



Assessment of the effects of the changes in the property transfer tax

Dr Boško Mijatović Dr Boris Begović Marko Paunović, MA

OCTOBER 2007

ASSESSMENT OF THE EFFECTS OF THE CHANGES IN THE PROPERTY TRANSFER TAX

Dr Boško Mijatović

Dr Boris Begović

Marko Paunović, MA



Centar za liberalno-demokratske studije

Center for Liberal-Democratic Studies

1. INTRODUCTION

The Law on Property Taxes has been substantially amended in June 2007. These amendments have not only introduced some specific new articles of interest for the citizens and businesses, but have also introduced changes which will have a strong impact to revenues, and more generally financial position of local municipalities. There is some concern that financial position of Serbian municipalities may deteriorate.

In this study we shall:

- shortly present the system of taxation of transfer of absolute rights in Serbia prior to June 2007 and present the changes in the taxation system implemented in June 2007 and the problems which may arise at the local level (Chapter 2)
- try to quantify the impact to local finances in total and in selected municipalities (Chapters 3 and 4)
- suggest possible solutions for these problems (Chapter 5).

2. TAXATION OF TRANSFER OF ABSOLUTE RIGHTS

Taxation of transfer of goods and services is in Serbia done mostly through the Value Added Tax and through excise taxes. These two taxes are applied to new products which are, therefore, put into trade for the first time. Each successive sale of these products (such as food, drinks, clothes, books etc.) is usually free of taxation.

However, in some specific cases, even each successive sale of the product is subject to taxation, no matter how many sales have already occurred. This system is in Serbia applied to various used vehicles (cars, trucks, buses, boats, aircraft), used real estate (property and similar rights of long term renting of houses, apartments and some types of urban construction land), stocks and bonds and intellectual property rights. It is obvious that selection of the goods or rights that will be subject to this type of taxation is mostly made based on the potential value of the tax base, where the small tax bases have been avoided in order not to put too much burden on the tax administration. Of course, it is of great importance that property and changes in

ownership of these goods are subject to registration, which makes the transfer of ownership easily available to Tax Administration.

The taxpayer is either the person that sells or the person that acquires the right. Tax base is the contracted price, unless the tax administration thinks that it is lower than market price, in which cases it has the authority to reevaluate the tax base. Tax rates were 0.3% for stocks and bonds and 5% for all other cases except for used vehicles (2.5% from 2004 on). The low tax rate for stocks and bonds is probably due to the fact that the government is trying to avoid harming the development of the stock exchange in Serbia, and the high rate for other cases is probably a proof of fiscal motives.

The main changes introduced in June 2007 are:

- Tax rate has been reduced to 2.5% for real estate transactions. The main reason for this change is a tendency to correct the mistake from the past. Namely, five years ago when the Minister of Finance was Bozidar Djelic, this rate has been increased from the relatively reasonable 3% to very high 5%. The rationale at the time was to compensate losses incurred by the reduction of other taxes. We think that 5% tax rate was extremely high and has negatively influenced real estate transactions, taking into account that the share of cumulative taxes rises quickly in total value.
- Tax break for property transfer tax has been introduced for the purchase of first Home. This was intended as an incentive for faster acquisition of home for people not having that issue already resolved. Specifically, young people are promoted, as now they will need less money for buying their first home. This tax break is not unlimited though, but is only applicable to 40 square meters for the buyer and additional 15 square meters for each additional household member. These changes are harmonized with similar changes applied to the Value Added Tax.
- Taxation of construction land has also been widened. Namely, until the recent changes, property transfer tax has only been applicable to the right of use of construction land, but not to the leased state land. Changes from June 2007 introduce taxation of lease for longer than one year, with the rate of 2.5%. This

specific solution raises the issue of whether it is advisable to tax the lease. Namely, there is no transfer of property right, and property transfer taxes are usually applicable only when all the property rights are being transferred.

The first two changes are bringing reductions in the individual tax burden and therefore have to be embraced.

The reduction of the tax rate will not only reduce the burden for the Serbian family that is searching for a new home, but also can stimulate the buying, renovating and selling of properties, that may have a positive influence on the edificial substance. In the long run, the increased transactions can even compensate for revenue losses due to the reduced tax rate.

The tax relief for first buyers has to be seen as a subsidy for young people/families. It can assist the target group in improving their living conditions. Therefore this decision of the government has to be highly welcomed. On the other hand, it has to be asked if a tax relief was the best solution to achieve this effect. According to tax theory, subsidies given via tax relief can only be the second best solution. Direct subsidies are usually easier to administrate and much more transparent. But here we are confronted with an additional problem: The Serbian national government promised its citizens a subsidy, whose fiscal burden has to be borne by local governments.

This last argument will be discussed during this study in more detail. The basic problem is easy to express: national government has reduced the taxes that are earmarked for municipal budgets. Namely, the property transfer tax is a tax regulated by Republic of Serbia (it sets the tax base, tax credits and tax breaks, and tax rates) but the tax revenue is the revenue of local municipalities. This puts this tax in the group of so-called "conceded taxes". The loss of the local tax revenues begs the question of whether something should be done and what should be done. The reduction in tax revenues, without any compensation, would result in reduction of local revenues, with potentially negative consequences for stability of local budgets and provision of local public services.

