PROSPECTS FOR THE PROPERTY TAX IN UKRAINE[1]

This report attempts to provide some perspective on property tax issues in Ukraine. In many Western and European countries the property tax is the financial backbone of local government finance. In part because of its popularity in other countries, Ukrainian policymakers have often expressed an interest in determining whether a property tax could be added to the revenue arsenal of local governments in Ukraine. One concrete expression of this interest is the draft tax code which contains a provision for a Ukrainian property tax but which also indicates that separate legislation still needs to be developed for this tax.

In the first part of this report the attributes of a property tax that potentially make it an attractive new tax base are described. The second deals with the recent history of property tax initiatives and legislative efforts to introduce a property tax into the revenue repertoire of local governments. A recounting of this history raises many of the policy issues that would have to be settled before a satisfactory property tax could work in Ukraine. A more detailed discussion of a number of design and implementation issues that must be resolved before a property tax can move forward in Ukraine is presented next. The final section of this report outlines the major features of a tentative proposal for the form of a feasible property tax. An appendix to this report takes a brief look at the way in which property taxes currently work in the countries of Poland and Jamaica.

1. The Importance of a Property Tax for Local Governments in Ukraine

The intergovernmental fiscal reforms enshrined in the new Budget Code take Ukraine a long way down the road of fiscal decentralization. However, a critical element of local fiscal autonomy is missing from these reforms. The benefits of fiscal decentralization will never be fully realized unless local governments are empowered with a significant revenue source that they can adjust at the margin. If local residents want more public services and are willing to pay for them, local governments need access to a tax base over which they have control of the rates on that base. Similarly, if local residents want fewer public services and lower tax burdens, local governments need a tax base, or bases, on which they can lower tax rates.

Truly autonomous local governments require the revenue means to respond their constituent's preferences for public services. Presently, the revenues of local governments in Ukraine consist primarily of the proceeds from the personal income tax collected in their area, the land tax, and a host of minor taxes and fees. Local taxes and fees, such as the fees for market stalls and parking, and the communal services tax, comprise an insignificant share of total local government revenue, usually no more than five per cent. Local governments have some discretion to set rates for local taxes and fees but the revenue impact of this rate discretion is minimal. The base and rate of the personal income tax are determined by national legislation and local governments can adjust the rates for the land tax only within narrow limits.

Given the revenue straightened circumstances of local governments, their per capita expenditures are by and large currently determined by the amounts of expenditure planned for them in the annual State budget. Acting as agents of the central government, local governments are given targeted subventions for finance an array of social protection programs that are defined by national legislation. Depending on their per capita revenue resources from the revenue basket (basically the personal income tax), local governments either receive, or make, a formula based transfer from, or to, the State budget to finance local governments' delegated responsibilities for health and education as set out the in the State budget. These expenditures for social protection, health and education easily

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comprise at least three-quarters of the total spending of local governments. Proceeds from the land tax and a raft of local taxes and fees are available to finance own-expenditure responsibilities such as local roads, refuse collection and local parks.

The budget code has been indispensable in defining clear and sensible expenditure and revenue assignments for local governments and in creating a new formula based transfer system between the State budget and different tiers of local governments. But the code did not, and could not, offer local governments an important marginal revenue source that they could adjust at the margin. Currently, if local governments desire more revenue they have only limited tools to do so. They may, for example, step up enforcement efforts and they may try to improve the quality of their public services in order to attract new investment and expand the size of their personal income tax base. However, neither of these tools is a reliable source of new revenue and both take time, especially the effort to grow the local tax base, to yield revenue results. In this context, the property tax is logically seen as a promising vehicle to fill the marginal revenue requirements of local governments.

The property tax is an attractive candidate to meet the marginal revenue needs of local governments for several reasons. First, as experience elsewhere has shown, the property tax base is relatively immobile making the property tax difficult to either avoid or evade in the presence of property tax differentials. Also, many of the services that would be financed by a property tax provide benefits to property owners and the tax, therefore, has a strong benefit rationale. Moreover, the property tax base can be defined in a way that limits the property tax burden on low income households, making the tax conform to ability-to-pay principles. A property tax may also be an effective means of taxing incomes earned in the shadow economy. Finally, the tax is relatively stable in the face of fluctuations in the business cycle and, if properly designed, is not terribly difficult to administer once the institutional requirements for implementing the tax are in place.

