., and Youngman, J., eds., *Making the Property Tax Work: Experiences in Developing and Transitional Countries*, Cambridge: Lincoln Institute of Land Policy, 2007.

which are significantly higher in case of properties (especially buildings). In area-related property taxation systems it is extremely difficult to tie the amount of taxation to the payment capabilities of a taxpayer. In such case, the differentiation of taxation level without referring to the value of property is not possible. It is, however, a feature of these systems which does not evoke protests of less affluent taxpayers. This may only be explained by relatively low burden constituted by those taxes. Taxpayers do not protest for fear that it might lead to increasing taxation for all taxpayers. And they are right, since you cannot increase the tax rate only with reference to one group of taxpayers, omitting others, who have the properties of the same areas. This would constitute subject discrimination, forbidden by the constitution.

### **Simplicity of solutions of area systems of property taxation**

The area systems of property taxation offer simplicity of solutions used at the tax collection stage. To administer and collect them we do not need complex and specialized tax structure. A tax paid on the square meter usually only requires multiplying the number of meters by an appropriate rate, which cannot be too complicated or costly. The collection of such taxes does not require financing very expensive mechanisms of valuation and appreciation of the property value, typical for *ad valorem* systems. This definitely constitutes an advantage of area-related taxes. On the other hand, it restricts the possibility of obtaining higher income on taxation of property whose value grows and the area remains unchanged. As a result, the simplicity in determining the tax makes it impossible to obtain higher income from properties whose market prices grow rapidly. Area-related taxes are characterized, at least it is assumed so, by lack of differences in taxation of property depending on its location and development. In this way, the so-called income “chimneys” appearing when properties are taxed according to their value, are cut. The value of property located in urban areas is usually higher therefore the taxation incomes obtained by local budgets are higher. This is to the detriment of rural and economically undeveloped areas, where the value of properties is relatively lower. In a situation where the tax is paid on the area, value is of no importance, therefore revenues obtained from taxation of land by particular local authorities are comparable. This positive feature of area-based systems – in practice – remains invisible, due to differentiation in tax burden imposed on entrepreneurs and other taxpayers. The highest tax on square meter is paid by entrepreneurs, which explains why communes with most developed economy obtain the highest incomes.

The area-related systems encourage people to keep land for speculative purposes. This is due to the fact that the property value growth does not translate itself into increased amount of taxation. The tax imposed on the land worth 100 and 1000 money units is the same, which, following the trend of growing prices for property, justifies purchasing them and waiting for the growth in their value. This phenomenon is dangerous, especially in the cities, where there is not much land for investment.

In my opinion it is this feature of area systems that makes it impossible to consider them to be rational systems. The view is shared by most countries where they are used. Such countries initiated work aimed at changing the area system into a cadastre system.

### **The subject and object scope**

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Taxpayers of property taxes are their owners (or property users). Due to the subject scope of property taxes two solutions are possible: one tax with broad subject scope or a few tributes imposed on particular types of real estate. Most European countries have used the solution consisting in adopting a uniform tax structure imposed on particular categories of property<sup>3</sup>. In some countries (France, Denmark, United Kingdom), a different concept was applied, selecting various performances imposed on particular types of property. For example, in France, the law makers adopted a solution consisting in separate taxation of two types of property: tax on undeveloped properties (*taxe fonciere sur les proprietes non baties*), tax on developed properties (*taxe fonciere sur les proprietes baties*), dwelling tax (*taxe d'habitation*). On the other hand, the taxation system in Great Britain comprises two taxes imposed on two categories of property: „*Council Tax*” – on residential property and „*Non-Domestic Rate*” – for other properties (non-residential). The value base of taxation requires adoption of formalized method of property valuation and determination how often it needs updating. Taking into account a variety of practical solutions, as a simplification we may assume that this could be the capital (hypothetical price) or rental value of property. There are two ways of property valuation for tax purposes these are:

- common taxation, run in a comparative or income way. The comparative way contains determination of a given property value, assuming

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<sup>3</sup> Compare: Felis P., *Elementy teorii i praktyki podatków majątkowych. Poszukiwanie ładu w opodatkowaniu nieruchomości w Polsce z perspektywy przedsiębiorców oraz jednostek samorządu terytorialnego*, SGH, Warszawa 2012 and K. Wójtowicz, *System opodatkowania nieruchomości w Polsce*, UMCS, Lublin 2007.