Fiscal theory does not approve of such arrangements – where one level is in charge of taxation policy and another level suffers the consequences – taking into account that it

simply leads to the situation where one level shifts the burden to another level. Starting from this position, the Law on Municipal Financing envisages the mechanism, which would compensate the losses of local budgets incurred by the national tax policy changes. So, the Article 39 defines the compensational transfer, which “compensates the part of the lost revenues which is a result of the changes in national regulations, which is not compensated by other revenues”.

This short article has all the necessary elements:

1. It prescribes the obligation of compensating the local revenues lost due to the changes in national regulations
2. Prescribes two possible methods for compensation:
 - a. Through “conceding” to municipalities of other revenues
 - b. Through compensational (meaning cash) transfer from national to local budgets

3. THE IMPORTANCE OF PROPERTY TRANSFER TAX

For the purposes of estimating the local tax losses due to the changes in Law on Property Taxation, we have gathered the data on property transfer tax collection at the municipal level for the period 2004-2006 and January – June 2007.

The amount of collected property transfer tax is given in the following table:

Table 1: Property Transfer Tax Revenues (000 dinars)

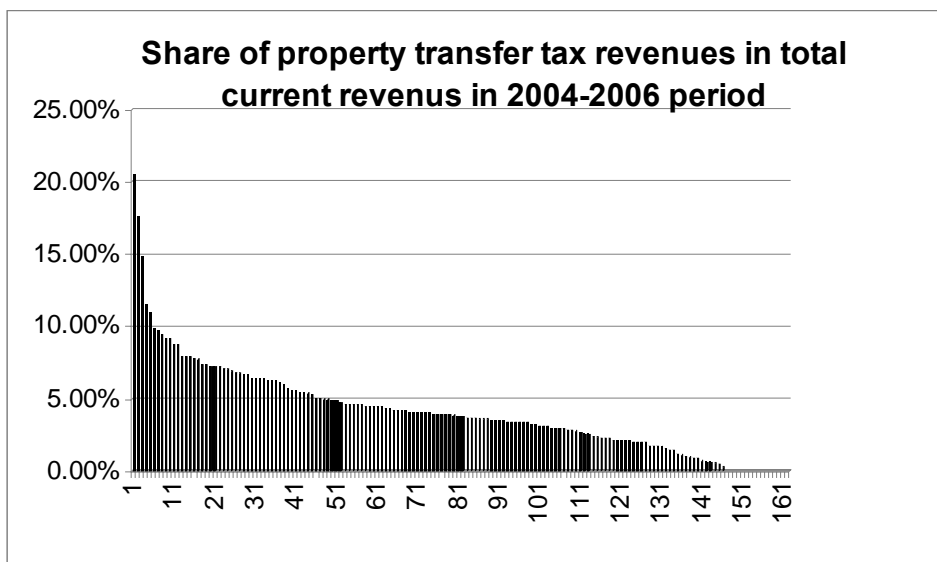
| Type | 2004 | 2005 | 2006 | I-VI 2007 |
|--|-----------|-----------|------------|-----------|
| Real Estate | 6,066,467 | 7,700,291 | 9,707,195 | 5,451,634 |
| Used Vehicles | 929,751 | 828,085 | 881,803 | 493,716 |
| Stocks and Bonds | 93,070 | 411,274 | 1,143,858 | 382,295 |
| Other (including Gift and Inheritance Tax) | 267,341 | 426,307 | 544,038 | 310,031 |
| Total | 7,356,628 | 9,365,956 | 12,276,895 | 6,637,677 |

As can be seen from the previous table, by far the largest share in total property transfer tax is the tax collected from the real estate transfer, with approx. 81% from 2004 to 2006.

First, we shall analyze the importance of the real estate transfer tax in the 2004 - 2006 period. As expected, there is a big difference in importance of this tax among municipalities. The revenue from this tax has represented over 20% of total current revenues in the municipality of Cajetina, but only 0.27% in the municipality of Trgoviste. The summarized average for the named period is 7.41%. Also, the share of this tax in total local revenues is relatively stable with 7%, 7.8% and 7.4% in 2004, 2005 and 2006 respectively. We can conclude that it represents a relatively important and stable source of revenues, with varying importance between municipalities.

In summary, for 99 municipalities, this source of revenue is less important (less than 5% share), for 42 it is relatively important (between 5 and 10% share) and for 5 municipalities it is very important (above 10% share). The distribution of the share of property transfer tax in total current revenues in the period 2004-2006 is given in the following graph.

Chart 1: Share of Property Transfer Tax Revenues in Total Current Revenues



Totally (the sum for 2004-2006 period) collected revenues from property transfer tax also very greatly from 12.8 billion dinars in a three-year period in Belgrade (around 150 million Euros) to 353 thousand dinars (around 4 thousand Euros) in Tgoviste. It is extremely important to mention that almost two thirds of totally collected property transfer tax is collected in Belgrade and Novi Sad (66.69% in 2004, 64.83% in 2005, and 65.84% in 2006).

However, it should be stressed that even though this revenue is not very important source for some of the municipalities, it nevertheless represents own revenue of the municipal budget and therefore all changes in the rate or assessment should be done only after the thorough discussion with the representatives of local municipalities.

Based on everything said so far, we can conclude that halving the tax rate and introducing the tax break for first time homebuyers shall have major impact on functioning of many Serbian municipalities. However, one should keep in mind that consequences shall be felt primarily in relatively rich municipalities, where the share of this tax is greater. Poor municipalities have not relied on this tax to a high degree so far, so they will hardly feel the reduction in the tax rates.