2. The History of the Property Tax in Ukraine

Recent history is replete with numerous abortive attempts to introduce a property tax in Ukraine. In 1995 the Cabinet of Ministers submitted a draft property tax law to the Verkhovna Rada. This law would have defined the tax base to include both residential and non-residential property and would have used the depreciation adjusted replacement value of buildings to measure the size of the base. A single tax rate of .05 per cent was to be applied to this base and the tax was to be collected by the State Tax Administration (STA). A wide category of the population, including war invalids and Chernobyl survivors, would have been exempted from the tax. Although passed in first reading, this draft law subsequently floundered in the Rada over the issue of how to measure the base and define the list of exemptions.

In 1996 the Cabinet of Ministers resubmitted the earlier draft law after revising it in some important respects. First, local governments would have had the discretion to set rates between one and three per cent of replacement value. In addition, exemptions were to be geared to the size of the residential property, with smaller properties now being exempt. Assessment appeals were also envisaged in this reworked draft. However, this new draft met the same fate in the Rada as the original one.

A new draft law was unveiled in the Rada in 1998, inspired by Y. Zhovtiak, the deputy head of the Rada Budget Committee, and R. Bezsmertny, the President's personal representative in the Rada. This draft differed considerably in design from its predecessors. The base of the proposed property tax would have been confined to residential property only and for larger cities over 50,000 population the base would be measured by current market value while for smaller communities the base would be determined by replacement cost considerations adjusted for location coefficients. Tax rates were to be between .1 and .3 per cent of assessed value but at a higher rate of .6 per cent for properties larger than 100 square meters. Tax assessment was to be performed by the Bureau of

Technical Inventory (BTI) while collection was to entrusted to the STA. No exemptions were to be allowed outside of the Chernobyl impacted area and an assessment appeal process was to be created. This law also received first reading blessing but subsequently stalled in the Rada, mainly over the issue of how to implement a market value approach to property taxation.

The same year, 1998, another real estate tax bill was submitted to the Verkhovna Rada for consideration. It was sponsored by members of Parliament, including S. Gmyria, O. Cherenkov, and A. Levchenko. This draft law proposed a concept of real estate taxation, which differed radically from that proposed by E. Zhovtiak and R. Bezsmertny. Firstly, the tax suggested by this law was designed as a national rather than local tax. Local governments would be given no power with respect to tax rates. Those rates were strictly determined in the law itself and depended on only one factor – area of the property. The draft law exempted properties under 100 square meters for constructions, 50 square meter for dachas, and 30 square meters for garages. At the same time, no social exemptions were stipulated outside the Chernobyl zone. The draft law included in the list of objects to be taxed not only existing constructions but also uncompleted projects but land lots were excluded. This draft law failed to pass the first reading in the Verkhovna Rada.

The third parliamentary bill was developed and submitted to the Verkhovna Rada for consideration in late 1999 by P. Melnyk MP. Similarly to the bill sponsored by Zhovtiak and Bezsmertny, this bill designed the real estate tax as a local tax. At the same time Melnyk's bill provided a wider autonomy to local governments with respect to setting tax rates. With account for certain restrictions, the radas of villages, settlements, and cities/towns would have full discretion to set the rates. Local radas would determine and approve in local budgets the rates for the tax on land lots, except for agricultural land. The only restriction was that those rates had to be no larger than the rates determined in the bill. Also local radas were allowed to set rates for the tax on buildings and constructions (between 1 and 2 percent of the tax base). The draft law envisaged a number of social exemptions. In particular, invalids of Groups 1 and 2 would be exempted as well as pensioners, citizens with three or more children, war and labor veterans, and Chernobyl survivors. Besides, the draft law proposed a non-taxed area of 21 square meters per family member plus 10.5 square meters per family. In any case, at least 80 square meters of the total area would be exempted. This bill was also rejected by the Parliament.