that it reflects the value of the so-called representative real estate, and its correction due to features differing both properties, and finally the time factor. In the income way, we estimate income obtained from the property, decreased by operational costs incurred due to maintaining the property; this is done on the basis of actual incomes or the comparative analysis of incomes generated by properties similar to the valued one,

- self-taxation, in which the taxation base is determined by the taxpayer himself, by classifying the property into a certain value range determined by the taxation authorities,
- the bookkeeping method, in which the taxation base is determined on the basis of the bookkeeping balance value; it refers mostly to buildings used by enterprises.

In most European countries, the common property taxation is performed, conducted by authorized state or local administration bodies. The system of property taxation in France is an example of a variant in which the taxation base is the annual rent value of the property. In case of some properties, the cadastral rent value is decreased by lump-sum costs of maintaining the property. And thus for undeveloped properties, 80% of their value is taken, for developed properties the taxation base is the amount equal to 50% of cadastral rent value of a given property. On the other hand, in case of residential tax, the French law-makers did not adopt a solution typical for the other two types of property taxes. The taxation base is the amount equal to 100% of cadastral value of property.

In Great Britain, the taxation base for non-residential properties used for business purposes is the so-called rent value of property, that is hypothetical amount of annual rent which the owner would receive if he decided to rent a given property on market principles. The estimation of rent values of properties is performed every five years, since the process is extremely complicated. The statement of valuation of particular properties valid since 1<sup>st</sup> April 2010 contains the effects of rent value estimation as of 1<sup>st</sup> April 2008. On the other hand, in case of residential properties, the taxation base is their market value (properties were valued according to market prices which they could fetch on 1<sup>st</sup> April 1991).

The taxation base for area tax in Germany is the property value (market or rent), corrected by a certain indicator determined in the law. The valuation of particular categories of property is done according to certain norms precisely determined in the act on the principles of estimating property objects for tax purposes (for example the area belonging to agriculture and forest companies located in “old” lands – their market value from 1964, determined in line with the act of valuation; the land property – the value

determined in 1935). The determined value of moveable property is a starting point for calculating the taxation base. In the process of property valuation for fiscal purposes, an essential role is played by its updating. Apart from determining dates for new property valuation, it is justifiable to assume the obligation of annual indexation of property value between consecutive valuations. Such indexation should be most of all used in systems where there are quite rare repetitions of performed valuations. Contrary to property re-valuations, possible annual indexation is only a current correction in the property value, resulting from observed market trends. Just like in case of other elements of the property taxation system, also in this matter we may observe different approaches in particular states.

### **The amount of tax burden**

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Tax rates are another element of the construction in which we can observe significant discrepancies. In contemporary democratic countries, local authority units have been guaranteed a certain scope of competencies in determining the level of tax rates. Depending on the constitutional position of the local authority in a state, that is on the scope of its independence in relations with central authority, it may independently shape the level of property tax rates or – which is observed much more frequently – it has limited competencies. These restrictions may cover: the necessity to observe certain statutorily limited levels of tax burden and the right to use certain rate multipliers, taking into account local circumstances. Tax rates are sometimes determined locally and sometimes by the central government.

In practice, in all European countries the level of tax rates is differentiated depending on the type, use and location of particular properties. For example, in Austria, tax rates range from 0.05% to 0.2% of the taxation base. The actual level of burden is usually much higher, since communes can use the coefficient (*Hebesatz*) reaching even 500% of the tax amount. In Estonia, the area tax rates range from 0.1% to 2.5% of the estimated value of the land. In Germany, tax rates are established, depending on the taxation object, between 2.6‰ and 10‰ of the taxation base. German local authorities, similar to Austrian ones, have the possibility of increasing the amount of tax burden. Due to considerable autonomy of communes when determining the amount of the so-called multipliers, tax rate coefficients, burdens imposed on property may differ between particular communes. The rates are determined separately for the area constituting an agricultural and forest farm (A type of land tax) and for real estate (B type of land tax). The average amount of multipliers measured in all communes in 2010 was in case of