4. EFFECTS OF CHANGES IN THE TAXATION OF PROPERTY TRANSFER

4.1. Introductory remarks

Before we proceed with the more detailed analysis we want to stress that the previous tax rate for real estate transfer taxation was extremely high and that has probably generated relatively significant tax evasion. Therefore halving the tax rate will most likely not lead to halving the tax proceeds. Besides tax evasion, as additional effect we can expect increased demand for real estate as a result of lower prices. The estimations of real estate demand elasticity have not been done in Serbia, but some international experiences show that elasticity is around 1, meaning that a certain drop in prices leads to the same increase in demanded quantity.

However, it is extremely difficult to estimate how the market will distribute the 2.5% which are saved among buyers and sellers. Our assumption is that at least 2% will be

transferred to buyers, in the form of lower prices. Taking into account international research, we can estimate that reduction in tax rate would lead to 2% increase in demand, which can not even closely compensate for the tax revenue losses, but from a wider standpoint, effect to Serbian economy can be substantial.

In addition, we assume that the effect of reduction in tax evasion is of similar order of magnitude, meaning that we estimate that reduction in tax evasion would lead to increase of 2% in the value of reported transactions.

Namely, tax evasion in the sense of fully hiding transactions for the long period of time is nearly impossible, but contracted price can be underreported. Although there is a legal provision that if the Tax Administration assesses the price to be «unrealistic» it can reassess it, there is some margin for undervaluing, either because of corruption, or because of lack of interest of Serbian Tax Administration. Lack of interest is frequently mentioned, since Tax Administration is a national agency and as such is not particularly interested in the collection of non-national taxes. Therefore, we can expect that the priorities of Tax Administration lie in some other revenues and that property transfer tax does not receive the needed attention.

As a result of the reduction in tax rate, there is another channel for increase in trade of houses and apartments. Namely, recently (during the first half of 2007, but even before) high tax rate lead to another way of underreporting – non-registering the property until the proclaimed changes in the Law came to effect. Some people just decided to wait for the announced tax changes to be implemented in order to register the transfer of property. In other words, the trade has been implemented (contracts have been signed, money has been transferred, people have moved in), but that contract has not been registered in the court or cadastre in expectations of the reduction in tax rate. Now, after the rate has been halved, these contracts shall be formalized, and taxes shall be paid, which shall lead to increase in tax collected in 2007. These and other reasons have led us not to rely too much on the 2007 data.

4.2. Analysis of the tax revenue trend from 2004-2006

Following graph provides the trends in collection of property transfer taxes (real estate only) in the 2004-2006 period in Belgrade, Novi Sad, and remainder of Serbia.

Chart 2: Revenues from Real Estate Transfer Tax, by regions

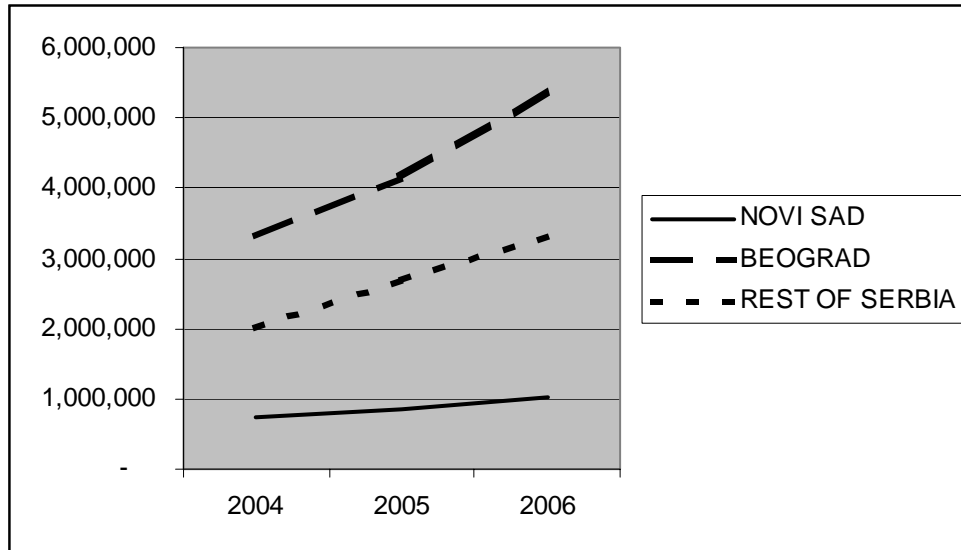


Table 2: Collection and Growth rate of Real Estate Transfer Tax, by Region (000 dinars)

| | 2004 | 2005 | 2006 | 2005 / 2004 | 2006 / 2005 | 2006 /2004 |
|----------------|-----------|-----------|-----------|-------------|-------------|------------|
| BEOGRAD | 3.315.864 | 4.146.395 | 5.361.107 | 25% | 29% | 61% |
| NOVI SAD | 730.052 | 846.000 | 1.029.883 | 16% | 22% | 41% |
| REST OF SERBIA | 2.020.551 | 2.707.897 | 3.316.205 | 34% | 22% | 64% |
| TOTAL | 6.066.467 | 7.700.291 | 9.707.195 | 27% | 26% | 60% |