The draft Tax Code of Ukraine, which was approved by the Verkhovna Rada on second reading on November 29, 2001, also contains a special section (Section VI) dedicated to property taxation. Many provisions of this section actually repeat those from Melnyk's bill of 1999 (these provisions were briefly described above). Similarly to Melnyk's bill, the draft Tax Code sees buildings, constructions and land plots (either owned or used) as objects of taxation. The tax base in both drafts is measured based on appraisal (the Cabinet of Ministers should develop the methodology for this appraisal) or based on the area (if appraisal is not available). For buildings, in both drafts the apprised base would be determined as a product of area and average cost per measurement unit of the construction set based on a special multifactor assessment. According to both drafts, the book value would be applied as the tax base for constructions.

Provisions of both drafts with respect to the tax rates were almost identical. The proposed Tax Code grants the same discretion to local governments in this respect as Melnyk's bill. With regard to exemptions, the difference is that the non-taxed area for each family would depend on the size of the community. In communities with a population above 50 thousand, the non-taxed are would be 21 square meters per family member plus 10.5 square meters per family but no smaller than 80 square meters (similarly to Melnyk's bill). In smaller communities, 40 square meters per family member would be exempted plus 10.5 square meters per family (with no minimum area). For more than a year the draft Tax Code has been waiting for third reading and has not been enacted so far.

These failed attempts to introduce a property tax have served the useful purpose of revealing the main political and technical issues that need resolution before a property tax can become a Ukrainian reality. The remainder of this report looks more closely at all of these issues.

3. The Linkage of the Land Tax to the Property Tax

A conventional property tax consists of two elements in its base, the value of land and the value of buildings or structures, usually combined into a single property appraisal unless a split rate system applies. In this respect, Ukraine already possesses a nascent property tax in the form of a land tax. A relic from Soviet times, the land tax was until recently a fixed levy on the quantity of land with adjustments made for both the location and the functional use of the land. In recent years land valorization commissions have been at work throughout Ukraine to convert the base of the land tax into something approximating the market value per hectare. On this new *ad valorem* base local governments in urban areas now impose a one per cent rate of tax. In rural areas, the tax rates are lower, .1 per cent for annual cropland and only .03 per cent for land used in growing perennial crops. In addition, a five per cent stamp duty also applies on the registered value of any land sales transaction.

With some exceptions, not much is known about the appraisal techniques that have been used to evaluate land. In the large city of Kiev, for example, land was appraised by dividing the city into 1,483 zones and a value was ascribed to each of these zones. Applying the tax rate of one per cent resulted in tax rates ranging from 4 to about 5,000 UAH per square meter of land.

Some countries, such as Jamaica which is described in the appendix, apply a property tax to only the land component of the value of a property. The rationale for this site value form of property taxation is that it avoids the distortions that would arise if structures and improvements were also included in the tax base. Proponents of a site value tax hark back to the writings of Henry George and emphasize the economic neutrality or low efficiency cost of this type of property tax. If Ukraine, however, eventually decides to proceed with a property tax that includes buildings it will be necessary to consider how this new tax can be integrated with the existing land tax to give coherent shape to a property tax.

4. Major Design Issues in Introducing a New Property Tax

(a) Market Value or Replacement Value as the Method of Assessment?

It is easy to demonstrate that if replacement value of buildings were used as the method of valuing the property tax base it would have the potential of seriously distorting location decisions and causing an inefficient spatial pattern of economic activity. Use of replacement value could also result in objectionable equity effects. If, for example, an apartment building were appraised for property tax purposes at its replacement value the property tax bill would be apportioned among the building's occupants on the basis of square footage owned. If the building contained some luxury apartments owner of these units would be effectively taxed at lower rates than others. The only way to prevent this outcome is to base assessment on market values.

However, market value assessment can only take place if a vibrant real estate market operates allowing market values to be readily observed or easily imputed. In many areas of Ukraine this requirement for a property tax cannot currently be met and it will be some time before this data will be readily available to any local property tax office. The question is whether anything can be done in the interim. Below, a compromise solution in the guise of a unit value assessment approach is outlined.

(b) All Forms of Real Estate or just Residential Real Estate?