the A type land tax – 301%, whereas in case of B type tax – 410% of tax amount. In Great Britain, a principle was introduced, stating that the amount of “*Council Tax*” depends on the value range in which a given residential property is classified (differentiated amount ranges for England, Scotland and Wales). The tax is calculated on the basis of the value range in which a given property is classified and defined proportions between these ranges. With reference to the second tax – “*Non-Domestic Rate*”, rates are different for England and Wales. In England, separate rates are for London and for the rest of England. Apart from the base rate, a separate rate for small enterprises is applied. The “*Non-Domestic Rate*” in the period of 2012/2013 amount to slightly over 45 pence for each pound of rent<sup>4</sup>.

There are very considerable differences between countries with respect to the extent to which local governments are free to determine tax rates. Sometimes rates are essentially set by the central government. Sometimes there is some local discretion, within centrally-set limits. Sometimes there is complete local discretion. Where rates are determined locally, local governments first determine their expenditure requirements. They then subtract non-property tax revenues available (for example, intergovernmental transfers, user fees, and other revenues) from their expenditure requirements to determine how much they need to raise from property taxes. The resulting property tax requirements are divided by the taxable assessment to determine the property tax rate. Even where rates are locally determined, there are often limits placed on them by the central government. Setting tax rates at the local level places accountability for tax decisions at the local level. Local determination of tax rates is particularly important in many countries in which a senior level of government determines the tax base. Local tax rates may have to be set within limits, however, to avoid distortions. A minimum tax rate may be needed to avoid distorting tax competition. Richer local governments may choose to lower tax rates to attract business. With their larger tax bases, they can provide equivalent services at lower rates than poorer competing regions. The resulting location shifts are not always allocatively distorting, but they are generally politically unwelcome. In addition, a maximum rate may be needed to prevent distorting tax exporting, whereby local governments levy higher tax rates on industries

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<sup>4</sup> Compare: Boadway R.W. and Harry M. Kitchen, H. M. (1999), *Canadian Tax Policy*, 3rd ed., Canadian Tax Foundation, Toronto 1999; Becker A. P., ed., *Land and Property Taxation*, University of Wisconsin Press, Madison, WI. 2002; Kitchen H., *Property Taxation in Canada*, Canadian Tax Foundation, Toronto 1992; Kitchen H. and E. Slack, *Business Property Taxation*, Government and Competitiveness Project, School of Policy Studies, Queen’s University, Kingston, Canada, 1993.

in the belief that the ultimate tax burden will be borne by non-residents<sup>5</sup>. Many local governments levy rates that differ by property class. Different tax rates may be imposed for different classes of property (residential, commercial and industrial, for example). This system gives local governments the power to manage the distribution of the tax burden across various property classes within their jurisdiction in addition to determining the size of the overall tax burden on taxpayers. Generally, where such variable tax rates are applied, properties are assessed at a uniform ratio (100 percent or some lesser percentage) of market value. Another and probably more common way to differentiate among property classes is through a classified assessment system. Under this system, classifications or types of property assessed value, but a uniform tax rate is applied. In terms of accountability, variable tax rates would be more visible and easier to understand for taxpayers than a classified assessment system, which may, unfortunately, be one reason that differentiated rates are less commonly employed than differentiated assessment ratios<sup>6</sup>. In many countries tax rates are differentiated by property class, or there is assessment differentiation or tax relief for some classes of property. Variable tax rates (or other differentiation of property taxes among property classes) may be justified on a number of grounds<sup>7</sup>:

On the basis of fairness with respect to benefits received, it can be argued that the benefits from local public services are different for different property classes. In particular, a case can be made on benefit grounds for taxing non-residential properties at a lower rate than residential properties.

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<sup>5</sup> Compare: Boadway R.W., Kitchen H. M., *Canadian Tax Policy, 3rd ed.*, Canadian Tax Foundation, Toronto, 1999; De Soto H., *The Mystery of Capital, Basic Books*, New York, 2000.

<sup>6</sup> See more: Guevara, M. M., Gracia J.P., Espano M. V. C., *A Study of the Performance and Cost Effectiveness of the Real Property Tax*, Manila 1994; Holland, D. M., Vaughan W., *Self-Assessment of Property Taxes*, in: A. P. Becker, ed., *Land and Property Taxation*, University of Wisconsin Press, Madison, WI., 1997; Kitchen H., *Property Taxation in Canada*, Canadian Tax Foundation, Toronto 1992.