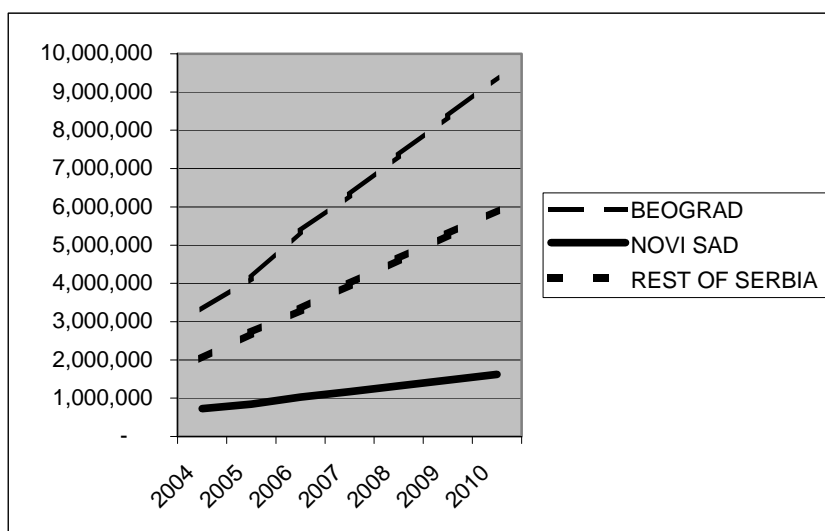
It can be concluded that Belgrade shows the fastest growth, followed by the rest of Serbia and Novi Sad.

However, one also should bear in mind that property transfer tax is growing in importance in other European countries. It is a fact that it has been one of the strongest growing sources of local revenues, growing much faster than other taxation sources. Therefore, we can expect that in the future, the importance of this tax in Serbia will also increase.

4.3. Projection of revenues without changes in tax rate (base scenario)

We shall estimate tax revenues (without applying changes in tax regulations) by separating Serbia into these three big components and by extrapolating each of them.

Chart 3: Property Transfer Tax Revenues, Projection to 2010, by Region



The above chart is based on the following data (000 din):

Table 3: Property Transfer Tax Revenues, Projection to 2010, by Region (000 dinars)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2010/2006 |
|----------------|-----------|------------|------------|------------|------------|-----------|
| BEOGRAD | 5.361.107 | 6.319.699 | 7.342.320 | 8.364.942 | 9.387.564 | 75% |
| NOVI SAD | 1.029.883 | 1.168.476 | 1.318.392 | 1.468.308 | 1.618.224 | 57% |
| REST OF SERBIA | 3.316.205 | 3.977.204 | 4.625.031 | 5.272.858 | 5.920.684 | 79% |
| TOTAL | 9.707.195 | 11.465.379 | 13.285.743 | 15.106.108 | 16.926.472 | 74% |

At first sight, it may seem unrealistic to assume that the revenues from this tax will increase by nearly 75% in the 2006-2010 period (in just 4 years). But as we have demonstrated with the real data from 2004 to 2006 this is quite realistic. However, we will give here some explanation for the development. One should keep in mind that this increase is the result of two different components – increase in the number of transaction and increase in the average price of real-estate (square meter). If the average price of average real estate would grow by 7% and the number of

transactions by only 7%, the value of the collected tax would increase by 75% in 4 years. Annual growth rates of 7% and 7% do not seem unrealistic, taking into account the previous growth. Pairs of various growth rates needed to accomplish the estimated projection are given in the following table:

Table 4: Annual growth rates of average price and average number of transaction needed to reach projected tax revenues

| Average annual growth of average price | Average annual growth of number of transactions |
|--|---|
| 5,50% | 7,50% |
| 6% | 8% |
| 6,50% | 7,50% |
| 7% | 7% |
| 7,50% | 6,50% |
| 8% | 6% |

Based on everything said so far, we believe that our projections are realistic, and that it is methodologically correct to extrapolate the values for the next four years. In addition, the fact is that real estate prices mostly do not depend on inflation, but are based on dinar euro exchange rate. If we suppose mild depreciation of dinar (of, say 5% annually), the estimated revenues may even be understated.

4.4. Effects of the reduction of tax rate

Our assumptions can be summarized as follows:

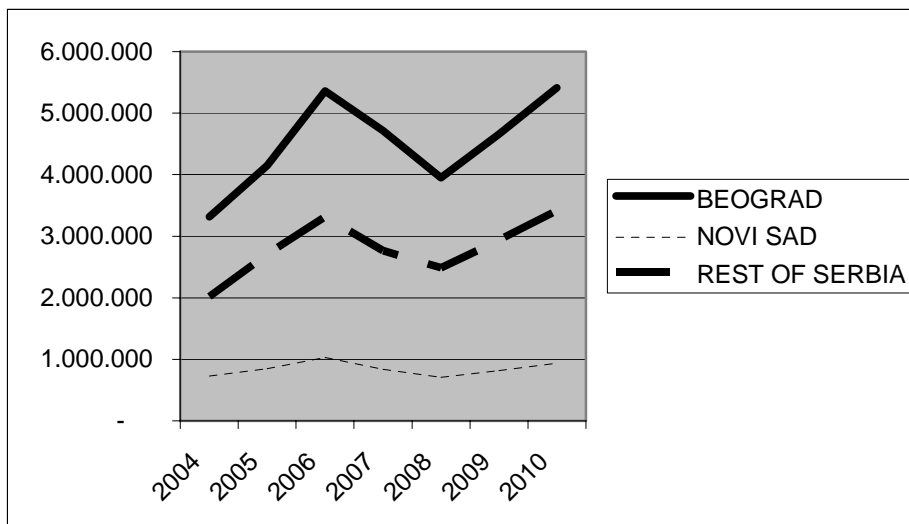
- The reduction of tax rate from 5% to 2.5% results in the reduction of collected revenues by mostly 50% initially
- The reduction of tax rate from 5% to 2.5% results in the reduction of prices by 2%
- The reduction of the price leads to the increase in real estate trading by 2% based on increased demand

- The reduction of the price leads to the increase in the average reported value by 2%

Based on this, the preliminary conclusion is that lost revenues based on this source (the reduction in the tax rate) will be between 40% and 50%, compared to the situation where the tax rate has not been changed.