If non-residential real estate were encompassed in the property tax base that base would be significantly larger than if it were excluded. Many countries do include commercial and industrial property in their property tax base but it is probably not a good example to follow. From a local government perspective, it is better to confine the tax to residential structures because then the tax will be paid by local residents who consume most of the benefits from local public services. If the tax were extended to non-residential real estate the tax would be borne, at least in part, by non-resident consumers and non-resident factor owners. Such an outcome could trigger an inefficient level of local government spending and lessen the level of accountability of local government officials. One of the canons of local government finance is that all local taxes should be borne by local residents.

(c) How should Exemptions be Structured?

Many countries use property tax credits or so-called circuit breakers to ameliorate the property tax burden on low income households. These mechanisms, however, are administered through the income tax system and appear to be beyond the administrative reach of Ukraine since most personal income taxes are paid via withholding rather than through separate filing of declarations.

A cruder form of property tax relief that is administratively feasible will probably be needed in Ukraine. One option would be to grant an exemption to small property tax holdings by making the tax apply to properties only above a certain size threshold. While simple, this approach is problematic in that it leaves unanswered the question of exactly where to set the threshold and it creates worrisome notch problems. If the threshold, for example, were set at 45 meters of living space, those who lived in residences with 46 square meters would be subject to tax while those living in quarters with only 44 square meters would pay no tax. Presumably, tax policies would strive to avoid such stark tax eligibility comparisons.

Another option would be to build upon the means testing that is used to determine eligibility for social protection payments. This means testing is one method of reliably identifying low income households and the property tax exemption might be restricted to only those households which qualify for these payments.

(d) Would Property Tax Receipts be In or Out of the Formula Based Transfer System?

With the passage of the budget code and the implementation of a new system of formula based transfers to and from local governments in Ukraine, an important issue is whether revenues from a new property tax would, or would not be, included in the calculations of local government revenue capacity according to the formula. If they were included the results could be entirely perverse. Counting property tax revenues as part of local government revenue in estimating transfer levels would provoke a one-for-one substitution of property tax revenues for State funded transfer payments. In this case the ultimate beneficiary of new local government property taxes would be the State government and surely this would not be the intended result. It is certainly a result that would not be supported by any local government in Ukraine and, if it were perceived as possible, local governments would have no incentive whatsoever to adopt a new property tax.

To prevent this peculiar outcome from occurring, it would be important to amend or modify the budget code so that all revenues from a property tax would be excluded from the transfer calculations, just as the land tax is at the moment.

(e) How would a new Property Tax be Effectively Administered?

Dating from Soviet times, the Bureau of Technical Inventory (BTI) has about 200 offices scattered throughout Ukraine, some of which are fully computerized. Besides having the internal capacity to calculate replacement values for all types of buildings, this office registers all ownership deeds to dwellings as these dwellings become either newly built, privatized or sold, and, in addition, issues certificates for all dwelling renovations. The BTI is, therefore, well positioned to carry out the assessment function by preparing a property assessment roll containing the names, addresses and property characteristics of all property owners in Ukraine. However, it only records market values of properties that have recently turned over and is not in a position to carry out market value assessment without further large efforts and resources. It could, however, perform the assessment function if a simpler assessment method were used, as is discussed below.

After receiving assessment data from the BTI, the STA would be responsible for sending out assessment notices along with information about the place, time and nature of property tax payment. The STA would also be responsible for collecting the tax and remitting it to the Treasury account of local governments and would carry out normal enforcement procedures according to existing legislation on collection, including the possibility of property tax liens.

5. Unit Value Assessment: A Feasible Property Tax for Ukraine?

As indicated earlier, a major stumbling block to adopting a property tax in Ukraine has been the absence of reliable information on market values and the realization that it will likely take many years before this information becomes available on a regular basis.

Other countries operating a property tax system have faced similar data constraints and have overcome them by introducing a unit value method of property tax assessment. Unit value assessment is an approximation to market value assessment, admittedly somewhat crude, but its application lends itself to gradual evolution towards a full blown system of market value assessment. As recently as 1998 unit value assessment was used in the city of Rotterdam before it switched to market value assessment.