<sup>7</sup> Maurer R., Paugam A., *Reform toward Ad Valorem Property Tax in Transition Economies: Fiscal and Land Use Benefits*, Land and Real Estate Initiative, Background Series 13, World Bank, Washington 1992; Netzer D., *Economics of the Property Tax*, The Brookings Institution, Washington DC., 1996; Netzer D., *The Relevance and Feasibility of Land Value Taxation in the Rich Countries*, in: D. Netzer (ed.), *Land Value Taxation: Can It and Will It Work Today?* Lincoln Institute of Land Policy, Cambridge, MA, 1997; Tanzi V., "Pitfalls on the Road to Fiscal Decentralization," Working Paper No 19, Carnegie Endowment for International Peace, Washington, DC., 1992; Youngman, J. M. Malme J. H., *An International Survey of Taxes on Land and Buildings*, Kluwer Law and Taxation Publishers, Deventer, 1994.

On efficiency grounds, it has been argued that property taxes should be heavier on those components of the tax base that are least elastic in supply. Since business capital tends to be more mobile than residential capital, efficiency arguments again lead to the conclusion that business property should be taxed more lightly than residential property. In reality, however, lower rates are generally applied to residential properties.

Variable tax rates can also be used to achieve certain land use objectives. Since higher property taxes on buildings tend to slow development and lower taxes speed up development, a municipal policy to develop some neighborhoods instead of others might support differential taxes in different locations as well as for different property classes.

### **Tax reliefs and exemptions.**

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The amount of burden is related to the issue of tax preferences (reliefs and exemptions). The following types of preferences are worth paying special attention since they allow to use taxes to perform other functions (economic, social functions):

- subject ones, concerning particular type of property (state, commune property, used by administration bodies and intended for providing public services),
- resulting from the personal situation of a taxpayer (age, illnesses, number of dependants, affluence level),
- object ones, related to the way the property is used (agricultural or forest activity). In most European countries the catalogue of valid tax reliefs and exemptions is gradually being limited.

No country taxes all immovable property uniformly. In addition to the limited coverage of some property taxes and the effects on tax burdens of the valuation options mentioned above, there are myriad other ways to vary property tax burdens among different types of property and taxpayers. Sound reasons for granting exemptions and other forms of property tax relief exist, and all property tax systems provide selective relief. Administrative simplicity is the chief rationale for exempting government property<sup>8</sup>.

Exemption of certain non-governmental organizations can be rationalized on the ground that they provide socially worthwhile services that government otherwise might have to provide. Exemptions of charitable,

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<sup>8</sup> See more: Bird R. Slack, E., eds., *International Handbook of Land and Property Taxation*, Cheltenham: Elgar, 2004; Brown, P., Hepworth, M., *A Study of European Land Tax Systems*, "working Paper Series", Cambridge: Lincoln Institute of Land Policy, 2001.

educational, and religious properties fall into this category. Exemptions and relief for residential properties are intended to cushion residents from excessive property tax burdens<sup>9</sup>. They are politically popular as well. It is common to classify property on the basis of its use and to vary the amount of tax exacted from property in each class. The ostensible purpose of differentials is to shift burdens toward those better able to pay and away from those who are least able or who need an incentive to perform a useful activity. However, the real purpose can be merely to appease voters. Typically, agricultural and residential property is favored, and business property is not. The main mechanisms for establishing property tax differentials are to employ differing assessment ratios, differing property tax rates, or both. In area-based systems, different coefficients can be applied to the area measurements instead of, or in addition to, rate differentials<sup>10</sup>.

The differentials can be based on the population of a municipality, location within a municipality, and story within a building. Their rationale is to bring property tax obligations into line with presumed ability to pay or with general value patterns. Differentials based on types of crops or soil classifications have the same purpose. As noted, the basis of valuation also can be varied, such as between market value and current use value.