In order to analyze the effect of the reduction of the tax rate, we used as the basis our base scenario (where no changes in the tax rate are taking place). Those values are reduced by 50% (so that the effect of the halving of the tax rate can be seen), and then multiplied by annual growth rates from the base scenario, increased by 4%, the assumed effect of demand elasticity and reduction in tax evasion. The data for 2007 has been calculated the following way: it is a sum of two separate components – half of the projected revenues reduced by 50% and a real collection in the first six months of 2007. The findings are given in the following graph and table.

Chart 4: Projected Real Estate Transfer Tax Revenues, with changes in the tax rate



**Table 5: Projected Real Estate Transfer Tax Revenues, with changes in the tax rate
(000 dinars)**

| AREA | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|----------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| BEOGRAD | 3,315,864 | 4,146,395 | 5,361,107 | 4,716,761 | 3,949,456 | 4,657,506 | 5,413,190 |
| NOVI SAD | 730,052 | 846,000 | 1,029,883 | 836,521 | 709,868 | 818,983 | 935,361 |
| REST OF SERBIA | 2,020,551 | 2,707,897 | 3,316,205 | 2,764,698 | 2,487,742 | 2,935,709 | 3,413,820 |
| TOTAL | 6,066,467 | 7,700,291 | 9,707,195 | 8,317,979 | 7,147,066 | 8,412,198 | 9,762,372 |

Based on these projections the revenue losses are calculated by subtracting projected revenues from the base scenario revenues. The lost budgetary revenues are presented in the table below:

Table 6: Estimated municipal losses due to the changes in the tax rate (000 dinars)

| AREA | 2007 | 2008 | 2009 | 2010 |
|----------------|------------|------------|------------|------------|
| BEOGRAD | -1,602,938 | -3,392,864 | -3,707,436 | -3,974,373 |
| NOVI SAD | -331,956 | -608,524 | -649,325 | -682,863 |
| REST OF SERBIA | -1,212,507 | -2,137,289 | -2,337,149 | -2,506,864 |
| TOTAL | -3,147,400 | -6,138,677 | -6,693,910 | -7,164,100 |

If the changes in revenues would include only reduction in the tax rate, the loss would, expressed in the percentages compared to the base case scenario look like this:

Table 7: Estimated municipal losses due to the changes in the tax rate, relative to the base line scenario

| AREA | 2007 | 2008 | 2009 | 2010 |
|----------------|------|------|------|------|
| BEOGRAD | 48% | 46% | 44% | 42% |
| NOVI SAD | 48% | 46% | 44% | 42% |
| REST OF SERBIA | 48% | 46% | 44% | 42% |
| TOTAL | 48% | 46% | 44% | 42% |

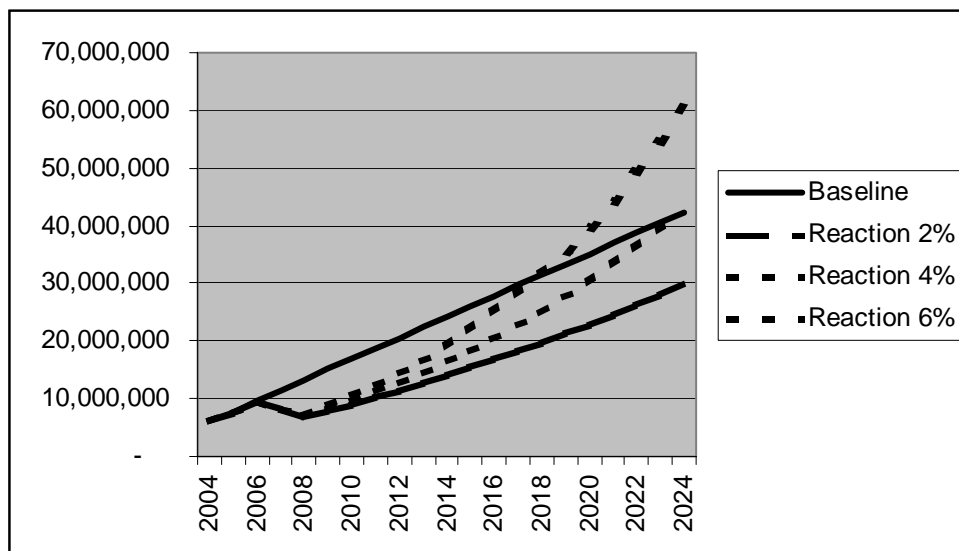
There can be another additional effect from halving the tax rate, which is practically impossible to calculate, but which can be important. We already mentioned this possibly effect in chapter 2. Namely, it is still rare in Serbia that firms specialize in

renovation and reconstruction of apartments and houses. Such firms are in the business of buying potentially attractive apartments, currently in bad state, renovating them and reselling them. We can assume that the 5% tax rate was a major obstacle (jointly with the inefficient system of property registration) for the development of such businesses and that the reduction in tax rate can lead to creating new businesses. The final effect might be that the demand elasticity is higher than we assumed.