Roughly speaking, the method of unit value assessment works in the following way. The basic unit of property taxation in a city would be the volume of weighted square meters of living space owned by a property owner where the weights reflect both the location and quality of living space, the latter is measured by age of building and the extent of recent renovations. Location weights would be established from easily obtained information of a city's residential rent gradient. Real estate journals and newspapers provide data on residential rents in different areas of a city and from this data it would be possible to deduce how much rents for houses and apartments of similar quality vary among different locations. In the center of a city comparable rents might, for example, be five times higher than those which would be paid at the outer fringes of the city. In this case an apartment located in the center would be given a location weight of five compared to a weight of one at the fringes.

Information on the shape of the rent gradient would allow property tax officials to partition the area of a city into zones resembling concentric circles from the center with most of the comparable properties within each zone having roughly comparable values. Within each zone different properties could be distinguished according to the age of the property and the occurrence of a major renovation. Armed with this information, property tax liabilities could be assessed on the basis of the number of weighted square meters of a residential property.

Once the unit value assessment had been completed, a city would divide the total number of weighted square meters in its jurisdiction into the amount of revenue it wished to raise from the property tax and establish the property tax rate measured in Hryvnia per square meter. This rate,

multiplied by the number of weighted square meters, would determine the tax liability for each property. A simple numerical example using four properties situated in different zones can be used to illustrate how this process would work. Table I below shows more clearly how the property tax would work in practice.

Table 1. An Illustration of a Unit Value Based Property Tax

Property in Zone	Square Meters	Location Coefficient	Quality Coefficient	Tax Base	Tax Rate per Square Meter	Total Tax
A	50	1	1	50	2	100
B	50	2	.5	50	2	100
C	50	3	2	300	2	600
D	50	4	2	400	2	800
Total	200			800		1600

In this example each property is assumed to have the same number of square meters of living space, 50 in each case. Given the location and quality coefficients assumed in the table, the tax base is measured as the product of these coefficients and the common amount of taxable living space. The weighted quantity of square feet is 800, the size of the local property tax base. Assuming that the local government wishes to raise 1600 Hryvnia in total property tax revenue, the implied property tax rate is 2 Hryvnia per adjusted square meter of property. Applying this uniform tax rate to all properties yields the amount of tax liability shown in the last column of Table I.

Over time, as data on market transactions accumulates and property tax assessors are trained in property appraisal, it will become possible to switch from unit value assessment to more refined market value assessment. In the interim, unit value assessment would provide a reasonable approximation to market value assessment.

It should also be pointed out that the use of location coefficients in applying unit value assessment implicitly includes the value of land in the property assessment. With a separate land tax in existence, the implication is that property would be taxed twice with the introduction of unit value assessment. At some point it will be desirable to see how these two taxes might be integrated into a comprehensive property tax. One option would be to retain the land tax in rural areas and replace this tax in urban area with a new unit value based property tax.

APPENDIX

Property Taxes in Poland and Jamaica

Poland

Unlike Ukraine, Poland had a previous history of applying property taxation during the inter-war years. This history may explain the rapid appearance of a local property tax in Poland after it regained its independence in 1991.

In Poland the property tax applies to both residential and non-residential property. The base is the number of hectares in the case of agriculture and square meters for buildings. A unit tax per hectare or per square meter is assessed against this base. The central government sets the maximum rate and it seems almost all Polish Gminas (the lowest and most basic level of subnational government) have adopted this rate in practice although local governments are free to determine their own set of exemptions and incentives. A split rate system is in force where land is taxed at a lower rate than commercial buildings. In 1998 the property tax accounted for a little over 11 per cent of Gmina revenues. A number of other Eastern European economies, such as Hungary, appear to apply a very similar approach to property taxation.

The tax is administered primarily at the Gmina level. Each Gmina is responsible for identifying, registering and assessing taxable property as well for collecting the tax. Enforcement, however, is a function of the central government.

Poland is currently considering moving to a market value basis of property tax assessment. USAID has recently sponsored a pilot project on market value assessment in the city of Krakow.

Jamaica

In Jamaica the property tax is a central government revenue instrument collected at the Parish level and accounts for about 5 per cent of total central government revenues. Somewhat unusually, the government has chosen as the base for this tax the unimproved value of land. In other words, Jamaica has a site value form of property tax and has made this choice to protect the neutrality of the tax and avoid any discouragement to improvements to land values. The tax is levied at progressive rates and, given the concentration of land ownership, is considered to be a highly progressive component of the overall tax system.