The main types of property can be taxed differentially. Of particular interest to policymakers is a differential between land and buildings. Some have long advocated *not* taxing buildings or taxing them at a lower rate than land. Estonia and Ukraine are examples of countries that tax only land value. Denmark is an example of a country that, in effect, taxes buildings at a lower rate than land. The chief rationale for taxing land at a (much) higher rate than buildings is more efficient land use. The argument has two elements. First, as land essentially is fixed in supply, a uniform tax on land value cannot be avoided. If the effective tax rate on land is high, speculation or hoarding land becomes uneconomic. Second, taxing buildings is a disincentive to development. It also is argued that land value taxation is

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<sup>9</sup> Malme, J.H., and J.M. Youngman, eds., *The Development of Property Taxation in Economies in Transition: Case Studies from Central and Eastern Europe*. WBI Learning Resources Series. Washington: The World Bank, 2001.

<sup>10</sup> Maurer R. Paugham A., *Reform toward Ad Valorem Property Tax in Transition Economies: Fiscal and Land Use Benefits*, Land Use and Real Estate Initiative, Background Series 13, Washington, DC, 2001: The World Bank. <<http://www1.worldbank.org/wbiep/decentralization/ecalib/TGsum1.pdf>>; McCluskey, W.J. *Property Tax: An International Comparative Review*, Aldershot: Ashgate, ed. 1991. *Comparative Property Tax Systems*, Aldershot: Avebury; McCluskey, W.J., Plimmer F., *The Potential for the Property Tax in the 2004 Accession Countries of Central and Eastern Europe*, RICS Research Paper Series, vol. 7, no. 17, London: The Royal Institution of Chartered Surveyors, 2007.

easier to administer than land and building taxation, because cadastral record keeping is simpler. Unfortunately, there are few, if any, examples of where the putative superiority of the preferential taxation of buildings has been demonstrated. There are several reasons for this. The disincentive effects of taxing buildings are trivial when effective tax rates are low. Taxing all land at its full market value can collide with other policy objectives, such as providing affordable housing in cities, preserving the ambiance of old town centers, and preserving farmland and open space. Valuation of land in developed areas, where site values often are greatest, is more difficult, because, by definition, there are few vacant land sales. In this situation, indirect methods of estimating land values require estimates of building values, undercutting the economy of administration argument. The resulting land value estimates would be more subject to challenge on appeal. Although it would be theoretically possible to tax 100 percent of land rents under an annual value tax, under a capital value tax, the greater the percentage of real or imputed rents that are taxed away, the smaller the tax base due to capitalization effects. Hence, there also is a revenue sufficiency problem with exempting buildings. Another dimension along which differentials may be constructed is the value of each property or the total value of a taxpayer's property holdings<sup>11</sup>.

Such differentials can be created by imposing progressive tax rates. The rationale for progressive rates is "ability to pay." However, the strength of the argument for progressive rates is weak when applied to the value of individual properties. The value of individual properties can have little correlation to the income or wealth of the taxpayer, especially when the property is mortgaged. High marginal effective rates encourage the subdivision of parcels and other efforts to avoid them. In contrast, the Council Tax in the United Kingdom has a regressive structure<sup>12</sup> – that is, higher value properties have lower effective property tax rates<sup>13</sup>. For instance Sweden's local real estate fee also seems to have a regressive structure in that the fee is capped at SEK 6,000 for one and two-family dwellings and at SEK 1,200 for apartment units. The fee rate for one and two-family dwelling is 0.75 percent of

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<sup>11</sup> Müller A.: *Importance of the Recurrent Property Tax in Public Finance, Tax Policy & Fiscal Decentralization*, paper presented at the international conference on property and land tax reform sponsored by the Institute of Revenues, Rating & Valuation, Tallinn, Estonia, June 2003.