4.5. Effects with various elasticity levels

As we have already mentioned, total change in behavior is comprised of two components each of which is very difficult to estimate. The first component is related to the reduction of tax evasion due to the reduction in tax rates, while the other is related to the increased demand due to the lower real estate prices. Our starting assumption was that both of these components have unit elasticity and that, therefore, the reduction in prices by 2% (as a result of a 2.5% reduction in taxes) shall lead to the same increase in both components, resulting in a 4% increase in tax revenues, compared to the base scenario. The following graph shows the various trends of the tax collection dependent on reaction.

Chart 5: Various Real Estate Transfer Tax Revenues, by elasticity



These data were generated the following way: we have increased projected revenue growth rates by a reaction rate (elasticity factor). By doing so, we were able to control

for the various levels of reaction. As the graph demonstrates, with our assumption of 4% increase, only in 2024 will the lower tax rate lead to the same tax revenues as the old one. If the reaction were higher (6%) it would happen in 2017. Of course, if the reaction were lower (1, 2, or 3%) the time needed to reach the collection would be more distant in the future.

4.6. Assessment of the tax loss due to the first time home buyers tax credit

Taking into account that relevant database does not exist, the estimation of this loss is much less reliable. Namely, the share of first time homebuyers in total number of homebuyers can only be anticipated. Based on the interviews with some real estate agents, the estimates are between 25% and 50%, meaning that average Serbian family during lifetime changes between one and four apartments, if the number of business transactions remains relatively low.

Tax administration has certain data on the age of the people who purchased apartments and houses; it could potentially (with certain reasonable assumptions) be estimated what is the share of first time homebuyers. However, those data can be extremely unreliable for the following reason. Until recent changes, parents were indifferent between giving money and buying home for their children. In the case of buying home and then transferring the property to a child, the parents were obliged only to pay property transfer tax, whereas gifts were tax-free. However, with the current law changes, it is more profitable (less costly) to give the money to children for which they would purchase home and thereby be tax-exempt. So, with the changes in the law, the whole incentive system is changed and we can expect changes in the structure of homebuyers, from older (parents) to younger (children). Also, with more available home mortgages, we can expect a larger share of younger homebuyers, so that we believe that relying on historic data would be methodologically incorrect.

These two effects can cumulatively significantly reduce the tax revenues. The precise estimates are very hard to provide, but we could expect that in the most dramatic scenario, in a few years, 50% of all transactions might be tax-free. If we, however, take a more conservative assumption that within the next few years one third of all home transactions are «first time» trades and that usually those are smaller units, we can

very roughly conclude that the loss due to these tax breaks will be around one third of the tax total revenues, which is an additional loss of 2.4 billion dinars in 2008.

Expected revenues are as follows (the projected revenues are reduced by 33% compared to table 5):

Table 8: Projected Real Estate Transfer Revenues, after the inclusion of the first time homebuyers tax break (000 dinars)

| AREA | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|----------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| BEOGRAD | 3,315,864 | 4,146,395 | 5,361,107 | 3,914,912 | 2,606,641 | 3,073,954 | 3,572,706 |
| NOVI SAD | 730,052 | 846,000 | 1,029,883 | 694,312 | 468,513 | 540,529 | 617,338 |
| REST OF SERBIA | 2,020,551 | 2,707,897 | 3,316,205 | 2,294,699 | 1,641,910 | 1,937,568 | 2,253,121 |
| TOTAL | 6,066,467 | 7,700,291 | 9,707,195 | 6,903,923 | 4,717,064 | 5,552,050 | 6,443,165 |

Losses due to the first time homebuyers' tax break in 2007-2010 period:

Table 9: Projected Real Estate Transfer Revenue Losses, due to the first time homebuyers tax break (000 dinars)

| AREA | 2007 | 2008 | 2009 | 2010 |
|----------------|------------|------------|------------|------------|
| BEOGRAD | -801,849 | -1,342,815 | -1,583,552 | -1,840,485 |
| NOVI SAD | -142,209 | -241,355 | -278,454 | -318,023 |
| REST OF SERBIA | -469,999 | -845,832 | -998,141 | -1,160,699 |
| TOTAL | -1,414,056 | -2,430,003 | -2,860,147 | -3,319,206 |

The estimate is additionally complicated by the fact that first time homebuyers are not fully tax-exempt, but only up to a certain limit in the size of the home (for example, for a family of four, up to 85 square meters), but we believe that we can mostly neglect this feature, since a huge majority of first time homebuyers is buying relatively small housing units.

This square meter restriction also demonstrates a serious weakness in the adopted law. Despite its (hopefully) relatively small quantitative effect, it imposes an additional burden to the administration. Furthermore, introduced to avoid inequity (namely that rich buyers of large apartments are higher subsidized than poor families who can only

afford to buy small ones) it only partly makes the grade. Even if only a restricted amount of space is tax free, this solution especially benefits the buyers of expensive housing. For example, if a family of four buys an 80 square meters house in a poor municipality (or alternatively, a house in a very poor shape), the tax break may amount to 1000 euros (2.5% tax rate, at 500 euros per sqm). At the same time, a buyer of an 80 square meters house in exquisite surroundings (or just an expensive renovated apartment) may easily get a tax break of 5000 euros (2.5% tax rate, at 2.500 euros per sqm). We believe that the better solution would be to limit the tax break to a certain amount (in dinars), or far better as a direct subsidy to first time home buyers.