<sup>12</sup> Paugham, A.: *Ad Valorem Property Taxation and Transition Economies*, "ECSIN Working Paper" No 9/1999, Washington: The World Bank, p. 34–37. <<http://www1.worldbank.org/wbiep/ decentralization/library9/Esw-tax2.PDF>>

<sup>13</sup> Almy, R., Dornfest, A., Kenyon, D.: *Fundamentals of Tax Policy*, Kansas City: IAAO., 2008. p. 280.

assessed values, which implies that once the value exceeds SEK 800,000, the fee reaches the maximum. The apartment unit rate is 0.4 percent, which implies that the maximum is reached at SEK 300,000 in assessed value<sup>14</sup>. It is not uncommon for a mix of differentials to coexist in the same property tax system. Although they can result in apparent contradictions, it is difficult to evaluate their effects because of differences in bases for property taxes. Estimating *effective property tax rates* (taxes as a percentage of market value) would make it possible to do this when data on property prices can be obtained. However, it is generally reckoned that differentials on the order of 1:3 are sufficient to influence taxpayer behavior. Infrequent revaluations can have the effect of introducing de facto differentials. For example, in 1976 the level of value of most real property in Germany was nearly 50 percent of market values, but agriculture land values were less than 10 percent of market values and forestland was less than 2 percent<sup>15</sup>.

In addition to differentials, there are several additional ways of providing property tax relief to residential property owners and occupants. These measures can be comprehensive, favoring all residential properties, or selective, favoring only the elderly, the disabled, those who provided qualifying military service, or those with lower incomes. Relief usually is restricted to a person's primary residence (in fact, second or holiday houses can be taxed at higher than normal rates). Relief can be given for only a portion of the assessed value (or area of the property), providing a further element of progressivity to a property tax system. Small, low-value residences are exempt from property taxes on grounds of "efficiency" (Netherlands). Other approaches for providing selective residential property tax relief are based on building area and area per family member. Residential property also can completely escape taxation (Belgium). An application for such relief can be required, and eligibility can be verified ("means testing"). Eligibility can be based on some combination of age, property value, and family income. Another approach is to place limits on the proportion of income that can be taken by property taxes (these measures are called "circuit-breakers" in the United States). Property taxes in excess of the limit may be waived or rebated. In comparison to blanket measures, the aim is to target relief where it is most needed. Local governments may be compensated for the loss of revenue<sup>16</sup>.

<sup>14</sup> *Inventory of Taxes in the EU: Sweden*, 2004. [http://ec.europa.eu/taxation\\_customs/resources/documents/tax\\_inventory\\_18\\_sw.pdf](http://ec.europa.eu/taxation_customs/resources/documents/tax_inventory_18_sw.pdf)

<sup>15</sup> *Inventory of Taxes in the EU: Germany*, 2006. [http://ec.europa.eu/taxation\\_customs/resources/documents/tax\\_inventory\\_18\\_de.pdf](http://ec.europa.eu/taxation_customs/resources/documents/tax_inventory_18_de.pdf)

<sup>16</sup> McCluskey W.J., Plimmer F.: *The Potential for the Property Tax in the 2004 Accession Countries of Central and Eastern Europe*, RICS Research Paper Series, vol. 7, no. 17/2007, London: The Royal Institution of Chartered Surveyors.

Some systems allow needy taxpayers to delay payment of property taxes temporarily without incurring any penalties other than perhaps interest. A number of property tax systems make it possible for elderly people to defer property taxes on their residences indefinitely. Any unpaid tax may remain a lien on the property, which is to be repaid when owner sells the property or is to be recovered from the owner's estate when he or she dies. The lien may be capped at the value of the property. Denmark allows taxpayers aged 65 years or more to defer the land tax related to either an owner-occupied dwelling or an owner-occupied summerhouse<sup>17</sup>.

Another strategy for providing property tax relief is to limit year-to-year increases in taxes while property values are increasing. A longstanding variant of this strategy is to continue to rely on values set in the distant past (sometimes called "base-year" values). Countries commonly exempt from property taxation some or all of the property owned by certain types of non-profit organizations, provided that the properties are used for qualifying purposes. That is, the exemption is granted to a qualifying legal person, rather than a physical person or family<sup>18</sup>. Common exemptions include property owned by: (1) governments (central, regional, and local governments) and used for governmental purposes (including property of foreign states, such as embassies); (2) institutions that provide charitable, educational, and other quasigovernmental services and used for stipulated purposes (such as non-profit hospitals); and (3) religious institutions and used for religious purposes. Usually institutional exemptions are complete (100 percent) and are of indefinite duration. Initial applications and periodic reapplications can be required. Other unusual situations also are mentioned. For example, sports facilities are exempt in Denmark. As discussed in the subsection on incentives, agricultural and forest properties can be exempted in whole or in part<sup>19</sup>. Two other categories of property are worthy of

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<sup>17</sup> *Property Tax Regimes in Europe European Union*. (2011, 2012, 2013) *Taxation Trends in the European Union: Data for the EU Member States, Iceland and Norway*, <[http://ec.europa.eu/taxation\\_customs/taxation/gen\\_info/economic\\_analysis/tax\\_structures/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm)> (accessed 17 December 2011) European Union, Directorate-general Taxation and Customs Union (2002) *Inventory of Taxes in the EU*.