4.7. Estimates of losses in specific municipalities

The table provides historic and projected tax revenues in 2004-2010 period in selected Serbia municipalities, if no changes to the tax laws have been implemented (base scenario),

Table 10: Projected Real Estate Transfer Revenues, baseline scenario (000 dinars)

| Municipality | Share in total revenues in 2004-2006 | Average growth rate in % (2004-2006) | 2004 | 2005 | 2006 | 2007 proj | 2008 proj | 2009 proj | 2010 proj |
|--------------|--------------------------------------|--------------------------------------|--------|--------|---------|-----------|-----------|-----------|-----------|
| KRUŠEVAC | 7.96% | 24.08% | 69,207 | 97,926 | 104,453 | 125,774 | 143,397 | 161,020 | 178,643 |
| POŽAREVAC | 5.52% | 41.63% | 36,584 | 54,254 | 73,225 | 91,329 | 109,650 | 127,971 | 146,292 |
| UŽICE | 4.29% | 67.04% | 20,446 | 48,985 | 46,292 | 64,421 | 77,344 | 90,267 | 103,191 |
| VALJEVO | 7.25% | 25.46% | 45,848 | 61,908 | 71,746 | 85,732 | 98,681 | 111,630 | 124,579 |
| SOMBOR | 6.90% | 32.16% | 46,639 | 53,675 | 80,102 | 93,602 | 110,334 | 127,065 | 143,797 |
| SVILAJNAC | 6.33% | 11.06% | 12,915 | 13,474 | 15,870 | 17,041 | 18,519 | 19,996 | 21,474 |
| KLADOVO | 3.34% | 4.19% | 9,439 | 7,989 | 9,885 | 9,550 | 9,773 | 9,996 | 10,219 |

The following table provides projection for the years 2007 to 2010, taking into account the law changes. Also, we provide a table with estimated revenue losses in table 12.

Table 11: Projected Real Estate Transfer Revenues (000 dinars), after the inclusion of the first time homebuyers tax break and reduction in tax rate

| Municipality | 2007 | 2008 | 2009 | 2010 |
|--------------|---------|--------|--------|--------|
| KRUŠEVAC | 122,615 | 64,403 | 75,210 | 86,780 |
| POŽAREVAC | 67,809 | 47,544 | 57,708 | 68,608 |
| UŽICE | 55,856 | 30,057 | 36,482 | 43,374 |
| VALJEVO | 76,400 | 44,661 | 52,542 | 60,982 |
| SOMBOR | 79,982 | 51,063 | 61,158 | 71,980 |
| SVILAJNAC | 21,849 | 9,327 | 10,474 | 11,697 |
| KLADOVO | 9,044 | 5,471 | 5,819 | 6,187 |

Table 12: Projected Real Estate Transfer Revenue Losses, due to first time homebuyers tax break and reduction in tax rate (000 dinars)

| Municipality | 2007 | 2008 | 2009 | 2010 | Loss per capita in 2008 in dinars |
|--------------|---------|---------|---------|---------|-----------------------------------|
| KRUŠEVAC | -3,160 | -78,994 | -85,810 | -91,863 | 601 |
| POŽAREVAC | -23,520 | -62,106 | -70,264 | -77,684 | 829 |
| UŽICE | -8,565 | -47,287 | -53,785 | -59,817 | 570 |
| VALJEVO | -9,332 | -54,021 | -59,088 | -63,597 | 558 |
| SOMBOR | -13,620 | -59,271 | -65,907 | -71,817 | 609 |
| SVILAJNAC | 4,807 | -9,192 | -9,523 | -9,776 | 360 |
| KLADOVO | -506 | -4,302 | -4,177 | -4,032 | 182 |

It can be concluded that some municipalities, which are relatively rich, will suffer more from the recent tax changes, which is expected. On the other hand, relatively poor municipalities (such as Kladovo) will hardly be hurt. Even if some of these losses seem trivial for some of these municipalities, these taxes are still their own revenue and as

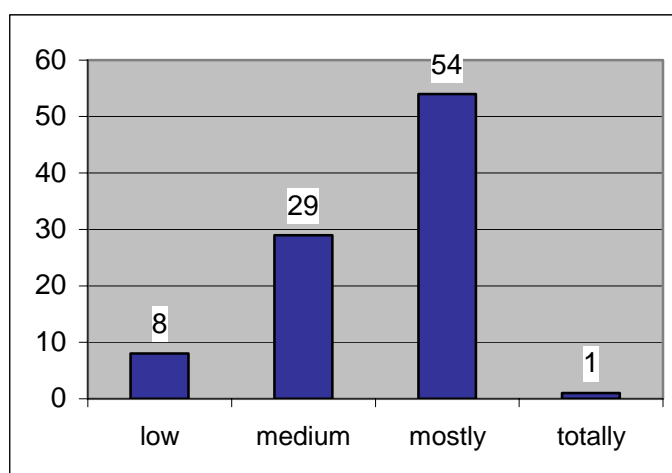
such, have a different quality than transfers. Also, these losses accumulate through time. Although 50 thousand euros loss (4 million dinars) per year for Kladovo is not much, it still comes to 200 thousand euros in 4 years, and Kladovo would certainly use that money.

4.8. Effects of changes due to the different treatment of urban land

While the budgets of local municipalities will certainly suffer losses due to the reduction of tax rate and tax breaks for the first time homebuyers, there will be a gain due to the taxation of urban land owned by the state which shall be leased for over one year.

The estimate of future revenues based on the history is not possible to provide since it is a new tax, not previously administered, and therefore there is no historic data. Unfortunately, there is also no data on the leasing of urban land in Serbia, so we cannot use that either. One assessment of the stock of urban land in state ownership can be estimated based on a survey done in 2006 by CLDS for the purposes of the study on privatization of this land. The finding is that the degree of using this type of land is relatively high. The graph shows the use of this land.

Chart 6: Usage of the state owned land, by municipalities



As we can see, the usage of the state owned land is relatively high: in 55 of municipalities this land is used either fully, or to a highest degree, while in 37 there is

still some land for development. This degree of usage of state urban land means that in the largest part of Serbia the future revenues from leasing this land shall be modest since only new leasing contracts shall be taxed, meaning this can not be a way of compensating losses due to the reduction in tax rates and introduced tax breaks.

5. SUMMARY AND POSSIBLE SOLUTIONS FOR THE MUNICIPAL REVENUE LOSSES

First of all, we have to repeat that in general we appreciate the reduction of the property transfer tax rate. This does not only reduce the tax burden for homebuyers but also can have positive effects for business and - in the long run – even for the edificial condition.

Concerning the tax relief for first time home buyers, we see it as a valuable support for young people/families to improve their living conditions. On the other hand we stressed that a tax relief can not be the best solution to achieve this effect. A direct subsidy of a certain amount to first time homebuyers would have been the better solution - with reference to transparency, administrative costs and even equity. But the main topic of our study was the assessment of tax revenue losses for local authorities induced by national tax policy.

We have seen in the previous paragraphs that financial effects of the recent taxation changes from July 2007 will negatively affect local finances. Namely the tax reductions and tax breaks that the Parliament introduced will not harm the central budget, but local budgets, in the estimated amount of 8.5 billion dinars in 2008 only (table 13). For such situations, The Law on Municipal Financing has envisaged a mechanism for compensation of local budget losses, either through «conceding» some other revenues, or through increase in cash transfers directed to municipalities. Both mechanisms shall be evaluated.

Table 13: Total revenue losses as a result of tax changes

| AREA | 2007 | 2008 | 2009 | 2010 |
|----------------|------------|------------|------------|-------------|
| BEOGRAD | -2,404,787 | -4,735,679 | -5,290,988 | -5,814,858 |
| NOVI SAD | -474,165 | -849,879 | -927,779 | -1,000,886 |
| REST OF SERBIA | -1,682,506 | -2,983,121 | -3,335,290 | -3,667,563 |
| TOTAL | -4,561,456 | -8,568,680 | -9,554,057 | -10,483,306 |

The first question that needs clarification is the following one: should it be a unique compensation or a permanent compensation? Our opinion is that this compensation should be permanent, since the loss will most likely be also permanent. The expectation that the lower tax rate will eventually generate revenues which would catch up to the base scenario is expected in the very long term and is therefore very uncertain.

The second question is the following: is it better for municipalities to be compensated through transfers or through increase in some other conceded taxes? Theoretically, municipalities should be indifferent, since both options should lead to the same outcome. However, in real life one needs to bear in mind the dangers and risks which arise during administering and political decision making, but also characteristics of the existing institutional arrangements and adjust the strategy accordingly.

Starting from there, we believe that municipalities should aim towards compensation through conceding some other taxes, and not through additional cash transfers. The reasons are the following:

- Total transfers from national to municipal budgets are capped by the Law on Municipal Finances at 1.7% of GDP, so that possible use of compensational transfer for compensating discussed losses would only reduce general transfers from the central budget to municipalities, which would mean that compensation would not really occur. Namely, articles 37 and 41 of the Law clearly state that total amount of transfers is fixed, expressed in percentage of GDP and that general transfer is calculated by deducting compensational, transitional and equalization transfers from total transfers. It means that, no matter how high the loss of the municipalities after the legislative changes are,

municipalities can not get additional funds, but one type of transfer can be substituted by another, and therefore, the only acceptable solution for municipalities is the other one – that other sources of fiscal revenues are redistributed towards municipalities, in the amount that would compensate their losses due to the recent changes

- Redistribution of the other sources of revenues is also more favorable solution for municipalities from an administrative and political point of view. Namely, that option is more resistant to changes than the alternative since the taxes are more difficultly changed than individual transfers. Also, this option is financially safer and more stable than transfers since the money does not «go through» the national budget and cannot be temporarily diverted to the central budget.

The third change in the property taxation, the one introducing taxation of the lease of the urban land, will bring some increase in the local revenues. However, it is extremely uncertain by how much will this increase the revenues, but it is certain that it will not be much. Therefore, the general transfers should be reduced by that amount in the following way – transfers should be fully paid to municipalities initially, and when the data on collection is available, the following tranches of the transfer should be reduced accordingly.

In order to be able to provide a full strategy for the local municipalities, including the specific source of the additional revenue and the needed rate of that revenue which would be directed towards municipalities, it is needed to analyze the tax structure of municipalities (each of them individually), which was not a task of this project.

Published by:

Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH

Internet: www.gtz.de

Commissioned by:

Federal Ministry for Economic Cooperation and Development
of the Republic of Germany

GTZ-project responsible:

Reform of the Intergovernmental Finance System in Serbia

Print:

Lighthouse Agency, Belgrade

Belgrade, November 2007



Deutsche Gesellschaft für
Technische Zusammenarbeit (GTZ) GmbH

GTZ-Projekt:
Reform des öffentlichen Finanzsystems in Serbien

Terazije 16/14
11 000 Belgrad
Serbien
T/F: 011/386 289 7001
www.gtz.de