<sup>18</sup> Bahl, R., *Property Tax Reform in Developing and Transition Countries*, a report prepared for the United States Agency for International Development under a contract with Development Alternatives, Inc. under the Fiscal Reform and Economic Governance Task Order, GEG-I-00-04-00001-00 Task Order No. 07/2009.

<sup>19</sup> See more: Jyh-Bang J., Tan L., *Taxation on Land Value and Development. When There Are Negative Externalities from Development*, "The Journal of Real Estate Finance and Economics", 2008, Volume 36(1); Yuan, B., K. Connolly, Bell M.E., *A Compendium of Countries with an Area-Based Property Tax*, "Working Paper Series", Cambridge, 2009: Lincoln Institute of Land Policy.

note. The first is public areas, open spaces, and environmentally sensitive land. Streets, public squares, and the like often are not assessed (that is, not separately identified and measured or valued). Denmark is an example. Other open space can be exempted (Ireland, Sweden, and United Kingdom) or pay reduced property taxes (Germany and Netherlands).

## Conclusions

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Before analyzing the main reasons for reforming the property taxation system in Poland we need to establish the meaning in which the concept of “system” will be used in this publication. It is necessary due to the fact that we may have justified doubts whether there is any “system” of property taxation in Poland at all.

The most important reasons for reforming property tax system:

1. It is a typical historical system, shaped not on the basis of arbitrarily adopted assumptions but by continuous adjustment of its particular elements – taxes – to the changing social and economic situation. In fact, for the past few decades the same rules regulating the agricultural and forest tax have been used, subject only to modifications, and never thoroughly reformed.

2. This system is not adjusted to those operating in the European Union, dominated by systems based on taxable properties cadastre. The Polish system of registering and taxing properties has been severely criticized by EU experts, who emphasized the necessity of its reform.

3. It is an obsolete system, based on taxing the area of the property (buildings and land), only slightly reflecting value as the taxation base (buildings). The assets in these taxes are valued for the taxation purposes in square meters and hectares (conversion and physical), not in money.

4. In fact there is no uniform and credible register allowing proper calculation of taxes imposed on the property. The area being the taxation base is supposed to be derived from the register of land and buildings. In reality, though, there is only the register of land, whereas the evidence of buildings is still waiting to be created.

5. It is a system which does not bring any expected income for local budgets. This is mostly attributed to the fact that buildings, constructions and the so-called construction objects which are not permanently joined to the ground are covered by any register, and so tax bodies of communes find it extremely difficult to determine which of these objects have not been registered for taxation.

6. Taxes comprising this system, even though they are becoming performances similar in type due to the implemented changes, still demonstrate



certain heterogeneity of their construction. Further changes to the agricultural tax and property tax have transformed these performances from revenue (agricultural tax) and revenue-capital (property tax) into capital types of taxes, with some typical elements of revenue taxes.

7. The current system does not solve the problems of agriculture taxation, including taxation of agricultural real estate. At present taxes imposed on properties, especially agricultural tax, are the only performances burdening farm owners (not counting incomes from special sections of agricultural production). Since that professional group does not pay taxes on revenue or income obtained from conducting agricultural activity, attempts are made at making the agricultural tax a revenue-income-capital tax.

8. It is a system without the “general part”, within which common institutions for all taxpayers would be regulated. In none of the constitutional acts are taxes treated as a whole; on the contrary – property tax is classified into the local taxes and fees, while agricultural and forest taxes are not.

9. In spite of appearances, the structure of these taxes may be shaped by communes only to a small extent. For no apparent reason the scope of the power given to the council differs for particular taxes. The competencies granted to councils are not adequate to the constitution-guaranteed right of territorial self-government units to determine the level of local taxes and fees.

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